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

Chartered Professional Accountants of Canada, 277 Wellington St. W., Toronto Ontario, M5V3H2
The Canadian Bar Association, 500-865 Carling Avenue Ottawa, Ontario K1S 5S8

May 27, 2015

Ms. Alexandra MacLean
Director, Tax Legislation Division, Tax Policy Branch
Department of Finance
L'Esplanade Laurier, East Tower
140 O'Connor Street, 17th Floor
Ottawa, ON K1A 0G5

Dear Ms. MacLean:

Re: 2015 Federal Budget -- Amendments to Section 55

We would like to thank you, Davine, Kerry and Robert for taking the time to speak with us recently. We believe that the conversation was very productive, and helped us to gain insight into the policy concerns which prompted the proposed amendments to section 55.

As we discussed, the purpose of this submission is to set out the more fundamental concerns we have with the proposed amendments. We have also set out an alternative approach to amend section 55 in a manner that could address many of our concerns while at the same time addressing what we understand to be the Department's concerns. We have prepared the attached submission in summary format so that we could put our concerns in front of the Department on a timely basis; however, we would be pleased to send you more detailed submissions on any specific matters that you believe warrant elaboration.

Based on our telephone conversation, we have been guided in developing our alternative approach by our understanding of the following general principles:

- the proposed amendments to section 55 are, in large part, a response to the planning that is contemplated in the recent decision in *D&D Livestock*;

- the proposals are not intended to prejudice, or to create uncertainty in respect of, normal cash movements within Canadian corporate groups or conventional loss consolidation structures; and

- section 55 is today, and should continue to be, an anti-avoidance provision that applies to transactions that would otherwise give rise to an inappropriate result; the proposals are not intended to convert section 55 into a general rule of mechanical application.

We understand the Department's desire to address the planning in *D&D Livestock* through legislative changes to section 55 (although, as we discussed, we believe that much of that type of planning could otherwise be challenged successfully under the general anti-avoidance rule). However, the amendments as currently proposed may have inadvertently affected routine, every day cash movements within Canadian corporate groups. In particular, the addition of proposed subparagraph 55(2.1)(b)(ii), together with the removal of cash dividends from the exception in paragraph 55(3)(a), has created significant uncertainty in the tax community. These concerns have been expressed to us in relation to a broad spectrum of non-abusive transactions, ranging from small owner-manager situations to transactions involving large, Canadian, public corporations. Absent tax consolidation, the ability to move funds within a corporate group on a tax-free basis is a practical necessity. In addition, the cost of maintaining current safe income calculations would add significantly to the tax compliance burden faced by Canadian businesses; under the proposals (particularly the change to paragraph 55(3)(a)) the safe income safe harbour may now be required in many internal dividend transactions.

Our group believes that, since the enactment of subsection 55(2) in 1980, the provision has operated in a fair and balanced manner to deter inappropriate surplus-stripping transactions. There is significant experience dealing with subsection 55(2) as it currently reads within both the tax community and the Canada Revenue Agency (the "CRA"). While the text of subsection 55(2) itself is difficult to parse, this experience has led to a general understanding of the effect of the provision and a satisfactory degree of certainty in respect of the dividends-received deduction that is a cornerstone of the Canadian tax system. Furthermore, in the context of a rule that imposes a low threshold "one of the purposes" test, a meaningful component of this certainty for taxpayers in many circumstances has come from paragraph 55(3)(a) (especially given the very significant consequences that may result from the unexpected application of subsection 55(2)). Accordingly, our approach has been to preserve this aspect of the legislation to the extent possible, and to try to address your concerns with the addition of a more targeted anti-avoidance provision.

Finally, we also note that the proposals have a number of more technical problems relating to, for example, double taxation or over-inclusion of income arising from the removal of existing paragraph 55(2)(b). Some of these issues arise from the attempt to have one rule apply to both "gain shares" and "loss shares".

To this end, the basic framework of our approach is to: (i) leave existing subsection 55(2) mostly unchanged;[1] (ii) create a broad anti-avoidance rule to curtail the planning contemplated in *D&D Livestock* (and similar planning); and (iii) reinsert cash dividends (and all deemed dividends) into paragraph 55(3)(a). Given the critical importance of the statutory provisions involved, if your Department believes that there are concerns with cash dividends under paragraph 55(3)(a) in a gain share scenario that have not been addressed in our proposed new anti-avoidance "loss share rule", we would appreciate the opportunity to continue our dialogue with you to create a separate rule (or to augment our anti-avoidance "loss share rule") with a view to fully addressing your concerns.

We understand that the CRA has reviewed the proposals and may be willing to assist with the interpretation of the purpose test in particular circumstances. This is obviously a welcome development. In our view, however, the wording of the legislation should nevertheless be narrowed in focus, so that it may accomplish your Department's objectives while at the same time allowing taxpayers to interpret the provisions in a reasonable and predictable manner.

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[1] Part III of this submission has a new version of subsection 55(2) which is intended to mirror the "new" style of drafting contemplated in the budget proposals. However, we cannot overstate our preference to maintain subsection 55(2) in its current form, having regard to the historic experience noted above and the fundamental importance of this provision to every day planning.

We would like to thank you again for your consideration of this matter. Having regard to the breadth of the concerns we have received with the proposals, a large number of members of the Joint Committee and others in the tax community have participated in the discussions concerning our submission and have contributed to its preparation, in particular:

Firoz Ahmed (Osler, Hoskin &Harcourt LLP)
Bruce Ball (BDO Canada LLP)
Ian Crosbie (Davies Ward Phillips & Vineberg LLP)
Ken Griffin (PwC Canada LLP)
Michael McLaren (Thorsteinssons LLP)
Rick McLean (KPMG LLP)
Siobhan Monaghan (KPMG Law LLP)
Kim Moody (Moodys Gartner Tax Law LLP)
Angelo Nikolakakis (Couzin Taylor LLP)
Joel Nitikman (Dentons Canada LLP)
Janice Russell (Deloitte LLP)
Mitchell Sherman (Goodmans LLP)
Carrie Smit (Goodmans LLP)
Jeffrey Trossman (Blake, Cassels & Graydon LLP)
Eric Xiao (Ernst & Young LLP)

We trust that you will find our comments helpful and would be pleased to discuss them further at your convenience.

Yours very truly,

Janice Russell
Chair, Taxation Committee
Chartered Professional Accountants of Canada

Mitchell Sherman
Chair, Taxation Section
Canadian Bar Association

Cc: Gabe Hayos, Vice President, Taxation, CPA Canada

Part I – Conceptual and Technical Concerns with Proposals in Notice of Ways and Means Motion

A. Subparagraph 55(2.1)(b)(ii) / Paragraph 55(3)(a)

- As discussed with you (and as noted above), our most significant concern with the proposals is the uncertainty that proposed subparagraph 55(2.1)(b)(ii) will create with respect to inter-corporate cash dividends that are paid routinely within corporate groups. This concern is magnified by the narrowing of paragraph 55(3)(a) to contemplate only subsection 84(3) deemed dividends.

- As a matter of interpretation, our concern is that the wording of subparagraph 55(2.1)(b)(ii) is broad and appears to apply to almost every dividend.

- In a gain share scenario under existing subsection 55(2), one is required to consider whether the gain on an arm's length sale of shares would be reduced. Although we acknowledge that existing subsection 55(2) contemplates a hypothetical sale, it was generally accepted in practice (having regard to the anti-avoidance nature of the provision) that the purpose test would likely not be satisfied if no sale of the dividend payor's shares was reasonably contemplated. The ability to provide comfort to taxpayers in practice was further supported by the application of paragraph 55(3)(a). Although the new wording also has a purpose test, there is no obvious link to a gain reduction purpose (directly or indirectly); in other words, in existing subsection 55(2) the purpose is to achieve a tax result, whereas in the new wording, the purpose test is less clear. Accordingly, because the results described in clauses (A) and (B) seem to arise on (virtually) every dividend, it is very difficult to conclude that the "one of the purposes" condition might not be satisfied in many common, non-abusive situations.

- We had understood from our telephone conversation that proposed subparagraph 55(2.1)(b)(ii) was intended to be an analogue to the gain share rule in current subsection 55(2). However, if proposed subparagraph 55(2.1)(b)(ii) applies in all circumstances, the effect would be to add a new substantive rule in the gain share context. We did not think that this was your intention.

- Our alternative proposal is to limit the application of subparagraph 55(2.1)(b)(ii) to situations involving a "loss share", consistent with your primary motivation to override the planning in *D&D Livestock*, and to add a gain reduction purpose to this provision. We also believe that the consequence of the application of such provision should be a reduction in adjusted cost base, rather than the realization of an immediate gain.

- However, if you conclude that the proposals should remain as drafted:

    - we believe that new subparagraph 55(2.1)(b)(ii) should only apply to "loss" shares;

    - we believe it is <u>imperative</u> to clarify that routine cash movements within corporate groups are not subject to the proposals;

    - we believe that paragraph 55(3)(a) must be expanded to again include these cash dividends, and all deemed dividends;

    - because there may be uncertainty in applying the definition of "safe income determination time" to regular periodic dividends, safe income should be determined immediately before the dividend in question is paid if safe income must be relied upon to support every inter-corporate dividend;

- subparagraph 55(2.1)(b)(ii) should also exclude subsection 84(2) dividends that arise on winding-ups where the share is disposed of;

- clarification is required as to whether clause 55(2.1)(b)(ii)(B) is intended to apply to cash (i.e. property in subsection 248(1) includes money unless a contrary intention is evident);

- if it is determined that it is appropriate to move forward with the draft legislation in its current form, it should be considered whether the consequence of the application of the rule should be a reduction of adjusted cost base in all circumstances (e.g. gain share context as well).

B. Paragraph 55(2)(b)

- The proposals amend subsection 55(2) to remove current paragraph 55(2)(b). This paragraph deemed a dividend that was subject to subsection 55(2) to be proceeds of disposition if the share was disposed of by the taxpayer.

- We believe that the removal of paragraph 55(2)(b) in the context of the proposals will create significant issues. Consider the following example where a share is redeemed:

FMV	\$100
ACB	\$60
PUC	\$10

- If the share is sold in the normal course, the taxpayer would realize proceeds of disposition of \$100 and have a capital gain of \$40. Similarly, if the share is redeemed under current subsection 55(2), the taxpayer would also realize proceeds of disposition of \$100 and have a capital gain of \$40.

- However, if the share is redeemed and the deemed dividend is subject to the proposals, the taxpayer will have a deemed gain of \$90. Such a result is clearly inappropriate and, we assume, unintended.

- A corollary issue arises as to whether there could be <u>double tax</u> where subsection 55(2) applies under the proposals to create a deemed gain, but does not reduce proceeds of disposition, on a share redemption. If the proposals are maintained, a separate provision must be added to reduce the actual proceeds of disposition by the amount of the deemed gain. Consideration should also be given to addressing an existing double tax issue where a deemed dividend (intended to be equal to safe income) actually exceeds safe income as ultimately calculated.

- The proposals contemplate that dividends subject to subsection 55(2.1) will be a "gain … for the year" in which the dividend is received by the dividend recipient. This change – characterizing the dividend as a gain for the year instead of as proceeds of disposition – may adversely affect timing considerations. For example, it is not clear that the dividend recipient will have an immediate credit to its capital dividend account even though there may have been an actual disposition of the share. It is also not clear whether this gain will increase "safe income" in relation to another dividend paid as part of the series having regard to the definition of "safe income determination time".

C. Paragraph 55(2.1)(c)

- Paragraph 55(2.1)(c) refers to income earned or realized that could reasonably be considered to "contribute to" the capital gain. The current version of subsection 55(2) uses the term "attributable to". Although we do not believe there should be a significant difference in the meaning accorded to these terms, we would prefer to maintain the existing language because there is significant guidance and experience applying the current provision.

- The proposals may give rise to an immediate gain where a dividend is paid, even on a loss share. However, it does not appear that the existence of underlying "safe income" will reduce or eliminate such a phantom gain. Consider the following example: XCo acquires 100% of the shares of YCo on incorporation for $100. YCo purchases a building and earns rent (which is subject to tax in YCo). Subsequently, at a time when YCo has $20 of cash and safe income but the building has decreased in value to $70, YCo pays a cash dividend of $20 to XCo. Immediately prior to the dividend, there is therefore a $10 loss in the YCo shares. In this example, although subparagraph 55(2.1)(b)(ii) might create an immediate $20 phantom gain, the existence of "safe income" does not appear to change this result because there is no actual gain in the YCo shares immediately before the dividend is paid. We believe that such an outcome is clearly inappropriate.

- It is less clear whether the existence of "safe income" should be relevant in our "loss share" construct because the consequence is a reduction in adjusted cost base; however, existing safe income should otherwise remain intact, to be used against a gain if the applicable shares subsequently appreciate in value, and our proposed loss share rule attempts to accomplish this result.

D. <u>Stock Dividends: Subsections 55(2.2), 55(2.3), and 55(2.4), Paragraph 52(3)(a)</u>

- We understand from our discussion that the Department is primarily concerned with high-low stock dividends that are intended to shift value between classes of shares in a circumstance where there is not a corresponding shift of adjusted cost base.

- As discussed, public company stock splits are often implemented through the payment of high-low stock dividends on common shares (with the issue of additional common shares of the same class). These transactions are implemented in this way for commercial reasons that have no tax motivation.

- We therefore believe that the stock dividend proposals should not apply where the stock dividend is <u>paid in shares of the same class</u> as that on which the stock dividend is paid. If you do not want to extend this relief to all planning situations, the exception should nevertheless apply to listed shares. The exception should be broad enough to contemplate that the issuer may have multiple classes of shares outstanding (e.g., voting and non-voting common), and may need to pay a stock dividend on more than one class of shares (although always in the same class as the shares on which the stock dividend is paid).

E. <u>Part IV Tax Exception</u>

- The current version of the Part IV tax exception to subsection 55(2) refers to the payment of a dividend "*to* a corporation"; accordingly, the Part IV tax exception to subsection 55(2) is not available where the Part IV tax paid by the dividend recipient is refunded as part of the series where a dividend is paid to a corporation (but not to an individual).

- The proposals, instead, refer to the Part IV refund arising as a consequence of the payment of a dividend "*by* a corporation".

- It is not clear to us from our conversation whether this change was intentional:

- the current rules allow dividends to be paid to individuals without the loss of the Part IV tax exception;

- the reference to "*by* a corporation" is not evident to us because, as a general matter, dividends can only be paid by a corporation (as distinct from other forms of entity) and, more specifically in this context, it would appear to be the "dividend recipient" that is paying the dividend to obtain the dividend refund (i.e. of Part IV tax on the dividend otherwise subject to subsection 55(2)).

• If this change was intended, we would like to further discuss this issue with you to understand your concerns and perhaps to clarify the language and the scope of the exception. For example, if the dividend recipient's refund of Part IV tax arises on the payment of a dividend to a corporation that itself is subject to Part IV tax as a result of the dividend recipient's refund (or that is otherwise taxable under Part I on the dividend), presumably the receipt of the refund by the dividend recipient should not cause the Part IV tax exception to be inapplicable to the dividend recipient.

F. <u>Subsection 55(2.5)</u>

• Subsection 55(2.5) applies for the FMV reduction purpose test in clause 55(2.1)(*b*)(ii)(A). There is some uncertainty as to the intended purpose and effect of this provision. It may be intended to address the possible argument that a dividend paid on a worthless share cannot have the requisite value reduction purpose. Although this proposal operates to deem the share to have value, we are unclear how this interacts with the taxpayer's purpose because, in fact, the share has no value. Accordingly, the purpose cannot be to reduce value.

• An alternate interpretation of subsection 55(2.5) brought to our attention is to interpret it as a relieving provision in the context of a corporation which has only one class of shares outstanding.[2]

[2] By deeming the FMV of a particular share to be increased immediately before the dividend, it arguably causes the FMV of the share after the dividend to be worth the same as what it was worth immediately before the dividend. Arguably, as a result, there could not have been a purpose of effecting a reduction in the FMV of the share. If subsection 55(2.5) is interpreted this way, the purpose test in clause 55(2.1)(b)(ii)(A) will not be met for a dividend payor with a single class of shares. However, where a dividend payor has more than one class of shares (particularly common shares), the clause 55(2.1)(b)(ii)(A) purpose test could still be met because subsection 55(2.5) only applies to increase the FMV of a particular share if a dividend is received on "the" share.

<u>Part II – Proposed Alternative "Loss Share" Rule</u>[3]

(2.11) If this subsection applies to a taxable dividend received by a dividend recipient, notwithstanding any other provision of this Act,

(a) 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 to a corporation where the payment is part of the series referred to in subsection (2.12) **[NTD: Part IV tax exception to be discussed]**) is deemed not to be a dividend received by the dividend recipient, and

(b) in computing the adjusted cost base of the loss share to the holder thereof immediately after receipt of the dividend, the adjusted cost base to the holder of such share shall be reduced by an amount equal to the amount of the dividend described in paragraph (a). **[NTD: if ACB becomes negative, a gain will be realized under subsection 40(3).]**

(2.12) Subsection (2.11) applies to a taxable dividend (other than a dividend under subsection 84(2) or 84(3)) received by a dividend recipient as part of a transaction or event or a series of transactions or events if

(a) the dividend recipient is entitled to a deduction in respect of the dividend under subsection 112(1) or (2) or 138(6),

(b) at the time the dividend is received, the dividend recipient holds the share on which the dividend is received as capital property,

(c) as a result of the payment and receipt of the dividend, the fair market value of any share of capital stock (in this subsection and subsection (2.11) referred to as the "loss share") is reduced and, immediately after the payment of the dividend, the fair market value of the loss share is less than the adjusted cost base to the holder of the loss share (an "accrued loss"),

(d) one of the purposes of the payment or receipt of the dividend is to effect

(i) a significant reduction in the fair market value of any share, or

(ii) a significant increase in the cost of property, such that the amount that is the total of the cost amounts of all properties of the dividend recipient immediately after the dividend is significantly greater than the amount that is the total of the cost amounts of all properties of the dividend recipient immediately before the dividend,

with a view to using, directly or indirectly, an accrued loss in order to eliminate or reduce a gain which would otherwise be realized on the disposition of any property, and

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[3] This draft sets out the basic parameters which we envisage for a "loss share" rule. Needless to say, we would be pleased to consider this with you further with a view to finalizing the specific terms of the provision. For the time being, we would note the following: (i) there is some uncertainty respecting the Part IV tax exception; (ii) supporting rules may also be required in respect of the ACB reduction if there is more than one class of loss share; (iii) we have added in 2.11(a) that the dividend is deemed not to be dividend received by the dividend recipient, consistent with existing subsection 55(2); we should consider further whether such exclusion is necessary in a loss share context; (iv) integration of this provision with the stop-loss rules may be required; and (v) it should be considered whether safe income should be relevant in a loss share context (for example, if a negative ACB gain is realized).

(e) subsection (2) does not apply to the dividend.

55(2.2) - Carve out stock dividends paid on a class consisting of shares of the same class – otherwise leave as is.

55(2.3) - Carve out stock dividends paid on a class consisting of shares of the same class – otherwise leave as is.

55(2.4) - Carve out stock dividends paid on a class consisting of shares of the same class – otherwise leave as is.

55(2.5) – **[to discuss]**

55(3)(a) – Include all actual and deemed dividends, other than dividends contemplated in the loss share rule.

<u>Part III – Proposed "Gain Share" Rule (To mirror existing subsection 55(2))</u>

(2) If this subsection applies to a taxable dividend received by a dividend recipient, notwithstanding any other provision of this Act, 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 to a corporation where the payment is part of the series referred to in subsection (2.1)) **[NTD: The Part IV tax exception is the same as in existing legislation although we understand that Finance is considering this issue.]**

(a) is deemed not to be a dividend received by the dividend recipient,

(b) where a corporation has disposed of the gain share, shall be deemed to be proceeds of disposition of the gain share except to the extent that it is otherwise included in computing such proceeds, and

(c) where a corporation has not disposed of the gain share, shall be deemed to be a gain of the corporation for the year in which the dividend was received from the disposition of a capital property.

(2.1) Subsection (2) applies to a taxable dividend received by a corporation resident in Canada (in subsections (2) to (2.2) and (2.4) referred to as the "dividend recipient") as part of a transaction or event or a series of transactions or events if

(a) the dividend recipient is entitled to a deduction in respect of the dividend under subsection 112(1) or (2) or 138(6),

(b) one of the purposes of the payment or receipt of the dividend (or, in the case of a dividend under subsection 84(3), one of the results of the payment or receipt of the dividend) 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 of any share of capital stock (in subsections (2) to (2.1) referred to as the "gain share") immediately before the dividend, and

(c) the portion of the capital gain referred to in paragraph (b) 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 for the transaction, event or series as a part of which the dividend was received.

55(3)(a) – Include all actual and deemed dividends, other than dividends contemplated in the loss share rule.