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PROPOSED AMENDMENTS TO SECTION 55 CONTAIN UNWANTED SURPRISE

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Wolters Kluwer regularly features Dentons Canada LLP articles examining cases and topics of special interest.

The 2015 federal Budget proposes a significant overhaul of one of the most complex provisions in the *Income Tax Act* (Canada) (the "Act"), the "anti-capital gains stripping" rule in section 55. In addition to bringing in new rules to deal with certain stock dividend planning viewed as offensive by the Department of Finance ("Finance"), the proposed legislation eliminates an important safe harbour in the current rules by significantly restricting the conditions whereby a tax-free intercorporate dividend can be paid in a related-party context.

Section 55

Generally, section 55 seeks to prevent a taxpayer from stripping out the value of a corporation through intercorporate dividends that are effectively received tax-free due to the deduction available in section 112 of the Act. As a very basic example, suppose Mr. X held 100 common shares of Holdco and Holdco held 100 common shares of Opco. Mrs. Y has made an offer to purchase Opco for $100. Assuming that Holdco has no tax cost in the shares of Opco and Holdco has never had any income, Holdco will realize a $100 capital gain on the sale. However, if the value of Opco can be reduced through the payment of a tax-free intercorporate dividend out of redundant assets not needed in the business, then Holdco's gain will likewise be reduced. Subsection 55(2) can, under these circumstances, recharacterize the dividend as a capital gain to Holdco.

The rules in section 55 recognize that not all intercorporate dividends are offensive from a perspective of preventing gains stripping. In particular, "income earned or realized by any corporation after 1971" (known as "safe income") can generally be paid between corporations without fear of the application of section 55. What constitutes safe income is a matter of considerable interpretation, as the Act provides little assistance on this issue. The Canada Revenue Agency, for its part, has released numerous policy statements, technical interpretations, and advance tax rulings regarding its interpretation of safe income. The courts have not always agreed. Generally, it is assumed that tax-paid retained earnings of a corporation should constitute safe income for the purposes of section 55. As can be seen below, however, the determination of safe income will take on a far more significant meaning if the Budget proposals are enacted as announced.

The Carve-Outs

In general, the Act provides two broad exceptions to the application of subsection 55(2), in addition to the exclusion for dividends paid out of safe income. Under paragraph 55(3)(*a*), the "spin off" rule, an intercorporate dividend is generally excluded from the application of subsection 55(2) where as part of the series of transactions that includes the dividend there is no increase in an interest of the corporate payer by unrelated persons. In the context of closely held family corporations, where a married couple are the only shareholders, for example, this generally meant that ordinary course intercorporate dividends could be paid without consideration of safe income, as such dividends were "all in the family"— all shareholders were related for purposes of these rules and, therefore, paragraph 55(3)(*a*) would apply.

The other exception to subsection 55(2), namely, the "butterfly exception" under paragraph 55(3)(*b*), could generally apply in an unrelated context, but requires, *inter alia*, a *pro rata* distribution of the assets being transferred between corporations. Each of the two exceptions is complex and requires a careful review of all circumstances and transactions, as numerous exclusions can apply resulting in a dividend being recharacterized as a capital gain. An examination of paragraphs 55(3)(*a*) and (*b*) and related provisions is beyond the scope of this article.

The 2015 Budget

Budget 2015 proposed fairly major changes to the application of subsection 55(2) to intercorporate dividends. In particular, subsection 55(2) can now apply if one of the purposes of a dividend is: (i) to reduce a capital gain (in the case of a deemed dividend under subsection 84(3), the test is result-based, rather than purpose-based); (ii) to effect a reduction in the fair market value of a share; or (iii) to effect significant increase in the cost of properties owned by the dividend recipient. In addition, a new series of rules is being introduced to counter what was viewed by the government as an inappropriate result regarding the use of "high-low" stock dividends to reduce ultimately the value of any share or to increase the tax cost of a property. In essence, the ordinary rule that the "amount" of a stock dividend is equal to the paid-up capital of the shares used to pay the dividend is being modified for purposes of intercorporate dividends. For such dividends, the amount will be the greater of the paid-up capital of the shares and the fair market value. The consequence of this change is that "value-shifting" transactions involving the use of high-low stock dividends paid between corporations will now be subject to the application of subsection 55(2) if the remaining conditions are met.

If Opco in the above example paid a stock dividend of preferred shares to Holdco, Holdco could be deemed to realize a gain if the amount of the dividend (which would be either the fair market value of the shares received or their paid-up capital, whichever is greater) exceeds Opco's safe income and the purpose of the dividend is to reduce the value of the Opco common shares. It is expected that these changes, if enacted, will eliminate the particular form of tax planning through the use of stock dividends that the government found objectionable.

Amended Paragraph 55(3)(*a*) — A Hidden Danger?

The other significant change under discussion here, however, is targeting a less obvious form of perceived abuse. The paragraph 55(3)(*a*) exception, discussed briefly above, is being limited in its application solely to deemed dividends arising under subsection 84(3). Ordinary dividends paid in cash or other property (e.g., a note accepted as payment) are no longer protected under the related party safe harbour.

The implications of this amendment, which was included in the Budget papers effectively without comment by Finance, are wide reaching. Any intercorporate dividend is now potentially subject to the application of subsection 55(2) even where there is no unrelated party involved. Since paragraph 55(3)(*a*) will no longer apply to normal course dividends, taxpayers and their advisers must now consider whether the payer corporation has sufficient safe income on hand to support the dividend being paid. Given the overall uncertainty on the calculation of safe income, this change appears to result in a new area of significant uncertainty for taxpayers. Where there is insufficient safe income, taxpayers will be forced to rely on one of the purpose tests in order to escape the application of subsection 55(2).

From a policy perspective, this appears to be an inappropriate result. The paragraph 55(3)(*a*) exemption recognizes that within related groups, there is little mischief that can be achieved by paying dividends through an arbitrarily long chain of companies. Moreover, subject to the potential application of the general anti-avoidance rule, this limitation can easily be overcome through the conversion of shares to preferred shares which are then redeemed to achieve the same result within the protection of paragraph 55(3)(*a*). What Finance is seeking to achieve with this amendment is unclear. What is clear is that, if enacted, these changes will increase the costs to taxpayers of paying an ordinary dividend, as a safe income calculation will be required in each case.

We note that the first Budget bill, Bill C-59, introduced on May 7, 2015, did not contain the proposed amendments to section 55.

A number of tax lawyers from Dentons Canada LLP write commentary for Wolters Kluwer's Canadian Tax Reporter *and sit on its Editorial Board as well as on the Editorial Board for Wolters Kluwer's* Income Tax Act with Regulations, Annotated. *Dentons Canada lawyers also write the commentary for Wolters Kluwer's* Federal Tax Practice *reporter and the summaries for Wolters Kluwer's* Window on Canadian Tax. *Dentons Canada lawyers wrote the commentary for* Canada–U.S. Tax Treaty: A Practical Interpretation *and have authored other books published by Wolters Kluwer:* Canadian Transfer Pricing *(2nd Edition, 2011);* Federal Tax Practice; Charities, Non-Profits, and Philanthropy under the Income Tax Act; *and* Corporation Capital Tax in Canada. *Tony Schweitzer, a Tax Partner with the Toronto office of Dentons Canada LLP and a member of the Editorial Board of Wolters Kluwer's* Canadian Tax Reporter, *is the editor of the firm's regular monthly feature articles appearing in* Tax Topics.

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CURRENT ITEMS OF INTEREST

Canada Signs the Multilateral Competent Authority Agreement

On June 2, 2015, Minister Findlay signed the *Multilateral Competent Authority Agreement* ("MCAA"), which will set the stage for the automatic exchange of financial information with international partners commencing in 2018. This was one of the measures presented in the April 21, 2015 Budget. Canada is one of more than 90 jurisdictions that have, to date, committed to implementing the Common Reporting Standard. As of May 2015, a number of jurisdictions, including Germany, the United Kingdom, and France, have signed the MCAA.

Justice Canada Appoints Two New Tax Court Judges

The Honourable Don R. Sommerfeldt, a counsel with Dentons Canada LLP in Edmonton, is appointed a judge of the Tax Court of Canada, to replace Madam Justice G. Sheridan, who resigned effective May 1, 2014.

The Honourable Henry A. Visser, a lawyer with McInnes Cooper in Halifax, is appointed a judge of the Tax Court of Canada, to replace Madam Justice D. Campbell, who elected supernumerary status as of June 19, 2015. This appointment is effective June 19, 2015.

RECENT INCOME TAX INTERPRETATIONS

This is a regular feature summarizing recent noteworthy income tax interpretations issued by the Minister of National Revenue. Copies of these interpretations can be found in the Wolters Kluwer online Federal Income Tax service, under Window on Canadian Tax.

Paid-Up Capital of an LLC

The Canada Revenue Agency ("CRA") was asked how one determines the paid-up capital of an investment in a limited liability company ("LLC") in assessing whether an election could be made to receive a tax-free return of capital. The CRA noted that the starting point is the law of the jurisdiction under which the LLC is organized. If that does not provide for stated capital in a manner similar to Canadian corporate law, the investment in the LLC has no paid-up capital.

— *External Technical Interpretation, International Division, ¶12,986*

Marital Status where Partner Has Alzheimer's Disease

A taxpayer with Alzheimer's disease was confined to a nursing home and did not recognize his or her spouse, whose contact was limited to visits to ensure that care was being given and to tend to financial matters. The CRA advised it was a question of fact whether the relationship had broken down and, therefore, how marital status was to be reported.

— *External Technical Interpretation, Business and Employment Division, ¶12,987*

Foreign Exchange Loss on Wind-Up of Foreign Affiliate

The CRA had previously advised that paragraph 69(5)(*d*) provided that the stop-loss rule in subsection 40(3.6) did not apply to deny a loss on the wind-up of a foreign affiliate. In a follow-up interpretation, noting that subsection 88(3) specifically excludes paragraph 69(5)(*d*) from applying to a winding-up, the CRA was still of the view that subsection 40(3.6) would not apply, as the foreign affiliate and the parent would not be affiliated after the wind-up.

— *Internal Technical Interpretation, International and Large Business Directorate, ¶12,999*

Crowdfunding

Confirming previously issued interpretations, the CRA remains of the view that funds received by crowdfunding could be either a loan, a contribution of capital, a gift, or revenue from a business. This policy might change should security regulatory authorities develop rules to govern crowdfunding.

— *Internal Technical Interpretation, Business and Employment Division, ¶13,001*

RECENT CASES

Changes made to printer after being brought to market qualified for SR&ED credits

The taxpayer began to develop a miniature wireless portable printer in 2006 and was granted scientific research and development investment tax credits ("SR&ED ITCs") for 2006, 2007, and 2008. The objective for the printer was for it to be able to print 20 pages on one battery charge. It was brought to market in 2008 but more than 50 complaints were received, that the paper was curling and the battery was not lasting. Changes were made in 2009 and 2010. The taxpayer was denied an SR&ED credit for 2009 and 2010 on the basis that there were no longer technological uncertainties, the work done was routine engineering, and, for 2010, the taxpayer failed to file the prescribed forms on time.

The appeals from the assessments were allowed. Mr. Raja Tuli, the chief executive officer of the taxpayer, is the world's leading expert with respect to the miniaturization of high-tech equipment. He was a very credible witness. To qualify for the SR&ED credit there must be a scientific or technological uncertainty, a systematic investigation by experiment or analysis must be carried out, and the work must be undertaken to achieve technological advancement. The respondent argued that by bringing the printer to market there were no longer technological uncertainties but bringing the printer to market did not preclude technological uncertainty, as problems continued to exist. Tuli testified as to the detailed systematic investigations carried out to solve the curling and battery issues. It would have been helpful to have documentation detailing the investigations, but Tuli provided the detailed steps undertaken. They defined the problems, that of curling paper and a reduced battery life, put forward hypotheses for solving the problems, and conducted numerous experiments to try to resolve the problems. A new clutch design improved the curling issue and a new printer driver was developed that helped improve the battery life. Those were technological advancements that improved the printer and qualified for SR&ED credits. The work done was not just routine engineering. There was mainly hearsay evidence as to whether the prescribed information (a scientific report) was filed in a timely fashion. The appeals officer testified that the report was not attached to the return although it is possible that it had been detached. The respondent claimed it sent a letter to the taxpayer that the report had not been filed but it did not file that letter as evidence. Letters were filed by the taxpayer indicating that the report had been filed. Given that the 2010 return indicated a loss and the SR&ED credit was a major incentive, it is hard to believe that the report would not have been filed. On a balance of probabilities, there was no reason to doubt Tuli's testimony that the papers were filed in a timely fashion.

¶49,062, *6379249 Canada Inc.*, 2015 DTC 1109

Denied dividend refund amount not to be used in calculating dividend refund for future years

The taxpayer was appealing a reassessment that denied amendments to his tax returns to allow for a greater dividend refund ("DR"). The taxpayer was a Canadian-controlled private corporation which had paid taxable dividends to its shareholders in 2007, 2008, 2010, and 2011. Its DR claims for 2010 and 2011 were assessed as claimed in February 2012. The taxpayer had calculated its DR claims for 2010 and 2011 on the basis that it would receive a DR for 2007 and 2008. Its DR claims for 2007 and 2008 were denied in March 2012, as it had filed those returns late. In assessing the taxpayer's 2010 and 2011 returns, the MNR deducted the amount of the denied DR from 2007 and 2008 from the refundable dividend tax on hand ("RDTOH") account. The taxpayer was appealing, arguing that as it did not receive a DR in 2007 and 2008, the denied amounts should not reduce the RDTOH account.

The appeal was allowed with costs. The statutory scheme involving DRs and RDTOH accounts is complex and technical. Its purpose is to prevent the deferral of tax by earning income inside a corporation and to have integration of tax between a corporation and its shareholders. Its goal is to have neutrality whether one earns investment income inside a corporation or earns it personally. A corporation's RDTOH account is a notional account that determines the maximum amount of a DR that a corporation may receive on its payment of taxable dividends to its shareholders. The DR for preceding years is a component of the RDTOH calculation. The DR is an amount available for monetary refund or credit when certain conditions are met: (a) that taxable dividends are paid; and (b) that tax returns are filed within three years. The respondent argued that the DR is a notional calculation and even though the amounts were denied for the taxpayer's 2007 and 2008 years, the amounts should be used in calculating the RDTOH account. It also argued that there would be no limits on integration if the taxpayer's argument prevailed. In actuality, there are limits, as the DR is only available if the conditions are filed. If the DR is not available to a taxpayer, there are consequences. There is double taxation, as the corporation does not get a DR and the shareholder does not get credit for the tax paid. The corporation is also liable for late-filing penalties and arrears interest. Based on a textual, contextual, and purposive analysis, the definition of a DR is an amount actually received and not a notional amount. While the RDTOH account is notional, the components comprising the RDTOH, such as the DR, is not notional. As the taxpayer did not receive a DR in 2007 and 2008, those denied amounts cannot be used to reduce the RDTOH calculation for 2010 and 2011. The taxpayer was entitled to the higher DR for 2010 and 2011.

¶49,064, *Nanica Holdings Limited*, 2015 DTC 1111

CORRECTION

In "Providing for the Disabled Beneficiary — Part II" in *Tax Topics* No. 2256, we incorrectly noted that a $1 Canada Disability Savings Grant is afforded for each $10 contributed by a high-income family, to a maximum of $1,000 a year. In fact, grants are provided on a dollar-for-dollar basis to a maximum of $1,000 per year for high-income families. Thanks to Joe Krizmanic for bringing this to our attention.

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