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

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November 12, 2015

Ms. Alexandra Maclean
Director, Tax Legislation Division
Finance Canada
90 Elgin Street
Ottawa, ON K1A 0G5

Dear Ms. Maclean,

**Re: July 31, 2015 Draft Legislation -- Proposed Amendments to Section 55 and Related provisions**

We would like to thank you and your colleagues for speaking with us recently regarding the proposed amending legislation released on July 31, 2015 containing proposed amendments to section 55 and other related provisions (the "**Draft Legislation**"). During that call, we agreed to make a written submission elaborating and expanding on the points raised in our discussion and to provide you with examples illustrating our concerns. A number of our concerns were raised previously in our May 27, 2015 submission and, while we acknowledge that some of them were addressed, at least in part, a number of our fundamental concerns were not reflected in changes to the Draft Legislation.

This submission sets out the more fundamental concerns we have with the proposed amendments. During our conversation, we also raised concerns about the narrowing of the exception from subsection 55(2) where Part IV tax is applicable to the dividend. We remain concerned about the narrowing of the exception but intend to elaborate on those issues in a separate submission in the near term.

As expressed in our prior submission, in our view a more appropriate approach is to introduce a more targeted "purpose" test, and to preserve the basic features of the current system. Having regard to the Department of Finance's stated purpose in proposing the amendments, we previously recommended that you consider a more targeted purpose test, focusing on transactions that give rise to losses, as opposed to merely reducing value. Based on the Budget materials and the Explanatory Notes, we understood that the Department of Finance did not intend to fundamentally reshape the fundamental principle that dividends generally may be paid between corporations without taxation. However, we infer from the Draft Legislation that

such a targeted approach is not favoured. For reasons illustrated in the enclosed submission, we remain convinced that a more targeted approach is essential to the proper working of subsection 55(2) and urge you to reconsider such an approach. We would be very happy to re-engage on the architecture of the purpose test, and in that regard suggest that a face-to-face meeting would be useful.

A number of members of the Joint Committee and others in the tax community have participated in the submission and have contributed to its preparation, including in particular:

- Firoz Ahmed (Osler Hoskin & Harcourt LLP)
- Thomas A. Bauer (Bennett Jones LLP)
- R. Ian Crosbie (Davies Ward Phillips & Vineberg LLP)
- K. A. Siobhan Monaghan (KPMG Law LLP)
- Mitchell Sherman (Goodmans LLP)
- Jeffrey Trossman (Blake, Cassels & Graydon LLP)

We would like to thank you for your consideration of this submission. Once you have had an opportunity to review it, it will be evident that most of our concerns with the Draft Legislation remain. However we also remain very interested in continuing the dialogue and would be pleased to meet with you to explore our concerns in more detail.

Yours very truly,

Janice Russell
Chair, Taxation Committee
Chartered Professional Accountants of Canada

K. A. Siobhan Monaghan
Chair, Taxation Section
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Cc: Gabe Hayos, Vice President, Taxation, CPA Canada

The following submission addresses the draft amendments to subsection 55(2)[1] and related provisions released on July 31, 2015 (the "**Draft Legislation**").

**Introduction:**

Subsection 55(2) is an anti-avoidance rule that, in its current form, applies to an intercorporate dividend paid in a transaction or series of transactions one of the purposes of which is to reduce a capital gain on a share. We understand the Department's desire is to broaden the rule to curtail planning of the nature undertaken in *D&D Livestock*,[2] on the basis that the result in that case offended this statutory objective. While we take no issue with that goal, the tax community remains very concerned about the impact the Draft Legislation will have on a broad range of ordinary transactions that are not abusive and have absolutely nothing to do with engaging in the types of transactions undertaken in *D&D Livestock*. In our experience, uncertainty regarding the scope of the proposed amendments to subsection 55(2) has already significantly disrupted cash movements within corporate groups, because they are no longer something that can be undertaken without significant consideration regarding the potential application of subsection 55(2), notwithstanding that there may be no intention of ever disposing of the shares of the corporation that pays the dividends.

In particular, the new purpose test in proposed subparagraph 55(2.1)(b)(ii) seeks to determine if ***one*** of the purposes (not the *main* purpose, or even *one of the main* purposes) of the payment or receipt of the dividend is to effect a significant reduction in the fair market value ("**FMV**") of any share or a significant increase in the cost amount of all properties of the dividend recipient. "One of the purposes" is a very low threshold. Virtually all dividends will serve to reduce share value and increase the cost of property to the dividend recipient.[3] While it would remain open to a taxpayer to argue that ***none*** of its purposes in paying or receiving the dividend was to reduce share value or increase the cost of property, in our view that places an unreasonably high onus on the taxpayer, for several reasons. First, there is a significant concern that what is framed as a purpose test will, in practice, be applied based on the consequences of the dividend. Moreover, we can envision circumstances in which reducing the value of the shares on which the dividend is paid or increasing the cost of property of the dividend recipient will be a purpose of a dividend – and yet that purpose will be for reasons that have nothing to do with reducing a capital gain or increasing a capital loss. Moving cash within a corporate group to fund cash needs is but one example.

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1 Unless indicated otherwise, all statutory references in this letter are to the applicable provisions of the *Income Tax Act* (Canada) (the "**Act**").

2 *D&D Livestock Ltd. v. The Queen*, 2013 DTC 1251( (T.C.C.).

3 In the case of a cash dividend, this assumes that cash is property that has a cost. It is not clear whether this is intended. As discussed below, we recommend that the Explanatory Notes make it clear that cash is not property for purposes of proposed clause 55(2.1)(b)(ii)(B).

While it is true that subsection 55(2), in its current form, also applies a "one of the purposes" test, the current purpose test is limited to the purpose of reducing a capital gain. The current purpose test therefore grounds the rule in the tax avoidance concerns to which it relates, a key element that is lacking in the Draft Legislation. This critical distinction is discussed further below.

Subsection 55(2) is an anti-avoidance rule. In keeping with that character, we suggest that, as is the case with existing subsection 55(2), a link between the payment or receipt of a dividend and a transaction that gives rise to a capital gain or a capital loss, such as a disposition, should be a prerequisite to application of the rule. In other words, a stronger nexus between the factual circumstances giving rise to the potential application of the rule and its anti-avoidance objective should be retained. Without such a link, the proposed amendments to subsection 55(2) could upset fundamental rules underlying everyday cash movements, thereby potentially disrupting or distorting the efficient allocation of capital within corporate groups.

In our discussions, you asked for specific examples to illustrate the issues that we have identified with the Draft Legislation. We have included a number of examples in connection with each of the areas of concern discussed below in this submission. However, the Draft Legislation affects the rule at such a basic level that we are certain that many other examples will arise in practice as practitioners seek to determine whether the rule applies in a broad range of everyday fact patterns the details of which simply cannot be predicted.

## 1. Purpose Test: Cash Movements within Corporate Groups and Loss Consolidation Transactions

Based on our previous discussions, we understand that it is not intended that the Draft Legislation prejudice, or create uncertainty in respect of, normal course, non-tax-motivated cash movements by way of dividend within Canadian corporate groups, or conventional loss consolidation transactions. In the latter case, we understand the Canada Revenue Agency ("**CRA**") has issued advance income tax rulings that express the view that subsection 55(2) would not apply to dividends paid in the course of loss consolidation transactions. We nonetheless believe that the intention that the legislation not apply to loss consolidation transactions and normal course cash movements should be made explicit.[4] At a minimum, this intention should be stated in the Explanatory Notes. Indeed, we understand that in the context of these loss consolidation ruling, the CRA did not readily conclude that subsection 55(2) would not apply. At least one of the rulings specifically states (under the Additional Information heading) that "the annual dividends have no purpose other than [to consolidate taxable income and tax attributes within a group of affiliated and related persons]." and the opinion proposed subsection 55(2) would not apply is premised on that being the case. This alone suggests that a "one of the purposes" test is simply too broad.

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[4] We note that one of the reasons the Department of Finance decided not to proceed with introducing consolidated group tax filing in Canada was because of the ability of related corporate groups to undertake loss consolidation transactions under the current regime.

Moreover, the broad scope of the purpose test in the proposed amendments serves to introduce considerable uncertainty into what, until now, has been a fundamental tenet of the Canadian tax system, namely that the payment of inter-corporate dividends generally does not attract corporate level tax under Part I. For both reasons of economic efficiency and fairness, legislation should be in a form that permits taxpayers to interpret and apply it in the context of their circumstances in a reasonable and predictable manner without having to apply to the CRA for a ruling. Given the potential scope of the Draft Legislation, that may no longer be feasible in many cases. At the APFF Conference held in October, the CRA was asked to address a number of questions regarding the application of proposed subsection 55(2). The CRA's responses both reinforce our concerns about the breadth of the legislation and illustrate the difficulty in applying the legislation in various circumstances.

It is common for corporate structures of both public and private enterprises to involve tiers of holding companies and operating companies. Corporate structures arise from a host of commercial and tax requirements, including limitation of liability, regulatory requirements, financing requirements, and historical combinations of enterprises. For example, in the real estate industry, and in the case of infrastructure projects (a stated priority of the incoming government), separate operating companies are invariably established for each property or project for commercial reasons.

Every day, Canadian private and public companies need to move cash up, down and across corporate chains. This rarely has anything to do with tax planning, but rather is the inevitable by-product of layered corporate structures. Thus, when cash in a 5$^{th}$ tier subsidiary needs to be used by the parent company to service debt or pay dividends, steps to move the cash upstream are inevitable, and the typical approach is to pay a dividend up the corporate chain. Other enterprises, particularly privately held companies, regularly distribute excess cash from the operating company to a holding company in order to limit the available assets that could be seized by creditors in the event of a default or insolvency.

The fundamental problem with the proposed amendments is that the new "purpose" test shifts the focus from reducing the gain which would be realized on a disposition to reducing value or increasing cost of the recipient's property. This shift in focus makes the new rule far broader. Under existing subsection 55(2), where a dividend was intended merely to move cash up a corporate chain, in circumstances where no disposition of the shares in the chain was ever expected to occur, a reasonable conclusion that none of the purposes of the dividend was to reduce a gain could readily be arrived at in most routine cases. In contrast, under the proposed amendments to subsections 55(2) and (2.1), it is doubtful that a corporate group, or its advisors, can safely make the reasonable judgment that none of the purposes of a dividend is to reduce value or increase the cost of property to the dividend recipient, when each dividend up the chain does precisely that. Similarly, how can the judgment be made that none of the purposes of the dividend was to increase the recipient's cost of property when the parent's need for the funds was in fact the prime motivation for the dividends?

In our view, the answer to these questions does not lie in the "safe income" exception. In other words, we do not believe that it is appropriate to condition the application of subsection 55(2) on a broad "purpose" test that applies to all (or almost all) dividends (because all dividends

reduce share value), and then provide only a limited "safe harbour" exception to the extent the taxpayer is able to demonstrate that the share has an accrued gain and that the dividend was paid out of "safe income". For one thing, such an approach would impose on all taxpayers, large and small, the obligation to continually track safe income on an ongoing basis, an unduly onerous and burdensome task, particularly when taxpayers have not done so, nor been required to do so, historically and where the shares in question may have been held for a very long period of time. This would result in a potentially significant increase in compliance costs for many taxpayers, with little or no readily ascertainable benefit to the fisc. The approach reflected in the Draft Legislation also gives rise to a number of inappropriate outcomes - for example, because the safe income exception has no application where the share is not in a gain position - that are discussed in greater detail below.

As previously noted, the tax-free nature of inter-corporate dividends is a bedrock feature of the Canadian system of corporate taxation, and should not be displaced by an undue enlargement of the scope of a specific anti-avoidance rule. The intent to preserve this bedrock feature ought to be reflected in the Draft Legislation and clearly communicated to taxpayers and their advisors. Otherwise everyday intra-group cash movements and capital allocation efficiency may be significantly and adversely affected.

As expressed in our prior submission, in our view a more appropriate approach is to introduce a more targeted "purpose" test, and to otherwise preserve the basic features of the current provisions. Having regard to the Department of Finance's stated purpose in proposing the amendments, we previously recommended that you consider a more targeted purpose test, focusing on transactions that give rise to losses, as opposed to merely reducing value. For reasons explained in this submission, we remain convinced that a more targeted approach is essential to the proper working of subsection 55(2), and urge that such an approach be reconsidered.

Should you ultimately decide not to adopt a more targeted purpose test as suggested, at a minimum, we ask that you at least provide some additional commentary in the Explanatory Notes concerning the intended scope of the purpose test. We respectfully suggest that such commentary should include the following guidance:

(a) While the new "purpose" test in subparagraph 55(2.1)(b)(ii) is intended to broaden the scope of subsection 55(2), it is not intended that subsection 55(2) apply to all dividends. The rule continues to be intended to address inappropriate tax avoidance transactions, and the "purpose" test must be interpreted with this underlying objective in mind. Thus, it is not appropriate to conclude that because every dividend arguably has the effect of reducing the FMV of the share on which the dividend was paid (and to increase the recipient's cost of property), subsection 55(2) should apply to every dividend. Dividends that are not part of a series of transactions having an inappropriate tax avoidance purpose should be excluded from the application of the rule.

(b) It is recognized that dividends are commonly paid within corporate groups for the principal purpose of moving cash from one corporation to another corporation for non-tax reasons. Examples include cash movements from a subsidiary to a parent in order to

enable the parent to meet its cash needs (such as servicing debt, paying dividends, paying other expenses, or re-deploying the cash in another group company). In such a case, while the result of the dividend may be to reduce the FMV of a share or to increase the cost of property to the recipient, in the absence of a reduced capital gain, increased capital loss or similar transaction, it is reasonable to conclude that none of the purposes of the dividend was to give rise to such a result, and therefore it is generally not intended that subparagraph 55(2.1)(a)(ii) would apply in such circumstances. This determination may need to be made with hindsight to take subsequent transactions into account.

(c) Clause 55(2.1)(b)(ii)(B) applies where one of the purposes of the payment or receipt of the dividend is to effect a significant increase in the "cost of property". In this regard, "property" is defined in subsection 248(1) to include money, unless a contrary intention is evident. In the context of dividends described in the preceding paragraph, it is not intended that "property" would include money.

(d) Subparagraph 55(2)(b)(ii) applies only where one of the purposes is to effect a <u>significant</u> reduction in value or increase in cost of property. In this regard, the determination of whether an amount is "significant" will depend on the context. Ordinary course dividends paid on a basis consistent with past practice would not generally be viewed as "significant". Similarly, where a preferred share carries a fixed or floating dividend at a reasonable rate, the payment of the dividend would not normally be considered "significant".

(e) The tax consequences of an ordinary "loss consolidation" transaction are not intended to be adversely affected by the proposed amendments to subsection 55(2). The purpose of these transactions is to consolidate losses or expenses within a corporate group. While an effect of the payment of a dividend on a share as part of such a transaction may be to reduce the share's FMV, this is not considered to be a purpose of the payment or receipt of the dividend.

You have asked us to provide specific examples that demonstrate the issues alluded to above. Below are some examples.

**Example 1:**

Pubco's capital structure includes third party debt financing, preferred shares and common shares. The common shares are listed on a designated stock exchange. Pubco carries on business through multiple subsidiaries (Sub 1, which itself owns, Sub 2 and Sub 3) and has used the proceeds of the debt and equity financings to fund its subsidiaries. Pubco causes each of its subsidiaries to pay dividends on their common shares quarterly in such amounts as are necessary to provide Pubco with cash to pay dividends on its preferred shares and common shares, to make payments on its third party debt and to fund its expenses. While all of the subsidiaries have cash flow from operations, some of them may not have safe income to match available cash (or may not be able to track safe income in order to be certain as to the amount of safe income from time to time). Subsidiaries may have varying cash requirements from time to time,

necessitating variations in the pattern of intra-group dividend payments. In some cases, there may be an accrued loss on a share and in others an accrued gain or neither a gain nor loss. Pubco has no intention of disposing of any of its subsidiaries. The amounts paid as dividends by the subsidiaries may be significant both in absolute and percentage value terms. The dividends paid by Sub 2 and Sub 3 to Sub 1 (and by Sub 1 to Pubco) will increase the cash in the hands of the dividend recipient and reduce the value of the shares of the dividend payers.

The concern is that on these facts the CRA may assert that one of the purposes of the series of transactions is to increase the cost of property (assuming property for this purpose includes money) to Pubco or to decrease the FMV of the shares of Sub 1, Sub 2 or Sub 3. Yet Pubco needs cash to meet its obligations and the dividends and interest paid by Pubco will be taxable to the recipients.

Dividends are typically used to move cash up a chain of corporations as part of a corporate group's overall cash management strategy. Imagine that rather than four corporations there are forty or more corporations in the group. In our view, subsection 55(2) ought not to apply to dividends paid up the chain in these circumstances, because the cash movement is not designed to achieve a tax benefit. Yet, the broad wording of the proposed purpose test leaves meaningful uncertainty as to whether or not the new rule may in fact apply.

**Example 2:**

Opco 1, a subsidiary of Opco 2, invests with an arm's length co-venturer in a new corporation (JVCo) to undertake a new business. They fund it with a combination of common shares and preferred shares that carry a cumulative dividend. JVCo is unable to pay dividends for the initial five years of operations. At the end of five years, JVCo has free cash flow but has no safe income on hand ("**SIOH**"). There is an accrued gain on both the common and preferred shares, but the accrued gain on the preferred shares is solely attributable to the accrued and unpaid dividends. JVCo pays the accrued dividends to Opco 1 and the Opco 2 at the end of beginning of year 6 with the purpose of becoming current on its preferred shares. The effect of the payment of the dividends is to eliminate the accrued gain on the preferred shares. Thereafter, JVCo stays current, pays the dividends regularly and begins to earn positive income.

In policy terms, subsection 55(2) should not apply to the payment of the accrued and unpaid dividends. While JVCo's purpose is to become current on its preferred shares used to finance its operations, a natural consequence of that purpose is the reduction in value of those shares. Consequently, there is meaningful uncertainty whether the reduction in value – an inevitable result – was one of the purposes of the dividends.

**Example 3:**

Buyco, an indirect subsidiary of Parent and one of a number of Parent subsidiaries, acquires Target from an arm's length party and pays $500 million for the shares, financed with equity from Parent and arm's length borrowing. Target is regulated and

cannot be amalgamated with Buyco. Target earns income leaving it with SIOH of $15 million. However, changes in the industry have resulted in the FMV of the Target shares dropping to $435MM, such that there is an accrued loss on the Target shares of $65 million (taking into account the SIOH). Nevertheless Buyco and its subsidiaries remain profitable, just less so than before. Buyco causes Target to pay it a $15 million dividend so that Buyco is able to pay interest on its third party borrowing, the result of which is a further reduction in FMV of the Target shares from $435 million to $420 million. Buyco pays its interest expense using the $15 million.

As in Example 1, the purpose of the dividend is to provide Buyco with the funds necessary to meet its obligations. That dividend both decreases the FMV of the Target shares by $15 million (increasing the accrued loss from $65 million to $80 million) and increases the cost of Buyco's property (assuming property includes cash). Clearly, the main purpose of the dividend is to provide funds to Buyco so it can meet its interest payment obligations. In our view, subsection 55(2) should not apply to the dividend paid by Target to Buyco.

This example also illustrates a deficiency inherent in re-formulating subsection 55(2) to provide for a broad purpose test and then relying on a safe income exception to exclude transactions that are not offensive from a tax policy perspective. Although Target pays a dividend out of safe income, because there is an accrued loss on the Target shares owned by Buyco, the safe income exception is not available in this case. That is because the safe income exception, as reflected in the Draft Legislation, simply does not apply where the shares in issue have an accrued loss. In policy terms, we believe that after-tax earnings should be available to be paid between corporations regardless of whether the shares on which they are paid are in a loss or gain position, but that is not what the Draft Legislation contemplates.

The above examples also illustrate that the application of proposed subsection 55(2) in a multiplicity of everyday, ordinary commercial contexts is fundamentally different than under the current rule. Because there is no longer a linkage to an actual gain being realized, the tax under the Draft Legislation could arise many years before the time at which any "offensive" transaction that could be linked to the earlier triggering event has occurred. And of course, it is entirely likely that no such transaction ever arises, and that the tax will have in effect been prepaid in connection with an apprehension of some abusive transaction that was never contemplated and did not occur. It appears that the general rule that inter-corporate dividends pass tax-free under Part I no longer holds true. Instead, taxpayers may now be forced to effectively pre-pay tax on hypothetical future dispositions that, in most cases, will never occur.

In our submission, this lack of connection between the incidence of taxation and an event that supports the policy rationale for taxation is too great, and the consequences are potentially disastrous. As discussed in this letter, we are strongly of the view that the Draft Legislation requires moderation to achieve a workable rule, and we recommend that the incidence of taxation be more closely linked to the transaction that warrants its imposition. We do not propose to describe in detail how this could be achieved, but would welcome the opportunity to discuss this with you. In outline, the proposal would be that in such circumstances subsection 55(2) gains would instead be treated as basis reductions or deferred gains. Such basis reductions could result in negative basis without current taxation, and the consequence of

the basis reduction or deferred gain would be realized when (and if) a triggering event occurred at a future time.

## 2. Safe Income Determination Time

To the extent the Draft Legislation is enacted substantially in its present form, the definition of "safe income determination time", insofar as it applies to subsection 55(2), must also be amended. Subsection 55(2) as proposed to be redrafted is not linked to an arm's length (or any other) sale on which gain is reduced or a loss is realized. Furthermore, the scope of paragraph 55(3)(a) is proposed to be narrowed significantly. As a result, in most cases taxpayers will need to rely on the "safe income" exception to avoid inadvertently falling within subsection 55(2), which in turn means that ascertaining the applicable "safe income determination time" at which to calculate safe income will be more important than ever. While some of the problems relating to "safe income determination time" set out below existed prior to the proposed amendments, such problems have been exacerbated by the very significant broadening of subsection 55(2).

The definition of "safe income determination time" includes the time immediately before the first payment of a dividend as part of the series of transactions. Given the expanded meaning given to "series of transactions" by virtue of subsection 248(10), there is a concern that for companies paying regular periodic dividends (whether as a result of a requirement in share rights contained in articles of incorporation, as a result of a publicly-stated dividend policy, or just a recurring course of conduct), the dividends might be treated as part of a "series of transactions", such that the "safe income determination time" may be permanently fixed immediately prior to the time of the first dividend in the series. Clearly, this would be an inappropriate result. Under current subsection 55(2), this potential outcome is largely attenuated by the fact that most periodic dividends are not likely to be caught by the current purpose test. However, in view of the proposed changes to the structure of subsection 55(2) and paragraph 55(3)(a), that presumption may no longer apply, in which case the determination of the applicable "safe income determination time" becomes increasingly important.

A further concern with the current definition of "safe income determination time" is that it fails to properly address a situation where a series of dividends is paid up the chain within a corporate group and one of the dividends (or a portion thereof) is subject to subsection 55(2). In those circumstances, the deemed gain under subsection 55(2) would not be included in the safe income of the initial dividend recipient (or any of the subsequent dividend recipients) until after the safe income determination time, since the deemed gain will, at the earliest, be included in the dividend recipient's income - and thus safe income - at the time of the dividend, and not "immediately before" the time of the first dividend in the series, which is the "safe income determination time". To make matters worse, where all the dividends paid up the chain are predicated on the erroneous assumption that the SIOH of the lowest-tier subsidiary was in excess of the dividend amount (assume there are no deficits or losses elsewhere in the chain), *all* of the dividends paid up the chain would potentially be subject to re-characterization under subsection 55(2), resulting in capital gains all the way up the chain, even though all of the dividends are sourced out of the same initial dividend paid by the lowest-tier subsidiary.

Clearly, such an outcome is not supportable from a policy perspective, and is presumably unintended. To address this concern, the rules should provide that where a dividend is subject to subsection 55(2), the resulting capital gain will be included in the dividend recipient's safe income prior to the applicable safe income determination time.

**Example 4:**

Parent owns directly Sub1. Sub 1 owns Sub 2 which owns Sub 3. Sub 3 owns Sub 4 and intends to sell Sub 4 to an arm's length person for cash. The accrued gain on the Sub 4 common shares is $40 million, of which Sub 3 believes $10 million is attributable to SIOH. Sub 2 owns preferred shares of Sub 4 with a redemption amount and FMV of $10 million. Those shares were issued several years ago when Sub 2 transferred an asset to Sub 4 on a rollover basis. The preferred shares have nominal paid-up capital ("PUC"). Sub 4 has significant cash on hand. Prior to the sale, Sub 4 redeems the preferred shares and the deemed dividend under subsection 84(3) results in a capital gain through the application of subsection 55(2).[5] Sub 4 also increases the stated capital of its common shares by $10 million. Sub 3 sells the common shares for $300 million, realizing a $30 million capital gain.

On filing its tax return, Sub 3 realizes the SIOH was only $9 million and makes a designation under paragraph 55(5)(f) to treat the excess $1 million deemed dividend realized under subsection 84(1) as a separate dividend subject to subsection 55(2). Sub 3 pays a $10 million dividend to Sub 2 which in turn pays an $18.5 million dividend to Sub 1, which significantly reduces the FMV of the Sub 2 shares. The $18.5 million dividend paid by Sub 2 is derived from Sub 2's after tax proceeds of the capital gain realized on the redemption of the preferred shares ($8.5 million) and the $10 million dividend ($1 million of which would be taxed as a capital gain) dividend received from Sub 3.

In this example, the deemed dividend received by Sub 2 on the redemption of the preferred shares and the excess deemed dividend to Sub 3 as a result of the PUC increase would both be income realized after the safe income determination time (which is immediately before the redemption). However, since they would both be taxed as capital gains, no further tax should be paid on the amount remaining after tax if it is paid as a dividend up the chain, regardless of the purpose of that dividend. Thus the rules need to be amended to ensure the dividends from Sub 3 to Sub 2 and from Sub 2 to Sub 1 do not attract subsection 55(2).[6]

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[5] The exception in paragraph 55(3)(a) is not available by virtue of subparagraph 55(3)(a)(iii).

[6] Under subsection 55(2), in its current form, the concern is less acute, since it can be reasonably argued that the purpose of the dividends is not to reduce the gain on a subsequent sale of the shares. However, as discussed above, the proposed change to the purpose test in subsection 55(2) will preclude the purpose test from serving as a meaningful "filter" to exclude transactions that are not offensive from a tax policy perspective, with the result that greater attention must now be paid to arriving at an appropriate determination of safe income.

**Example 5:**

Pubco owns all the shares of Sub 1 and Sub 2. Pubco pays quarterly dividends of $50 million in aggregate. Pubco is concerned that Sub 1 and Sub 2 may not have sufficient SIOH at the time of the first quarterly dividend but expects them to have $200 million of SIOH on hand by the end of the year. Pubco borrows money to pay its quarterly dividends. At the end of the year Sub 1 and Sub 2 pay dividends of $200 million representing SIOH generated in the year and Pubco repays the borrowed money.

The dividends paid by Sub 1 and Sub 2 are paid out of after-tax earnings and thus should not be subject to further corporate tax. However, the relevant safe income determination time may be the time that Pubco paid its first quarterly dividend. If so, SIOH generated by Sub 1 and Sub 2 after the first quarterly dividend would not be "available" to exempt the Sub 1 and Sub 2 dividends. Thus, such dividends could be subject to subsection 55(2). This is clearly not an appropriate result.

## 3. Stock Dividends

The proposed rules relating to stock dividends appear to be aimed at situations where a stock dividend is paid in a manner that misaligns share basis and share value. For example, assume A Co wholly-owns B Co., which only has common shares issued and outstanding. If B Co pays a stock dividend satisfied by issuing preferred shares with a FMV of $10 million and $1.00 is added to the stated capital (and PUC) of the preferred shares, under the existing rules of the Act the result of the stock dividend would be to reduce the FMV of the common shares of B Co by $10 million without changing the adjusted cost base ("**ACB**") of those shares.[7] Thus, A Co would potentially be able to reduce the amount of any gain on a subsequent sale of the B Co common shares. Even if the purpose of the stock dividend is to reduce such gain, the tax consequences under subsection 55(2), in its current form, would be not be significant, since the amount of the stock dividend that is potentially subject to re-characterization as a gain is nominal. Although these types of transactions have been successfully challenged under the general-anti avoidance rule (the "**GAAR**") (*i.e.*, *Triad Gestco*[8] and *1207192 Ontario Limited*[9]), we accept that the Department wants to preclude transactions of this nature without the need to resort to the GAAR.

Proposed subsections 55(2.2) to (2.4) would preclude this result by, among other things, deeming the amount of the B Co stock dividend to be $10 million for purposes of the application of subsections 55(2) and (2.1). Thus, if the purpose test in subsection 55(2.1) were satisfied, A Co would realize a $10 million capital gain.[10]

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7 The cost to A Co of the preferred shares would be nominal but their FMV would be $10 million.

8 *Triad Gestco Ltd.* v. *The Queen*, 2011 TCC 259

9 *1207192 Ontario Limited* v. *Canada*, 2012 FCA 259

10 Assuming that none of the exceptions to the application of subsection 55(2) applied.

While the application of the proposed stock dividend rules in the example described above may be appropriate, the breadth of the application of the proposed stock dividend rules can cause anomalous results in situations where there is no misalignment of the share value and ACB. Some of the problems with the Draft Legislation in this regard are identified below.

***Same Class Stock Dividends***

The Draft Legislation potentially gives rise to inappropriate outcomes in cases where stock dividends are paid for ordinary commercial reasons. These situations share two common features:[11]

(a) the payment of a stock dividend on a class of shares,[12] which is satisfied in shares of the same class (a "**Same Class Stock Dividend**"); and

(b) no misalignment of tax cost of any of the shares of the dividend payer and the FMV of such shares.[13]

A number of specific situations in which Same Class Stock Dividends may be adversely affected by the Draft Legislation are discussed in greater detail below.

***Public Company Stock Splits***

Almost all public company common share stock splits are undertaken through Same Class Stock Dividends in which the PUC of the stock dividend shares is set at a nominal amount. Since the amount added to the PUC of the stock dividend shares is less than the FMV of such shares, proposed subsection 55(2.2) would deem the amount of the stock dividend to be equal to such FMV (generally a large amount). Because the purpose of the stock split is to reduce the trading price of the dividend payer's shares and the stock split dividend reduces the FMV of the existing common shares of the dividend payer, the purpose test in draft clause 55(2.1)(ii)(A) would be satisfied.

The application of the stock dividend rules in proposed subsections 55(2.2) to (2.4) to public company stock split transactions would result in subsection 55(2) applying to corporate shareholders of the public company notwithstanding that such shareholder's total ACB and

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[11] An exception relates to the application of the proposed amendments to subsection 52(3) to capital dividends.

[12] For this purpose, a reference to a class of shares includes a reference to a series, in accordance with subsection 248(6).

[13] We acknowledge that the concerns described above may exist unless both factors are present. For example, assume that in the above example, A Co owned two classes of B Co common shares outstanding which were the same in all respects except entitlement to vote ("Class A Common Shares" and "Class B Common Shares"). If B Co paid a Same Class Stock Dividend on the Class A Common Shares and the stated capital of the stock dividend shares were set at a nominal amount, under the existing rules in the Act, the result of the dividend would be to reduce the FMV of the Class B Common Shares without changing the ACB of such shares. This would put A Co into a position to sell the Class B Common Shares for a reduced capital gain. Although it is a Same Class Stock Dividend, it would result in a misalignment of the FMV and ACB of the shares and so it may be appropriate for subsection 55(2) to apply.

total accrued gain remains unchanged (although the ACB and gain per share is reduced).[14] To treat such a transaction as one that results in all taxable corporate shareholders realizing a capital gain goes well beyond the perceived abuse at which the draft rules are aimed. Consider the following example:

**Example 6:**

Pubco's common shares are listed for trading on the Toronto Stock Exchange and trade at $200/share. Shareholder A, a public corporation, owns 100 Pubco shares with an ACB per share of $160. Pubco has no SIOH per share in respect of A (or at least such SIOH cannot be calculated). Pubco determines its trading price is higher than desirable and decides to undertake a 2:1 stock split by declaring a stock dividend payable as to one common share per common share outstanding with an aggregate addition to its stated capital of $1.00. As a result, A receives 100 new common shares. Assume that thereafter each Pubco common share has a FMV of $100 (i.e., one share that previously traded for $200 now is split into two shares that individually trade at $100). Under the existing rules of the Act, A does not realized a gain and the aggregate ACB, FMV and accrued gain on its shares of Pubco is unchanged. The ACB of the shares is averaged under section 47. This is exactly the same result as if Pubco had effected a stock split by way of the amendment of its articles. Under the Draft Legislation, since Pubco's purpose in paying the stock dividend was to reduce the FMV of every Pubco common share, A would realize a $100 capital gain per share.

The above example involves a Same Class Stock Dividend on the common shares of Pubco. Even if Pubco had preferred shares outstanding, the payment of the common share stock dividend would not affect the value of the preferred shares. Thus, there is no misalignment of tax cost and FMV for any class of shares of Pubco. We also note that some public corporations have more than one class of common shares outstanding (e.g., voting and non-voting or voting and multiple voting), the terms of which require that equivalent dividends be paid on each class. Any exception for Same Class Stock Dividends should accommodate equivalent dividends paid on the two classes in those circumstances. [15]

In summary, the application of proposed subsections 55(2) and (2.1) to a Same Class Stock Dividend undertaken to effect a stock split of common shares (and that is not designed to shift value from one class of shares to another) is not appropriate. The tax treatment of such stock dividends should be the same as that applicable to a stock split effected by way of articles of

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[14] In fact, public company stock splits sometimes result in the post-split shares trading at a combined value in excess of the trading value of the pre-split shares, so that the accrued gain on a shareholder's shares is actually increased as a result of the split.

[15] By contrast, if Pubco were to split a class of its preferred shares through the payment of a Same Class Stock Dividend on such preferred shares, there would be a shift of value toward the preferred shares and away from the common shares, in which case the proposed stock dividend rules should apply. As a practical matter, we note that as a matter of corporate law such a shift in value from the common shares to the preferred shares would generally require the prior approval of the common shareholders, which is unlikely to occur.

amendment. Thus, we recommend that Same Class Stock Dividends used to effect stock splits on shares of public corporations be excluded from the rules in subsections 55(2.2) to (2.4).

We understand you may be concerned that the use of a low PUC stock dividend to effect a stock split is inappropriate as a matter of corporate law, and that the Act should therefore not accommodate such transactions. From our perspective and that of Canadian capital markets, it is entirely appropriate to effect a stock split by way of stock dividend in the circumstances described above, since no shareholder is prejudiced by such action. Under Canadian corporate statutes, there are two ways to effect a stock split: either by way of articles of amendment (which requires a shareholder vote) or by way of a stock dividend (which is an action that can be undertaken by the directors). Given that both are permissible as a matter of corporate law, public corporations should be free to choose which mechanism to employ in its particular circumstances without undue adverse tax consequences being imposed on one alternative. If the securities regulators, who are charged with regulating public capital markets, or institutional shareholders, who hold public issuers accountable in establishing good corporate governance practices, were concerned that stock splits without a shareholder vote were somehow problematic, they could have and would have addressed the practice long ago. The fact that many of Canada's largest corporations have effected stock splits through stock dividends without objection is clear evidence that the practice is not only acceptable but potentially beneficial from a capital markets' efficiency perspective. We are concerned by any suggestion that tax measures should be used as a tool to effectively discriminate against one of the two alternatives, thereby potentially causing market inefficiencies.

***Cost of a Stock Dividend***

In general terms, paragraph 52(3)(a) provides that the cost of a share received by a corporation as a taxable stock dividend cannot exceed the corporation's safe income on hand ("SIOH") in respect of the share on which the stock dividend is paid. The "cost calculation" in paragraph 52(3)(a) actually starts with the amount of the stock dividend and then reduces it by the excess of such amount over SIOH. Draft paragraph 52(3)(a) proposes to provide a further cost limitation by providing that the starting point for the calculation of the cost of a stock dividend is the lesser of the amount of the dividend (the existing rule) and the FMV of the shares issued in payment of the stock dividend (the "**FMV Limitation**").

Again, this new rule appears to be aimed at situations where stock dividends are used to misalign value and tax basis (e.g. where a high-low preferred share is paid as a stock dividend on a common share). Such concerns do not apply to Same Class Stock Dividends where there is no misalignment of value between classes of shares. In addition, the application of draft paragraph 52(3)(a) to Same Class Stock Dividends can result in anomalous results, as illustrated below.

**Example 7:**

A Co owns all of the shares of B Co, which only has a single class of common shares outstanding. B Co's SIOH in respect of A Co is $4 million. B Co pays A Co a Same Class Stock Dividend. Because B Co believes its common shares will be worth $100,000 per

share on issuance, it issues 40 common shares with a stated capital of $100,000 per share in satisfaction of the dividend. Assume the per share FMV of the B Co common shares is actually $80,000 per share. Under proposed subsection 55(2.2), the amount of the dividend is the greater of $4 million and $3.2 million (40 x $80,000), being $4 million. Subsection 55(2.3) does not apply because the FMV of the stock dividend shares does not exceed the amount of the dividend.[16] Applying proposed paragraph 52(3)(a) to the stock dividend, A Co's cost of the stock dividend shares is only $3.2 million (*i.e.*, the FMV Limitation applies) despite the fact that A Co's SIOH in respect of B Co is reduced by $4 million. This cost is averaged with the ACB of A Co's existing common shares of B Co.

From a policy perspective, in this context there is no reason to reduce A Co's cost of its B Co common shares simply because the stock dividend shares have a lower FMV than the amount of the dividend. The "cost averaging" provisions in section 47 should ensure A Co's tax cost and the FMV of the B Co common shares are aligned regardless of number/FMV of B Co common shares issued on the Same Class Stock Dividend. That is, it should not matter if B Co issued 50 shares (the "correct" number by FMV) or 1 share. In summary, because there is no misalignment of tax basis and value and A Co's SIOH is actually reduced by the amount of the stock dividend,[17] A Co's cost of the B Co common shares should be increased by the amount of the dividend (*i.e.*, in this case, the amount of the SIOH) and not a lesser amount.

The correctness of the above proposition is supported by a consideration of the tax consequences of alternative SIOH transactions. If a SIOH dividend is deemed to be paid by a stated capital/PUC increase, the increase in A Co's cost of the shares of B Co would be equal to B Co's SIOH in respect of its common shares held by A Co. That is, no FMV Limitation would apply, notwithstanding that on a stated capital increase there is no change in the FMV of the shares issued (because no shares are issued). There is no sound tax policy basis for distinguishing the two cases: they have exactly the same effect but a taxpayer may not always have a choice to proceed one way instead of the other.[18]

We therefore recommend that the FMV Limitation in proposed subclause 52(3)(a)(ii)(A)(I) not apply where the stock dividend is a Same Class Stock Dividend and there is no misalignment between the tax cost of the shares of the dividend payer and the FMV of such shares.

***Same Class Stock Dividends - FMV Greater than PUC***

**Example 8:**

As a variation to Example 7, assume the FMV of the B Co shares is actually $120,000 per share. In that case, draft subparagraph 55(2.2)(b)(ii) appears to result in the amount of

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[16] See proposed paragraph 55(2.4)(b).

[17] The reduction would be the lesser of the amount of the dividend and the SIOH, but in the example there is sufficient SIOH.

[18] Under Canadian corporate statutes, increases in stated capital (and thus PUC) generally require shareholder approval by special resolution, whereas stock dividends do not.

the deemed dividend exceeding A Co's SIOH in respect of B Co (since the FMV of the shares issued on the stock dividend exceeds the amount of the dividend). This could expose A Co to subsection 55(2) risk in a non-abusive situation because the conditions in subsection 55(2.1) arguably are satisfied. In particular, the only purpose of the dividend may be to reduce a capital gain on existing common shares[19] but only by the SIOH – and that should be acceptable. However, by virtue of subparagraph 55(2.2)(b)(ii), in this circumstance, the dividend is deemed to be $4.8 million for purposes of paragraph 55(2.1)(c) and thus subsection 55(2) would appear to apply to the "extra" $800,000 dividend. Alternatively, the purpose test in clause 55(2.2(b)(ii)(A) could be satisfied if one of the purposes of the dividend is to reduce the value of the existing B Co common shares.

As in other Same Class Stock Dividends, the proposed amendments give rise to an unfair result in the above example. Regardless of the value of the shares issued on the stock dividend, the basis averaging rules in section 47 ensure that each share has the same ACB and that the overall gain is preserved; thus there is no need to impose an immediate gain recognition under subsection 55(2) in these circumstances.

For the reasons above, we recommend that the proposed subsection 55(2.2) to (2.4) not apply to Same Class Stock Dividends where there is no misalignment of basis and value.

***Basis Averaging***

Implicit in the conclusion that the above examples do not result in any misalignment of tax basis and value is that section 47 applies to average the cost of the shares received by a shareholder on a Same Class Stock Dividend with the shareholder's existing shares. If such averaging does not occur, misalignment can occur as illustrated in Example 9 below.

**Example 9:**

A Co owns 100 common shares of B Co, the only issued and outstanding shares of B Co. A Co's ACB of the B Co common shares is $1,000, the FMV of such shares is $2,000 and there is no SIOH in respect of such shares. B Co declares a stock dividend payable in common shares. The amount added to stated capital (and PUC) of the B Co common shares is $1.00 and 100 common shares are to be issued in satisfaction of the stock dividend. The declaration of the stock dividend should reduce the FMV of the existing 100 common shares of B Co from $2,000 to $1,000. If A Co sold such shares for $1,000 after the record date for the stock dividend but before it is paid, A Co's ACB of such shares immediately prior to the disposition would be $1,000, such that A Co would not realize a gain on the sale. Although A Co's cost of the B Co common shares received on the dividend would be nominal, it would not be averaged with the ACB of the existing shares, which were sold before the dividend was received. Thus, the effect of the stock dividend would be to reduce the FMV of the existing shares without an immediate pro rata reduction in tax cost.

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[19] That is, the purpose test in subparagraph 55(2.1)(b)(i) is satisfied.

It would seem inappropriate to exclude the stock dividend in Example 9 from the rules in proposed subsection 55(2.2) to (2.4) unless section 47 cost averaging results. Such cost averaging could be ensured by providing that, for the purposes of section 47, a stock dividend is deemed to have been received on the record date for the dividend.

***Cost of Stock Dividend Shares - Capital Dividends***

The FMV Limitation in proposed paragraph 52(3)(a) applies to a dividend whether it is a capital dividend or a taxable dividend. The existing and proposed cost limitation rules in paragraph 52(3)(a) are aimed at taxable dividends (which are deductible in computing taxable income) and are a back-stop to subsection 55(2). Capital dividends are not subject to subsection 55(2) and thus should not be subject to such rules.

We recommend that draft paragraph 52(3)(a) be amended so the FMV Limitation does not apply to capital dividends.

***Proposed Additional Amendments***

One means of addressing the issues relating to stock dividends and capital dividends might be to introduce a definition of "excluded dividend", to which subsection 55(2.3) and paragraph 52(3)(a) would not apply. We have given this idea some thought and would be pleased to work with you to explore this concept in more detail.

**4. <u>Deemed Proceeds or Deemed Gain</u>**

In our earlier submission we had asked for paragraph 55(2)(b) to be restored. The Draft Legislation has restored that provision, although in a more limited manner. It now applies only with respect to deemed dividends under subsections 84(2) or (3) where the relevant shares are cancelled, and not to any other disposition of the shares as is the case under the current legislation. In our view, in any circumstance in which a share is disposed of, the dividend should, to the extent subsection 55(2) applies, be considered proceeds of disposition of the share. Subsection 55(2) has always operated so that where a share has been disposed of, any re-characterized dividend is treated as additional proceeds of disposition of such share. Regardless of the reasons for expanding the scope of subsection 55(2), those reasons do not support re-characterizing a dividend as a capital gain (instead of proceeds) where the share on which the dividend has been received is disposed of. This is illustrated by the examples set out below:

> **Example 10**:
>
> A Co owns all the shares of B Co. A Co's ACB of the B Co shares is $10 million and their FMV is $10.1 million. B Co has previously paid $2 million of dividends to A Co out of SIOH. B Co pays a dividend of $1 million to A Co to which proposed subsection 55(2) applies. A Co then sells B Co to an arm's length party for $9.1 million.

Under existing subsection 55(2), A Co would have been deemed to have disposed of the shares for $10.1 million ($9.1 million and $1.0 million additional proceeds) so as to realize a capital

gain of $0.1 million, the appropriate result from a policy perspective. Under proposed subsection 55(2), A Co would be deemed to realize a capital gain of $1.0 million as a result of the dividend and would realize a $0.9 million capital loss on the sale ($9.1 million proceeds less $10 million ACB). However, such capital loss would be denied by virtue of subsection 112(3), because of the $2 million of dividends previously paid to A Co out of SIOH. Clearly this is inappropriate. Both transactions should yield the same result.

In addition, an error in calculating SIOH should not affect the timing of the capital gain from the disposition of the shares.

**Example 11:**

Holdco owns ACo, which owns all of the shares of BCo and intends to sell them to an arm's length party. The shares have FMV of $4 million and ACo's ACB is $3.2 million. ACo believes BCo's SIOH is $400,000 and causes BCo to pay it a $400,000 cash dividend before the sale, reducing the price that purchaser will pay to $3.6 million. Immediately following the sale, ACo pays a $1 million dividend to Holdco. In fact the SIOH is only $360,000, and ACo makes a paragraph 55(5)(f) designation to treat the excess $40,000 as a separate dividend, with the result that subsection 55(2) applies to that dividend.

Under current subsection 55(2), the $40,000 would be deemed to be part of the proceeds of disposition of the shares, so ACo's proceeds of disposition would be $3.64 million (being $3.6 million from the purchaser and $40,000 from the re-characterized portion of the dividend). ACo's capital gain from the disposition of the shares would thus be $440,000. This is the same capital gain as ACo would have realized had it accurately computed its SIOH and paid a pre-closing dividend equal to its actual SIOH.

Under the Draft Legislation, notwithstanding that the share is disposed of, the dividend is not treated as part of ACo's proceeds of disposition of the share, but is simply a capital gain for the year in which the dividend is received from the disposition of a capital property. This raises a question as to when the capital gain under paragraph 55(2)(c) arises – is it when the dividend is paid or at the end of the year or at some other time in the year? Depending on the answer to this question, a number of related issues potentially arise.

As described above, the time at which a deemed capital gain under subsection 55(2) is realized and included in the dividend recipient's income will be relevant in circumstances where the dividend recipient intends to pay a dividend out of its SIOH as part of the series. In addition, the time at which a deemed capital gain under subsection 55(2) is realized may be relevant to the computation of a corporation's capital dividend account ("**CDA**"). The CDA at a particular time includes the non-taxable 50% of a capital gain from a disposition of capital property **before** that time. A dividend recipient who receives a dividend to which subsection 55(2) applies because the dividend payer's purpose is one described in subsection 55(2), or because there is a miscalculation of SIOH, should be entitled to recognize any gain arising under subsection 55(2) as arising at the time the dividend is paid.

In light of the foregoing, we strongly recommend that paragraphs 55(2)(b) be restored to its current form in the Act.

## 5. Technical Drafting Issues

(a) In subparagraph 55(2.1)(b)(i) we believe the words "the portion of" in the phrase "a significant reduction in the portion of the capital gain" should be deleted. This language is unnecessary in the reformulation of the language.

Subclause 52(3)(a)(ii)(A)(I) restricts the amount added to the cost of a stock dividend share to "the amount of the stock dividend" less the amount of the dividend that may be deducted under subsection 112(1) – which is generally the SIOH. The provisions of subsections 55(2.2) to (2.4) contain a special rule for determining the amount of a stock dividend for purposes of subsections 55(2) and 112(1), (2) and 138(6). In the case of a high-low stock dividend that results in an addition to PUC that is greater than SIOH, it is not clear whether the amount of the stock dividend in subclause 52(3)(a)(ii)(A)(I) is the amount per the subsection 248(1) definition of "amount" (*i.e.*, the addition to PUC) or the amount determined after applying subsection 55(2) (*i.e.*, the portion of the stock dividend that is not subject to subsection 55(2)). We believe it is intended that the reference is to the latter but suggest that that be clarified. We believe this could be done by adding a few words to clause 52(3)(a)(ii)(A)(I) as follows: the amount of the stock dividend **(determined after the application, if any, of paragraph 55(2)(a) to such dividend)**

Please consider the following simple example.

**Example 12:**

Holdco owns 100% of the shares of Opco. Opco pays a stock dividend to Holdco in non-voting common shares with a FMV of $100 and a stated capital/PUC of $30, which is believed to be the SIOH. It is subsequently determined that the SIOH is in fact $20. Assume that subsection 55(2) applies to the stock dividend.

Applying the definition of "amount" in subsection 248(1) would result in the amount of the dividend being $30 (*i.e.*, the amount added to PUC). Paragraph 55(2.2)(b) provides that the amount of the dividend is $100 for purposes of applying subsections 55(2), (2.1), (2.3) and (2.4). Subsection 55(2.3) applies (by virtue of subsection 55(2.4) – it is a high-low stock dividend) to separate the stock dividend of $100 into a portion out of SIOH ($20) and the balance ($80), which balance is subject to subsection 55(2). Thus such balance is deemed not to be a dividend received and, by virtue of paragraph 55(2)(c), is deemed to be a capital gain of Holdco for the year.

Subclause 52(3)(a)(ii)(A)(I), which is relevant to the determination of the ACB of the share, starts with the lesser of the amount of the stock dividend and its FMV. Applying the definition of "amount" in subsection 248(1), the amount of the stock dividend would be $30. Applying subsection 55(2) to the $100 dividend deemed to be paid by paragraph 55(2.2)(b), the amount of the dividend would be reduced to $20.

From that amount, per subclause 52(3)(a)(ii)(A)(II), it is necessary to deduct the portion of ***that*** dividend that is deductible under subsection 112(1) – is that $30 or $20? – except the portion of ***that*** dividend (again $30 or $20) that is not in excess of SIOH.

Presumably, for both subclause (A)(I) and subclause (A)(II) in this example the amount of the dividend is intended to be $20 – that is the amount of the stock dividend out of SIOH – so that the amount determined under clause (A) on these facts is $20 (*i.e.*, $20 - $0). The alternative would be that the amount under subclause (A)(I) is $30 and it is reduced under subclause (A)(II) by $10. In either case, the net addition to cost under clause (A) would be the same $20 and, under clause 52(3)(a)(ii)(B), the deemed gain under paragraph 55(2)(c) – being $80 – would be added to that amount so the cost of the preferred shares to Holdco is $100.

However the correct interpretation of subclause (A)(II) is important because that amount is carried over to the changes to the definition of "capital dividend account". That is to say, we believe that in the example, the amount under subclause (A)(II) should be nil. This would be consistent with the approach to PUC increases under paragraph 53((i)(b). In our view, on these facts, the fact that there was an error in the SIOH determination should not affect the treatment of a capital gain realized on a subsequent disposition of the shares. Had the SIOH been appropriately determined, there would have been no deduction under subclause (A)(II) and, in this case, the full $100 FMV and cost of the shares has been taxed – as to $20 as earnings in Opco and as to $80 as a capital gain in Holdco.