SUBSECTION 55(2) – THE ROAD AHEAD

Kenneth Keung, CA, CPA (CO, USA), TEP, CFP, MTax, LLB
Moodys Gartner Tax Law LLP
Calgary

2016 Prairie Provinces Tax Conference
Planning in a High-Rate Environment

Subsection 55(2) – The Road Ahead[1]

Kenneth Keung CA, CPA (CO, USA), TEP, CFP, MTax, LLB
Moodys Gartner Tax Law LLP, Calgary.

Subsection 55(2) of the Act[2] was introduced on December 11, 1979, and until now, this provision of the Act has, by and large, remained the same. On April 21, 2015, the Department of Finance ("Finance") proposed a dramatic proposed overhaul to these rules as part of the 2015 federal Budget. The proposals went through certain minor revisions when Finance released draft legislation on July 31, 2015. Despite criticism and suggestions from the tax practitioner community, the draft legislation was largely unchanged when it was introduced to Parliament in 2016 as *Bill C-15* which received first reading on April 2016.[3] For ease of reference, the provisions contained in the draft legislation are referred to as the "new" section 55 rules in this paper.

With these new rules, the ability to pay tax-free dividends amongst related taxable Canadian corporations, once a foundational concept of the Canadian tax system, can no longer be taken for granted for dividends received after April 20, 2015. This paper will not attempt to cover all of the implications that the new section 55 rules entail as doing so is beyond the scope of one paper. Instead this paper will focus on the implications that these new rules have on commercial transactions commonly encountered by advisors of private enterprises, and to present practical planning ideas for dealing with these proposed rules going forward. The paper will also briefly review the concept of safe income on hand since the new rules make the safe income exception much more important than before.

Overview Of New Versus Old Section 55

In order to not tax corporate earnings more than once, subsections 112(1) and (2) generally enable corporations to receive taxable dividends from another taxable Canadian corporation, Canadian-resident corporation, or certain Canadian branches of non-resident corporations free of additional corporate tax to the extent they are "connected" for Part IV tax purposes. These include all types of taxable dividends: actual cash or in-kind dividends, deemed dividends on share redemption or repurchase, stock dividends and stated capital increase deemed dividends, etc. Where such tax-free intercorporate dividends are used in a manner that reduces capital gains that could have been realized on a fair market value ("FMV") disposition of any share of capital stock immediately before the dividend, old section 55 could apply to re-characterize the otherwise tax-free intercorporate dividends into proceeds of disposition or gains that were immediately taxable to the recipient corporation.[4] Because of this, the old section 55 rule was also known as the "capital gain stripping" rule. The new section 55 rules are born of the same spirit of the old rule, but its mandate and reach has been dramatically broadened.

Unless otherwise specified in the paper, the provisions of new section 55 apply to dividends received after April 20, 2015.

New subsections 55(2.1) and (2)

The charging provision of new section 55 remains in subsection 55(2). If it applies, new subsection 55(2) re-characterizes a taxable dividend received by a dividend recipient into either proceeds of disposition or a gain. The conditions that need to be met for subsection 55(2) are now in subsection 55(2.1), and these conditions are met if as part of a transaction or event or a series of transactions or events:

- (a) The dividend recipient is a corporation resident in Canada that has received a taxable dividend and is entitled to a subsection 112(1) or (2) or 138(6) deduction;
- (b) It is the case that
  - (i) One of the purposes of the payment or receipt of the dividend (or, in the case of a subsection 84(3) deemed dividend, one of the results of which) is to effect a significant reduction in the portion of the capital gain that, but for the dividend would have been realized on a disposition at fair market value ("FMV") of any share immediately before the dividend, or
  - (ii) The dividend (other than a subsection 84(2) or (3) dividend) is received on a share that is held as capital property by the dividend recipient and one of the purposes of the payment or receipt of the dividend is to effect
    - (A) a significant reduction in the FMV of any share, or
    - (B) a significant increase in the cost of property, such that the amount that is the total cost amount of properties of the dividend recipient immediately after the dividend is significantly greater than immediately before the dividend; and
- (c) The amount of the dividend exceeds safe income, after 1971 and before the safe-income determination time for the transaction, event or series, that could reasonably be considered to contribute to the capital gain that could be realized on a disposition at FMV immediately before the dividend, of the share on which the dividend is received.

The conditions in paragraph 55(2.1)(a) and subparagraph 55(2.1)(b)(i) are the same as the old subsection 55(2), and similar to before, the entire series of transactions or events must be considered. However, new subsection 55(2.1) now adds two new alternative purpose tests: to effect a significant reduction in the FMV, i.e. clause (b)(ii)(A), or a significant increase in the dividend recipient's cost base, i.e. clause (b)(ii)(B). As confirmed by the CRA in the 2015 Canadian Tax Foundation ("CTF") Roundtable[5], subsection 55(2) can apply if one of the new alternative purpose tests are met even if there is no capital gain inherent in the share (i.e. the condition in subparagraph 55(2.1)(b)(i)). Hence, the rule that used to be known as the capital gain stripping rule has now been expanded to police value stripping and basis multiplication, even in situations where no capital gain is being avoided.

Although the purpose tests in new section 55 now extend to situations where there is no capital gain inherent in a share, the safe income dividend exception in new subsection 55(2.1)(c) still requires that the safe income be reasonably considered to contribute to the capital gain that could be realized on a FMV disposition. The previous subsection 55(2) used the wording "attributable to" the capital gain, which arguably carries similar meaning as "contribute to". According to Finance's explanatory notes, this change of wording is intended to accommodate the new purposes as described in subparagraph 55(2.1)(b)(ii). This is not a change in the rules, but the fact that the safe income exception is not keeping up with the expansion of the purpose tests (to include situations where no capital gain is being avoided) could cause unfortunate results to the unwary as will be explained later.

It should also be noted that the subparagraph 55(2.1)(b)(i) capital gain reduction test continues to apply to both actual and deemed dividends, while applying a 'result test' for subsection 84(3) deemed dividends similar to old subsection 55(2). On the other hand, the new subparagraph 55(2.1)(b)(ii) value reduction / basis multiplication tests do not apply to deemed dividends under subsections 84(2) or (3), and only contain purpose tests.

If conditions in subsection 55(2.1) are met, then new subsection 55(2) applies to re-characterize the dividend provided that the new Part IV tax exception does not apply. The idea behind the Part IV tax exception is that if Part IV tax applies to an inter-corporate dividend then there is no deferral, hence no mischief, to prevent. The new Part IV tax exception is worded as follows:
"*the amount of the dividend (other than the portion of it, if any, subject to tax under Part IV that is not refunded as a consequence of the payment of a dividend by a corporation where the payment is part of the series referred to in subsection (2.1))*".

Except for one word, the new Part IV tax exception is exactly the same as it was in the old rule. In old subsection 55(2), the exception was rescinded to the extent the Part IV tax was refunded as a consequence of the payment of a dividend "to" a corporation. Whereas, in new subsection 55(2), the exception is rescinded to the extent the Part IV tax is refunded as a consequence of the payment of a dividend "by" a corporation. What this means is that under the old rules, the Part IV tax exception protected an inter-corporate dividend from subsection 55(2) re-characterization even if the Part IV tax was refunded due to a later dividend to an individual or trust as part of the same series. Under new subsection 55(2), such a refund cancels the Part IV tax exception because a later dividend to an individual or trust is still a dividend "by" a corporation.

Aside from the Part IV tax exception, new subsection 55(2) contains another difference from the charging portion of old subsection 55(2). In old subsection 55(2), the dividend was deemed not to be a dividend to the recipient corporation. Instead it was re-characterized into proceeds of disposition if the share in question was disposed of, and only if there was no disposition, would the dividend be re-characterized into a gain. Under new subsection 55(2), the dividend is also deemed not to be a dividend to the recipient corporation. However, unless the dividend is a subsection 84(2) or (3) deemed dividend, the dividend is re-characterized to be a capital gain of the dividend recipient for the year in which the dividend was received.

While the difference between re-characterization into proceeds versus gains at first blush appears to be a matter of lexicon, this difference actually stems from the heart of new subsection 55(2). Under old subsection 55(2), there is a presumption that if subsection 55(2) applied it would partly be because of a disposition of the share in the year or sometime in the foreseeable future, so it was appropriate that the default application was to re-characterize the dividend into proceeds that would otherwise have arisen on the disposition. Under new subsection 55(2), although the old purpose test remains in subparagraph 55(2.1)(b)(i), whether there is a disposition of shares in the year or in the future is no longer relevant in most cases due to the new purpose tests in subparagraph 55(2.1)(b)(ii). In this light, it seems appropriate for new subsection 55(2) to just re-characterize dividends into capital gains.

However, the fallout of this change is that unlike deemed proceeds, the amount of adjusted cost base ("ACB") inherent in the dividend-paying share is irrelevant in the determination of a deemed capital gain because by deeming a dividend to be capital gain, the re-characterization bypasses the normal subdivision-c concept of proceeds minus ACB equals capital gains. To illustrate, assume a holding corporation (Holdco) owns shares in an operating corporation (Opco) with a FMV of $1 million and an ACB of $5 million and Opco pays a dividend of $1 million to Holdco and one of the purpose tests in paragraph 55(2.1)(b) is met. Also, there is no safe income reasonably considered to contribute to capital gain that could be realized on a FMV disposition of the Opco shares immediately before the dividend (because the share has an accrued loss), so the paragraph 55(2.1)(c) exception does not apply. As a result, the $1 million dividend is deemed to be a capital gain under subsection 55(2) even though the Opco shares on which the dividend is paid has an ACB of $5 million.

Theoretically there is no double taxation from this result because the $1 million dividend reduces the FMV of the Opco shares by $1 million (assuming there is no other shares outstanding), while the $5 million ACB of the shares is preserved. If the Opco shares are subsequently disposed of and there are no other changes to FMV, then the disposition should result in a $5 million capital loss to Holdco which theoretically offsets the $1 million capital gain. However, there are a couple of potential pitfalls here. Firstly, the future capital loss on disposition can only offset the deemed capital gain in respect of the dividend if the disposition occurs within the three-year capital loss carryback period.[6] Secondly, the capital loss on the disposition could potentially not be available to the extent certain stop-loss or loss suspension rules apply to the capital loss. For instance, subsection 112(3) would reduce the $5 million capital loss by any taxable dividends and capital dividends Holdco has ever received on those shares (this would not include the $1 million dividend though because paragraph 55(2)(a) deems it not to be a dividend received by Holdco). Also, if the Opco shares are sold to an affiliated person, subsection 40(3.4) would suspend the loss in Holdco's hands. Under old subsection 55(2), the dividend would generally have been re-characterized into proceeds to be applied against ACB, prior to the application of these stop-loss or loss suspension rules.

Also, practitioners should consider the timing of the capital dividend account ("CDA") addition under the new rules. Where dividends were deemed to be proceeds of disposition under old subsection 55(2), it was clear that the CDA arose at the time of the disposition. Under new subsection 55(2), dividends other than subsection 84(2) or (3) deemed dividends are deemed to be capital gains 'for the year'. It is somewhat unclear whether this means that the addition to CDA occurs at the time of the dividend or at the end of the year. Until the CRA provides further guidance on this, it may be prudent to wait until immediately after the year to pay out the capital dividend from CDA.

The above discusses the re-characterization for dividends other than subsection 84(2) or (3) deemed dividends arising on a redemption, acquisition or cancellation of shares. For such deemed dividends, new paragraph 55(2)(b) deems the amount of the dividend to be proceeds of disposition. This is appropriate because the share is treated as being disposed of for the purpose of the Act, and the issues discussed above generally would not be an issue for such deemed dividends.[7] It is of interest to note that in the original version of proposed subsection 55(2) that appeared in the Notice of Ways and Means Motion released by Finance on April 21, 2015, all dividends subject to subsection 55(2) were to be re-characterized into a gain. This was revised to its current form in the July 31, 2015 draft legislation, presumably because if a subsection 84(2) or (3) deemed dividend is re-characterized into a capital gain, double-taxation occurs if the share being disposed of has an ACB higher than PUC. This is because the re-characterized capital gain would be equal to the excess of redemption or wind-up proceeds over PUC with no regard to the higher ACB that would otherwise have resulted in a lower capital gain on a straight disposition.

New subsections 55(2.2), (2.3) and (2.4) and amended subsection 52(3)

Other than for purposes of applying Part VI.1 tax, the amount of a stock dividend is limited to the amount by which the payor's paid-up capital ("PUC") is increased by reason of the payment of the dividend.[8] Because of this, it was relatively easy for both public and private corporations to issue shares as stock dividends that have high FMV but that carry nominal income inclusion to the recipient generally by limiting the legal stated capital increases to a dollar in their dividend resolution.[9] Such stock dividends are often referred to as "high-low" stock dividends for this reason. Old section 55 was generally never a concern when dealing with high-low stock dividend because any section 55 re-characterization risk was limited to the often nominal "amount" of the stock dividend.

New section 55 has now added to its arsenal subsections 55(2.2), (2.3) and (2.4), targeting inter-corporate "high-low" stock dividends. New subsection 55(2.2) requires that for purposes of applying subsections 55(2), (2.1), (2.3) and (2.4), the amount of a stock dividend and the dividend recipient's entitlement to a deduction under section 112 is to be determined as if it is equal to the greater of (i) the increase in the payor's PUC by reason of the dividend, and (ii) the FMV of the shares issued as stock dividend at the time of payment.

New subsections 55(2.3) and (2.4) are technical rules necessary to provide for a partial safe income dividend when a portion of the FMV of a high-low stock dividend does not exceed safe income on hand. It is a relieving provision for high-low stock dividends analogous to paragraph 55(5)(f) for regular dividends, and similar to the new paragraph 55(5)(f), no designation is necessary. It also makes certain that a stock dividend paid out of safe income properly reduces safe income. Since these provisions are directed to high-low stock dividends, they only apply if conditions in subsection 55(2.4) are met, which are:

(a) a dividend recipient holds a share upon which it receives the stock dividend;
(b) the FMV of the share(s) issued as stock dividend exceeds the amount by which the payor's PUC is increased because of the dividend (in other words, a high-low stock dividend); and
(c) subsection 55(2) would apply to the dividend if subsection 55(2.1) were read without reference to its paragraph (c).

The condition in paragraph (c) refers to all the conditions in subsection 55(2.1) being met if the safe income exception in paragraph 55(2.1)(c) were ignored. This is to cause subsection 55(2.3) to replace paragraph 55(2.1)(c) as the operative safe income exception for high-low stock dividend.

If the conditions in subsection 55(2.4) are met, subsection 55(2.3) applies to produce the following results:

(a) the amount of the stock dividend that does not exceed safe income on hand reasonably considered to contribute to the capital gain that could be realized on a FMV disposition, immediately before the dividend, of the share on which the dividend is received is deemed for purpose of subsection 55(2) to be a separate taxable dividend; and
(b) the amount in (a) above is deemed to reduce the safe income on hand of the share on which the dividend is received.

As an illustration, assume that Opco has safe income on hand of $100 and its Class A shares which are held wholly by Holdco have an aggregate accrued capital gain of $100 or more. Opco declares on its Class A shares a stock dividend of Class B shares with a legal stated capital of $1 but a FMV of $150. Assume Holdco and Opco are connected and Opco does not have a refundable dividend tax on hand ("RDTOH") balance, so that Part IV tax does not apply to Holdco on receipt of the stock dividend. Per subsection 55(2.2), for purposes of applying the new section 55 rules, the amount of the dividend and the subsection 112(1) dividend deduction entitlement would be considered to be $150, being the greater of the payor's PUC increase and the FMV of the shares issued. Assuming one of the purposes of the issuance of the Class B stock dividend were to significantly reduce the FMV of the Class A shares, all of the conditions in subsection 55(2.4) should be met so that subsection 55(2.3) would apply. As a result, subsection 55(2.3) would cause Holdco to have received two separate taxable dividends: (i) $100 paid out from Opco's safe income on hand that could reasonably be considered to contribute to the accrued gain on the shares on which the dividend is received and for which Holdco would receive as a taxable dividend that it can claim a subsection 112(1) deduction against, and (ii) $50 which would be re-characterized by subsection 55(2) as a capital gain to Holdco. Also, Opco's safe income on hand would be reduced by $100 to $0 immediately after the stock dividend by virtue of paragraph 55(2.3)(b). Note that subsection 55(2) would apply similarly if it were a ‘same class’ stock dividend, i.e. a stock dividend of Class A shares paid on Class A shares.

Where an individual shareholder receives a share by virtue of a stock dividend, the shareholder's cost in the share received equals the 'amount' of the stock dividend – here, 'amount' being the increase in the payor's corporation’s PUC since the modified meaning of 'amount' in new subsection 55(2.2) does not apply beyond subsection 55(2) to (2.4). However, where the recipient of the stock dividend is a corporation, paragraph 52(3)(a) limits the cost of a share received to the amount of the stock dividend less any portion deductible under subsection 112(1) to the extent it exceeds safe income on hand. Amended subsection 52(3) provides that in the case of a corporate recipient of a stock dividend, the recipient’s cost of the shares received shall be determined by subparagraph 52(3)(a)(ii) to be the total of:

- (A) the amount if any, by which
  - (I) the lesser of the amount of the stock dividend and its FMV, exceeds
  - (II) any portion of the amount of the dividend deductible under subsection 112(1) to the extent it exceeds safe income on hand reasonably considered to contribute to the capital gain that could be realized on a FMV disposition, immediately before the dividend, of the share on which the dividend is received; and
- (B) the total of A + B where

> 'A' is the amount of deemed gain under new paragraph 55(2)(c) in respect of that stock dividend - note that the amount of this deemed gain is based on the modified meaning of 'amount' in subsection 55(2.2) i.e. the FMV of the stock; and
> 'B' is the amount, if any, by which the amount of the safe income reduction under paragraph 55(2.3)(b) exceeds the amount determined in clause (A).

To illustrate this, we will use the numeric example from above whereby Opco with $100 safe income on hand declares a stock dividend with a legal stated capital of $1 but a FMV of $150 to Holdco. The amount determined under clause 52(3)(a)(ii)(A) would be $1, because the amount determined under subclause (A)(I) is $1 (being the lesser of the amount of the stock dividend and its FMV), and subclause (A)(II) is $0 because the whole $1 is from safe income. The amount determined under clause 52(3)(a)(ii)(B) would be $149. This is because variable A is $50, being the deemed capital gain under paragraph 55(2)(c), and variable B is $99, being the $100 safe income reduction under paragraph 55(2.3)(b) minus the $1 determined under clause 52(3)(a)(ii)(A). Holdco's cost of the shares received on the stock dividend is the total of clause (A) and (B), which is $150. This is a reasonable result because $100 of the value of the stock dividend is derived from safe income on hand, and Holdco incurred $50 of deemed capital gain under subsection 55(2).

New subsection 55(2.5)

Another addition to section 55 is subsection 55(2.5). This new subsection states that in determining whether a dividend causes a significant reduction in the FMV of any share (i.e. the clause 55(2.1)(b)(ii)(A) purpose test), the FMV of the share immediately before the dividend shall be increased by the amount, if any, that the FMV of the dividend received on the share exceeds the FMV of the share. This provision makes it possible for the clause 55(2.1)(b)(ii)(A) FMV reduction purpose test to be met even where the share in question starts off with a nil or insignificant FMV. For example, assume Opco has a FMV of $1,000,000 and, as part of an estate freeze, Holdco subscribes for one Class A share of Opco worth $1. Opco then borrows funds and pays a $500,000 dividend to Holdco on the Class A share. Without subsection 55(2.5), the purpose test in clause 55(2.1)(b)(ii)(A) would not be met because a reduction of $1 in the FMV of the Class A share is not significant. However, with subsection 55(2.5), one needs to apply that purpose test as if the Class A share was worth $500,000 immediately before the dividend, being the $1 plus the amount that the $500,000 dividend exceeds the FMV of the share. As a result, the $500,000 dividend would cause a significant reduction in the FMV of the Class A share, and if this effect was one of the purposes of the payment or receipt of the dividend then the purpose test in clause 55(2.1)(b)(ii)(A) would be met. It should be noted that there is a potential technical problem with subsection 55(2.5). That is, how it could be possible for one of the purposes of the payment or receipt of a dividend be to reduce the FMV of a share, if that FMV is but a notional amount deemed by subsection 55(2.5). It will be interesting to see how this unfolds in practice.

Amendment to paragraph 55(3)(a)

Subsection 55(3) provides for two key exceptions from subsection 55(2). The first of these is the 'butterfly' re-organization exception in 55(3)(b). A paragraph 55(3)(b) butterfly permits inter-corporate dividends as part of a tax-deferred divisive re-organization amongst related or unrelated persons, but stringent rules must be met including pro rata distribution of each types of property. Because of these burdensome requirements, this exception is generally not relied upon in everyday planning. The paragraph 55(3)(b) exception remains unchanged in new section 55.

The second of these exceptions is the related-party reorganization exception in paragraph 55(3)(a) and this exception is much less restrictive and is therefore very commonly relied on by both public and private corporations. Generally speaking, this exception is met if, as part of a series that includes the dividend, there were no dispositions to or increase in interests by an "unrelated person".[10] An "unrelated person" for this purpose is defined in subsection 55(3.01) and paragraph 55(5)(e), and is different from the standard related person test contained in subsection 251(2). Previously, if the paragraph 55(3)(a) exception was met, any inter-corporate actual or deemed dividends that are part of the series of transactions would not be subject to subsection 55(2).

The paragraph 55(3)(a) exception has now been significantly curtailed in the new rules. This is because the following limitation has been added to the pre-amble of paragraph 55(3)(a): "*in the case of a dividend that is received on a redemption, acquisition or cancellation of a share, by the corporation that issued the share, to which subsection 84(2) or (3) applies* ...". In other words, paragraph 55(3)(a) now only applies to a subsection 84(2) or (3) deemed dividend and not to an actual dividend. This is arguably the most disruptive of the changes to section 55 because in the past, practitioners were often safe to ignore subsection 55(2) and any safe income requirements as long as the inter-corporate dividend and the related series of transactions did not involve any unrelated persons. This is no longer true to the extent the dividend is not a subsection 84(2) or (3) deemed dividend.

As explained by the CRA in the 2015 CTF CRA Roundtable,[11] the policy reason for restricting paragraph 55(3)(a) to subsection 84(2) or (3) deemed dividends is because a redemption, acquisition or cancellation of shares normally results in the elimination of the ACB of the shares in question. Consequently, such deemed dividends are normally not helpful in artificially increasing tax basis or decreasing FMV and hence, new paragraph 55(3)(a) permits the exception only for such deemed dividends.

Amendment to 55(5)(f)

Old paragraph 55(5)(f) allowed a dividend recipient corporation to make a series of designations to deem it to have received separate dividends for the purpose of section 55. This was a relieving provision because subsection 55(2) is an 'all or nothing' provision which applies to re-characterize the whole amount of a dividend if the amount of the dividend exceeds safe income on hand. This could be particularly problematic since the computation of safe income is complicated. By using the designation to break down a dividend into a series of separate dividends, only the portion of the total dividend that exceeds safe income on hand would be re-characterized. In *Nassau Walnut Investments Inc. v R*,[12] the federal Court of Appeal confirmed that the taxpayer needs to positively make the designation in order for paragraph 55(5)(f) to apply in order to prevent the safe income portion of the dividend from being re-characterized as a capital gain under subsection 55(2).

New paragraph 55(5)(f) overrides *Nassau Walnut* and makes the application of the paragraph automatic. It provides that any inter-corporate taxable dividend that exceeds safe income on hand that could reasonably be considered to contribute to the capital gain that could be realized on a FMV disposition of the share, immediately before the dividend, on which the dividend is received be deemed split into two separate taxable dividends: one that is equal to the safe income on hand and the other equal to the remainder. This change is partly relieving because it removes the designation requirement and ensures that the safe income on hand portion of a dividend would not be re-characterized into a capital gain. At the same time, it prevents the taxpayer from intentionally converting safe income into capital gains by not filing the paragraph 55(5)(f) designation on purpose. This will be discussed later in the paper. New paragraph 55(5)(f) also does not apply to a stock dividend to which new subsection 55(2.3) applies, because that subsection already provides for an analogous rule that splits the stock dividend into two separate taxable dividends.

New paragraph 55(5)(f) applies to dividends received on or after April 18, 2016. For dividends received before that day, the designation regime remained applicable.

Other consequential amendments

Consequential to the substantive changes described above, a number of related provisions were amended to ensure consistency.[13]

Brief review of safe income and safe income on hand

"Safe income" and "safe income on hand" are not defined in the Act; they are terms used by the CRA and tax practitioners to describe the safe harbour that subsection 55(2) offers to dividends that reduce capital gains that could reasonably be considered to be attributable to anything other than income earned or realized by any corporation after 1971 and before the 'safe-income determination time'. These concepts remain largely the same in new section 55. The discussion on safe income in this paper is meant to be a brief review of certain key areas since a full dissertation on the computation of safe income on hand is beyond the scope of this paper.[14]

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:

> "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.[15]

There are a number of complications in determining the safe income on hand in respect of a share. One component of this is that the rules to determine safe income on hand are comprised of a hodge-podge of rules and exceptions handed down from CRA administrative views and court cases, rather than from a definitive guide or template. Also, despite CRA's comment regarding the distinction between safe income and safe income on hand, these terms are often used interchangeably by practitioners and by the courts.[16]

The premise is simple enough. Safe income on hand is meant to capture the portion of an increase in the value of the shares of the corporation that is attributed to income that it earned or realized for tax purposes, rather than through appreciation of its assets, internal goodwill or other means. The policy rationale underlying this is that corporate income that has been taxed once should not be taxed again when it is paid out as dividend to another corporation. However, while it is true to say that generally items that decrease a corporation's available funds (such as taxes and dividends paid) go to reduce its safe income on hand, the actual determination is often not so simple.

In *Kruco v. The Queen*,[17] the Federal Court of Appeal upheld the Tax Court's finding that so-called phantom income (deemed income under the Act that does not correspond to cash inflow in that year) should not reduce the safe income determination. Under this decision, the determination of "income" is based upon income for tax purposes pursuant to subsection 55(5). Accordingly, many items that the CRA has long considered to reduce safe income (such as certain non-deductible expenses) should arguably not adjust safe income as they are included in the determination of income under the Act.

Initially, following *Kruco*, the CRA accepted that the safe income on hand would be equal to a corporations' net income for tax purposes, as adjusted under paragraph 55(5)(b) or (c), less cash outflows that occur after the determination of net income, but before the dividend is paid (such as taxes and dividends) to the extent these outflows reduce the income to which the capital gain may be attributable.[18] Under this approach, non-deductible expenses would generally not 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.

Today, tax practitioners generally accept that safe income on hand represents net income for tax purposes adjusted by paragraph 55(5)(b) or (c), and reduced by the following common adjustments (not an exhaustive list):

- Dividends paid or payable, however capital dividends will not reduce safe income on hand because the amounts making up the CDA are not included in safe income;
- Taxes, including refundable tax and provincial tax (but refund of refundable taxes increases safe income on hand when received);

- Charitable donations, gifts and political donations not already deducted in net income for tax purposes;
- Losses denied by stop-loss or loss suspension rules;
- Non-deductible (portion of) expenses or expenditures, such as non-deductible portion of meals and entertainment, non-deductible interest, penalties, insurance premiums, club dues, automobile expense, etc.;
- Cumulative dividends attributable to preferred shares and not paid, if the computation is being done for dividends received on common shares.

For taxation years where losses are incurred, the CRA's view is that losses reduce safe income on hand when realized since losses impair the value of the corporation when they are incurred, not when they are claimed in a carry-over year. The CRA holds similar views for realized capital losses, which reduce safe income on hand when realized rather than when claimed.[19] Also, disbursements made to acquire capital property or other eligible capital expenditures do not reduce safe income on hand because these capital disbursements do not reduce the value of the corporation.

Where dividends are received out of safe income on hand of a payer corporation, it will be added to the safe income on hand of the recipient. Also, since subsection 55(2), and now new paragraph 55(2.1)(c), refers to "income earned or realized by any corporation", safe income on hand of a parent corporation generally includes the safe income on hand of its subsidiaries.

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 gains inherent in the share post-acquisition.[20] 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.[21]

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). An illustration of certain problems that may arise will be discussed further below.

Even if one can wade through the complications to determine a corporation's safe income on hand over a given period with some sense of certainty, it still needs to be considered how much of that safe income is attributable to that share at the relevant time. This requires a determination of allocation not only between classes of shares, but also between different holders of each class of shares. It also requires a determination of the holding period for each shareholder prior to the applicable safe income determination time because in most cases (with the main exception being shares acquired on rollover), income does not attribute to a gain on a share until the particular shareholder acquires it.

If a corporation has different classes of shares, one must determine how each class benefits from an increase in its assets to determine the allocation of safe income among classes. This requires an examination of the share rights and restrictions with the goal of determining the right to participate in the assets of the shares.[22] While some general rules can be applied in such a determination, generally a case-by-case determination of all of the share rights must be made.

One example of a general rule is the recent CRA determination that so-called skinny shares (i.e. shares with only a rights 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,[23] the CRA stated its view that dividends on skinny shares would be subject to the purpose tests under new subsection 55(2.1). The CRA has also stated 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.

The determination of the FMV of such skinny or non-participating shares is a valuation issue. Generally, one expects that the FMV of such skinny shares to be nominal since they have no participation rights, and any dividends paid on them is based on the whims of the directors. However, there may be special circumstances where such shares may have substantial value, for example, if they carry the controlling votes.

Is the CRA's statement that an accrued gain is necessary for safe income based on the changed language of new section 55? The former reference was to a capital gain that "<u>would</u> have been realized on a disposition at fair market value" where the new reference is to a capital gain that "could be realized on a disposition at fair market value". It is not clear that this difference in language should mandate such a result. However, it is now certain that when determining allocation of safe income on hand, one must consider the valuation of the shares on which the dividend is received in order to determine whether sufficient accrued gain exists on that share.

The CRA's view on discretionary dividend skinny (non-participating) shares however provides an insightful contrast to another recent technical interpretation on discretionary dividend participating shares. 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.[24] In CRA View document no. 2015-0593941E5, the CRA was 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 a case, the CRA indicates 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 entitled to the dividend that will be paid and declared.[25]

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 that 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, safe income dividend can be streamed disproportionately to a single class. It will also be interesting to see how this global approach to safe income on hand interfaces with the CRA's previous potpourri of rules on the allocation of safe income to different classes and different holders – time will tell.

Another matter of note is that the CRA has confirmed in the 2015 CTF CRA Roundtable and in recent technical interpretations that a dividend that has been re-characterized into capital gains under subsection 55(2) should not reduce the safe income on hand, even though that dividend in fact reduces the value of the shares of the dividend payor.[26]

Aside from all the technical complexity of computing safe income on hand, there are also practical challenges particularly for businesses that have been around for a long time and that never had the need to compute safe income on hand before now. The safe income computation period could begin from the inception of the business (but after 1971), and this could be a daunting task as many businesses may not have retained detailed historical records for much longer than the statutorily required six year retention period.[27] If the taxpayer has no historical records going back that far and the CRA is also unable to provide such historical information, what is the taxpayer to do? In that situation, the only alternative may be to estimate safe income on hand based on retained earnings but the approach is obviously at risk of CRA's scrutiny. Also, the complexity of this task multiplies if the business had undergone a corporate reorganization, even a simple one such as a common estate freeze, in its history.

Impact of new rules on inter-corporate cash movements and other common planning

Prior to April 21, 2015, except where there is a foreseeable disposition to or an increase in interest by an unrelated person is imminent, practitioners generally took for granted that Canadian domestic inter-corporate dividends are tax-free due to the offsetting deduction offered under subsection 112(1). Common 'everyday' planning that involves inter-corporate dividends may include:

- asset protection – paying a dividend up to the parent corporation which may then loan the funds back to the operating company;
- repatriation - providing funds to a parent corporation to fund dividends to ultimate shareholders, service debts owing at the parent's level, or to be redeployed in another area of the corporate group;
- refinancing - extract funds up to the parent corporation after a refinancing at the subsidiary's level;
- purification – extracting excess cash to preserve small business corporation or qualified small business corporation share status.

The above is obviously not an exhaustive list, but these 'everyday' planning transactions mostly relied on either the paragraph 55(3)(a) exception or the purpose test in old subsection 55(2) not being met. However, new paragraph 55(3)(a) no longer applies to dividends other than deemed dividends under subsection 84(2) or (3). Hence, unless there is sufficient safe income on hand, all of the above common transactions will need to fall outside of the new purpose tests in paragraph 55(2.1)(b) in order to avoid the application of subsection 55(2).

How to interpret the "one of the purposes" test?

All three purpose tests in new subsection 55(2.1)(b) use the wording 'one of the purposes of the payment or receipt of the dividend'. Thus, the most fundamental question is what the phrase 'one of the purposes' means, and how it differs from a result test? In *Placer Dome Inc. v R.*,[28] the Federal Court of Appeal examined the meaning of 'one of the purposes' in the context of applying old subsection 55(2), and concluded that in the context of subsection 55(2) the word ‘purpose’ is a subjective test (in contrast, ‘result’ would be an objective test). The Court went on to explain that it is the taxpayer who bears the onus of establishing that none of the purposes was that described in subsection 55(2):

> 20. Accepting for the moment that subsection 55(2) employs the term “purposes” in its subjective sense, there are three basic propositions relevant to the analysis. First, the onus or burden rests on the taxpayer to establish the inapplicability of subsection 55(2) of the Act. Second, mere denial (without explanation or elaboration) by a taxpayer that his or her purpose was to effect a significant reduction in capital gain is not by itself a sufficient basis on which to discharge that burden. Third, it is not necessary that the taxpayer adduce corroborative or additional evidence which shows or tends to show that his or her testimony is true….
>
> 21. Practically speaking, it is evident that once it is established that a transaction has the effect of reducing significantly a capital gain it is proper for the Minister to infer that the taxpayer had such a purpose. To rebut that inference the taxpayer (or his advisors) must offer an explanation which reveals the purposes underlying the transaction. That explanation must be neither improbable nor unreasonable. All the while it must be remembered that subsection 55(2) of the Act speaks of “one of the purposes” of the transaction. Consequently, the taxpayer must offer a persuasive explanation that establishes that none of the purposes was to effect a significant reduction in capital gain. It is in this sense that uncorroborated but credible testimony can be sufficient proof of taxpayer intention…

Therefore, while the purpose test is a subjective test, the CRA does not have the ability to discern the taxpayer’s actual motivation behind the transaction. As such, the CRA will have to make an inference based on the effect of the transaction, which the taxpayer then has the onus or burden to rebut with an explanation that is neither improbable nor unreasonable. Nothing in new subsection 55(2) or (2.1) suggests that the ‘one of the purposes’ test will not continue to be a subjective test. However, taxpayers will now have the onus to demonstrate that none of the purposes of the payment or receipt of the dividend is to effect a significant reduction in the FMV of any share or a significant increase in the recipient’s cost of property. This can become a very tricky exercise considering that a significant dividend necessarily has the effect of causing a corresponding reduction in the FMV of the issued shares and increasing the cost of the recipient’s property.

Since the announcement of the new section 55 rules, the CRA has on numerous occasions issued guidance to taxpayers on when they would consider the new purpose tests to be met. At the 2015 CTF CRA Roundtable,[29] the CRA acknowledged that a dividend on a share would normally result in a reduction of value of the share, but explained that it is not the result that determines the application of subsection 55(2.1) – but the "purpose and the motivation behind the purpose". To determine this purpose and motivation, the CRA would attempt to find the answer to the following questions:

1) What does the taxpayer intend to accomplish with a reduction in value?
2) How would such reduction in value be beneficial to the taxpayer?
3) What actions did the taxpayer take in connection with the reduction in value?

The CRA, quoting from the Supreme Court of Canada's decision in *Ludco*,[30] reiterated that in ascertaining the purpose behind actions, the courts would objectively determine the nature of the purpose, guided by both subjective and objective manifestations of purposes. The CRA went on to illustrate examples of when they would consider an indication of a purpose of reducing FMV or increasing cost to exist:

> Without limiting the application of the purpose test, a dividend that is directly or indirectly instrumental in the creation of an accrued loss on any share that may be used, or has the potential to be used, to shelter a gain on some other property provides an indication that the FMV reduction purpose exists (for example, one might consider transferring a property with an accrued income or capital gain to the corporation that issued shares that have an accrued loss.) Furthermore, it is also necessary to ascertain that the purpose of the dividend is not to increase the cost of property. For example, and without limiting the application of the purpose test, the use or possibility of using an increased cost amount of properties to shelter a gain is an indication that the purpose of the dividend is to increase cost.

Again, at the 2015 CTF CRA Roundtable,[31] the CRA was asked to comment on whether a significant creditor-proofing dividend (and subsequent loan-back) that exceeds safe income on hand and that significantly reduces the value of the shares could trigger the application of subsection 55(2). In its response, the CRA stated the following:

> When Opco pays a "lumpy" dividend such as in this creditor-proofing transaction in order to significantly reduce the value on the Opco shares, the apparent purpose of the payment of the dividend for the application of subsection 55(2) is to reduce the value on the Opco shares. When such purpose is present, subsection 55(2) applies to the dividend.

Therefore, even though a taxpayer's sole purpose and motivation behind the significant inter-corporate dividend may be creditor-proofing, the CRA would still consider a purpose of significantly reducing FMV of any share to exist. Following the CRA's logic from above, this is presumably because the reduction in value from the dividend could directly or indirectly create an accrued loss on a share that may be used to shelter a gain. This is the case even though the creditor-proofing dividend has not necessarily caused the FMV of the share to drop to the extent of creating an accrued loss at the time of the dividend, and even though the possibility of sheltering a gain may be in the distant future.

At the 2015 Tax Executive Institute ("TEI") Liaison Meeting,[32] the CRA attempted to provide assurance to practitioners that a 'safe-harbour' exists for regular dividends:

> Where a dividend is paid pursuant to a well-established policy of paying regular dividends and the amount of the dividend does not exceed the amount that one would normally expect to receive as a reasonable dividend income return on equity on a comparable listed share issued by a comparable payer corporation in the same industry, the CRA would consider that the purpose of the payment of such dividend is not described in proposed paragraph 55(2.1)(b).

Therefore, it appears that unless a significant inter-corporate dividend meets this stringent safe-harbour test, the dividend will likely be challenged under the new purpose tests. Also, it is not entirely clear what a 'well-established policy' means in this context.

What does 'significant' mean?

The purpose tests in paragraph 55(2.1)(b) are not met if there is no significant reduction in capital gain or FMV, and no significant increase in the cost of property of the dividend recipient. The term 'significant' is not defined in the Act. In *VIH Logging Ltd. v R.*,[33] the Federal Court of Appeal said that whether a reduction is 'significant' must be determined contextually, taking into account all of the relevant facts and circumstances, and the Court found that a reduction of $45,000 in the context of dividends totaling over $1.7 million was not significant. The Court's finding effectively rejected the CRA's previous position that whether a reduction is significant should be determined based on absolute, rather than the relative, size of the reduction.

After *VIH*, the CRA has generally maintained that whether a reduction is significant is a question of fact, and it can be based on either the absolute dollar amounts or percentage interest. The CRA has remained consistent with this view when commenting on the new purpose tests in subsection 55(2.1) at the 2015 CTF CRA Roundtable.[34] As there is no bright-line threshold, either in terms of dollar amount or relative percentage, as to when a reduction or increase is 'significant', this will likely become a challenging area on the administration of the newly expanded purpose tests in paragraph 55(2.1)(b). For businesses, this uncertainty will likely carry a chilling effect, making the decision of whether to undertake common inter-corporate dividends unnecessarily difficult.

In sum, what are the takeaways in terms of the new purpose tests? There are some commentators who have argued strongly that the new purpose tests should not impact common inter-corporate cash dividends due to the tests being subjective purpose tests. However, as outlined above, even though the purpose test is a subjective test, taxpayers and practitioners, as part of tax risk management, should not ignore the objective results of transactions (including common inter-corporate cash movement transactions) and it would be prudent to anticipate that the CRA's and courts' view could be coloured by hindsight. It also does not help that there is no easy determination of what constitutes 'significant'. The administration of these new purpose tests will certainly be challenging and controversial, which is to be expected when a significant dividend generally always significantly reduces the FMV of any share or significantly increase the cost of property of the recipient (particularly if one takes the view that cash is property – subsection 248(1) defines "property" broadly as property of any kind whatever).

Unless all facts and circumstances point to a certain inter-corporate dividend not being significant or that it fits into the CRA's stringent 'well-established policy' safe-harbour described above, practitioners should advise clients to expect the CRA, on an audit, to challenge the taxpayer on significant or 'lumpy' inter-corporate dividends in terms of the paragraph 55(2.1)(b) purpose tests. Taxpayers should be ready to support that none of the purposes and motivation behind the purposes were to reduce FMV of any share or increase cost of property of the recipient (perhaps using the three-question framework provided by the CRA at the 2015 CTF Roundtable discussed above). However, this may be an uphill battle considering that the CRA sees even a pure creditor-proofing dividend arrangement as meeting the purpose tests. That said, as discussed later in the paper, the CRA has indicated that it will not consider standard in-house loss consolidation arrangements to fall into the new purpose tests.

Safe income determination time issues

As discussed earlier, the time that safe income on hand stops contributing to the accrued gain of a share is the "safe income determination time" and that term is defined in subsection 55(1) and is based on a triggering event occurring at the earliest time of "a series of transactions or events".

What constitutes a "series" has been determined by the common-law, but this definition has been further expanded by subsection 248(10). The Federal Court of Appeal in *OSFC Holdings Ltd. v R.* and *Canutilities Holdings Ltd. v R.* defined a common-law series as a 'pre-ordination' test: each transaction is preordained to produce a final or composite result and when the first transaction of the series is implemented, all essential features of the subsequent transaction or transactions are determined by persons who have the firm intention and ability to implement them.[35]

This definition of a common-law series is later confirmed by the Supreme Court of Canada in *Canada Trustco Mortgage Co. v R.*[36] Therefore, the transactions must be "pre-ordained" in order to form a common-law series.

Subsection 248(10) then expands the meaning to deem a series of transactions or events to include "any related transactions or events contemplated in contemplation of the series". According to the Federal Court of Appeal in *OSFC*, whether the related transaction is completed in contemplation of the common law series requires an assessment of whether the parties to the transaction knew of the common law series, such that it could be said that they took it into account when deciding to complete the transaction.[37] Later, the Supreme Court of Canada in *Canada Trustco* added that "in contemplation" is read not in the sense of actual knowledge but in the broader sense of "because of" or "in relation to" the series, and it can apply to events before or after.[38] In *Copthorne Holdings Ltd. v R*, the Supreme Court of Canada clarified that the "because of" or "in relation to" tests does not require a strong nexus, but requires more than a "mere possibility" or a connection with "an extreme degree of remoteness". The court in Copthorne also made clear that a subsection 248(10) series allows either a prospective or retrospective connection of a transaction related to a common-law series.[39]

To sum up, a 'series of transactions or events' is very broad, as it includes both the pre-ordained common-law series, as well as any transactions or events done "because of" or "in relation to" the common-law series to the extent the connection between the common-law series and those transactions or events is more than a "mere possibility".

Safe income determination time is the earlier of (a) the earliest disposition to or increase in interest by an unrelated person that result from the series, and (b) the earliest dividend paid as part of the series. Income earned or realized after safe income determination time cannot be added to safe income even if it clearly contributes to the accrued gain on a share, and therefore, it can be critical to determine when the safe income determination time is. An obvious case where this is relevant is if the dividend paying corporation divides profit repatriation into a series of significant dividends to its parent corporation. For purpose of applying paragraph 55(2.1)(c), income earned or realized after the first dividend of that series would not be included in safe income on hand, even though those income could have qualified as safe income on hand if the dividends were not considered a series. Similarly if a corporate subsidiary pays a dividend to its corporate parent at the beginning of a year, equal to the amount of earnings the subsidiary expects to earn over the course of that year, the safe income determination time occurs immediately before the dividend and the earnings of the year do not get included as safe income. To manage this type of risk, a profitable corporation paying a safe income dividend should delay payment as much as possible in order to capture the highest possible amount of income in its safe income on hand.

However, due to how broadly a "series" is being interpreted, the safe income determination time issue could materialize unexpectedly on common commercial transactions. This risk is not new, but it is now heightened because of the expanded scope of new section 55 and the increased importance of relying on safe income on hand.

If one takes the broad interpretation of a series to an extreme, a corporation paying regular annual or quarterly dividends pursuant to a dividend policy could potentially be considered to have paid all such dividends as part of a series of transactions or events because they were all paid in accordance with the dividend policy, which calls for a series of dividend payments pre-ordained to achieve the composite result of moving retained earnings out of the corporation. If one of the later dividends is considered to have met the new purpose tests in paragraph 55(2.1)(b) – because, say, it was larger than the usual dividends due to a particularly profitable year, then none of the income earned by the corporation since the time of the earliest dividend may be considered safe income. While this illustration takes the broadness of a series to somewhat of an extreme, it is easy to imagine situations where safe income determination time could unexpectedly become a real issue.

For instance, assume Parent Co owns Mid Holdco, which owns a number of Opcos. Over a number of years, the Opcos pay regular dividends to Mid Holdco from their earnings, and as a result, there are large cash balances built up in Mid Holdco. In the current year, Mid Holdco pays that large cash holding to Parent Co as a dividend, and let us assume one of the purposes of that dividend is to effect a significant reduction in the FMV of the shares in Mid Holdco. Logically speaking, the dividend should be exempt from subsection 55(2) because that dividend derives from the aggregate safe income of the Opcos over the years. However, it is also true that the dividend in the current year by Mid Holdco occurred "because of", or at least is "in relation to", all the dividends paid to it by the Opcos and therefore the Mid Holdco dividend in the current year could be said to be part of the same series as all of the dividends paid by Opcos since they started paying dividends. Safe income determination time occurs at the time immediately before the earliest time that "a dividend" is paid as part of the series. Thus, none of the income earned or realized by the Opcos starting from the time the first Opco dividend was paid could be included as safe income on hand, and the entire Mid Holdco dividend potentially subject to re-characterization under new subsection 55(2). To avoid this exposure, the repatriation by Mid Holdco to Parent Co could be arranged as a partial share redemption in order to take advantage of the paragraph 55(3)(a) exception (assuming no transaction with unrelated persons as part of the series), or the parties could consider winding up Mid Holdco into Parent Co under subsection 88(1) which would avoid a deemed dividend altogether.

Another potential problem that may arise is when dividends are paid up the chain is if subsection 55(2) applies to the lower-tier dividend. Let's assume as part of the series, Mid Holdco sold one of its subsidiaries, Opco, to a third party, and prior to the sale, Opco had no safe income on hand but it paid a significant dividend to Mid Holdco. Subsection 55(2) would apply to the dividend payment by Opco, and Mid Holdco would report a capital gain equal to the amount of that dividend. However, because the safe income determination time occurred immediately prior to that dividend, the capital gain incurred by Mid Holdco from the dividend would not be included in Mid Holdco's safe income. Therefore, when Mid Holdco pays the dividend proceeds it received from Opco or the sale proceeds to Parent Co as a dividend, that dividend may potentially be subject to another subsection 55(2) re-characterization in the hands of Parent Co since it does not derive from safe income. This result in the same amount being taxed twice as capital gains. To avoid this, pre-sale planning should be done to avoid having to pay dividends up a chain of corporations.

All in all, 'everyday' planning that involves inter-corporate dividends must now be carefully thought out.

Part IV tax exception

Both old and new subsection 55(2) contains an exception for inter-corporate dividends subject to Part IV tax. However, whereas old subsection 55(2) disallows the exception where the Part IV tax is refunded as a consequence of the payment of a dividend 'to' a corporation (where the payment is part of the series), new subsection 55(2) disallows the exception where the refund is as a consequence of the payment of a dividend 'by' a corporation.

Previously, if a corporation receives a dividend with the purpose (or result, if it was a subsection 84(3) deemed dividend) of significantly reducing a capital gain and the dividend exceeds safe income on hand, and the dividend is subject to Part IV tax but as part of the same series the corporation paid a dividend to its shareholders and received a dividend refund, whether the Part IV tax exception applied depended on whether the shareholders were individuals or corporations. This was because Part IV exception was disallowed only where the refund was as a consequence of the payment of a dividend 'to' a corporation.[40] In contrast, after April 20, 2015, the Part IV exception no longer applies to the extent the Part IV tax is refunded as part of the series, irrespective of whether the subsequent dividends were to individual or corporate shareholders, because they are necessarily paid 'by' a corporation. This result is also confirmed by Finance in its explanatory notes to new subsection 55(2).

Therefore, after April 20, 2015, if a corporation receives a dividend on which Part IV tax applies either because the payor is not a connected entity or because the connected payor received a dividend refund, and the conditions in subsection 55(2.1) are met, the corporation will need to avoid paying any taxable dividends that could be included as part of the same series of transactions in order for subsection 55(2) to apply. Practically, it could be difficult to avoid this result. Even if a subsequent dividend to the shareholder of the dividend recipient corporation is not a pre-ordained event flowing from the original dividend, i.e. not part of a common-law series, it will be difficult to argue that it is not part of a subsection 248(10) series with the original dividend unless the funds used for the subsequent dividend is unrelated to the proceeds from the original dividend and, ideally, a reasonable time has passed. The result is the same if the subsequent dividend is a subsection 84(2) or (3) deemed dividend.

As explained later in the paper, it may end up being beneficial allowing subsection 55(2) to apply due to the tax rate on dividends being higher than the integrated effective tax rate on a corporate capital gain. In fact, as the paper illustrates later, the integrated effective tax rate in the prairie provinces on subsection 55(2) corporate capital gains after the proceeds are fully distributed to individual shareholders is between 26% to 28%, which is significantly lower than the proposed Part IV tax rate of 38.33% after 2015.[41] Therefore, if the dividend recipient corporation is not flowing out dividends to individual or trust shareholders to recover the Part IV tax as part of the same series and allowing subsection 55(2) to apply as a result, tax is actually being accelerated!

However, even if the application of subsection 55(2) may not necessarily be tax inefficient, the actual mechanics of the Part IV exception could still cause practical issues if subsection 55(2) in fact applies.

To illustrate, assume Holdco and Opco are both Canadian-controlled private corporations ("CCPCs"), and Opco has no safe income on hand. Opco paid a $261,000 dividend to Holdco, on which Holdco is subject to $100,000 of Part IV tax (either because Opco is not connected to Holdco, or because Opco is connected to Holdco but Opco had a RDTOH balance).[42] It is also assumed that the $261,000 dividend by Opco represents a significant dividend that meets one of the purpose tests in subsection 55(2.1). Subsequently, as part of the same series, Holdco pays a $261,000 taxable dividend to its shareholder and consequently, Holdco receive a refund of the $100,000 Part IV tax it paid on the dividend from Opco. Because of the dividend refund to Holdco, subsection 55(2) now applies to re-characterize the $261,000 dividend from Opco as a capital gain to Holdco. A number of potential mechanical and practical issues ensue.

Firstly, as a CCPC, Holdco is subject to refundable tax on the taxable portion of the capital gain and as a result, 30.67% of the taxable capital gain, i.e. $80,040, is added to Holdco's RDTOH under subsection 129(3). It is not entirely clear whether the $261,000 dividend that Holdco paid to its shareholder permits an immediate refund of that $80,040 to Holdco. The $261,000 Holdco dividend has already been fully 'used' to generate the refund of $100,000, although arguably that refund has now been reversed. This is because paragraph 55(2)(a) deems the $261,000 dividend by Opco to not be a dividend received by Holdco, and so, that dividend should not have been "assessable dividend" under subsection 186(3) in the first place. Thus Holdco should never have been assessed the Part IV tax of $100,000 under subsection 186(1) in the year of receiving the Opco dividend. Correspondingly, the $261,000 Holdco dividend should not be considered to have been used to generate the original $100,000 RDTOH refund and hence, should be available to provide an immediate refund of the $80,040 of RDTOH resulting from the subsection 55(2) deemed capital gain.[43] Hopefully, the CRA will issue a technical interpretation that confirms this result.

Secondly, the non-taxable portion of the capital gain is added to Holdco's CDA. However, the proceeds from Opco's dividend has already been paid out by Holdco as a taxable dividend to its shareholder. Although subsection 83(3) permits a subsection 83(2) capital dividend election to be late-filed, the directors of Holdco needed to have authorized the election to have been made when in fact they originally authorized Holdco to pay a regular taxable dividend in order to trigger the dividend refund to Holdco. It is unclear whether the CRA would allow Holdco to late-file a subsection 83(2) election with appropriate director resolutions stating the directors changed their instruction to Holdco for it to elect under subsection 83(2) instead with respect to the $261,000 dividend it paid to its shareholder.

Thirdly, if such a late-filed subsection 83(2) election is allowed and a portion of Holdco's dividend to its shareholder is treated as a capital dividend and not a taxable dividend, this would mean that the $100,000 dividend refund that Holdco received in the first place was overstated since subsection 129(1) permits refund only on taxable dividends paid. If that is the case, this would mean that a portion of the $261,000 dividend from Opco to Holdco was indeed subject to Part IV tax that was not subsequently refunded. Does that mean a portion of the subsection 55(2) re-characterization of the Opco dividend should then be reversed? Arguably not, because as explained above, the application of paragraph 55(2)(a) caused the $261,000 Holdco dividend to not be an assessable dividend and should never have attracted Part IV tax in the first place, thus making the Part IV tax exception inapplicable in any case.

It is of interest to note that if the Holdco is permitted to self-assess subsection 55(2) with respect to the $261,000 dividend from Opco in the first place, the above issues would not arise because Holdco would then not report Part IV tax payable on the receipt of that dividend (again, because paragraph 55(2)(a) causes it not to be an assessable dividend) and would have reported capital gain and filed a timely capital dividend election. However, the Tax Court of Canada in *Ottawa Air Cargo Centre Ltd. v R.* rejected such an approach because the Court found that for the Part IV exception to be disallowed, Part IV tax must be first paid and then refunded.[44]

Stock splits undertaken as stock dividends

A corporate investor of portfolio investments in most cases does not have to be concerned about the application of new (or old) subsection 55(2), provided that the dividends it is receiving is paid pursuant to a well-established policy of paying regular dividends and the amount of the dividend does not exceed the amount one would normally expect to receive as a reasonable dividend income return on equity on a comparable listed share in the same industry (although this determination in itself places a heavy burden on the portfolio investor).[45] However, stock dividends, particularly when issued to effect a stock split, appears to be problematic with new subsection 55(2).

It is common in Canada for public companies to effect a stock split through an issuance of low PUC stock dividend since a stock split usually requires amendment of the Articles. In the past, subsection 55(2) was generally not a concern because the payor corporation kept the PUC increase low. However, with new subsections 55(2.2), (2.3) and (2.4), such high-low stock dividends may trigger the application of subsection 55(2) because one of the purposes of such stock dividends would indeed be to significantly reduce the FMV of any share (as the corporation is trying to replicate a stock split). If the corporate investor is a minority shareholder, it will be difficult to determine to what extent, if any, the FMV of the stock dividend should be treated as a capital gain unless it knows what the safe income on hand is.

Note that subsection 55(2) is generally not a concern with foreign dividends because subsection 55(2) only applies where the dividend payor is a taxable Canadian corporation, a corporation resident in Canada, or a non-resident corporation that carries on business in Canada through a permanent establishment.[46] Also, the definition of a 'dividend' in subsection 248(1) specifically excludes a stock dividend from a non-resident corporation.

Inter-corporate value shift planning

The new subsection 55(2) rules have put a nail into the coffin of inter-corporate value shift planning using high-low stock dividends. These plans generally involved a holding corporation (Holdco) acquiring shares of a corporate subsidiary (Opco). Then Opco would immediately pay a high-low stock dividend to Holdco with redemption value equal to the amount that Holdco acquired the Opco shares for. Holdco then sells the worthless shares and claims a loss. The courts have found that the GAAR applies to these types of transactions.[47] Now, in addition to GAAR, the stock dividend will immediately trigger a capital gain to the extent the FMV exceeds safe income on hand under the new subsection 55(2) rules.[48]

However, there may be legitimate uses of inter-corporate value shifts that are now also caught under the new rules. For example, on a freeze, if one of the 'freezors' holds the operating corporation (Opco) shares in a holding corporation (Holdco), the freeze could previously be accomplished by Opco issuing a high-low preferred share stock dividend to Holdco thereby allowing new entrants to subscribe for new common shares in Opco for a nominal amount. Under the new subsection 55(2) rules, the stock dividend triggers capital gains unless the FMV does not exceed safe income on hand. Therefore, post-April 20, 2015, the freeze, in this situation, should be undertaken by Holdco transferring its shares to Opco under subsection 85(1) for new Opco preferred shares.

Skinny discretionary share planning

Prior to April 21, 2015, issuing non-participating discretionary dividend shares (i.e. skinny shares) has been a popular tool to pay out dividends without having gains accrued to the holder. As discussed earlier in the paper, this will generally no longer work if the skinny share is held by another corporation because paragraph the 55(3)(a) exception will no longer apply and the CRA is of the view that no safe income can accrue on such shares – unless special circumstances justify an accrued gain on those shares based on valuation principles.

What's the road ahead?

1) Restructure inter-corporate repatriation into share repurchases or redemptions

By keeping the paragraph 55(3)(a) exception available for subsection 84(2) or (3) dividends, new section 55 not only keeps related party 'butterfly' type transactions alive but also leaves open a key safe harbour for inter-corporate distributions. Instead of declaring inter-corporate dividends, planners should generally consider whether it is possible to restructure the transaction into a share redemption or repurchase, which results in a deemed dividend under subsection 84(3) to the extent the redemption or repurchase proceeds exceed PUC. There are many ways to achieve this. For example, holding corporations may exchange their common shares in subsidiaries into shares that can be redeemed or repurchased under subsection 51(1), 85(1) or 86(1) – although proper valuation may become an issue. Usually, the most preferable would be subsection 51(1) because the exchange is deemed not to be a disposition thereby reducing compliance requirements. If the exchanged shares are fixed value preferred shares, the usual estate freeze considerations should be considered, e.g. benefit conferral, value of the preferred shares, price adjustment clause, etc.

By restructuring a profit repatriation into a subsection 84(3) dividend, paragraph 55(3)(a) prevents subsection 55(2) from applying provided that none of the triggers in paragraph 55(3)(a) occur as part of the series of transactions or events. These trigger events generally involve disposing property to or increases in interests by an 'unrelated person'.[49] In the private business context, these trigger events can generally be avoided with careful planning, but these rules should be reviewed carefully – for instance, the fact paragraph 55(5)(e) deems siblings and certain trusts to be unrelated persons for this purpose often catch practitioners off-guard.

Another potential trap is the triggering of capital gains if the redeemed shares have ACB less than the PUC. Under subsection 84(3), redemption proceeds that exceed PUC is treated as deemed dividend. Proceeds of disposition, pursuant to paragraph (j) of its definition in section 54, is reduced by the amount of the deemed dividend. This means that if ACB is lower than PUC, the proceeds of disposition would be higher than ACB and a gain would result. Therefore, if the ACB is less than PUC, steps to reduce PUC (e.g. a resolution to reduce legal stated capital without consideration) should be considered prior to the redemption.

Given the relative ease of restructuring arrangements into subsection 84(3) deemed dividends, Finance and the CRA understandably do not want the taxpayer relying on subsection 84(3) deemed dividends and paragraph 55(3)(a) to usurp the spirit and objectives of new subsection 55(2). Finance made its intention clear in its Explanatory Notes to proposed paragraph 55(3)(a):

> The amended exception in paragraph (a) for related-person dividends is intended to facilitate *bona fide* corporate reorganizations by related persons. It is not intended to be used to accommodate the payment or receipt of dividends or transactions or events that seek to increase, manipulate, manufacture or stream cost base.

The CRA elaborated on this at the 2015 CTF CRA Roundtable, and explained that providing the paragraph 55(3)(a) exception for share redemptions is appropriate because a redemption normally results in the elimination of the ACB of the shares redeemed. It also indicated that an attempt to artificially create or unduly preserve ACB by relying on the paragraph 55(3)(a) or (b) exceptions would frustrate the object, spirit and purpose of the provision and the CRA would seek to apply GAAR to such situations.[50] As part of its response, the CRA gave the following as examples of arrangements it considers offensive:

- A note or other property (other than assets owned by the dividend payer at the beginning of the series that includes the redemption) received by a corporate dividend recipient as redemption proceeds and exempt under paragraph 55(3)(a), and that is used by a person to generate ACB that is significantly greater than the ACB of the shares that were redeemed.
- ACB is streamed prior to a reorganization exempted by paragraph 55(3)(a) or (b) such that the redemption only applies to low ACB shares and high ACB is preserved in shares that are not redeemed.

With respect to the first example cited by the CRA, it appears that it is still acceptable to carry out a transfer of high ACB property to the parent corporation through a share redemption provided that the property was owned by the subsidiary corporation at the beginning of the series.

Presumably this is because the CRA recognizes the need to provide for some degree of flexibility but it will only permit this for *bona-fide* internal re-organization. For instance, Opco wants to transfer to Holdco (its parent) a related party receivable that has a significant ACB equal to its FMV and that Opco had owned since the beginning of the series, but Holdco's shares in Opco has a nil ACB and PUC. The transfer can be undertaken as a redemption of the Opco shares held by Holdco. At the end of the transaction, the ACB in the hands of Holdco (relating to the receivable it received) will be significantly greater than the ACB Holdco previously had in the redeemed shares. Paragraph 55(3)(a) would exempt the resulting subsection 84(3) deemed dividend from the application of subsection 55(2), as long as no property is disposed to or no interest is acquired by unrelated persons as part of the series. The CRA would not seek to apply GAAR even though the redemption resulted in significantly increased ACB in Holdco's hands, because the receivable was owned by Opco at the beginning of the series.

While this CRA administrative position allows for flexibility, planners still need to be careful when the series that includes the redemption begins to ensure that the dividend payer indeed owned the property at that time. Also, CRA's statement specifically refers to assets owned by the dividend payer so it appears that assets owned indirectly by the dividend payer or by related entities would be outside of this administrative position. Thus, going back to the previous illustration, if the related party receivable that Opco owned was swapped for another asset (or repaid in cash) as part of the same series, and that substituted asset (or cash) is transferred to Holdco as the redemption proceeds, then the redemption may fall outside of the administrative position and the CRA may apply GAAR to challenge the applicability of paragraph 55(3)(a).

The second example of abuse that CRA cited at the CTF Roundtable was also understandable, as otherwise, corporations can continue to multiply ACB as they did before the new rules. For example, Holdco which owns Opco common shares with a FMV of $1,000,000 and ACB of $300,000 may first exchange those common shares for new Opco preferred shares redeemable for $300,000 and new Opco common shares worth $700,000 under subsection 85(1). Paragraph 85(1)(g) would allocate all of the $300,000 ACB to the new preferred shares. Afterwards, Opco repurchases the $700,000 of common shares held by Holdco, which results in a $700,000 subsection 84(3) deemed dividend and as long as none of the triggers in paragraph 55(3)(a) are met, subsection 55(2) would not apply to re-characterize the deemed dividend. As a result, Holdco extracted $700,000 of full basis property from Opco, while preserving the $300,000 ACB it has in Opco shares. From CRA's response, it appears the CRA will apply GAAR to such an arrangement.

Also, although paragraph 55(3)(a) leaves the exception open for subsection 84(2) deemed dividends, it is expected that reliance on subsection 84(2) deemed dividend will be less prevalent at least in the private business context because most wind-ups in the private context are structured to be subsection 88(1) wind-ups which precludes the application of subsection 84(2).[51]

2) Splitting up businesses under new paragraph 55(3)(a)

As mentioned earlier, new paragraph 55(3)(a) still permits related party split-up butterflies. However, there are new considerations in planning such a transaction in light of the new rules. Firstly, unless it is desirable to rely on the safe income exception, no inter-corporate dividends or stock dividends should be used. Secondly, practitioners should keep in mind CRA's and Finance's commentaries on paragraph 55(3)(a) as discussed above regarding the boundary of relying on this exception: that ACB is not artificially created or preserved other than through receiving property owned by the dividend payer at the beginning of the series as consideration for a share redemption.

The CRA, in external interpretation document #2015-0604521E5, juxtapose one set of paragraph 55(3)(a) spin-off transactions that it considers acceptable with another set that it indicates that it will seek to apply GAAR against. These serves as an excellent illustration of the CRA's view on what it considers acceptable under the new rules. Both set of transactions involve Parentco and its 100% owned subsidiary, Opco, and the two sets of transactions represent two alternative methods of transferring certain business assets of Opco to a new subsidiary under Holdco on a tax-deferred basis.

The following are the steps in the first alternative set of transactions:

1) Holdco forms Newco;
2) Holdco transfers Opco shares (with a value equal to the value of assets to be transferred on step 3) to Newco in exchange for Newco shares pursuant to subsection 85(1);
3) Opco transfers business assets to Newco in exchange for Newco shares pursuant to subsection 85(1);
4) Newco redeems the shares it issued to Opco on step 3 and issues a note to Opco as redemption payment;
5) Opco redeems the shares that Newco received on step 2 and issues a note to Newco as redemption payment;
6) The notes between Opco and Newco are offset and cancelled.

In its evaluation of this alternative set of transactions, the CRA made the following observations:

- Holdco's aggregate ACB in the shares of Newco and Opco after the transactions is equal to Holdco's aggregate ACB in Opco shares prior to the transactions;
- Although the redemption of the shares with notes on steps 4 and 5 have the potential of increasing the recipient's ACB in properties, the notes cancelled on step 6 eliminated any increases.

In CRA's view, paragraph 55(3)(a) would apply to prevent application of subsection 55(2) provided that there is no triggering event described in paragraph 55(3)(a), and GAAR does not apply. However, the CRA stated that its view is made on the assumption that the amount of ACB in the Opco shares that Holdco transferred to Newco on Step 2 represents the same proportion of FMV of Opco shares transferred to Newco. Presumably, this is to ensure there is no manipulation or preservation of ACB (e.g. Holdco first streaming the Opco shares' ACB to a separate class that is not transferred to Newco). However, it is unclear why the CRA believes this is necessary because even if Opco shares' ACB is fully preserved, Holdco's aggregate ending ACB in the shares of Newco and Opco should still be equal to the aggregate ACB in Opco shares prior to the transactions.

The second alternative set of transactions that the CRA commented on in document #2015-0604521E5 is as follows:

1) Holdco forms Newco;
2) Opco transfers business assets to Newco in exchange for Newco shares pursuant to subsection 85(1);
3) Newco redeems the shares issued to Opco on step 2 and issues a note to Opco (the "Newco Note") as redemption payment;
4) Opco redeems a portion of its shares (with a value equal to the value of assets transferred on step 2) and transfers the Newco Note to Holdco as redemption payment;
5) Holdco transfers Newco Note to Newco in exchange for Newco shares or as a capital contribution (thereby cancelling the note).

Holdco's ACB in shares of Opco is reduced by the proportion of Opco shares redeemed, and its ACB in shares of Newco is increased by the amount of the Newco Note, which equals the FMV of the assets transferred on step 2. Assuming the FMV of the assets transferred (which also equals the FMV of Opco shares redeemed) is significantly higher than Holdco's ACB in the redeemed Opco shares, Holdco's aggregate ACB in the shares of Newco and Opco would be significantly higher than its ACB in Opco shares prior to the transactions. All of the steps would occur on a tax-deferred basis assuming there is no triggering event described in paragraph 55(3)(a). The CRA found the tax-free increase of ACB in the hands of Holdco to be an inappropriate result under the scheme of new subsection 55(2), and indicated that it will seek to apply GAAR.

The CRA's position can be reconciled to the CRA's response at the 2015 CTF Roundtable described above when they explained in what circumstances it is abusive to rely on subsection 84(3) and paragraph 55(3)(a) to circumvent subsection 55(2).[52] Specifically, in that response, the CRA said that it would be offensive if a note or property (other than assets owned by the dividend payer at the beginning of the series) is received by the dividend recipient, and the arrangement results in an increase of ACB of properties of the recipient. Here, Opco did not own the Newco

Note at the start of the series, but it transferred the Newco Note to Holdco as consideration of the partial share redemption. As a result of that transfer, which is exempted by paragraph 55(3)(a), Holdco's ACB significantly increased.

It is interesting to note that the new subsection 55(2) rules already reduced the amount of ACB duplication possible in the second alternative set of transactions. Prior to the new rules, Opco could have transferred the Newco Note up to Holdco through a dividend-in-kind instead of a redemption of shares, thereby preserving all of Holdco's ACB in the shares of Opco. Such a dividend would not protected by paragraph 55(3)(a) post April 20, 2015.

It is also important to note here that the amendment to paragraph 55(3)(a) or subsection 55(2) should generally not impact a traditional paragraph 55(3)(a) split up planning for a corporation owned directly by an individual or a trust. In those situations, the distributing corporation may continue to use a high-low stock dividend to get high value low ACB/PUC shares in the hands of the individual or trust, who may then transfer those shares to a new corporation under subsection 85(1). The distributing corporation may then transfers assets to the new sister corporation for shares under subsection 85(1). The shares between the two corporations are then redeemed for notes, which are then offset and cancelled. Since the initial high low stock dividend is not paid to a corporation, subsection 55(2) has no application because the first condition in subsection 55(2.1) is that the dividend recipient is entitled to a dividend deduction which is not afforded to an individual or trust. The subsequent share redemptions should fall within paragraph 55(3)(a) provided none of the triggering events described in that paragraph apply, and the CRA should not seek to apply GAAR because the promissory notes are cancelled at the end of the transactions.

3) Update safe income on hand computation annually

The expanded scope of the new subsection 55(2) and the uncertainty with respect to the new purpose tests means that a corporation with corporate shareholder(s) should include in its tax risk management process the computation of safe income on hand for each corporate shareholder and to update that computation annually. In fact, during a panel discussion at the 2015 CTF annual conference, the CRA official has said that it would be a 'healthy practice' for corporations to start doing safe income computations.

Even if a corporation plans to rely on share redemption and repurchases going forward in order to fall into the amended paragraph 55(3)(a) exception, there may still be circumstances where a distribution cannot be accommodated by a share redemption or repurchase or where a dividend distribution is inadvertently made. Given the potential amount of complexity involved with such a computation particularly for complex organizations with long history, businesses would be well advised to have safe income on hand computations ready well before any dividend distributions.

It may also be prudent to calculate safe income on hand for a corporation that has no corporate shareholder today. Reorganization in the future may cause shares of the corporation to be transferred into holding companies on tax-deferred basis (which generally means the shares transferred inherit the previous safe income on hand), or dividends may be allocated to corporate beneficiaries if a trust shareholder is involved. Having safe income on hand balances ready allows businesses to plan transactions with confidence.

4) *Pay inter-corporate dividends 'safely'*

If an inter-corporate dividend that is not a subsection 84(3) deemed dividend is paid, the ideal scenario is that the purpose tests in subsection 55(2.1) are not met. This would mean none of the purposes is to effect one of the objectives described in paragraph 55(2.1)(b), but as discussed above this may be tricky for the taxpayer to prove. However, if the amount of the dividend is not 'significant' both in terms of absolute dollar amount and percentage basis, then the risk of falling into the purpose tests should be greatly diminished. Therefore, inter-corporate dividends should ideally not be 'lumpy', be paid pursuant to a well-established policy of paying regular dividends and the amount of the dividend does not exceed the amount that one would normally expect to receive as a reasonable dividend income return on equity on a comparable listed share issued by a comparable payer corporation in the same industry.[53]

To the extent a significant inter-corporate dividend has to be paid, the amount of the dividend should not exceed the amount of safe income on hand that contributes to the accrued gain on the share on which the dividend is received (unless it is certain that the taxpayer can support that none of the purposes of the dividend is one described in paragraph 55(2.1)(b)). As discussed above, the CRA is generally flexible in terms of allocation of safe income on hand to participating discretionary dividend shares,[54] but the CRA affords the taxpayer no flexibility to allocate safe income where the dividend paying share has no accrued gain (e.g. non-participating shares) or insufficient accrued gain.[55] Therefore, practitioners should work with clients to monitor the FMV of each class of shares, particularly in times of economic downturn or other circumstances negatively impacting valuation.

One type of planning involving inter-corporate dividends that has been confirmed by the CRA to fall outside of the purpose tests in paragraph 55(2.1)(b) is the loss consolidation arrangement. At the 2015 CTF CRA Roundtable,[56] the CRA expressed that in-house loss consolidation arrangements designed solely to move losses between related or affiliated corporations and on which the CRA ruled favourably in the past would not be considered to have a purpose described in paragraph 55(2.1)(b). The CRA further stated that an indication that such a purpose is absent is that any ACB created as part of the arrangement is eliminated on the unwinding of the loss consolidation structure.

Loss consolidation arrangement usually involves a profitable corporation (Profitco) and a related or affiliated corporation with losses (Lossco). Typically, Profitco would subscribe for dividend-paying preferred shares in Lossco with cash, and Lossco would in turn use the subscription proceeds to loan the funds back to Profitco in return for an interest-bearing promissory note. The dividends paid by Lossco to Profitco, which may be funded by additional capital contributions by Profitco, is received tax-free by Profitco pursuant to subsection 112(1). The interest paid by Profitco to Lossco reduces Profitco's taxable income and the interest income is sheltered by Lossco's losses. To unwind the structure, Lossco could redeem the preferred shares by issuing a promissory note, and this promissory note could then be used to offset and cancel the promissory note issued by Profitco. Therefore, at the end of the arrangement, no additional ACB is created and the CRA has ruled favourably that such arrangement should not attract subsection 55(2).[57]

It is generally recommended that before implementing a loss consolidation plan, the taxpayer request an advance tax ruling from the CRA particularly if the steps or facts differ from the previously published rulings. Similarly, for any other inter-corporate dividends, if the taxpayer believes that it should fall outside of the new purpose tests but would like additional assurance from the CRA, they may apply for a ruling as well. The CRA has indicated that it will consider issuing favourable rulings on new subsection 55(2) where all facts and circumstances support the absence of any of the purposes described in paragraph 55(2.1)(b).[58] However, this process is costly and time consuming, and for these reasons it may not be practical for small business enterprises in many cases.

5) Pay attention to inter-corporate PUC

PUC in shares owned by corporate shareholder has generally been an after-thought for tax practitioners because in most cases, there was no need to rely on inter-corporate PUC as inter-corporate dividends and deemed dividends were usually not subject to subsection 55(2). With the expanded scope of subsection 55(2), return of capital between corporations will become much more important because it avoids having to deal with subsection 55(2) in the first place and because it is easier to execute and more flexible than share redemptions and repurchases. For instance, capital can be returned on a share exactly to the extent of PUC whereas a share redemption generally requires the entire share value (both the PUC portion and the deemed dividend portion) to be realized.

This means that practitioners should be mindful of preserving PUC where possible. For example, when acquiring target corporations, it will now be more important to use 'Buyco' strategies to refresh and preserve PUC. What this typically involves is the purchaser incorporates and funds a corporation (Buyco) for the purpose of acquiring the target corporation. Buyco acquires the target corporation and winds up the target into it on a tax deferred basis under subsection 88(1). By using a Buyco rather than directly acquiring the target corporation, the purchaser holds shares in Buyco with PUC equal to the purchase price (in contrast, if the target corporation shares was acquired directly, the PUC of the shares would remain as before the acquisition). Additionally, there may be possibility to bump the ACB of certain non-depreciable assets on the winding up of the subsidiary by virtue of paragraphs 88(1)(c) and (d).

Another similar PUC related planning transaction is an inter-corporate "pipeline". To illustrate, assume Holdco owns all of the shares of Opco, and the Opco shares has high ACB but a low PUC. Opco would like to make a significant distribution to Holdco but does not want to risk being subject to subsection 55(2) by paying a dividend and is not interested in restructuring the distribution as a share redemption or repurchase to take advantage of the paragraph 55(3)(a). As a solution, Holdco could incorporate another subsidiary, Sisterco, and Holdco would transfer the shares of Opco to Sisterco under subsection 85(1) electing at proceeds equal to Opco shares' aggregate ACB, and taking back new Sisterco shares as consideration. Pursuant to subsection 85(2.1) and since subsection 84.1(1) does not apply to corporate-to-corporate transfers, the PUC of the Sisterco shares taken back would equal to the elected amount, i.e. Opco shares' ACB. Opco could then wind-up into Sisterco under subsection 88(1) and Sisterco can distribute funds to Holdco as a return of capital to the extent of the PUC of its shares (which is now equal to the high ACB of the Opco shares prior to the reorganization). The courts' decisions in *Descarries* and *MacDonald* should be considered when planning such transactions.[59]

Any planning to preserve PUC must also consider the possible application of GAAR. In *Copthorne Holdings Ltd. v. R*,[60] the Supreme Court found that the GAAR applied where, as part of a series of transactions, the PUC of the shares of a former subsidiary, which would have been cancelled on a vertical amalgamation, were preserved on a horizontal amalgamation. This arrangement effectively duplicated the amount of PUC and the court found this to be abusive. Thus, any planning that has the effect of 'double-counting' PUC may attract the application of GAAR.

6) The trust triangle structure lives on

There are generally two basic types of 'triangle' structures for using trusts to hold private family enterprises. The first one is to have a family trust hold 99% of the participating common shares of an operating corporation (Opco), and the remaining 1% (separate class) being held by a holding corporation (Holdco), which would also be wholly owned by the family trust. The second type is to have the family trust hold 100% of the participating common shares of Opco, and Holdco being named as one of the discretionary beneficiaries of the family trust. Often, Opco also has outstanding fixed value preferred 'freeze' shares held directly by the founder of the business.

With respect to the first type of structure, the purpose of allowing Holdco to hold a separate class of shares is so that profits generated by Opco that is not needed for the family's personal needs may be paid out as a dividend on the separate class of shares held by Holdco. This is usually done for creditor proofing reasons, and to sweep out excess cash so as not to jeopardize Opco's small business corporation status or its shares' qualified small business shares status. At the same time, by having the family trust hold 99% of the participating common shares, substantially all of the capital gains may be allocate to the family trust on an eventual sale of Opco and such gains may be allocated to the various individual beneficiaries (who may be entitled to claim the lifetime capital gain exemption).[61]

Even though the separate class held by Holdco only constitutes 1% of the outstanding participating common shares, the jurisprudence generally allows dividend to be disproportionately paid on one common share class to the exclusion of other common share classes.[62] The dividend received by the holding corporation would be tax-free pursuant to subsection 112(1). Part IV tax would not apply as long as Opco is controlled by the family trust and the trustee(s) of the trust do not deal at arm's length with Holdco.[63]

However, this type of structure could potentially be problematic under the new rules. If a significant dividend is paid to Holdco and there is a potential for falling into one of the purpose tests (e.g. a creditor proofing dividend), it would then be necessary to rely on the safe income exception in paragraph 55(2.1)(c). Given the shares on which the dividend is received represents only 1% of the participating common shares, there is a question whether more than 1% of the safe income on hand may be allocated to those shares. However, as discussed earlier, the CRA appears to allow for disproportionate allocation of safe income on hand for participating common shares where a corresponding disproportionate dividend is paid on the share.[64] This result still fundamentally rests on whether the specific rights attached to the share class could support the hypothetical capital gain on those shares, so businesses relying on this administrative position still need to exercise caution and examine their share articles. Nevertheless, assuming the CRA does not change its position in the future, this structure continues to be viable form of holding private companies.

With respect to the second type of triangle structures, the objectives of flowing profits and excess cash to Holdco are similar to the first structure but the distribution is first paid by Opco to the family trust which then makes a distribution to Holdco as a beneficiary. Holdco is deemed to have received the distribution as a dividend from Opco allowing it to claim a corresponding deduction under subsection 112(1).[65] There should be no question of safe income allocation with respect to the Opco dividend as long as there is sufficient hypothetical capital gain on the 100% of the participating common shares held by the family trust. Some practitioners have questioned whether the dividend's character as a safe income dividend is preserved when the amount is allocated to Holdco through the trust. Given the wording of paragraph 104(19) which, for purposes of the Act (other than Part XIII), deems the beneficiary to have received a taxable dividend on 'the' share on which the trust received the dividend, the safe income dividend's character should indeed be preserved in the hands of the beneficiary. In fact, the CRA has recently confirmed that a safe income dividend allocated by a family trust to a corporate beneficiary retains its character as a safe income dividend in the corporate beneficiary's hands.[66] Although the interpretation was issued prior to new subsection 55(2), the new legislation does not appear to impact it. Therefore, this second type of structure should continue to work well under the new regime.

Based on the foregoing, it appears both forms of trust 'triangle' structures are useable going forward. However, it is the author's opinion that the second type of structure, with the trust holding all of participating common shares of Opco and Holdco receiving the dividends as a beneficiary, appear to be on more solid statutory footing, whereas the first type of structure relies primarily on the CRA's administrative position. Also, on a side note, practitioners should be mindful of the recent loss restriction event rules in section 251.2 when adding corporate beneficiaries to an existing trust particularly if the trust deed allows for automatic inclusion into the class of beneficiaries as new corporations are created (e.g. including as beneficiaries any corporation that the beneficiaries control at any time).[67] If a trust undergoes a loss restriction event, consequences include deemed taxation year end (and corresponding T3 return filing requirement), loss of tax attributes and mandatory write-down of tax basis.[68]

7) Replacing stack corporate structure with limited partnerships

One way to manage the new section 55 rules is to avoid them altogether. Rather than structuring holding corporations and various corporate subsidiaries to manage separate business divisions and liability exposure, the same can be accomplished with using internal limited partnerships. Profits from each limited partnership can be paid up to the holding corporation as capital draws (to the extent of ACB) without triggering any capital gain or other tax implication. Theoretically the amount of tax-free capital draws allowed by a limited partnership is the same as the amount of tax-free distribution by a corporate subsidiary because ACB of partnership interest is generally derived from capital contributions and each year's partnership earnings – which is similar in concept to PUC and safe income on hand for a corporate subsidiary. However, the computation of ACB of a partnership interest is well-defined and is familiar to practitioners, and there is no generally no uncertainty as to whether a drawing exceeds ACB.

Conversion from a stacked corporate structure to an internal limited partnership structure can generally be accomplished in a tax-deferred manner. For example, a holding corporation (Holdco) with multiple wholly owned subsidiaries (Opcos) may wind-up the Opcos under subsection 88(1). Alternatively, if the Opcos cannot be wound-up for business reasons, the assets can be spun out under a paragraph 55(3)(a) butterfly reorganization. Holdco could then establish a series of new limited partnerships, each with a nominal shell corporation acting as general partner (the partnerships may also share a single general partner corporation but non-tax considerations usually make this unpalatable). Holdco then transfers the former business assets and liabilities to the new limited partnerships under subsection 97(2). Going forward, the business divisions previously held by separate corporate subsidiaries will be operated by separate limited partnerships. It will be important that Holdco not take an active role in the activities of the limited partnerships (such role should be carried out by the general partner corporations) in order to preserve its liability protection.

Aside from avoiding subsection 55(2) on repatriation, a real benefit offered by an internal limited partnership structure is that it allows the ‘mixing’ of profits and losses of the various internal partnerships. Whereas, with corporate subsidiaries, losses of one subsidiary is trapped inside that subsidiary unless planning transactions are undertaken to unlock them (e.g. amalgamation, wind-up and loss consolidation arrangements as described earlier in the paper). The partnerships will need to keep track of their at-risk amount (“ARA”) as a limited partner may only claim losses from a partnership to the extent of its ARA in respect of the partnership.[69] In the recent Tax Court of Canada case of *Green v R*,[70] the court ruled the business losses of a lower-tier limited partnership allocated to an upper-tier partnership in excess of ARA continue to be business losses in the hands of the upper-tier partnership, so that such losses can, in turn be allocated to the partners of the upper-tier partnership (to the extent of the upper-tier ARA).

If the Tax Court’s decision in *Green* is correct, it appears that even greater flexibility in terms of the profit and loss mixing can be achieved by placing the limited partnerships underneath a ‘master’ limited or general partnership that is held by the top holding company, because the flow of losses to the upper-tiered partnership would not be restricted by ARA at the lower-tier. However, the Minister has appealed the *Green* case to the Federal Court of Appeal, so it will prudent for practitioners to wait before restructuring businesses into stacked partnership structures to take advantage of *Green*. Further, even if the decision is not overturned at the Federal Court of Appeal, there is always a risk that Finance may introduce legislative amendments to effectively overturn the Tax Court’s decision.

8) Intentionally triggering subsection 55(2)

Despite the paper's emphasis on planning to avoid the application of subsection 55(2), intentionally triggering the re-characterization provision of subsection 55(2) may in some circumstances be a tax-efficient manner of profit repatriation. Consider the following numerical illustration that compares an individual shareholder top marginal tax rate on eligible and non-eligible dividends, to the integrated, post-distribution, effective tax rate on CCPC-earned capital gain:

	Alberta	Saskatchewan	Manitoba
Federal and provincial combined top marginal tax rates on			
Eligible dividend	**31.71%**	**30.33%**	**37.78%**
Non-eligible dividend	**40.24%**	**40.06%**	**45.69%**
Compared to:			
Inter-corporate dividend received	$ 100.00	$ 100.00	$ 100.00
If s.55(2) applies:			
Corporate tax on capital gain *	$ (25.35)	$ (25.35)	$ (25.35)
Refundable dividend tax on hand refund*	$ 15.35	$ 15.35	$ 15.35
Cash available for distribution	$ 90.00	$ 90.00	$ 90.00
Individual shareholder receives following distributions:			
Tax-free capital dividend - s.83(2)	$ 50.00	$ 50.00	$ 50.00
Non-eligible dividend	$ 40.00	$ 40.00	$ 40.00
Personal tax on non-eligible dividend	$ (16.10)	$ (16.02)	$ (18.28)
Net after-tax proceeds	$ 73.90	$ 73.98	$ 71.72
Effective tax rate	**26.10%**	**26.02%**	**28.28%**
* Refundable tax on CCPC investment income and RDTOH rates are based on federal Bill C-2			

Capital gains earned by a CCPC does not generate any addition to the general rate income pool ("GRIP") so any taxable dividend paid out from the capital gain proceeds is not an eligible dividend. However, a private corporation can add to its CDA the 50% non-taxable portion of the capital gain, which in turn allows the corporation to pay out a capital dividend under subsection 83(2) that can be received tax-free by the individual shareholder. For an individual shareholder in the top marginal rate brackets, a capital gain triggered at the corporate level then paid out as a combination of tax-free capital dividends and non-eligible dividends will generally result in less overall tax than if the shareholder just receives an eligible or non-eligible dividend (as seen in the numeric illustration above for the prairie provinces). The rate differential is particularly acute if the corporation does not have GRIP and could only pay out non-eligible dividends: non-eligible dividends are subject to tax at 40.06% to 45.6% versus the integrated rate on CCPC-earned capital gain of 26.1% to 28.28% in the prairie provinces.

These tax savings can potentially be further improved if this capital gain planning is combined with a non-CCPC election under subsection 89(11). Subsection 89(11) allows a CCPC to elect not to be a CCPC for specific provisions of the Act by filing an election prior to the filing due date of a particular taxation year. The result of the election is that the corporation losses the small business deduction and is taken out of the GRIP regime and into the low rate income pool ("LRIP") regime. However, the elected corporation is still subject to refundable tax on investment income under section 123.3 and any non-taxable portion of capital gains is still added to the CDA.

Therefore, by making the election in the year of a significant capital gain and assuming the subsection 89(8) does not calculate a large opening LRIP balance,[71] a corporation will generally be able to pay out a portion or all of the taxable dividend from the capital gain proceeds as eligible dividends while still being entitled to RDTOH refund and the ability to pay out the non-taxable portion of the capital gain as capital dividend. Hence, combining a subsection 89(11) election with a triggering of corporate capital gain will generally further lower the integrated effective tax rate. However, the capital gain will result in a significant LRIP addition in the subsequent year hampering the ability of the corporation to pay eligible dividends in the future.[72] As such, careful planning will be required when executing such a plan.

Another consideration is that, as discussed at the beginning of the paper, a dividend that is deemed to be a capital gain by subsection 55(2) reduces the value of the shares of the dividend payor but the ACB of those shares are preserved. Therefore, if the dividend recipient subsequently disposes of those shares, a loss may arise to the extent FMV of the shares have been reduced below ACB, and the loss may offset the subsection 55(2) deemed capital gain. To the extent possible, the dividend recipient should pay out the CDA from the deemed capital gain before that loss occurs, but as noted earlier in the paper, the uncertainty about timing of the CDA addition under new subsection 55(2) may make this planning trickier if the disposition occurs in the same year as the deemed capital gain.

The bottom line is this: if funds are required for shareholders' personal needs, it is usually beneficial beneficial to trigger a corporate capital gain under subsection 55(2) on an inter-corporate dividend in the same or a preceding year in order to generate CDA. However, can a taxpayer self-assess under subsection 55(2) to re-characterize a dividend otherwise deductible under subsection 112(1) dividend into a capital gain? At the 2015 CTF Roundtable, the CRA was asked about a scenario where a deemed dividend arising on a share redemption exceeded the safe income on hand attributable to the redeemed shares, and a designation under paragraph 55(5)(f) was intentionally not made so that subsection 55(2) re-characterized the entire deemed dividend as proceeds of disposition (note that this question was asked before the amendment to paragraph 55(5)(f) was announced on April 18, 2016 to remove the designation requirement).[73] In its response, the CRA indicated that the GAAR Committee was of the view that it would be unlikely that the GAAR could be successfully applied to these transactions, but the CRA expressed that it was concerned about this type of surplus stripping and has referred the issue to Finance.

At the time, it was unclear whether the CRA was just concerned about the taxpayer converting otherwise safe income dividend into capital gains by 'gaming' the paragraph 55(5)(f) designation, or whether it was about the whole concept of self-assessing subsection 55(2) to surplus strip at the integrated corporate capital gains rate. As discussed earlier in the paper, Finance announced amendments to paragraph 55(5)(f) on April 18, 2016 likely in response to CRA's recommendation in order to remove the designation requirement in paragraph 55(5)(f). Therefore, it appears that self-assessing the non-safe income portion of dividends as capital gains under subsection 55(2) should be sound planning for now, at least until Finance announces further changes.

This type of planning could be accomplished by reducing or isolating safe income on hand prior to an inter-corporate dividend so that the desired portion of the dividend can be re-characterized. This can be done, for example, by first increasing stated capital of a class of shares (which creates a subsection 84(1) deemed dividend), or by 'dropping' funds into new subsidiary with no safe income and having that subsidiary pay a dividend back up.

Conclusion

The proposed changes to section 55 represent a whole new landscape for advisors to both public and private companies. The uncertainty of the application of the new purpose tests will be a real challenge until the jurisprudence in the area develops. But planning and transactions must go on, and the astute planner will explore ways (such as subsection 84(3) deemed dividends to rely on the narrowed paragraph 55(3)(a) exception) to navigate this new landscape, and even take advantage of these new rules to create new tax saving opportunities for their clients.

---

[1] I would like to thank Kim G C Moody FCA, TEP and Josh Schmidt LLB of Moodys Gartner Tax Law LLP for their contributions and helpful suggestions. Any errors or omissions are my responsibility.

[2] RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

[3] One substantial change from the July 31, 2015 version of the draft legislation was the amendment to paragraph 55(5)(f) making that paragraph automatic rather than requiring a designation.

[4] Both the old and new section 55 rules can re-characterize tax-free dividends under subsection 138(6), which is a similar provision for life insurers.

[5] CRA document no. 2015-0610651C6, November 24, 2015.

[6] Paragraph 111(1)(b).

[7] Subsection 84(9) ensures this result for greater certainty.

[8] Subsection 248(1) definition of an “amount”, paragraphs (b) and (c).

[9] “Paid-up capital” is defined in subsection 89(1), and the starting point for its determination is based on paid-up capital for legal purposes.

[10] The triggering events for paragraph 55(3)(a) are contained in its sub paragraphs (i) to (v).

[11] CRA document no. 2015-0610681C6, November 24, 2015.

[12] [1998] 1 C.T.C. 33.

[13] These include paragraph 53(1)(b), paragraph (j) of the definition of 'proceeds of disposition' in section 54, subparagraph 55(3.01)(d)(i), clause (a)(i)(A) and clause (a)(ii)(A) of the definition 'capital dividend account' in subsection 89(1).

[14] For a more detailed discussion of safe income on hand, please see Mark Brender, *Subsection 55(2): Then and Now*, Report of Proceedings of the Sixty-Third Tax Conference, 2011 Conference Report (Toronto: Canadian Tax Foundation, 2012), 12:1-35, and Janette Y. Pantry and Bill S. Maclagan, *Issues and Updates - Safe Income*, 2008 British Columbia Tax Conference, (Vancouver: Canadian Tax Foundation, 2008), 4:1-35.

[15] CRA document no. 9408795, July 20, 1994.

[16] In *Brelco Drilling Ltd. v. R.*, 99 D.T.C. 5253, the Federal Court of Appeal stated that “As noted above, in two recent decisions, unanimous panels of this Court have accepted that "safe income" means "safe income on hand"…”

[17] 2003 FCA 284.

[18] CRA *Income Tax Technical News* No. 33.

[19] John R. Robertson, *Capital Gains Strips: A Revenue Canada Perspective on the Provisions of Section 55*, in Report of Proceedings of the Thirty-Third Tax Conference, 1981 Conference Report (Toronto: Canadian Tax Foundation, 1982).

[20] CRA document no. 2000-0053165, December 11, 2000.

[21] CRA documents no. 2000-0003253, 2000, and 2007-0243161C6, October 5, 2007.

[22] The allocation is primarily based on the shares' entitlement to participate in earnings – see CRA documents no. 2002-0158885, November 4, 2002) and 2010-0388821E5, January 12, 2011.

[23] CRA document no. 2015-0610661C6, November 24, 2015.

[24] For example, see CRA Technical Interpretation 2010-0388821E5, January 12, 2011, and 2013-0503511E5, June 3, 2014.

[25] Based on English translation of CRA document no. 2015-0593941E5, December 3, 2015, provided by Canada Tax Service—McCarthy Tétrault.

[26] *Supra* notes 23 and 25.

[27] Subsection 230(4).

[28] 96 D.T.C. 6562.

[29] *Supra* note 5.

[30] *Ludmer c. Ministre du Revenu national*, 2001 SCC 62.

[31] CRA document no. 2015-0623551C6, November 24, 2015.

[32] CRA document no. 2015-0613821C6, November 17, 2015.

[33] 2005 D.T.C. 5095.

[34] *Supra* note 5.

[35] 2001 D.T.C. 5471, at paragraph 24, and 2004 D.T.C. 6475.

[36] 2005 D.T.C. 5523.

[37] 2001 D.T.C. 5471, at paragraph 36.

[38] *Supra note 36*, at paragraph 26.

[39] 2012 D.T.C. 5007, at paragraphs 47 and 56.

[40] *Canutilities Holdings Ltd. v R.*, 2004 D.T.C. 6475.

[41] Based on proposed amendment to subsection 129(1) and subsection 186(1) to change the dividend refund rate and Part IV tax rate from 33% to 38.33%, effective for tax years ending after 2015.

[42] *Ibid.*

[43] Provided that Holdco did not late-file its tax return for the year of the receipt of the re-characterized dividend by more than three years – see preamble of subsection 129(1).

[44] 2007 D.T.C. 661.

[45] *Supra* note 32.

[46] This is because paragraph 55(2.1)(a) requires the dividend recipient to be entitled to a deduction in respect of the dividend under subsections 112(1), (2) or 138(6).

[47] *1207192 Ontario Ltd. v. R.*, 2012 FCA 259, *Triad Gestco Ltd. v. R.*, 2012 FCA 258 and *Global Equity Fund Ltd. v. R.*, 2012 FCA 272.
[48] Due to new subsections 55(2.2), (2.3) and (2.4).
[49] Discussion of the trigger events in paragraph 55(3)(a) is beyond the scope of this paper. For a more fulsome discussion, see Rick McLean, *Splitting Up Private Companies*, 2014 Ontario Tax Conference, (Toronto: Canadian Tax Foundation, 2014), 10: 1-30. and Ted Citrome, *An Introduction to Paragraph 55(3)(a),* Report of Proceedings of Fifty-Eighth Tax Conference, 2006 Conference Report (Toronto: Canadian Tax Foundation, 2007), 36:1-31.
[50] *Supra* note 11.
[51] Paragraph 88(1)(d.1).
[52] *Supra* note 11.
[53] *Supra* note 32.
[54] *Supra* note 25..
[55] CRA document no. 2015-0595601C6, October 9, 2015.
[56] CRA document no. 2015-0610671C6, November 24, 2015.
[57] For a recent ruling by the CRA on loss consolidation arrangement, see CRA document no. 2015-0604071R3, 2015.
[58] *Supra* note 32.
[59] *Descarries v R.*, 2014 TCC 75 and *MacDonald v R.*, 2013 D.T.C. 5091.
[60] 2012 D.T.C. 5007.
[61] Subsections 104(21) and (21.2).
[62] In *Neuman v MNR*, [1998] 3 C.T.C. 177, the Supreme Court of Canada found that subsection 56(2) could not apply to dividends in a family income splitting situation.
[63] Pursuant to subsections 186(1) and 186(4), Part IV tax is not applicable if the payer corporation is controlled by the recipient corporation. Subsection 186(2) expands the definition of 'connected' to where a corporation is controlled by persons with whom the recipient corporation does not deal at arm's length. For trusts, *de jure* control is generally considered to rest with the trustee(s) of the trust.
[64] *Supra* note 25.
[65] Subsection 104(19) designation by the trust allows the character of the dividend to flow through to the beneficiary.
[66] CRA document no. 2014-0538061C6, October 10, 2014.
[67] Subparagraph 251.1(4)(d)(i) deems any discretionary beneficiary of a trust to be a majority-interest beneficiary. Therefore, a newly incorporated corporation that springs as a discretionary beneficiary automatically becomes a majority-interest beneficiary, potentially causing the trust to undergo a loss restriction event under subsection 251.2(2). Subsection 251.2(3) provides an exception where the acquisition of equity of the trust is by a person who was affiliated immediately before the acquisition, but the exception appears not to apply to a new corporation that springs as a beneficiary upon incorporation because it did not acquire equity of the trust and it was not affiliated immediately before that time. The other exceptions in subsection 251.2(3) also appear not to apply.
[68] These concerns have also been noted by the Joint Committee on Taxation of the Canadian Bar Association and the Chartered Professional Accountants of Canada in its submission to Finance dated October 15, 2013.
[69] The definition of ARA and the restriction for limited partner claiming losses up to ARA are contained in subsections 96(2.1) and (2.2). Losses that cannot be claimed by a partner due to lack of ARA is carried forward indefinitely and may be claimed when the partner has positive ARA, see paragraph 111(1)(e).
[70] 2016 TCC 10.
[71] Subsection 89(8) applies when a corporation ceases to be a CCPC. Generally speaking, subsection 89(8) adds to the corporation's LRIP the amount by which the tax cost of its assets less its liabilities and PUC exceeds its GRIP balance
[72] Variable D of the definition of low rate income pool in subsection 89(1).
[73] CRA document no. 2015-0610701C6, November 24, 2015.