Canadian Bar Association

Chartered Accountants of Canada
Comptables agréés du Canada

The Joint Committee on Taxation of The Canadian Bar Association and The Canadian Institute of Chartered Accountants

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March 7, 2007

Mr. Gerard Lalonde
Acting Director
Tax Legislation Division
Tax Policy Branch
Department of Finance
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140 O'Connor Street
Ottawa, Ontario
K1A 0G5

Dear Mr. Lalonde:

<u>Bill C-33—Proposed Amendments to Paragraphs 52(3)(a) and 53(1)(b)</u>

The enclosed submission sets out the Joint Committee's concerns and suggestions with respect to the proposed amendments to paragraphs 52(3)(a) and 53(1)(b) of the *Income Tax Act* (Canada) contained in Bill C-33. The submission is substantially the same as the draft submission that was provided to you on February 2, 2007.

Our principal concern is that the proposed amendments are unduly broad. They are not limited to transactions that could be considered to produce abusive tax results, but rather apply to all stock dividends and to all deemed dividends arising from the conversion of contributed surplus to paid-up capital. Consequently, the proposed amendments will, if enacted, prevent the implementation of certain routine tax planning steps. As explained in the submission, the rationale for the amendments continues to be unclear to us.

We trust that our comments and suggestions will be helpful. If you do not concur with our concerns expressed in the submission, we would like to meet with you and your colleagues to discuss these concerns further.

Lastly, we would like to acknowledge the time that your colleagues have taken to discuss these amendments with us, and thank them for doing so.

Yours truly,

Bruce Harris, CA
Chair, Taxation Committee
Canadian Institute of Chartered Accountants

William R. Holmes
Chair, Taxation Section
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c: Brian Ernewein – Department of Finance
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Submission of the
CICA-CBA Joint Committee on Taxation
Regarding Proposed Amendments to Paragraphs 52(3)(a) and 53(1)(b)

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A. Introduction

This submission sets out the concerns and suggestions of the Joint Committee with respect to the proposed amendments to paragraphs 52(3)(a) and 53(1)(b)[1] contained in Bill C-33, which received first reading in the House of Commons on November 22, 2006.

Paragraph 52(3)(a) deems the cost of shares received as a stock dividend to equal the amount of the stock dividend. The amendment to this paragraph would provide for a stock dividend received by a corporation to have a nil cost to the extent that the dividend is deductible by the corporation under subsection 112(1).

Paragraph 53(1)(b) adds to the adjusted cost base (**"ACB"**) of shares the amount of any dividend deemed by subsection 84(1) to have been received on the shares. The amendment to this paragraph would exclude a deemed dividend received by a corporation if the dividend is deductible by the corporation under subsection 112(1) and arose directly or indirectly on the conversion of contributed surplus into paid-up capital (**"PUC"**).

B. Purpose of Proposed Amendments

The purpose of the proposed amendments is not clear from the amendments themselves. According to the Explanatory Notes to the Notice of Ways and Means Motion of November 9, 2006 that preceded Bill C-33, the amendments are consequential to revisions to the expenditure limitation proposals in proposed section 143.3 which were released for consultation on November 17, 2005. This does not provide any insight into the purpose of the amendments.

Based on a discussion with officials of the Department of Finance (**"Finance"**), our understanding is that the amendments are intended to address a fairly narrow concern: Finance wants to ensure that there can be no inappropriate increase in outside basis after a tax-deferred transfer of property to a corporation under section 85.

The following is an example of an increase in outside basis that we understand is to be prevented by the amendments. A corporation, ACo, transfers appreciated capital property to another corporation, BCo, for consideration consisting solely of shares of BCo. The

[1] Statutory references in this submission are to the *Income Tax Act* (Canada) (the **"Act"**), except as otherwise indicated.

parties elect under subsection 85(1) to have the transfer occur at an agreed amount equal to the ACB of the property. This agreed amount is the cost of the transferred property to BCo and the cost to ACo of the BCo shares received as consideration. Following this transaction, ACo is connected with BCo. Subsequently, BCo pays a stock dividend to ACo equal to the excess of the fair market value of the transferred property over its tax cost. Pursuant to subsection 52(3), the stock dividend shares have a cost to ACo equal to this excess. The end result is that ACo holds shares of BCo with an aggregate ACB equal to the fair market value of the property it transferred to BCo, without any gain having been realized and without the dividend having been taxed (since ACo can deduct the dividend under subsection 112(1) and it is not subject to Part IV tax).

C. Concern with Amendments

The Joint Committee's fundamental concern with the proposed amendments is that they are not limited to transactions that could be considered to produce abusive tax results. Rather, they apply to *all* stock dividends and to *all* deemed dividends arising from the conversion of contributed surplus to PUC. The amendments, if enacted in their present form, will prevent taxpayers from implementing routine transactions in an efficient way or, in some cases, at all. There cannot be any justification for such broad-reaching amendments that will place a roadblock in the way of taxpayers who want to undertake acceptable transactions.

A common situation where stock dividends are used is to distribute retained earnings without the distribution of cash. For example, a private corporation may pay a stock dividend in order to recover refundable dividend tax on hand. With the introduction of the enhanced dividend tax credit, a Canadian-controlled private corporation may now want to pay a stock dividend in order to distribute its "general rate income pool" to its shareholders.

Stock dividends are also used in connection with "safe income crystallizations". These transactions increase outside basis to reflect the income earned or realized (as defined in subsection 55(5)) by the corporation paying the stock dividend or by corporations in which it holds a direct or indirect interest.[2] Safe income crystallizations are generally undertaken in anticipation of the sale of shares.

As an alternative to paying stock dividends, corporations sometimes pay dividends for tax purposes by increasing their stated capital. The increase in stated capital may involve, in whole or in part, a conversion of contributed surplus as described in amended paragraph 53(1)(b). An increase in stated capital may be used, for example, to implement a safe income crystallization.

[2] The Explanatory Notes to paragraphs 88(1)(c.3) to (c.5) describe a safe income crystallization transaction implemented by way of an increase in paid-up capital. One purpose for the addition of these paragraphs was to ensure that the paragraph 88(1)(c) bump would be available to a purchaser who acquires shares from a vendor who has implemented a safe income crystallization.

It is acknowledged that it is not essential that a corporation be able to pay a stock dividend or convert contributed surplus to PUC in order to increase the basis in its shares. This result could also be achieved if a corporation were to pay a dividend in cash or by way of a promissory note, and the shareholders receiving the dividend were then to acquire new shares of the corporation. However, such transactions are generally not as convenient to implement. In particular, in the case of a cash dividend, it may be necessary for daylight loan financing to be obtained. Furthermore, there may be a concern as to whether all the shareholders will subscribe for new shares of the corporation.

D. What is the Problem?

We would like to propose alternative amendments to address Finance's concern. However, the difficulty we have encountered is that it is not at all apparent what specific tax-planning manoeuvres the proposed amendments are intended to counteract. As noted above, we believe that Finance is concerned with steps taken to obtain an inappropriate increase in outside basis after a rollover of property to a corporation. However, this requires a determination of when it is inappropriate for outside basis to be increased. It does not follow from the mere fact that property has been rolled to a corporation that any subsequent increase in outside basis should be disallowed. For example, if a corporation pays a stock dividend to a corporate shareholder and the stock dividend is attributable to the corporation's tax-retained earnings, there should not be any objection to the stock dividend shares having a cost to the taxpayer.

To determine when an increase in outside basis of a corporation is inappropriate, the focus must be on the tax benefit that is achieved by virtue of the additional basis. The tax benefit is a reduction in a capital gain that would otherwise be realized on a disposition of shares of the corporation. Where a stock dividend is used to increase outside basis, other shares held by the dividend recipient (or by other shareholders) will decrease in value, and hence any unrealized capital gain on those other shares will be reduced. Where the increase in outside basis is produced by a PUC increase, there is a reduction in the unrealized capital gain on the shares whose PUC is increased. In either event, the increase in outside basis should be considered inappropriate only if the consequent actual or potential reduction in capital gain is inappropriate. We know from the proposed amendments that Finance is concerned only where the increase in outside basis is associated with a tax-free inter-corporate dividend (actual or deemed). Thus, whatever Finance's specific concern may be, the concern involves two key elements: a tax-free inter-corporate dividend and a resulting reduction in a capital gain.

There is already a set of rules in the Act—the anti-avoidance rule in subsection 55(2) and the related rules in section 55—that apply with respect to reductions of capital gains associated with the payment of inter-corporate tax-free dividends.[3] We therefore

[3] Where subsection 55(2) applies with respect to a stock dividend, the stock dividend shares will have a cost of nil. This result follows because paragraph 55(2)(a) deems the stock dividend not to be a dividend, and so the cost of the shares is deemed by paragraph 52(3)(a.1) to be nil. Similarly, a dividend deemed to be paid by virtue of an increase in PUC does not result in an increase in the ACB of the shares.

conclude that Finance must be of the view that subsection 55(2) does not apply to some situations that Finance regards as abusive. We have not been able to ascertain, either from public material or from our discussion with Finance officials, what specific deficiencies Finance has identified in section 55.

Assuming our conclusion is correct, amending provisions other than section 55 to address the deficiencies does not seem appropriate to us. Section 55 contains a complex set of rules that reflect a number of tax policy principles. Without a considerable amount of overlap or duplication, amendments made to other provisions will not also reflect those principles. This is the fundamental problem with the proposed amendments. One of the most important principles underlying subsection 55(2) is that a tax-free inter-corporate dividend is not offensive if the capital gain that is reduced is attributable to “safe income”. The proposed amendments do not reflect this principle at all. Another principle underlying subsection 55(2) that is not reflected in the proposed amendments is that an inter-corporate dividend is not considered abusive to the extent that the dividend is subject to unrefunded Part IV tax.

While the proposed amendment to paragraph 53(1)(b) is more limited than the proposed amendment to paragraph 52(3)(b), in that it is restricted to situations where contributed surplus is converted to PUC, this restriction is not adequate to ensure that the amendment is consistent with subsection 55(2). Where contributed surplus is recorded in connection with the transfer of property to a corporation on a tax-deferred basis, the contributed surplus will remain in the corporation’s financial statements even after the corporation has subsequently disposed of the property and realized a gain. The contributed surplus will not be replaced by retained earnings. Thus, it does not necessarily follow from the fact that a corporation has contributed surplus that arose on a rollover of property to the corporation that a conversion of that contributed surplus to PUC is offensive. For example, assume that a corporation, XCo, transfers shares of another corporation, TCo, to a third corporation, YCo, solely for shares of YCo. The ACB of the TCo shares to XCo is $100 and their fair market value is $1,000. XCo and YCo elect under section 85 at an agreed amount of $100. Assume further that YCo accounts for the transaction by recording $100 of share capital and $900 of contributed surplus.[4] YCo subsequently sells its shares of TCo for $1,000. No amount would be recorded under generally accepted accounting principles in YCo’s income or retained earnings in respect of this sale, nor would the $900 of contributed surplus be transferred to YCo’s retained earnings. In these circumstances if, following the sale of the shares of TCo, YCo were to convert the $900 of contributed surplus into paid-up capital of the shares held by XCo, the proposed amendment to paragraph 53(1)(b) would apply with the result that no amount would be added to the ACB of the shares of YCo. We submit that this is inappropriate since the contributed surplus would correspond to a gain that has been realized for tax purposes.

The proposed amendments would apply only with respect to two types of dividends, namely stock dividends and deemed dividends resulting from the conversion of

[4] It has been assumed in this example that XCo and YCo are not related parties for accounting purposes. Also, the accounting for future income taxes related to the transfer has been ignored.

contributed surplus to PUC. If subsection 55(2) fails to apply to such dividends in certain circumstances in which it should apply, then the same must be true for other dividends paid or deemed to be paid in those circumstances. As noted above, outside basis can be increased by the payment of a cash dividend or a dividend paid by way of a promissory note, followed by the acquisition of shares with the cash or the note. It can also be increased by a PUC increase that does not involve the conversion of contributed surplus. Presumably, some or all of these other methods for increasing outside basis must give rise to the same concern as the methods to which the proposed amendments apply. Amendments made to section 55 would apply to all types of dividends.

E. Amendment to Definition of CDA

We also have a concern with the consequential amendment that would require a taxpayer's capital dividend account to be determined without reference to the amendments to paragraphs 52(3)(a) and 53(1)(b). No clear explanation has been provided as to why this amendment is required. The Explanatory Notes merely state that it ensures that subparagraphs 52(3)(a)(ii) and 53(1)(b)(ii) "cannot be used in conjunction with a capital dividend election to convert corporate surplus into capital gains upon which a capital dividend election could be made." Discussion with Finance officials has not helped to shed any further light on the specific concern intended to be addressed by the amendment. In our view, subject to further information being provided by Finance, we do not believe that a case has been made for amending the definition of capital dividend account, nor have we been able to discern any rationale for doing so.

F. Dividends / PUC Increases / Contributed Surplus

It appears from our discussions with Finance officials that the corporate law principles governing the payment of dividends and the increase of stated capital may not be fully understood. This observation also applies with respect to generally accepted accounting principles (**"GAAP"**) regarding the recognition of contributed surplus. Since these principles are part of the background against which the proposed amendments were developed, we have included a discussion of them.

The following discussion of corporate law is limited to the *Canada Business Corporations Act* (the **"CBCA"**) and the *Business Corporations Act* (Ontario) (the **"OBCA"**). However, the discussion is also relevant with respect to other provinces that have adopted the same corporate law model.

1. Conditions for Payment of Dividends

Under the CBCA and the OBCA, a corporation may pay a cash dividend or a dividend in kind if both a liquidity test and a solvency test are met[5]. There are no other requirements

[5] CBCA, subsection 43(1) and section 42; OBCA, section 38.

that need to be satisfied. In particular, there is no requirement that a corporation have retained earnings or contributed surplus from which to pay a dividend.

It is generally understood that there is no restriction on the payment of stock dividends.[6] The declared amount of the dividend must be added to the stated capital account for the class of shares issued in payment of the dividend.[7]

2. Increase in PUC of Shares When No Additional Shares Issued

Under the CBCA and the OBCA, a corporation is permitted to add to its stated capital account for a class of shares "any amount it credited to a retained earnings or other surplus account."[8]

3. Contributed Surplus

Contributed surplus is an accounting concept, not a corporate law concept. The Canada Revenue Agency (**"CRA"**) agrees with this. In a technical interpretation relating to paragraph 84(1)(c.3), the CRA stated: "The term 'contributed surplus' is not defined in the Act. It is our view, however, that the meaning of 'contributed surplus' should be based on its meaning under generally accepted accounting principles."[9]

Paragraph 3251.03 of the CICA Handbook contains the following definition of "contributed surplus":[10]

> **Contributed surplus** comprises amounts paid in by equityholders. Contributed surplus in the form of surplus paid in by equityholders includes premiums on shares issued, any portion of the proceeds of issue of shares without par value not allocated to share capital, gain on forfeited shares, proceeds arising from shares donated by equityholders, credits resulting from redemption or conversion of shares at less than the amount set up as share capital, and any other contribution by equityholders in excess of amounts allocated to share capital.

Where a corporation transfers property to another corporation (the "transferee") in exchange for shares of the transferee, the amount of contributed surplus recorded by the transferee is therefore equal to the excess of (i) the amount at which the transferred property is recorded in the accounts of the transferee, over (ii) the amount added to the transferee's share capital for financial statement purposes in respect of the issuance of the shares. If the first amount equals the second, no contributed surplus is recorded.

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[6] Kevin McGuinness, *The Law and Practice of Canadian Business Corporations* (Toronto: Butterworths, 1999), p.425.

[7] CBCA, subsection 43(2); OBCA, subsection 38(2).

[8] CBCA, subsection 26(6); OBCA, subsection 24(5).

[9] CRA Document No. 2002-0146655, dated October 30, 2002.

[10] A substantially similar definition of "contributed surplus" in paragraph 3250.05 of the CICA Handbook continues to apply to some corporations for a transitional period.

Under GAAP, the amount at which transferred property is recorded by the transferee corporation is determined as follows. If the transferor and transferee corporations are not related parties[11], the transferee records the property at the price paid for it or the fair market value of the property if different from the amount paid. If the corporations are related parties, the general rule is that the transferee must record the property at the transferor's carrying amount. As exceptions to this rule, the property is recorded at the exchange amount (the price paid for the property) if (i) the transfer occurs in the normal course of operations, or (ii) there is a substantial change in ownership interest in the property and the exchange amount is supported by independent evidence.

The general rule under GAAP is that when a corporation issues shares in exchange for property, the amount to be added to the corporation's financial statement share capital is equal to the amount at which it records the property. However, the corporation is permitted to add a smaller amount. The amount added to share capital for financial statement purposes will not necessarily equal the amount added to stated capital for corporate law purposes (and hence to PUC for tax purposes).

The following example illustrates the above. Assume that corporation XCo transfers shares of another corporation, TCo, to a third corporation, YCo, solely for shares of YCo. ACo's carrying amount and ACB of the TCo shares is $100. The shares have a fair market value of $1,000 at the time of transfer. XCo and YCo elect under subsection 85(1) at $100. If XCo and YCo are not related parties for purposes of GAAP, YCo would record its investment in TCo at $1,000.[12] YCo would either add $1,000 to its share capital, in which case it would not record any contributed surplus, or it would add only $100 to its share capital (so as to keep the share capital consistent with PUC for tax purposes), in which case it would record contributed surplus of $900.

If XCo and YCo are related parties for GAAP purposes, then YCo would record its investment in TCo at either $100 or $1,000, depending on the circumstances as described above. For example, YCo would be required to record its investment in TCo at $100 if YCo is a wholly-owned subsidiary of XCo. If the investment is recorded at $100, then YCo would add $100 to its share capital, and would not record any contributed surplus. If the investment in TCo is recorded at $1,000, then YCo's options for recording share capital and contributed surplus would be the same as for a transaction between non-related parties.

The key point to be drawn from the above is that the recording of contributed surplus is optional. For financial statement purposes, a corporation can add the full amount received

[11] The concept of related parties is defined in paragraph 3840.03 of the CICA Handbook. It is broader than the concept of related for purposes of the Act. For example, it includes situations where one entity has significant influence over another.

[12] Recording the investment at $1,000 is not technically accurate under GAAP. Under section 3465.43 of the CICA Handbook, if the tax basis is less than the amount recorded for accounting purposes then it is necessary to book the future income tax related to the asset at the time of acquisition. The accounting for the future income taxes related to the transfer has been ignored in this example.

in exchange for the issuance of shares (measured on an accounting basis) to the share capital for the shares. Alternatively, if it so chooses, it can add a smaller amount, in which case the difference will be recorded as contributed surplus.

G. Summary

The proposed amendments are unduly broad, and will interfere with acceptable tax planning steps. We are not able to suggest any alternative to the amendments, since Finance has not clearly identified the specific concerns the amendments are intended to address. It is apparent, however, that whatever the concerns may be, they must relate to perceived deficiencies in subsection 55(2) or in section 55 more generally. That being the case, we recommend that the proposed amendments be replaced by amendments that are targeted at those deficiencies. This will ensure that the amendments do not depart from the principles underlying section 55.

If this recommendation is not accepted, then we recommend as an alternative that suitable limitations be placed on the proposed amendments to paragraphs 52(3)(a) and 53(1)(b) so that they apply only to inappropriate stock dividends and conversions of contributed surplus. If this approach is followed, the principles underlying subsection 55(2) should be used as a guide to determine the limitations to place on the amendments. In particular, the amendments should not apply with respect to dividends that can be considered to have as a result the reduction of capital gains that are attributable to safe income, nor should they apply with respect to dividends that are subject to Part IV tax. As a further limitation, the amendments should apply only after property has been transferred to a corporation on a tax-deferred basis.

Lastly, we recommend that the proposed amendment to the definition of CDA not be proceed with. There does not seem to be any persuasive need for this amendment.

March 7, 2007