



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

January 19, 2018

Brian Ernewein  
General Director, Tax Policy Branch  
Finance Canada  
90 Elgin Street  
Ottawa, ON K1A 0G5

Dear Mr. Ernewein:

**Subject: Subsection 55(2) Amendments – Follow-Up to Our Meeting with Canada Revenue Agency**

Last fall, we met with senior members of the Canada Revenue Agency ("CRA") to review a submission the Joint Committee made seeking guidance regarding the manner in which the CRA would be administering subsection 55(2) as amended following the 2015 federal budget proposals.

Although the meeting was extremely informative, the CRA was only able to deal with some of the issues raised, which were subsequently discussed at the 2017 Canadian Tax Foundation CRA Roundtable. Based on the meeting, we believe that a number of the issues in the submission cannot be dealt with by the CRA in isolation and accordingly, we ask for your consideration of these issues. A copy of the submission is enclosed.

We trust you find the enclosed useful and would be pleased to discuss the issues raised at your convenience.

Yours very truly,

Kim G. C. Moody  
Chair, Taxation Committee  
Chartered Professional Accountants of Canada

Jeffrey Trossman  
Chair, Taxation Section  
Canadian Bar Association

Cc: Andrew Marsland, Senior Assistant Deputy Minister, Tax Policy Branch, Finance Canada  
Costa Dimitrakopoulos, Director General, Income Tax Rulings Directorate, CRA  
Stéphane Prud'homme, Director, Income Tax Rulings Directorate, CRA  
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April 20, 2017

Randy Hewlett  
Director General  
Income Tax Rulings Directorate  
Canada Revenue Agency  
112 Kent Street, Ottawa, Ontario K1A 0L5

Dear Randy:

**Subject: Subsection 55(2) Amendments**

The 2015 federal budget introduced significant changes to subsection 55(2) and related provisions (the “Amendments”). The detailed explanatory notes to the Amendments released by the Department of Finance indicated that the changes were intended to address the same tax policy concerns underlying the existing language of subsection 55(2), being the undue reduction of corporate capital gains that would otherwise arise on a planned sale of property.

Having had the chance to review these rules and apply them to actual taxpayer situations, the Joint Committee has many concerns over the complexity and reach of these rules. In particular, the Joint Committee has identified a number issues in the following contexts:

- The interpretation of the new purpose tests in paragraph 55(2.1)(b) and concern that the tests may impact dividends where a reduction of a corporate capital gain was never a motivation.
- The timing and scope of the deemed gain arising under paragraph 55(2)(c) and the interaction of the deeming rule with other provisions of the Act.
- The application of the Amendments to transactions intended to capitalize safe income, including uncertainty and complexity in calculating the cost of a stock dividend and the impact on the computation of a taxpayer’s capital dividend account.
- The amendments to the related party exception in paragraph 55(3)(a) and concerns over the application of subsection 55(2) to ordinary cash movements within a corporate group.
- The interpretation of the Part IV tax exception in subsection 55(2) and compliance issues under *Ottawa Air Cargo Centre Ltd. v R.*

Our objective in sending this letter to you is to begin a dialogue and bring to the Canada Revenue Agency’s (the “Agency”) attention the potentially unintended consequences to small and large corporations across the country that may arise from an overly broad or literal interpretation of these rules in advance of a proposed meeting in the coming months.

We hope that the Agency will respond by adopting interpretations that we believe are consistent with the policy objective behind the Amendments. We also hope that the Agency will develop meaningful guides and aids to the public in navigating and complying with these rules.

The Joint Committee would like to acknowledge the significant contributions of the following individuals in the preparation of this material.

Rick McLean (KPMG LLP)

Ken Griffin (PricewaterhouseCoopers LLP)

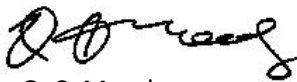
Terry Speiss (MNP LLP)

Eric C Xiao (Ernst & Young LLP)

Gwen Watson (Torys LLP)

If you would like to discuss any of the comments in advance of the upcoming meeting, please contact us.

Yours very truly,



Kim G. C. Moody

Chair, Taxation Committee

Chartered Professional Accountants of Canada



K.A. Siobhan Monaghan

Chair, Taxation Section

Canadian Bar Association

Cc:

Marina Panourgias, Senior Rulings Officer, Income Tax Rulings Directorate, CRA

Gabe Hayos, Vice President, Taxation, CPA Canada

# Subsection 55(2) Discussion Document

2017-04-19

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# The Purpose Tests

## Paragraph 55(2.1)(b)

- The purpose tests will be referred to herein as the “**Gain Reduction Purpose Test**”, “**FMV Reduction Purpose Test**”, and “**Cost Amounts Increase Purpose Test**”.
- These purposes and purpose tests will be referred to herein as the “**Three Purposes**” and “**Three Purpose Tests**”, respectively.

# The Three Purpose Tests

## Question:

- Can CRA provide further guidance on the approach to an assessment of the Three Purpose Tests?

## Recommendation:

- For paragraph 55(2.1)(b), “purpose” should be interpreted in a subjective manner which focuses on the motive of the taxpayer and not on the result of a dividend.
- For a taxpayer to have a purpose described in paragraph 55(2.1)(b), the motivation must involve current or future tax reduction.
  - The Explanatory Notes state that subsection 55(2) is amended to address the “same policy concern” – “reduction of corporate capital gains”.
- The taxpayer must offer a persuasive explanation that establishes that none of the Three Purposes exist.
- While it is not necessary that the taxpayer adduce corroborative or additional evidence, any explanation of purpose must be neither improbable nor unreasonable.

# The Three Purpose Tests - Discussion

- **Three cases considered the Capital Gain Reduction Purpose Test in former 55(2)**

- *CPL Holdings Ltd. v. The Queen*, 95 DTC 5253 (FCTD) (“*CPL Holdings*”)
- *Placer Dome Inc. v. The Queen*, 96 DTC 6562 (FCA), aff'g 96 DTC 1787 (TCC) (“*Placer Dome*”)
- *Meager Creek Holdings Ltd. v. The Queen*, 98 DTC 2073 (TCC) (“*Meager Creek*”)

- **Summary of Findings**

- The purpose test is not a results test.
- The purpose test is subjective and focuses on the motive of the taxpayer.
- The burden of proof rests with the taxpayer.
- The standard of proof requires that a taxpayer demonstrate that none of the purposes be a reduction in a capital gain [under former subsection 55(2)].

- **Recent Jurisprudence**

- In *10113981 Saskatchewan Ltd. v. The Queen*, 2017 TCC 3, the trial judge reaffirmed the meaning of purpose set out in *Placer Dome*, holding that “it is clear that the ‘purpose’ test in [former] subsection 55(2) requires a subjective understanding whereas an objective approach is required for the ‘results’ test”.



# The Three Purpose Tests - Discussion

- ***Placer Dome, CPL Holdings and Meager Creek* established:**
  - Whether a particular purpose test is subjective or objective depends on the statutory context in which it appears.
  - The context of former subsection 55(2) suggests that the purpose test must be subjective
    - The two terms (purpose and result) could not bear the same meaning in the same provision, and
    - Because “result” is necessarily objective, “purpose” must be interpreted as intended to be applied in a contrasting subjective manner.
  - The courts made a clear distinction between the purpose of a dividend and the result of a dividend.
  - The purpose test (under former subsection 55(2)) looks to the actual motives of the dividend recipient and dividend payer and "extends a personal invitation to the taxpayer to testify as to his or her state of mind at the time the transaction or transactions were put into effect“.

# The Three Purpose Tests - Discussion

- ***Placer Dome, CPL Holdings and Meager Creek established:***
  - Where a transaction has the effect of significantly reducing a capital gain [under former subsection 55(2)], the CRA may infer that the taxpayer had such a purpose, but it is then open to the taxpayer to rebut this inference.
  - The dividend recipient must offer a persuasive explanation that establishes that none of the purposes was to reduce a capital gain [under former subsection 55(2)].
  - It is not necessary to adduce corroborative or additional evidence.
  - Uncorroborated but credible testimony can be sufficient proof of intention.
  - Any explanation of purpose “must be neither improbable nor unreasonable”.
  - “[M]ere denial” of a gain-reduction purpose, without any explanation, is not sufficient to satisfy the burden of proof.
  - A corporate shareholder will not meet the burden of proof by showing that the “main purpose” of a dividend was business related.

## *Ludco* and the Paragraph 20(1)(c) Purpose Test

- In *Ludco v. The Queen*, 2001 SCC 62 ("*Ludco*"), the Supreme Court of Canada considered the purpose test for interest deductibility under paragraph 20(1)(c).
  - 20(1)(c) does not have both a purpose and results test
- The court held, “[i]n the interpretation of the Act, as in other areas of law, where purpose or intention behind actions is to be ascertained, courts should objectively determine the nature of the purpose, guided by both subjective and objective manifestations of purpose”.
- Very recent jurisprudence does not apply the principle that objective manifestations of purpose are critical to ascertain the purpose or intention behind actions under former subsection 55(2) because of the particular language therein that distinguishes between purpose and result.
- In *10113981 Saskatchewan Ltd. v. The Queen*, 2017 TCC 3, the trial judge reaffirmed the meaning of purpose set out in *Placer Dome*, holding that “it is clear that the ‘purpose’ test in [former] subsection 55(2) requires a subjective understanding whereas an objective approach is required for the ‘results’ test”.

## The Three Purpose Tests – Meaning of “Significant”

### Question:

- Would the CRA consider adopting an administrative position or further guidelines on what “significant” means for the Three Purpose Tests

### Discussion:

- 2015-0610651C6
  - Whether a reduction of value is significant is a question of fact and could be measured in terms of an absolute dollar amount or on a percentage basis

# The Three Purpose Tests

Interaction with Paragraph 55(5)(f) and  
Subsection 55(2.3)

# The Three Purpose Tests: Interaction with Paragraph 55(5)(f) and Subsection 55(2.3)

- **Background:**

- Paragraph 55(5)(f), or paragraph 55(2.3)(a) in the case of a high-low stock dividend, bifurcates a dividend into a safe-income dividend and a non-safe-income dividend

- **Question:**

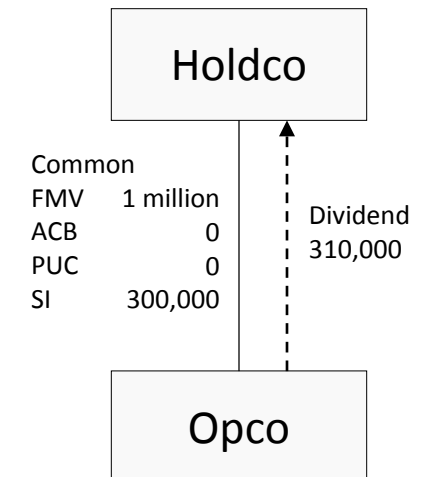
- Are the Three Purpose Tests to be evaluated after the application of these paragraphs?

OR

- Are the Three Purpose Tests to be evaluated before the application of these paragraphs and to consider only the “actual” dividend with the same purpose applying to both deemed separate dividends?

- **Example:**

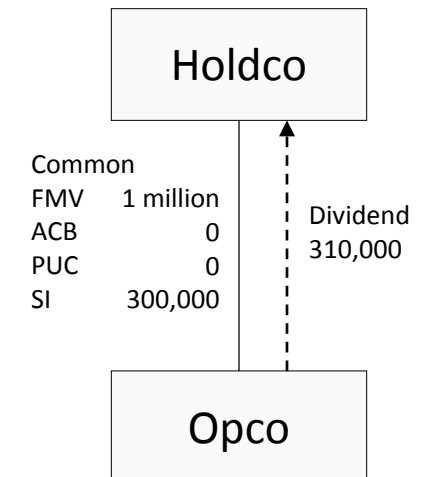
- The shares of Opco have an FMV of \$1 million and have an ACB of nil and safe income of \$300,000.
- It was estimated that safe income was \$310,000 and a cash dividend in that amount was paid.



# The Three Purpose Tests: Interaction with Paragraph 55(5)(f) and Subsection 55(2.3)

- **Discussion:**

- Under paragraph 55(5)(f)
  - \$300,000 is deemed to be a separate taxable dividend.
  - \$10,000 is deemed to be a separate taxable dividend.
- Should subsection 55(2.1) be read twice?
  - Once for each of the separate taxable dividends?
- If so, and if the amount of \$10,000 is not considered to be “significant”, then paragraph 55(2.1)(b) should not apply to the \$10,000 dividend because the purpose of that dividend could not have been to effect a significant reduction in a capital gain or FMV.
- In determining whether a reduction in fair market value is “significant”, does subsection 55(2.5) apply after the application of Paragraph 55(5)(f) or paragraph 55(2.3)(a)?
  - Also see slide 72



# The Three Purpose Tests

Ordinary Course Dividends & Well-Established  
Dividend Policy



# Ordinary Course Dividends & Well-Established Dividend Policy

- **Question**

- Can CRA provide clarification on “ordinary course dividends” and “well-established dividend policy”?

- **Comment**

- It is acknowledged that some clarification was provided in Technical Interpretation 2016-0627571E5.
- However, there is uncertainty amongst tax practitioners on the meaning of these terms.

- **Recommendation**

- Issuance of a technical interpretation clarifying CRA’s position on ordinary course dividends and dividends paid pursuant to a well-established dividend policy.
  - Do the CRA’s comments represent an administrative position?

## Ordinary Course Dividends & Well-Established Dividend Policy - Discussion

- At the Canadian Tax Foundation's (CTF) 2015 annual conference at the Canada Revenue Agency Round Table ("**Round Table**") and at a Tax Executive Institute Liaison Meeting (November 17, 2015) ("**TEI Meeting**"), the CRA referred to a "**well-established dividend policy**". Reference was made in the related questions to "**ordinary course dividends**".
  - The TEI Meeting comments are reflected in CRA document 2015-0613821C6.
- **CRA Comments**
  - The CRA said that where a dividend is paid pursuant to a well-established dividend policy and the amount of the dividend does not exceed a reasonable dividend return on equity on a listed share issued by a comparable corporation in the same or similar industry, the purpose of the dividend would not be described in proposed paragraph 55(2.1)(b).
  - Technical Interpretation 2016-0627571E5 provided some clarification.

# The Three Purpose Tests

## Creditor-Proofing Dividends

## CRA Comments - Creditor Proofing

### **Question:**

- Would CRA reconsider its statement that the FMV Reduction Purpose Test or Cost Amounts Increase Purpose Test is met on the payment of a creditor-proofing dividend where the reduction in FMV or increase in cost amounts is only the “result”?

### **Recommendation:**

- A clarification that the FMV Reduction Purpose Test and the Cost Amounts Increase Purpose Test are “purpose” tests and, while a creditor-proofing dividend might result in a reduction in the FMV of a share or an increase in cost amounts, the reduction in value or increase in cost amounts is not necessarily the purpose.

## CRA Comments - Creditor Proofing - Discussion

- In CRA documents 2015-0623551C6 and 2015-0617731E5, the CRA expressed the view that the purpose of creditor proofing is to reduce the FMV of a share or to increase the cost base of property. The fact that the purpose of the dividend is also to achieve creditor proofing would not alter that conclusion.
- However, if the sole purpose of the dividend is to protect assets of the Dividend Payer from potential creditors of the Dividend Payer, the dividend might not have one of the Three Purposes.
- For a taxpayer to be considered to have a “purpose” of reducing FMV or increasing cost base, the motivation behind that reduction or increase must involve current or future tax reduction
- A dividend recipient that has no intent to use preserved or created cost base or “use” a reduction in FMV should not be subject to subsection 55(2)
- The CRA appears to be inappropriately taking a “results” based approach to determining purpose in this situation.
- In *CPL Holdings*, the series of transactions included the transfer of an operating company to a holding company on a tax-deferred basis, followed by a dividend payment to the holding company by the operating company, the proceeds of which were used by the holding company to make a secured loan to the operating company. At paragraph 28 of *CPL Holdings*, the court accepted that the purpose of the dividend was creditor-proofing, to protect assets from the threat of a lawsuit, not to avoid taxation.

# Same-Class Stock Dividends

# Same-Class Stock Dividends

## **Issue:**

- Would the CRA accept that a same-class stock dividend would not satisfy any of the Three Purpose Tests?

## **Discussion:**

- A same-class stock dividend is often used to implement a share split
- As a result of a same-class stock dividend, a shareholder's total FMV, ACB, PUC and safe income should not change

# Deemed Gain

## Timing of Deemed Gain Under Paragraph 55(2)(c)



## Timing of Deemed Gain Under Paragraph 55(2)(c)

- Where subsection 55(2) applies to a dividend that is not received on a redemption, acquisition or cancellation of a share to which subsection 84(2) or (3) applies, the dividend recipient is deemed to have a gain under paragraph 55(2)(c), for the year in which the dividend was received from the disposition of a capital property.

### **Question:**

- Does the deemed gain occur at the time of the payment of the dividend?
- Does the addition to the capital dividend account occur at the time of the payment of the dividend?

### **Recommendation:**

- The gain and the addition to the capital dividend account should be considered to occur at the time of the payment of the dividend.
- This is appropriate given that a particular dividend is paid at a particular time and it is the particular dividend that is recharacterized as a gain.
- For paragraph 55(2)(b), the gain arises at the time of the dividend.
  - For consistency, the gain under paragraph 55(2)(c) should occur at the time of the dividend payment.
- “For the year” could be interpreted to mean that the CDA increase happens at the beginning of the year
- In CRA document 2011-0412131C6, the CRA indicated that in the event of the application of former paragraph 55(2)(c) to a dividend, the capital gain would 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 and as such, could be distributed as a capital dividend only in the following years.
  - It is not clear why the capital dividend could only be distributed in a following year.

Deemed Gain

Scope of Deeming Rule

## Scope of Deeming Rule in Subsection 55(2)

### Question:

- Do the deeming rules in paragraphs 55(2)(a), (b) and (c) apply for all purposes of the Act?

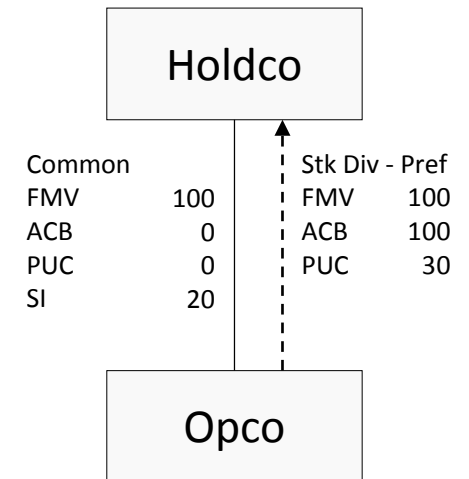
### Discussion:

- The CRA has generally taken the view that the deeming rules apply for all purposes of the Act
  - Examples:
    - In a situation in which a dividend is recharacterized as a gain, the dividend recipient is not entitled to a GRIP addition
      - See CRA document No. 2007-0233771C6
    - A deemed dividend received pursuant to subsection 84(1) to which former paragraph 55(2)(a) applied would be deemed not to be a dividend such that 53(1)(b) would not apply. As such, no amount would be computed under paragraph 53(1)(b)(ii) which is relevant for clause (a)(i)(A) of the definition of “capital dividend account” in subsection 89(1).
      - See CRA document 2011-0421141E5
- The Explanatory Notes to amended paragraph 52(3)(a) suggest that the “amount of the dividend” and “the amount of the dividend that the shareholder may deduct under subsection 112(1)” are not affected by the application of subsection 55(2) to the dividend.
- If a cash dividend was recharacterized (deemed to be a gain) under paragraphs 55(2)(a) and (c), would the amount of the subsection 112(1) deduction be equal to the actual amount of the cash dividend?

# Scope of Deeming Rule in Subsection 55(2)

**Example** (See calculations for subparagraph 52(3)(a)(ii) amounts in subsequent slide)

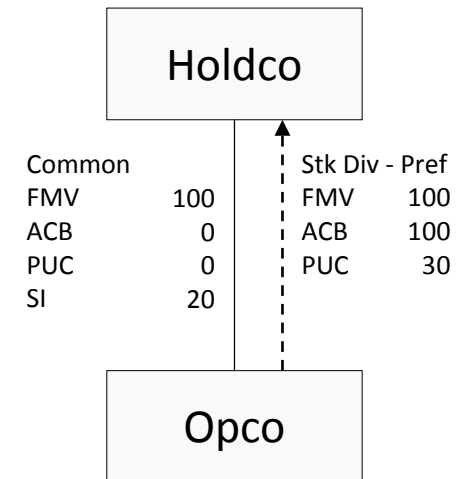
- The safe income contributing to the capital gain on the Opco shares is estimated to be \$30 but is finally determined to be \$20
- A stock dividend, payable by the issuance of preferred shares, is paid by Opco to capitalize safe income and freeze existing value
- Assuming that one of The Three Purposes is satisfied on the payment of the stock dividend
  - Holdco is deemed to have a gain of \$80 equal to the FMV of the stock dividend less the safe income
- Several different dividend “amounts” are computed for different purposes
  - Subsection 248(1) “amount”: \$30
  - Subsection 55(2.2) amount: \$100
  - Paragraph 55(2.3)(a) amount: \$20
  - Remaining taxable dividend: \$80
    - Under paragraph 55(2.3)(a), \$20 of the subsection 55(2.2) amount of \$100 is deemed to be a separate taxable dividend



# Scope of Deeming Rule

**Example** (See calculations for subparagraph 52(3)(a)(ii) amounts in subsequent slide)

- For paragraph 52(3)(a), the Explanatory Notes suggest that the “the amount of the dividend that the shareholder may deduct under subsection 112(1)” is \$30 even though Holdco will have a deemed gain of \$80 leaving a taxable dividend of \$20.
- The amount computed for the ACB of the stock dividend shares is \$100 in this example irrespective of whether the original “amount” of \$30 is adjusted for the application of subsection 55(2).
  - However, there is a difference in the amount computed under paragraph 53(1)(b)(ii) which is relevant for clause (a)(i)(A) of the definition of “capital dividend account” in subsection 89(1).
- The application of subsection 55(2) recharacterizes a portion of the 55(2.2) dividend of \$100.
  - Subsection 55(2.2) applies only for the purposes of subsections 55(2), (2.1), (2.3) and (2.4).
  - \$80 of the \$100 dividend is recharacterized to not be a dividend.
  - There is no provision that recharacterizes the \$30 dividend amount.
    - Should the \$30 dividend amount be recharacterized as \$20?
- Does this mean that for other purposes of the Act that the amount of the dividend is \$30?
  - Addition to GRIP
  - 112(3)
  - Part IV
- If the amount of the dividend for other purposes of the Act is intended to be \$20, there is no provision that adjusts the \$30 dividend.
- If the amount of the dividend for other purposes of the Act is \$30, will a similar (consistent) approach be taken for paragraph 53(1)(b)?



# Scope of Deeming Rule

			If "amount" is not reduced by 55(2) recharacterization		If "amount" is reduced by 55(2) recharacterization	
Cost of Stock Dividend 52(3)						
52(3)(a)(ii)(A)	(A) the amount, if any, by which					
52(3)(a)(ii)(A)(I)	(I) the amount that is the lesser of the amount of the stock dividend and its fair market value			30		20
	exceeds					
	(II) the amount of the dividend that the shareholder may deduct under subsection 112(1)		30		20	
	in computing the shareholder's taxable income,					
	except any portion of the dividend that,					
	if paid as a separate dividend, would not be subject to subsection 55(2) because					
	the amount of the separate dividend would not exceed the amount of the					
	income earned or realized by any corporation — after 1971 and before					
	the safe-income determination time for the transaction, event or series of transactions					
	or events as part of which the dividend is received — that could reasonably be considered					
	to contribute to the capital gain that could be realized on a disposition at fair market value,					
52(3)(a)(ii)(A)(II)	immediately before the dividend, of the share on which the dividend is received, and		20	10	20	0
	ACB addition under 52(3)(a)(ii)(A)			20		20
52(3)(a)(ii)(B)	(B) the amount determined by the formula					
	A + B					
	where					
A	is the amount of the deemed gain under paragraph 55(2)(c) in respect of that stock dividend,		80		80	
	and					
B	is the amount, if any, by which the amount of the reduction under paragraph 55(2.3)(b)		0		0	
	in respect of that stock dividend to which paragraph 55(2)(a) would otherwise apply					
	exceeds the amount determined for clause (A) in respect of that dividend.					
	ACB addition under 52(3)(a)(ii)(B)		80		80	
	Total ACB		100		100	

# Capitalizing Safe Income

# CDA Calculation – Stock Dividends and Subsection 84(1) Deemed Dividends

- **Issue:**

- Clarification of CDA calculation in clause (a)(i)(A) of the definition of “capital dividend account” in subsection 89(1)

- **Introduction:**

- The definition of capital dividend account was amended as a result of amendments to paragraphs 52(3)(a) and 53(1)(b) [for dispositions after 2006]
  - The amendments to paragraphs 52(3)(a) and 53(1)(b) introduced a reduction in the ACB addition for an amounts not representing safe income
  - The related amendments to the definition of capital dividend account were to prevent a form of “surplus stripping” that could otherwise arise as a result of the paragraph 52(3)(a) and 53(1)(b) amendments in a situation in which paid-up capital exceeded ACB
  - For a safe-income capitalization as part of a sale transaction, it would not be appropriate for the CDA reduction to apply
  - CRA appeared to accept previously that a deemed dividend received pursuant to subsection 84(1) to which former paragraph 55(2)(a) applied would be deemed not to be a dividend, such that paragraph 53(1)(b) would not apply. As such, the related amendment to the definition of CDA would also not apply.
    - See, for example, CRA document 2011-0421141E5
- See further analysis in subsequent slides



Capitalizing Safe Income

Stock Dividends

# Cost of Stock Dividend and CDA Calculation

- **Issues:**

- Clarification of calculation in subparagraph 52(3)(a)(ii)
  - Explanatory Notes suggest that the “amount of the dividend” and “the amount of the dividend that the shareholder may deduct under subsection 112(1)” should not be adjusted for subsection 55(2) re-characterization of dividend as a gain
  - See previous discussion under “Scope of Deeming Rule”
- Clarification of CDA calculation in clause (a)(i)(A) of the definition of “capital dividend account” in subsection 89(1)
- Is one of the Three Purposes satisfied on the payment of a stock dividend that was issued to capitalize safe income?

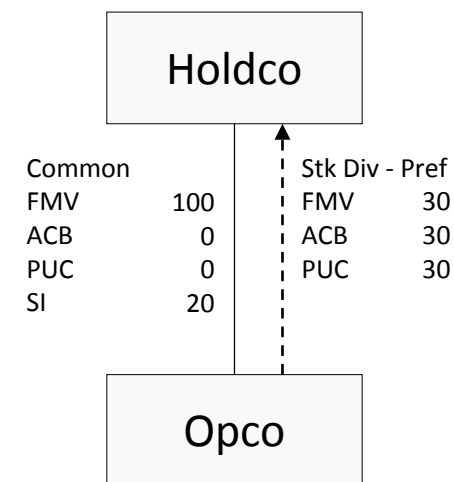
- **Comment:**

- Under amended subparagraph 52(3)(a)(ii), there does not appear to be a concern with double taxation where a stock dividend is subject to subsection 55(2) because, in general terms, the ACB of the stock dividend shares will include an amount for the deemed gain (as well as amount for safe income).
  - However, see discussion later where paragraph 52(3)(a.1) applies

# Cost of Stock Dividend and CDA Calculation

**Example** (See calculations for subparagraph 52(3)(a)(ii) amounts in subsequent slide)

- The shares of Opco are to be sold to a third party
- The safe income contributing to the gain on the Opco shares is estimated to be \$30 but is finally determined to be \$20
- A stock dividend, payable by the issuance of preferred shares, is paid by Opco
- Assuming that one of the Three Purposes is satisfied on the payment of the stock dividend
  - Holdco is deemed to have a gain of \$10 equal to the FMV of the stock dividend less the safe income
  - On the sale of the Opco shares, Holdco realizes a gain of \$70 on the common shares
  - The total gain is \$80 equal to the FMV of Opco less safe income
    - Double taxation does not arise as a result of subsection 55(2) applying
  - If the “amount” of the dividend for purposes of paragraph 53(2)(a) is not adjusted for the subsection 55(2) re-characterization, then an amount of \$10 is computed under subclause 52(3)(a)(ii)(A)(II) which is relevant for clause (a)(i)(A) and (a)(ii)(A) of the definition of “capital dividend account” in subsection 89(1)
    - Holdco disposes of the stock dividend preferred shares for FMV proceeds of \$30 with ACB of \$30.
    - However, for purposes of computing Holdco’s CDA, a “negative” amount should arise under clause (a)(ii)(A).
    - For clause (a)(ii)(A) of the definition of “capital dividend account” in subsection 89(1)
      - The ACB of the stock dividend preferred shares should be \$40.
      - A capital loss (recomputed for CDA purposes) of \$10 would result.
  - If the “amount” of the dividend for purposes of paragraph 53(2)(a) is adjusted for the subsection 55(2) re-characterization, then an amount does not arise for subclause 52(3)(a)(ii)(A)(II) which is relevant for clauses (a)(i)(A) and (a)(ii)(A) of the definition of “capital dividend account” in subsection 89(1)
    - No impact to Holdco’s CDA



# Cost of Stock Dividend and CDA Calculation

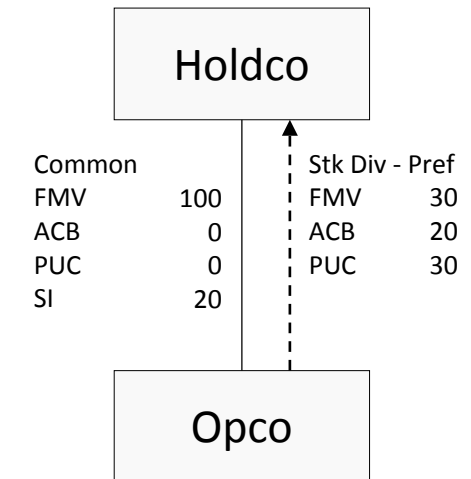
## One of the Three Purpose Test(s) is Satisfied

			If "amount" is not reduced by 55(2) <u>recharacterization</u>		If "amount" is reduced by 55(2) <u>recharacterization</u>	
Cost of Stock Dividend 52(3)						
52(3)(a)(ii)(A)	(A) the amount, if any, by which					
52(3)(a)(ii)(A)(I)	(I) the amount that is the lesser of the amount of the stock dividend and its fair market value			30		20
	exceeds					
	(II) the amount of the dividend that the shareholder may deduct under subsection 112(1)		30		20	
	in computing the shareholder's taxable income,					
	except any portion of the dividend that,					
	if paid as a separate dividend, would not be subject to subsection 55(2) because					
	the amount of the separate dividend would not exceed the amount of the					
	income earned or realized by any corporation — after 1971 and before					
	the safe-income determination time for the transaction, event or series of transactions					
	or events as part of which the dividend is received — that could reasonably be considered					
52(3)(a)(ii)(A)(II)	to contribute to the capital gain that could be realized on a disposition at fair market value,					
	immediately before the dividend, of the share on which the dividend is received, and		20	10	20	0
	ACB addition under 52(3)(a)(ii)(A)			20		20
52(3)(a)(ii)(B)	(B) the amount determined by the formula					
	A + B					
	where					
A	is the amount of the deemed gain under paragraph 55(2)(c) in respect of that stock dividend,			10		10
	and					
B	is the amount, if any, by which the amount of the reduction under paragraph 55(2.3)(b)			0		0
	in respect of that stock dividend to which paragraph 55(2)(a) would otherwise apply					
	exceeds the amount determined for clause (A) in respect of that dividend.					
	ACB addition under 52(3)(a)(ii)(B)			10		10
	Total ACB			30		30

# Cost of Stock Dividend and CDA Calculation

**Example** (See calculations for subparagraph 52(3)(a)(ii) amounts in subsequent slide)

- The shares of Opco are to be sold to a third party
- The safe income contributing to the gain on the Opco shares is estimated to be \$30 but is finally determined to be \$20
- A stock dividend, payable by the issuance of preferred shares, is paid by Opco
- Assuming that **none** of The Three Purposes is satisfied on the payment of the stock dividend
  - Holdco is not deemed to have a gain under paragraph 55(2)(c)
  - On the sale of the Opco shares, Holdco realizes a \$70 gain on the common shares and a \$10 gain on the preferred shares
  - The total gain is \$80 equal to the FMV of Opco less safe income
    - Double taxation does not arise as a result of subsection 55(2) applying
  - An amount of \$10 is computed under subclause 52(3)(a)(ii)(A)(II) which is relevant for clause (a)(i)(A) of the definition of “capital dividend account” in subsection 89(1)
  - On the sale of the preferred shares, a CDA addition is not available relating to the \$10 gain on the preferred shares



# Cost of Stock Dividend and CDA Calculation

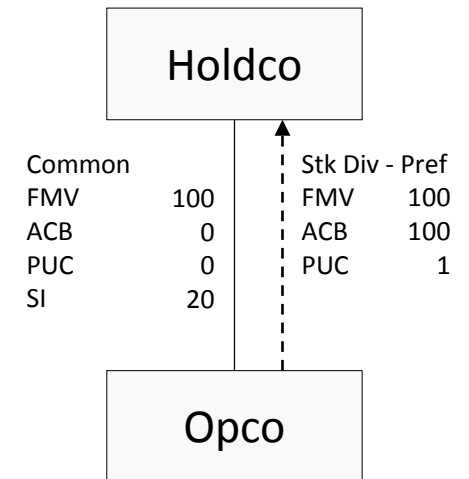
## None of the Three Purpose Test(s) are Satisfied

Cost of Stock Dividend 52(3)					
52(3)(a)(ii)(A)	(A) the amount, if any, by which				
52(3)(a)(ii)(A)(I)	(I) the amount that is the lesser of the amount of the stock dividend and its fair market value				30
	exceeds				
	(II) the amount of the dividend that the shareholder may deduct under subsection 112(1)		30		
	in computing the shareholder's taxable income,				
	except any portion of the dividend that,				
	if paid as a separate dividend, would not be subject to subsection 55(2) because				
	the amount of the separate dividend would not exceed the amount of the				
	income earned or realized by any corporation — after 1971 and before				
	the safe-income determination time for the transaction, event or series of transactions				
	or events as part of which the dividend is received — that could reasonably be considered				
	to contribute to the capital gain that could be realized on a disposition at fair market value,				
52(3)(a)(ii)(A)(II)	immediately before the dividend, of the share on which the dividend is received, and		20		10
	ACB addition under 52(3)(a)(ii)(A)				20
52(3)(a)(ii)(B)	(B) the amount determined by the formula				
	A + B				
	where				
	A	is the amount of the deemed gain under paragraph 55(2)(c) in respect of that stock dividend,			0
		and			
	B	is the amount, if any, by which the amount of the reduction under paragraph 55(2.3)(b)			0
		in respect of that stock dividend to which paragraph 55(2)(a) would otherwise apply			
		exceeds the amount determined for clause (A) in respect of that dividend.			
	ACB addition under 52(3)(a)(ii)(B)				0
	Total ACB				20

# Cost of Stock Dividend and CDA Calculation

**Example** (See calculations for subparagraph 52(3)(a)(ii) amounts in subsequent slide)

- The shares of Opco are to be sold to a third party
- The safe income contributing to the gain on the Opco shares is estimated to be \$30 but is finally determined to be \$20
- A stock dividend, payable by the issuance of preferred shares, is paid by Opco
  - FMV of preferred share issued as stock dividend: \$100
  - Stated capital of preferred share issues as stock dividend: \$1
- Assuming that one of the Three Purposes is satisfied on the payment of the stock dividend
  - Holdco is deemed to have a gain of \$80 equal to the FMV of the stock dividend less the safe income
  - On the sale of the Opco common and preferred shares, Holdco does not realize a gain or loss
  - The total gain is \$80 equal to the FMV of Opco less safe income
    - Double taxation does not arise as a result of subsection 55(2) applying
  - Because the paid-up capital of the preferred shares issued as a stock dividend does not exceed safe income, no amount is computed under subclause 52(3)(a)(ii)(A)(II) which is relevant for clause (a)(i)(A) and (a)(ii)(A) of the definition of “capital dividend account” in subsection 89(1)
  - Similar to example in technical interpretation 2016-0668341E5F



# Cost of Stock Dividend and CDA Calculation

## One of the Three Purpose Test(s) is Satisfied

			If "amount" is not reduced by 55(2) <u>recharacterization</u>		If "amount" is reduced by 55(2) <u>recharacterization</u>		
Cost of Stock Dividend 52(3)							
52(3)(a)(ii)(A)	(A) the amount, if any, by which						
52(3)(a)(ii)(A)(I)	(I) the amount that is the lesser of the amount of the stock dividend and its fair market value			1		1	
	exceeds						
	(II) the amount of the dividend that the shareholder may deduct under subsection 112(1)			1		1	
	in computing the shareholder's taxable income,						
	except any portion of the dividend that,						
	if paid as a separate dividend, would not be subject to subsection 55(2) because						
	the amount of the separate dividend would not exceed the amount of the						
	income earned or realized by any corporation — after 1971 and before						
	the safe-income determination time for the transaction, event or series of transactions						
	or events as part of which the dividend is received — that could reasonably be considered						
	to contribute to the capital gain that could be realized on a disposition at fair market value,						
52(3)(a)(ii)(A)(II)	immediately before the dividend, of the share on which the dividend is received, and			1	0	1	0
	ACB addition under 52(3)(a)(ii)(A)				1		1
52(3)(a)(ii)(B)	(B) the amount determined by the formula						
	A + B						
	where						
A	is the amount of the deemed gain under paragraph 55(2)(c) in respect of that stock dividend,				80		80
	and						
B	is the amount, if any, by which the amount of the reduction under paragraph 55(2.3)(b)				19		19
	in respect of that stock dividend to which paragraph 55(2)(a) would otherwise apply						
	exceeds the amount determined for clause (A) in respect of that dividend.						
	ACB addition under 52(3)(a)(ii)(B)				99		99
	Total ACB				100		100



# Cost of Stock Dividend and CDA Calculation – 52(3)(a.1)

## Example:

- The shares of Opco are to be sold to a third party
- It was estimated that the safe income contributing to the gain on the Opco shares was \$20 but was finally determined to be \$nil

## Discussion:

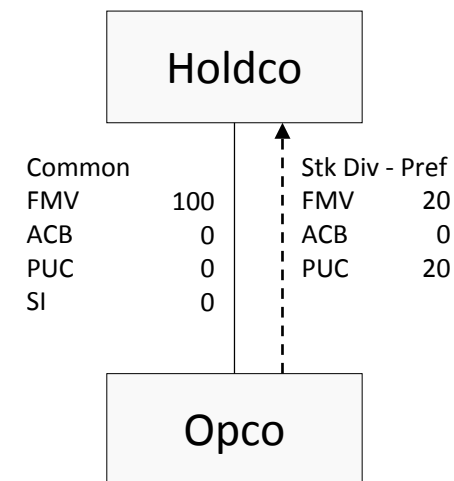
- If the purpose of the dividend is to reduce the FMV of the common shares of Opco, paragraph 55(2)(a) would deem the entire “amount” of the dividend not to be a dividend
- In CRA Document 9830665F (discussed in a subsequent slide), the CRA’s view was that paragraph 52(3)(a.1) would apply rather than paragraph 52(3)(a).
  - Paragraph 52(3)(a.1) applies “where the stock dividend is not a dividend”

## Comment:

- The amendments to subsection 55(2) and subsection 52(3) provide an addition to cost for shares issued as stock dividends for subsection 55(2) deemed gains and for safe income

## Question:

- In this example, would the CRA’s view be that paragraphs 55(2)(a) and 52(3)(a.1) apply?
  - If so, the cost of the stock dividend shares would be nil
- Would CRA agree that it would not be appropriate for double taxation to arise on the sale of the stock dividend shares?
  - See CRA Document 9830665F discussed later
- Alternatively, if subsection 55(2) did not apply, the stock dividend shares would have a cost of nil under paragraph 52(3)(a)
  - However, the CDA available to Holdco would be reduced because an amount would be computed under subclause 52(3)(a)(ii)(A)(II) which is relevant for clause (a)(i)(A) of the definition of “capital dividend account” in subsection 89(1)



# Redemption of Stock Dividend Share

- In technical interpretation 2016-0668341E5F, a high-low stock dividend (FMV \$700,000; PUC \$1) was issued in a situation in which the stock dividend was paid on shares that had safe income of \$700,000.
- It was concluded that the ACB (under subparagraph 52(3)(a)(ii)) of the stock dividend shares would be equal to their FMV of \$700,000.
- However, it was stated that, if the stock dividend shares were redeemed, subsection 55(2) would apply but by reason of the adjusted cost base, the gain would be nil.
- **Comment:**
  - Subsection 55(2) should not apply because there was no gain that could be or was reduced as a result of the redemption.
    - This conclusion is relevant because, if subsection 55(2) applies, the dividend is not a dividend received for other purposes.
- **Recommendation:**
  - Could CRA clarify that subsection 55(2) would not apply because the redemption did not result in a reduction of a capital gain?

# Capitalizing Safe Income

84(1) Deemed Dividends on  
Stated Capital Increases

## 84(1) Deemed Dividends on Stated Capital Increases

- Where 55(2) is applicable to a dividend that is not received on a redemption, acquisition or cancellation of a share to which subsection 84(2) or (3) applies, the dividend recipient is deemed to have a gain under paragraph 55(2)(c) for the year in which the dividend was received, from the disposition of a capital property.
- **Issues:**
  - For deemed dividends arising under subsection 84(1), that exceed safe income, there is potential for double taxation on the same gain.
  - Clarification of calculation in paragraph 53(1)(b).
  - Clarification of CDA calculation in clause (a)(i)(A) of the definition of “capital dividend account” in subsection 89(1).
  - Is one of the Three Purposes satisfied on a stated capital increase that is effected to capitalize safe income?

## 84(1) Deemed Dividends on Stated Capital Increases - Discussion

- CRA Document 2011-0421141E5
  - The CRA considered the interaction between paragraph 53(1)(b), subsection 55(2) and the definition of CDA.
  - The CRA stated that a deemed dividend received pursuant to subsection 84(1) to which paragraph 55(2)(a) applied would be deemed not to be a dividend such that paragraph 53(1)(b) would not apply.
  - As such, no amount would be computed under subparagraph 53(1)(b)(ii) for clause (a)(i)(A) of the definition of “capital dividend account” in subsection 89(1).
  - The CRA also stated that generally the deemed gain pursuant to subsection 55(2) would give rise to an addition to CDA, but that such an addition could be subject to GAAR.
  - The CRA also said that if subsection 55(2) did not apply to the dividend, paragraph 53(1)(b) would apply to limit the ACB of the share but that the gain for purposes of computing CDA would be smaller because the ACB of the share would not be so limited for those purposes.

## 84(1) Deemed Dividends on Stated Capital Increases - Discussion

- CRA Document 2011-0415891E5
  - The CRA considered the application of paragraph 53(1)(b) and subsection 52(3).
  - Paragraph 53(1)(b)
    - The CRA took the position that if paragraph 55(2)(b) applies (*i.e.*, there is a sale of the share as part of the series), no amount will be recharacterized pursuant to subsection 55(2) because the amount will already have been included in the proceeds of disposition.
    - The CRA also suggested that if paragraph 55(2)(c) applies they would seek to ensure there was no double taxation and said their position could be that the subsection 55(2) applies at the time of the dividend but that the amount would be removed from proceeds of disposition at the time of eventual sale.
  - Paragraph 52(3)(a)
    - The CRA cited an earlier position (9830665F) and took the position that that paragraph 248(28)(a) would apply.
    - The CRA then said that the typical approach is to apply paragraph 55(2)(b) and exclude the amount from the computation of proceeds, but then stated that another approach would be to not apply paragraph 55(2)(b).

## 84(1) Deemed Dividends on Stated Capital Increases - Discussion

- CRA Document 9830665F
  - The CRA considered the following situation:
    - One corporation (“Gestion”) holds all of the common shares of another corporation (“Opco”).
    - Opco pays a dividend of \$100,000 to Gestion.
    - The dividend is thought to be out of safe income but the safe income in Opco shares turns out to be nil.
    - The CRA considered two alternative scenarios:
      - 1) the dividend was paid as a demand promissory note with a face amount of \$100,000; and
      - 2) the dividend was a stock dividend of preferred shares redeemable for \$100,000.
  - The CRA assumed that after the dividend was paid, Gestion sold all of the common shares of Opco along with the note/preferred shares to an arm’s-length buyer.

## 84(1) Deemed Dividends on Stated Capital Increases - Discussion

- CRA Document 9830665F (continued)
  - Situation 1: Promissory Note
    - The CRA stated that paragraph 55(2)(a) would apply to the dividend so that it would be deemed not to be a dividend.
    - As such, subsection 52(2) would not apply but subsection 52(1) would apply.
    - Pursuant to subsection 52(1), the ACB in the note would be \$75,000 as such was the amount added to Gestion's income in respect of the note.
      - The document is from 1998, so that taxable capital gains were  $\frac{3}{4}$  of capital gains. Thus, the \$75,000 is  $\frac{3}{4}$  of the \$100,000 capital gain deemed by paragraph 55(2)(b).
    - Accordingly, when Gestion disposes of the note for its fair market value (assumed to be \$100,000), it could realize a capital gain of \$25,000.
    - The CRA took the position that paragraph 248(28)(a) applies and no capital gain is realized on the disposition of the note.



## 84(1) Deemed Dividends on Stated Capital Increases - Discussion

- CRA Document 9830665F (continued)
  - Situation 2: Stock Dividend
    - The CRA stated that paragraph 55(2)(a) would apply to the dividend so that it would be deemed not to be a dividend.
    - As such paragraph 52(3)(a.1) (rather than 52(3)(a)) would apply to deem the ACB of the preferred shares to be nil.
      - Paragraph 52(3)(a.1) applies where a “stock dividend is not a dividend”
    - Thus, on the disposition of the preferred shares for fair market value (assumed to be \$100,000), Gestion could realize a capital gain of \$100,000.
    - The CRA again stated that this would contradict paragraph 248(28)(a).
    - As in 2011-0415891E5, the CRA stated that it typically applied paragraph 55(2)(b) but did not impose a capital gain on the disposition of the preferred shares; alternatively, the CRA stated that it might not apply paragraph 55(2)(b) and instead include a gain on the disposition of the shares.

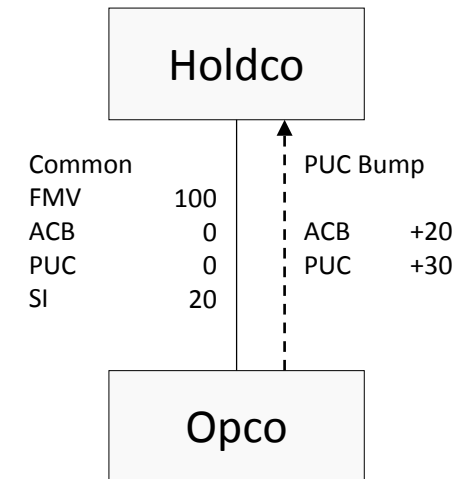
## 84(1) Deemed Dividends on Stated Capital Increases - Discussion

- CRA Documents 2011-0415891E5 and 2011-0421141E5 suggest that paragraphs 55(2)(a) and (c) can apply to a subsection 84(1) deemed dividend that exceeds safe income.
- If paragraphs 55(2)(a) and (c) apply:
  - No amount is computed under subparagraph 53(1)(b)(ii) for clause (a)(i)(A) of the definition of “capital dividend account” in subsection 89(1).
  - However, there is the potential for double taxation because paragraph 53(1)(b) does not provide for an ACB addition for the deemed gain.
    - However, the CRA has previously indicated that it would not seek to tax the gain twice.
- A taxpayer might “prefer” that subsection 55(2) applies so that no amount is computed for clause (a)(i)(A) of the definition of “capital dividend account” in subsection 89(1).
- Questions:
  - Is the “purpose” of the dividend evaluated before or after the application of paragraph 55(5)(f)?
    - Can a taxpayer have a purpose (for the deemed non-safe income dividend) to increase cost amounts or reduce gains if the non-safe dividend does not result in an addition to ACB?
  - Would the CRA accept that paragraphs 55(2)(a) and (c) can apply so that no amount is computed under subparagraph 53(1)(b)(ii) for clause (a)(i)(A) of the definition of “capital dividend account” in subsection 89(1)?
    - If so, would the CRA confirm that double taxation will not arise?

# 84(1) Deemed Dividend: Double Taxation, ACB Addition and CDA Calculation

Example (See calculations for paragraph 53(1)(b) amounts in subsequent slide)

- The shares of Opco are to be sold to a third party
- The safe income contributing to the gain on the Opco shares is estimated to be \$30 but is finally determined to be \$20
- The stated capital of the shares of Opco is increased (“PUC Bump”) by \$30
- Assume that subsection 55(2) applies
  - Holdco is deemed to have a gain of \$10 equal to the amount of the PUC Bump less safe income
  - On the sale of the Opco shares, Holdco realizes a gain of \$80 on the common shares
  - The total gain is \$90 instead of \$80
    - Double taxation arises as a result of subsection 55(2) applying
  - If the 84(1) deemed dividend is recharacterized as a gain for purposes of paragraph 53(1)(b), then an amount of nil is computed under subparagraph 53(1)(b)(ii) which is relevant for clause (a)(i)(A) of the definition of “capital dividend account” in subsection 89(1)
  - If the 84(1) deemed dividend is not recharacterized as a gain for purposes of paragraph 53(1)(b), then an amount of \$10 is computed under subparagraph 53(1)(b)(ii) which is relevant for clause (a)(i)(A) of the definition of “capital dividend account” in subsection 89(1)
    - On the sale of the common shares of Opco, Holdco’s CDA addition is reduced
  - The CRA has previously taken the view that if 55(2) applies, there is no dividend for subsection 84(1) and for the ACB calculation in paragraph 53(1)(b)
    - See for example 2011-0421141E5



# PUC Bump

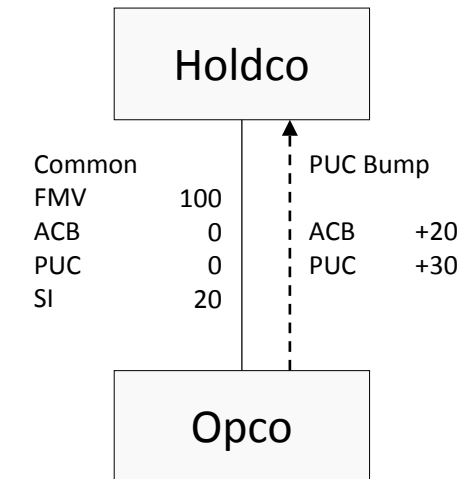
## Assume that Subsection 55(2) Applies

		If 84(1) amount is reduced by 55(2) <u>re-characterization</u>			If 84(1) amount is not reduced by 55(2) <u>re-characterization</u>		
53(1)(b)	(i) the total of all amounts each of which is the amount of a dividend on the share deemed by subsection 84(1) to have been received by the taxpayer before that time			20			30
	exceeds						
	(ii) the portion of the total determined under subparagraph (i) that relates to dividends in respect of which the taxpayer was permitted a deduction under subsection 112(1) in computing the taxpayer's taxable income,		20			30	
	except any portion of the dividend that, if paid as a separate dividend, would not be subject to subsection 55(2) because the amount of the separate dividend would not exceed the amount of the income earned or realized by any corporation after 1971 and before the safe-income determination time for the transaction, event or series of transactions or events as part of which the dividend is received — that could reasonably be considered to contribute to the capital gain that could be realized on a disposition at fair market value, immediately before the dividend, of the share on which the dividend is received		20			20	
				0			10
	53(1)(b) ACB addition			20			20

## 84(1) Deemed Dividend: Double Taxation, ACB Addition and CDA Calculation

Example (See calculations for paragraph 53(1)(b) amounts in subsequent slide)

- The shares of Opco are to be sold to a third party
- The safe income contributing to the gain on the Opco shares is estimated to be \$30 but is finally determined to be \$20
- The stated capital of the shares of Opco is increased (“PUC Bump”) by \$30
- Assume that subsection 55(2) does not apply
  - Holdco is not deemed to have a gain
  - On the sale of the Opco shares, Holdco realizes a gain of \$80 on the common shares
  - Double taxation does not arise
  - For purposes of paragraph 53(1)(b), an amount of \$10 is computed under subparagraph 53(1)(b)(ii) which is relevant for clause (a)(i)(A) of the definition of “capital dividend account” in subsection 89(1)
    - On the sale of the common shares of Opco, Holdco’s CDA addition is reduced



## PUC Bump

Assume that Subsection 55(2) Does Not Apply

53(1)(b)	(i) the total of all amounts each of which is the amount of a dividend on the share deemed by subsection 84(1) to have been received by the taxpayer before that time			30
	exceeds			
	(ii) the portion of the total determined under subparagraph (i) that relates to dividends in respect of which the taxpayer was permitted a deduction under subsection 112(1) in computing the taxpayer's taxable income,		30	
	except any portion of the dividend that, if paid as a separate dividend,		20	
	would not be subject to subsection 55(2) because the amount of the separate dividend would not exceed the amount of the income earned or realized by any corporation			
	after 1971 and before the safe-income determination time for the transaction, event or series of transactions or events as part of which the dividend is received — that could reasonably be considered			
	to contribute to the capital gain that could be realized on a disposition at fair market value, immediately before the dividend, of the share on which the dividend is received			10
	53(1)(b) ACB addition			20

Capitalizing Safe Income

Promissory Note as Payment of Dividend

# Promissory Note as Payment of Dividend

## Question:

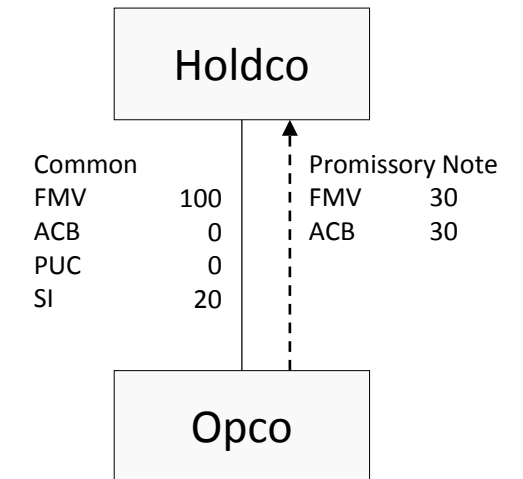
- Can a safe income dividend be paid by the issuance of a promissory note without double taxation if the safe income amount is proved to be a lower amount?

## Recommendation:

- There should be no concerns if a safe income dividend is paid by the issuance of a promissory note.
- To the extent that the amount of the note exceeds safe income, a deemed gain will arise.
- Including any deemed gain, on the sale of the shares and note of Opco, Holdco should realize a gain equal to the FMV of the Opco shares less safe income.
- Holdco's CDA addition should reflect the gain on the Opco shares less safe income.
- The ACB of the note should be equal to its FMV.

## Discussion:

- Subsection 52(1) should include the full capital gain because the gain was included in *computing* taxable income; the provision does not require the full capital gain to be included in taxable income.
  - See discussion on CRA Document 9830665F in preceding slide.
  - The CRA indicated that the ACB addition to the promissory note would be limited to the taxable capital gain but that paragraph 248(28)(a) applies and no capital gain is realized on the disposition of the note.
  - Has CRA changed its view on this?





# Safe Income

# Computation of Safe Income

## **Question:**

- Could the CRA prepare a comprehensive guide describing CRA's views on the calculation and allocation of safe income?

## **Discussion:**

- Under the amendments to section 55, it will be necessary to compute safe income in more situations than under the former rules.
  - Safe income dividends are excluded from the application of subsection 55(2) without regard to the Three Purpose Tests.
  - Paragraph 55(5)(f) is now automatic meaning that safe income must be “used”.
- Several views on the computation and allocation of safe income have been issued over several years.
- Some of these positions might be no longer applicable due to court decisions.
- An updated comprehensive guide describing CRA's views on the calculation and allocation of safe income would provide CRA, taxpayers and their advisors more certainty.

# Computation of Safe Income

## **Issue:**

- Costs of preparing safe income calculations

## **Discussion:**

- The CRA has been encouraging taxpayers to prepare safe income calculations
- In many situations, calculations will be required for many years and for many corporations in a group
  - There may be complexities due to corporate reorganizations and other transactions

## **Question:**

- Will the CRA accept that the costs of preparing the calculations are deductible to the dividend payer and are not a benefit to its shareholders?

# Computation of Safe Income

## Issue:

- Does “attributable to” have the same meaning as “contribute to”?

## Discussion:

- Former subsection 55(2) asked if the amount of the capital gain reduction was reasonably attributable to anything other than safe income.
- New paragraph 55(2.1)(c) asks if the safe income contributes to a capital gain on the share.
- Does the new language affect the analysis or computation of safe income?
- The Explanatory Notes explain the change as “intended to accommodate the new purposes described in subparagraph (b)(ii)” (i.e., the FMV Reduction Purpose Test and the Cost Amounts Increase Purpose Test)
  - The Old Rules referred to a reduction of a capital gain that is attributable to something other than safe income.
  - The two new purpose tests can apply where no capital gain exists
  - Accordingly, the older drafting would not accommodate these new tests.
- The approach taken under former 55(2) was to consider whether safe income contributed to a gain on a share and court decisions have, on more than one instance, generally referred to safe income in that manner
  - See *Brelco Drilling Ltd. v. The Queen*, 98 DTC 1422, [1998] at paragraph 31. And *The Queen v. Kruco Inc.*, 2003 DTC 5506 (FCA), affirming *Kruco Inc. v. The Queen*, 2001 DTC 668 (TCC) at paragraph 45.

## Recommendation:

- The amendments to subsection 55(2) should not impact the analysis or computation of safe income
- The findings in *Kruco* should still apply
  - Technical Interpretation 2016-0672321C6 suggests that CRA’s view is that the reasoning in *Kruco* still applies

# Computation of Safe Income

## Issue:

- Should safe income be reduced by accounting reserves and contingent liabilities?

## Discussion:

- Technical Interpretation 2016-0672321C6 referred to *Kruco* (*The Queen v. Kruco Inc.*, 2003 DTC 5506 (FCA)).
- *Kruco* found that the starting point for computing safe income is the deeming provision in paragraph 55(5)(c) (for private corporations) (see *Kruco* at paragraph 37). The court also found (at paragraph 41) that safe income on hand should be computed by

Reducing this income by reference to cash outflows, which take place after it has been computed in conformity with paragraph 55(5)(c), **but before the dividend is paid**, does no violence to the deeming provision since the deemed amount is accepted as the starting point and modified only by reference to subsequent events which are relevant to the subsection 55(2) computation, i.e. cash outflows which take place after the income has been determined - in conformity with the deeming provision - and which reduce the income to which the capital gain can be “reasonably ... attributable”.

- However, Technical Interpretation 2016-0672321C6 stated that the FCA's decision supports the notion that the safe income should also be reduced by contingent liabilities and accounting reserves in the determination of the amount of safe income that can be viewed as contributing to the capital gain on a share.
- Contingent liabilities and accounting reserves would not represent cash outflows before the dividend is paid.

## Question:

- Can CRA explain its reasoning for the position that *Kruco* supports reducing safe income for contingent liabilities and accounting reserves which is contrary to the decision?

## Safe-income determination time – Subsection 55(3.01)

### **Background:**

- Paragraph 55(3)(a) is relevant only for dividends received on a redemption, acquisition or cancellation of a share, by the corporation that issued the share, to which subsection 84(2) or (3) applies.
- Paragraph (a) of the definition of “safe-income determination time” in subsection 55(1) refers to events described in subparagraphs 55(3)(a)(i) to (v).

### **Question:**

- Does subsection 55(3.01) apply for paragraph (a) of the definition of “safe-income determination time” even though subsection 55(3.01) applies only for the purposes of paragraph 55(3)(a).
  - Would each dividend (paid as part of the series) be analyzed considering the particular dividend recipient and taking into account paragraph 55(3.01)(a).

# Safe-income determination time

## **Issue:**

- Uncertainty in the determination of the safe-income determination time.

## **Discussion:**

- The legislative definition of “safe-income determination time” was introduced several years ago under the former 55(2) and was designed, generally speaking, for a share sale transaction.
- The CRA has recently emphasized the importance of safe income and described safe income as being essential to prevent double taxation.

# Safe-income determination time

## Example:

- Periodic dividends
  - Holdco owns all of the shares of Opco
  - Opco has a policy to pay a dividend each quarter or each year to distribute earnings (that would represent safe income on hand)
- Do these dividends constitute a series such that the safe income determination time is triggered on the first dividend?

## Discussion:

- Technical Interpretation 2016-0672321C6 was recently released. This interpretation stated that a ruling has recently been issued in which the CRA took the view that regular, recurring annual dividends would not, in the circumstances of the ruling request, be part of a series of transactions and that the ruling confirmed that the safe income determination time in respect of the first and second annual dividends will be immediately before each such dividend.
- This is welcomed guidance.

## Recommendation:

- Could the CRA elaborate on this position?



# Safe-income determination time

## Example:

- Opco has income from a property that is partially sheltered by CCA, such that cash flow exceeds taxable income (and, hence, safe income).
- Assume Opco expects this to occur for a number of years, but wants to distribute the cash flow each year (and therefore, plans to pay annual dividends) to avoid a build-up of cash in Opco. Taxable income will eventually "catch up".
- If the first dividend paid triggers the safe-income determination time, future earnings will not be available as safe income.

# Safe-income determination time

## Example: Multiple Holdcos

### Question:

- Would the CRA accept that a 55(2) gain can create safe income for subsequent dividend payments "up a chain" through Holdcos?
- If not, multiple levels of 55(2) gains could result in respect of the same underlying gain/dividend.

# Safe-income determination time

**Example:** Accessing safe income of Targetco

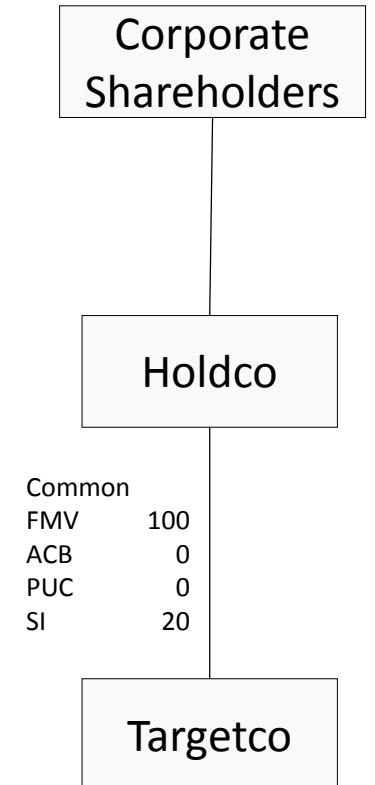
- The shares of Targetco are to be sold to a third party
- Targetco pays a safe income dividend of \$20 to Holdco
- Holdco realizes a capital gain of \$80 on the sale of the Targetco shares
- Holdco will distribute the sale proceeds as taxable and capital dividends to its corporate shareholders

**Question:**

- Does the safe-income dividend paid by Targetco trigger the safe-income determination time regarding the distribution of the sale proceeds by Holdco?
- If so, the taxable dividends paid by Holdco will not be safe-income dividends.

**Recommendation:**

- The safe-income determination time should not be triggered with respect to the dividends to be paid by Holdco.
  - It would be inappropriate if Holdco could not distribute taxed gains as safe income.
- Alternatively, it would be appropriate to say that the Three Purpose Tests should not be satisfied on the payment of a dividend by Holdco of sale proceeds.



# Safe Income - Global Approach and Discretionary Shares

## Question:

- Further to CRA's response to Question 2 at the 2016 CTF Roundtable, when will the CRA complete its study in regards to additional views on the allocation of safe income to discretionary dividend shares?
- Does CRA expect that any of its recent previous technical interpretations will change?
  - CRA Document 2015-0593941E5 introduced the “global approach” to the allocation of safe income to discretionary dividend shares.

# Safe Income - Global Approach and Discretionary Shares

## Technical Interpretation 2015-0593941E5

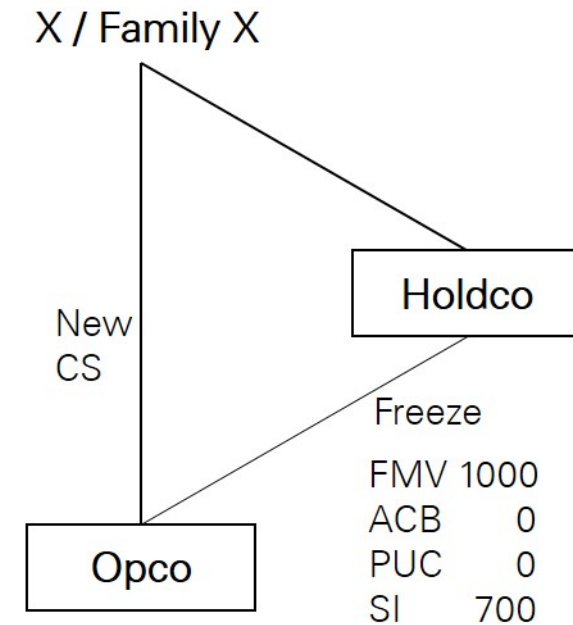
### Issue:

- Assuming the “global approach” will still be accepted by the CRA, could the CRA provide further guidance on this approach?
- In Technical Interpretation 2015-0593941E5, the CRA introduced the concept of using a “global approach” to the allocation of safe income where all of the corporation’s shares are discretionary dividend shares?
- In this interpretation, the CRA looked at five hypothetical scenarios. These scenarios involve the payment of dividends on participating shares with discretionary dividend entitlements (essentially common shares but with discretion to pay a dividend on one class to the exclusion of another similar class) and those paid on non-participating shares with discretionary dividend entitlements. The CRA generally took a “global approach” to the allocation of safe income where all of the corporation’s shares are participating, discretionary dividend shares. The CRA did this by allowing the safe income to be streamed to one class of shares to the exclusion of others in certain situations. Where there are discretionary dividend shares that are non-participating, the CRA said that the allocation of safe income will depend on whether the shares have value in excess of their ACB, which can only be determined based on the particular facts. If the shares have an accrued gain, it appears the CRA will allow the global safe income to be streamed to those shares to the exclusion of other shares.
- While not entirely clear, the CRA appears to conclude that a declared but unpaid dividend adds to the value of a participating discretionary dividend share but, in the case of a non-participating discretionary dividend share, it would only add to the share’s value if the dividend receivable is attached to the share itself and is not a separate right. It is unclear why the CRA reached the conclusion that a dividend receivable would add value to a participating share yet, for non-participating shares, it seems to be concerned about whether the dividend receivable can add value.
- The TI also leaves other uncertainties. For example, the CRA did not comment on how to deal with different holding periods under the “global approach” nor does it consider freeze shares or preferred shares that are issued on a section 85 rollover.
- Would the CRA require shareholders to agree on the allocation of safe income (and what would happen if the amount computed was later found to be incorrect)?

# Accessing Safe Income on Freeze Shares

## Example:

- Individual X held common shares of Opco that had a FMV of 1,000, with an ACB and PUC of nil
  - The safe income attributable to the shares was \$700
- The common shares were exchanged for fixed value preferred shares (Freeze Shares) and were transferred to Holdco
  - The Freeze Shares have a discretionary dividend entitlement
- New common shares were issued to family members of X



# Accessing Safe income on Freeze Shares

## Discussion:

- Under former 55(2) it was generally accepted that the safe income on the Freeze Shares could only be accessed by a stated capital increase or on a redemption of the freeze shares. A stated capital increase equal to the safe income on the Freeze Shares would reduce the gain on those shares that was attributable to safe income. A redemption of the Freeze Shares would result in a reduction of a capital gain that was attributable, up to the safe income amount, to safe income.
- Assume that, subsequent to the freeze, Opco earned an additional \$500 of safe income, represented by cash, which increased the FMV of the new common shares. If Opco pays a \$500 dividend to Holdco, will it be a safe income dividend?
- Under the “global approach”, if the declared dividend adds value to the Freeze Shares, the \$500 of post-freeze safe income and increase in value might shift to the freeze shares. In such a case, the safe income on the new common shares would decrease by \$500. The FMV of the freeze shares would remain at \$1,000 and, presumably, would still have safe income of \$700. This might not be the desired result from an estate planning perspective, because the post-freeze growth has shifted away from the new common shares. Under this scenario, if the freeze shares were later redeemed for \$1,000, \$700 of the deemed dividend of \$1,000 should be a safe income dividend.
- As an alternative approach, a cash dividend paid on the Freeze Shares might “access” the \$700 of safe income that contributes to the gain on the Freeze Shares. New paragraph 55(2.1)(c) asks if a dividend paid on a share exceeds the amount of the safe income that is contributing to a gain on that share. In this example, a dividend of \$500 does not exceed the safe income of \$700 on the Freeze Shares. Under this scenario, \$500 (of the \$700) of safe income on the Freeze Shares has been accessed. Does the safe income of the common shares remain unchanged? If the redemption amount of the Freeze Shares is fixed at \$1,000, the \$500 dividend has shifted value away from the common shares. On a later redemption of the Freeze Shares, a deemed dividend of \$1,000 will arise. If the freeze shares have only \$200 of safe income remaining, \$800 is potentially subject to subsection 55(2). This is because the Holdco has received a total amount of \$1,500 (\$500 cash dividend plus \$1,000 redemption proceeds) compared to safe income of \$700. Under this scenario, the common shares should still be entitled to the safe income earned post-freeze of \$500.

# Safe Income

## Question:

- Can the CRA provide clarification on response (c) of Question 2 from the 2016 CTF Roundtable?
- Can CRA provide specific examples of when 163(2) penalties could be applied, 152(4) applies to reassess beyond the normal reassessment period, and 239(1) will be applied?

## Discussion:

- In response to Question 2, the CRA commented on an “incorrect claim” of an amount of safe income and referred to subsections 152(4), 163(2), 239(1).
- In many situations, prior year corporate tax returns are not available to accurately calculate safe income, and prior year financial statements need to be relied on instead or other estimates are required.
- Technical Interpretation 2016-0672321C6 which was recently released provided some guidance on this point.



## Safe Income and Loss Consolidation

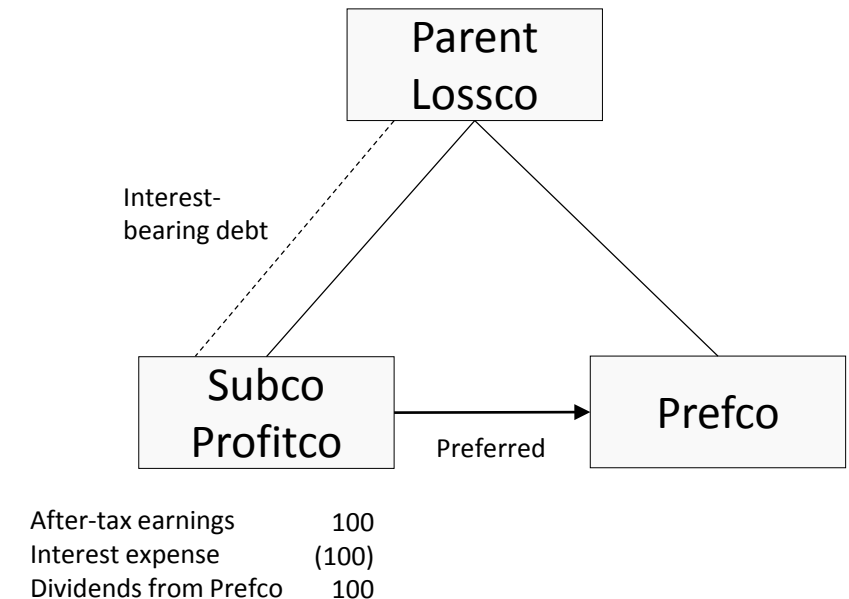
- Assume a typical in-house loss consolidation entered into by Parent (Lossco) and Subco (Profitco).
- Subco earns \$100 that would be taxable (and would be safe income) but for the loss consolidation.
- Under the loss consolidation, Subco pays \$100 of interest and receives \$100 of dividends from a sister company (Prefco) in which it holds preferred shares and to which Parent makes capital contributions.
- The interest expense decreases Subco's taxable income but the arrangement is an "in and out" from a cash perspective in that the interest expense is matched by dividend income.
- Subco has \$100 cash from its earnings and would like to pay \$100 dividend to Parent.

### Question:

- What is the amount of the safe income in respect of the shares of Subco?

### Comment:

- Under former 55(2), safe income was not relevant because paragraph 55(3)(a) applied to the cash dividend paid by Subco.
- In this situation, if the dividends received from Prefco are included in Subco's safe income, the appropriate amount of safe income would result.



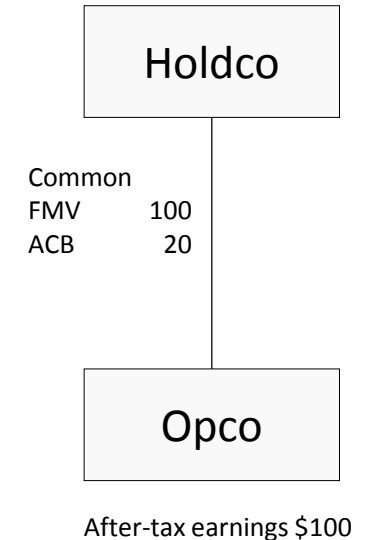
# Safe Income Contributing to a Gain

## Example:

- Holdco owns 100% of the shares of Opco.
- The shares of Opco have an FMV of \$100 with an ACB of \$20.
- Opco's balance sheet
  - Cash: \$100
  - Asset: FMV \$0; ACB \$20
  - Share capital: \$20
  - Retained Earnings: \$100
- Opco has realized after-tax earnings of \$100 that would be safe income (ignoring any consideration of the FMV and accrued gain on the shares of Opco).
- Opco pays a \$100 cash dividend to Holdco.

## Questions:

- For the purpose of the Gain Reduction Purpose Test, can it be said that the safe income dividend reduced the gain of \$80 to nil such that the Gain Reduction Test should not apply?
- For the purpose of the FMV Reduction Test and the Cost Amounts Increase Purpose Test, can it be said that the earnings of \$100 contribute to the gain of \$80 on the shares of Opco?
- Does Paragraph 55(5)(f) apply?
  - Does paragraph 55(5)(f) bifurcate the dividend into a safe-income dividend of \$80 and a separate taxable dividend of \$20?
- Are valuations required for paragraph 55(2.1)(c) when safe-income dividends are paid?



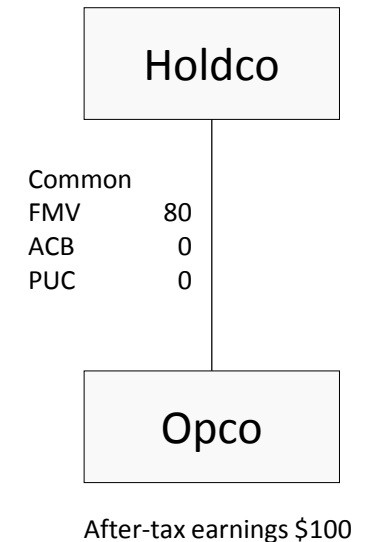
## Safe Income Contributing to a Gain and 55(2.5)

### Example:

- Holdco owns 100% of the shares of Opco.
- The shares of Opco have an FMV of \$80 with no ACB or paid-up capital.
- Opco's balance sheet
  - Cash: \$100
  - Asset: FMV \$0; ACB \$20
  - Debt: \$20
  - Retained Earnings: \$100
- Opco has realized after-tax earnings of \$100 that would be safe income (ignoring any consideration of the FMV and accrued gain on the shares of Opco).
- Opco pays a \$100 cash dividend to Holdco.

### Questions:

- Does Paragraph 55(5)(f) apply?
  - Does paragraph 55(5)(f) bifurcate the dividend into a safe-income dividend of \$80 and a separate taxable dividend of \$20?
- For the purpose of the Gain Reduction Purpose Test , can it be said that the safe income dividend reduced the gain of \$80 to nil such that the Gain Reduction Test should not apply?
- For the purpose of the FMV Reduction Test, paragraph 55(2.5) should apply
  - Does paragraph 55(5)(f) apply before subsection 55(2.5)
  - What would be the addition to FMV for subsection 55(2.5)?
  - (Also see slide 12)
- For the purpose of the Cost Amounts Increase Purpose Test can it be said that the earnings of \$100 contribute to the gain of \$80 on the shares of Opco?



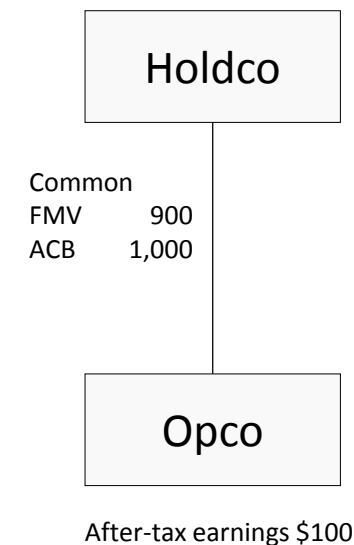
## Safe Income Contributing to a Gain – Temporary Fluctuations in Value

### Example:

- In the past, Holdco acquired the shares of Opco for \$1,000, which reflected the FMV of Opco's assets at that time.
- Since Holdco acquired the shares, Opco has realized after-tax earnings of \$100, represented by cash.
- However, owing to market conditions, the FMV of Opco's assets has decreased to \$800, resulting in a temporary decline to \$900 (including the \$100 of cash) in the FMV of the Opco shares.
- If Opco pays a \$100 cash dividend to Holdco, the safe-income exception does not apply even though that amount represents after-tax income earned by Opco.
- The FMV Reduction Purpose test could apply.

### Question:

- If the FMV of the Opco assets and shares subsequently recovers in value, such that the FMV of the Opco shares exceeds their cost base, then is the safe-income exception "restored"?



## Safe Income – Paragraph 55(5)(a)

### **Question:**

- How will CRA interpret paragraph 55(5)(a)?
- Is this paragraph still relevant?

### **Discussion:**

- This paragraph refers to a capital gain attributable to anything other than income earned or realized based on the wording of former subsection 55(2).

Paragraph 55(3)(a)

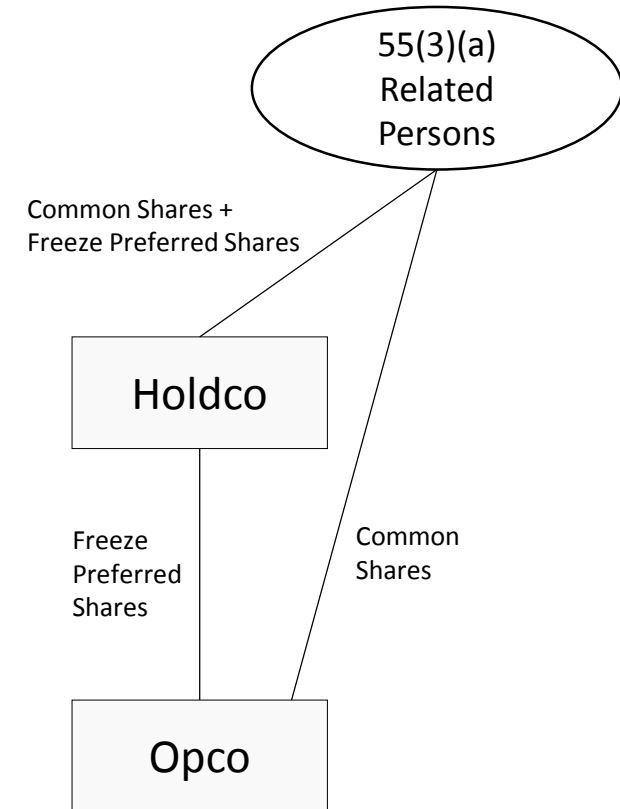
## Paragraph 55(3)(a)

- The Explanatory Notes state that “the amended exception in [paragraph 55(3)](a) for related-person dividends is intended to facilitate bona fide corporate reorganizations by related persons.”
- **Questions:**
  - What constitutes a bona fide corporate reorganization?
  - If GAAR was applied by the CRA, would 55(2) be applied (immediate taxation) or would cost amounts of property (e.g. promissory notes) be reduced?
    - See example on following page where shares are redeemed for a promissory note.
  - Would the application of GAAR depend on when the structure was established?
    - See the example on the following page
      - Assume the plan to redeem the freeze shares was established before the amendments were introduced

# Paragraph 55(3)(a) - Bona fide corporate reorganization?

## Example 1:

- Holdco and Opco are related corporations
- Holdco owns freeze preferred shares of Opco that have an FMV greater than PUC, ACB and safe income
- The shares of Holdco and the common shares of Opco are owned by persons who are related to Holdco and Opco
- **Scenario 1:**
  - Opco periodically redeems some of the freeze preferred shares held by Holdco for FMV cash consideration
- **Scenario 2:**
  - Opco periodically redeems some of the freeze preferred shares held by Holdco for FMV consideration consisting of a promissory note
  - When cash is available in Opco, the promissory note is repaid
- The purpose of the redemptions in Scenarios 1 and 2 is to reduce the frozen value over time.
  - The redemptions of the Opco freeze preferred shares might be matched by redemptions of some of the Holdco freeze preferred shares
  - In Scenario 2, the redemptions might occur at the beginning of the year. As cash is needed by a shareholder of Holdco, the notes are drawn down

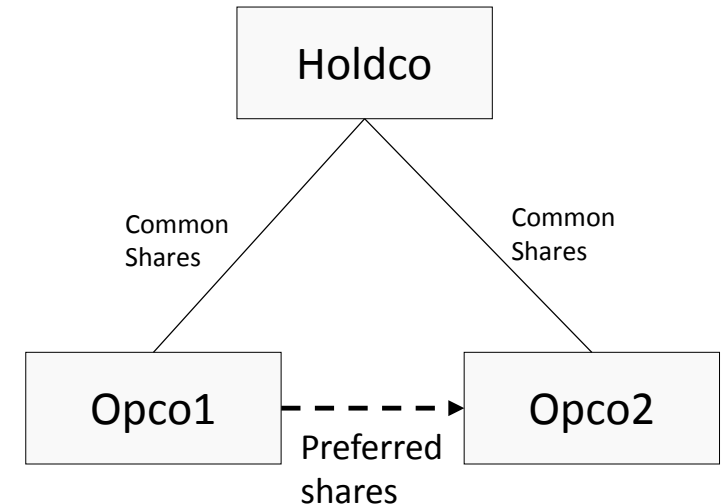




## Paragraph 55(3)(a) - Bona fide corporate reorganization?

- **Example 2:**

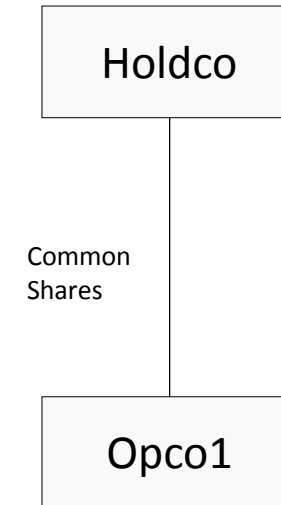
- Holdco, Opco1 and Opco2 are related corporations
- Opco1 has excess cash; Opco2 requires cash in its business
- Opco1 subscribes for preferred shares of Opco2
- In a subsequent year, the following transactions are implemented to clean up the intercompany share ownership
  - Opco1 purchases for cancellation some of its common shares owned by Holdco
    - Opco1 transfers the preferred shares of Opco2 to Holdco as consideration
  - Holdco exchanges the preferred shares of Opco2 for additional common shares



## Paragraph 55(3)(a) - Bona fide corporate reorganization?

- **Example 3:**

- Holdco owns all of the shares of Opco1
- Opco1 has excess cash; Holdco requires cash in its business to fund expenses
- Opco1 purchases for cancellation some of its shares held by Holdco



## Paragraph 55(3)(a) - GAAR

- Technical Interpretation 2015-0604521E5 describes a spin-off transaction that is meant to qualify under paragraph 55(3)(a)
- Under “Alternative 2”, the steps result in increased ACB amounts
- The CRA indicates it would consider the application of GAAR to Alternative 2
- However, there is no indication of the taxpayer’s motive, if any, in creating or using the ACB
- Would CRA agree that if a taxpayer has no intent to use the ACB that GAAR should not apply and paragraph 55(3)(a) should apply?

# Part IV Exception

## Part IV Exception

### Issues:

- Compliance issues under *Ottawa Air Cargo Centre Ltd. v. R.* (“*Ottawa Air Cargo*”)
- 2016 CTF Roundtable, Question 4 - Ability to late file CDA election after amended return has a capital gain
- Other issues raised in submission made by the Joint Committee to Finance regarding the Part IV tax exception

## Part IV Exception

### Issue:

- Application of *Ottawa Air Cargo* to connected corporations

### Discussion:

- Ottawa Air Cargo Centre Ltd. received proceeds on redemptions of shares of Air Stol Inc.
- Ottawa Air Cargo Centre Ltd. and Air Stol Inc. were not connected for the purposes of section 186.
- The amounts of the redemption proceeds in excess of the paid-up capital of the shares were deemed to be dividends under subsection 84(3).
- Subsection 55(2) would have applied to the deemed dividends absent the Part IV exception.
- Ottawa Air Cargo Centre Ltd. was subject to Part IV tax under paragraph 186(1)(a).
  - Under paragraph 186(1)(a), Part IV tax is payable on dividends received from non-connected corporations.
  - The Part IV tax payable by the recipient of the dividend does not depend on the payer's dividend refund.
- In *Ottawa Air Cargo* the court found that Ottawa Air Cargo Centre Ltd. was required to report the deemed dividends and claim a dividend refund before subsection 55(2) could apply.
  - Ottawa Air Cargo Centre Ltd. only reported a capital gain under subsection 55(2)
- Upon receiving the dividend refund, Ottawa Air Cargo Centre Ltd. would be required to refile its tax return on the basis that the deemed dividends were recharacterized as capital gains under subsection 55(2), which refiled tax returns would not document the dividends and the refund of Part IV taxes.

# Part IV Exception

## Question:

- How would a dividend recipient file its tax return when a dividend is received from a connected corporation (in a situation in which subsection 55(2) would apply absent the Part IV exception)?

## Example:

- Holdco receives a dividend from a connected corporation, Opco.
- Opco will be entitled to a dividend refund.
- Assume that subsection 55(2) will apply to the dividend received by Holdco unless the Part IV exception applies.
- Holdco pays the proceeds of the Opco dividend to the shareholder(s) of Holdco.
- Holdco and Opco have the same taxation year-end.
- Holdco and Opco file their returns at the same time.

## Discussion:

- Paragraph 186(1)(b) applies to dividends received from connected corporations.
  - The Part IV tax is based on the payer corporations' dividend refund.
- In *Presidential MSH Corp. v. R*, the court found that the term “dividend refund” meant that an amount had to be refunded and not just calculated.

## Part IV Exception

### Discussion:

- At the time Holdco files its return, Opco has not yet received a dividend refund.
- Should Holdco report a capital gain under subsection 55(2) because Holdco is not yet subject to Part IV tax because Opco has not yet received a dividend refund?
- Alternatively, should Holdco report a capital gain as well as a dividend and dividend refund?



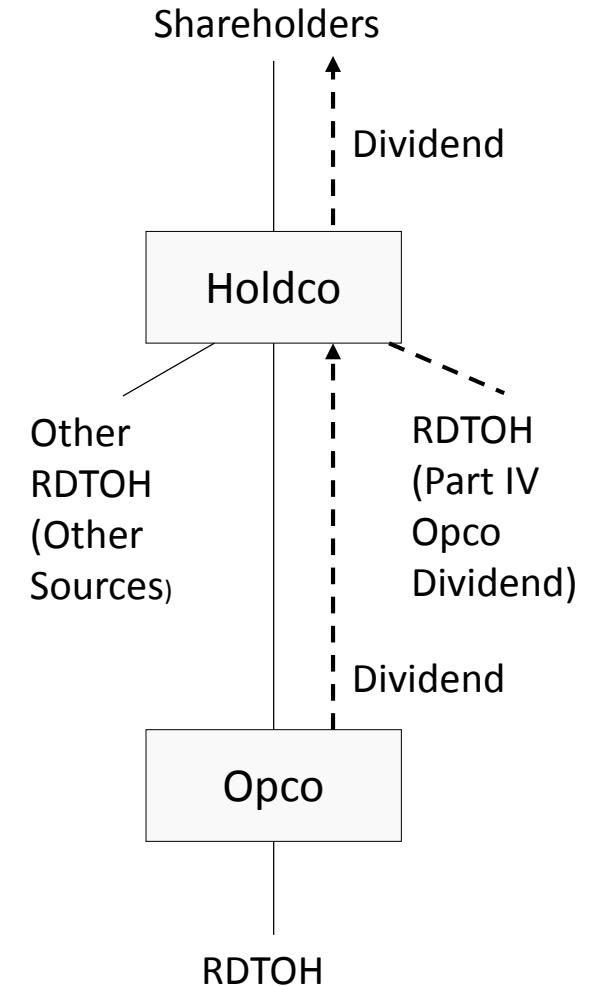
## Part IV Exception

### Example:

- Opco paid a dividend to Holdco
  - Opco received a dividend refund
- Holdco has RDTOH from other sources (“Other RDTOH”)
  - Part IV from other dividends
  - RDTOH from other investment income
  - Might have been earned either before or after the dividend was received from Opco
- Assume the dividend would be subject to subsection 55(2) absent the Part IV tax exception

### Question:

- If the amount of RDTOH recovered by Holdco (by paying dividends to its shareholders) never exceeds the amount of Holdco’s Other RDTOH, can Holdco say that the Other RDTOH was recovered?



## Part IV Exception

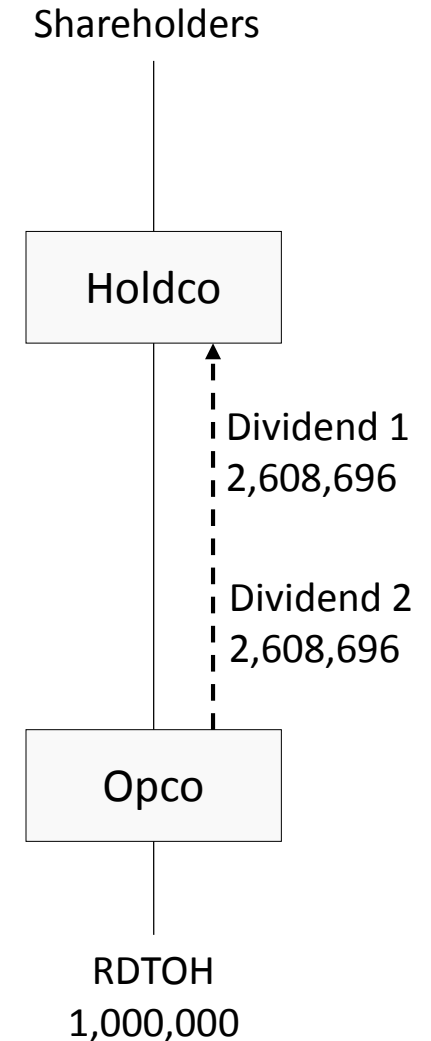
### Example: Scenario A

- Opco has RDTOH of \$1,000,000
- Opco pays a dividend (Dividend 1) to Holdco in the amount of \$2,608,696 that does not satisfy the purpose tests / results test or is paid out of safe income
- Opco pays a second dividend (Dividend 2) to Holdco in the amount of \$2,608,696 that does satisfy the purpose tests / results test and is not paid out of safe income
- Holdco does not pay the proceeds from Dividend 1 and Dividend 2 to the shareholders of Holdco as a dividend
- Each of Dividend 1 and Dividend 2 paid by Opco is sufficient to result in a dividend refund to Opco equal to the full amount of Opco's RDTOH
  - $2,608,696 \times 38.33\% = 1,000,000$

### Question:

- Can Holdco “allocate” the Part IV payable to Dividend 2?

[Continued next page]



## Part IV Exception

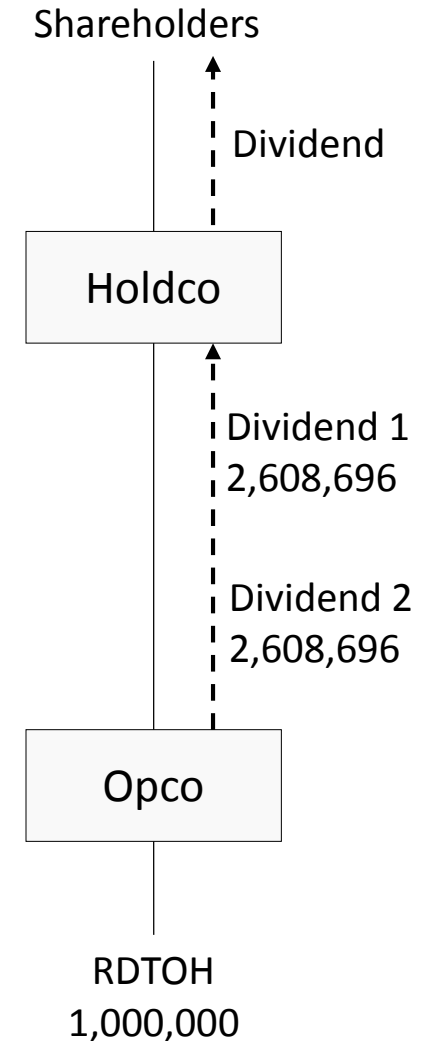
### Example: Scenario B

- Opco has RDTOH of \$1,000,000
- Opco pays a dividend (Dividend 1) to Holdco in the amount of \$2,608,696 that does not satisfy the purpose tests / results test or is paid out of safe income
- Opco pays a second dividend (Dividend 2) to Holdco in the amount of \$2,608,696 that does satisfy the purpose tests / results test and is not paid out of safe income
- Holdco pays the proceeds from Dividend 1 and Dividend 2 to the shareholders of Holdco as a dividend
- Dividend 1 paid by Holdco is sufficient to result in a dividend refund to Opco equal to the full amount of Opco's RDTOH
  - $2,608,696 \times 38.33\% = 1,000,000$

### Question:

- Can Holdco “allocate” the Part IV payable to Dividend 1

[Continued next page]



# Part IV Exception

## Discussion: Scenario A

- In Scenario A, if Holdco can “allocate” the Part IV payable to Dividend 2
  - Dividend 2 would be subject to Part IV tax and not subject to subsection 55(2)

## Discussion: Scenario B

- In Scenario B, if Holdco can “allocate” the Part IV payable to Dividend 1
  - Dividend 2 would not be subject to Part IV tax and would be subject to subsection 55(2) without the compliance burden required by *Ottawa Air Cargo*

## Discussion: Both Scenarios

- Is the Part IV tax paid by Holdco required to be allocated pro rata to all of the dividends received from Opco
  - $\$2,608,696 \times 2 = \$5,217,392$
  - Part IV tax: \$1,000,000
  - Each dividend of \$ 2,608,696 subject to Part IV tax of \$500,000
  - For subsection 55(2), what is the amount of the second dividend that is subject to Part IV tax?
    - Is it \$1,304,348 ( $\$1,304,348 \times 38.33\% = \$500,000$ )
    - If so, is \$1,304,348 subject to the compliance requirements of *Ottawa Air Cargo*

# Part IV Exception

## Issue:

- Multiple tax return amendments required as a result of Holdco receiving a Part IV refund

## Example:

- Holdco receives a dividend, that is subject to Part IV tax, and that would be subject to subsection 55(2) absent the Part IV tax exception
- Holdco pays a taxable dividend to the shareholders of Holdco which will result in a dividend refund to Holdco and the application of subsection 55(2)
- The amount of the taxable dividend paid by Holdco is equal to the amount that would be paid by Holdco to recover RDTOH if the dividend received by Holdco was, instead, a capital gain
- For example, Holdco receives a dividend of \$400,000 (that is subject to Part IV tax because the connected payer corporation received a dividend refund)
  - The part IV tax is \$153,333
    - $\$400,000 \times 38.33\%$
  - If the \$400,000 was a capital gain (and not a dividend), the refundable tax would be \$61,333
    - $400,000 \times 30.66\% \times 50\%$

[Continued next page]

## Part IV Exception

### Example (continued):

- Holdco would need to pay a dividend in the amount of \$160,000 to recover RDTOH of \$61,333
  - $\$61,333 / 38.33\%$
- Based on *Ottawa Air Cargo*, Holdco initially reports:
  - the full amount of the dividend received as a dividend (\$400,000);
  - a dividend paid of \$160,000
  - a dividend refund of \$61,333
- Upon assessment, Holdco is deemed, under paragraph 55(2)(c) to have a gain of \$160,000
- Holdco would be required to file an amended return
- The amended return would report a dividend of \$240,000 and a capital gain of \$160,000
- The amount of the taxable dividend paid by Holdco (\$160,000) does not change; accordingly Holdco still reports a dividend refund of \$61,333
- Subsection 55(2) will apply again because Holdco is reporting a dividend (that was subject to Part IV) (\$240,000) and some of the Part IV tax is being refunded (dividend refund of \$61,333)

[Continued next page]

## Part IV Exception

### Example (continued):

- The end result is:
  - The entire amount of the dividend of \$400,000 is recharacterized as a capital gain
  - The initial taxable dividend paid by Holdco in the amount of \$160,000 does not change
  - The RDTOH on the deemed gain will be fully recovered by the taxable dividend payment
  - The remaining cash in Holdco will be approximately equal to the CDA of \$200,000 from the deemed gain

### Comment:

- This example is different from the 2016 round table question, in that, in the scenario described here, the initial taxable dividend declared and paid is limited to a fraction of the dividend (rather than the full amount)
- No "late filed" CDA election is used
- The analysis is similar to the iterative calculation that is required for Part IV and RDTOH in butterfly reorganizations where one of the corporations has a balance of RDTOH

### Question:

- Would CRA allow a “streamlined” approach to the filing of Holdco’s return to report a capital gain of \$400,000 on the initial return given that is the end result?

[Continued next page]

## Part IV Exception

### Example (continued):

- Supporting calculations are attached
- The supporting calculations show the results after three iterations
  - A substantial portion of the dividend received by Holdco has been recharacterized as a capital gain
  - After more iterations, all of the dividend would be recharacterized as a capital gain
  - It was assumed (for illustration purposes) that Holdco's dividend refund first recovered the RDTOH on the deemed gain(s)
    - If all of the refund was "allocated" to the Part IV on the dividend received, the end result would be the same
      - Certain amounts in the iterations would change, but after several iterations the entire dividend received by Holdco would be recharacterized as a capital gain and all of the RDTOH on the deemed gains would be recovered



**Part IV Example: Assumes 55(2) Applies Unless Part IV Exception Applies**

<b>1</b>	Holdco owns all of the shares of Opco			
<b>2</b>	Opco realizes a capital gain of	<u>1,000,000</u>		
	Opco corporate tax at 50.16%	250,830		
	Refundable portion	<u>153,333</u>		
	Opco net corporate tax	<u>97,497</u>		
<b>3</b>	Opco pays a taxable dividend to Holdco	399,999	Note: this amount results in full dividend refund to Opco & is approximately equal to the remaining cash in Opco	
<b>4</b>	Holdco pays a dividend to shareholders	160,000	Note: If Holdco was subject to 55(2) on the dividend from Opco of	399,999
			Holdco would be subject to refundable tax of	61,333
			Holdco would need to pay a dividend of	160,000
			to recover the RDTOH created	
<b>5</b>	Holdco is subject to 55(2) on	160,000		
<b>6</b>	Holdco corporate tax on 55(2) gain at 50.16%	40,133		
	Refundable portion	<u>24,533</u>		
	Net	<u>15,599</u>		
<b>7</b>	Holdco Summary at this point - T2 Version 2			
	Taxable dividend received	399,999		
	Recharacterized - 55(2)	<u>(160,000)</u>		
	Remaining portion of dividend	<u>240,000</u>		
	RDTOH - Part IV on Opco dividend	92,000	Note: Only the remaining portion of the dividend is subject to Part IV	
	Refundable tax on capital gain	24,533		
	Dividend refund	<u>(61,333)</u>	Note: have recovered the RDTOH that would arise if entire dividend from Opco was recharacterized as a capital gain	
	Remaining RDTOH	<u>55,200</u>		
	CDA - on 55(2) gain	<u>80,000</u>		
<b>8</b>	On Holdco's amended T2 (T2 Version 2), a dividend from Opco is reported in the amount of:	240,000		
	Holdco also reports a dividend refund of:	61,333		
<b>9</b>	If the dividend refund on T2 Version 2 is considered to			

recover the RDTOH on the 55(2) gain first, the refund would partially relate to the dividend from Opco

	Refund	61,333
	RDTOH on deemed gain	(24,533)
	Refund related to Opco dividend	<u>36,800</u>
	Divided by the dividend refund rate results in	<u>96,000</u>
<b>10</b>	Holdco would be subject to 55(2) on an additional	<u>96,000</u>
<b>11</b>	Holdco corporate tax on 55(2) gain at 50.16%	24,080
	Refundable portion	<u>14,720</u>
	Net	<u>9,360</u>
<b>12</b>	Holdco Summary at this point - T2 Version 3	
	Taxable dividend received	399,999
	Recharacterized - 55(2)	(160,000)
	Recharacterized - 55(2)	<u>(96,000)</u>
	Remaining portion of dividend	<u>144,000</u>
	RDTOH - Part IV on Opco dividend	55,200
	Refundable tax on capital gain	24,533
	Refundable tax on capital gain	14,720
	Dividend refund	<u>(61,333)</u>
	Remaining RDTOH	<u>33,120</u>
	CDA - on 55(2) gain	80,000
	CDA - on 55(2) gain	<u>48,000</u>
		<u>128,000</u>
<b>13</b>	On Holdco's amended T2 (T2 Version 3), a dividend from Opco is reported in the amount of:	144,000
	Holdco also reports a dividend refund of:	61,333
<b>14</b>	If the dividend refund on T2 Version 3 is considered to recover the RDTOH on the 55(2) gains first, the refund would partially relate to the dividend from Opco	
	Refund	61,333
	RDTOH on deemed gain	(24,533)
	RDTOH on deemed gain	<u>(14,720)</u>
	Refund related to Opco dividend	<u>22,080</u>

	Divided by the dividend refund rate results in	<u>57,600</u>		
15	Holdco would be subject to 55(2) on an additional	<u>57,600</u>		
16	Holdco corporate tax on 55(2) gain at 50.16%	14,448		
	Refundable portion	<u>8,832</u>		
	Net	<u>5,616</u>		
17	Holdco Summary at this point - T2 Version 4			
	Taxable dividend received	399,999		
	Recharacterized - 55(2)	(160,000)		
	Recharacterized - 55(2)	(96,000)		
	Recharacterized - 55(2)	<u>(57,600)</u>	Total 55(2) amount:	313,599
	Remaining portion of dividend	<u>86,400</u>		
	RDTOH - Part IV on Opco dividend	33,120		
	Refundable tax on capital gain	24,533		
	Refundable tax on capital gain	14,720		
	Refundable tax on capital gain	8,832		
	Dividend refund	<u>(61,333)</u>		
	Remaining RDTOH	<u>19,872</u>		
	CDA - on 55(2) gain	80,000		
	CDA - on 55(2) gain	48,000		
	CDA - on 55(2) gain	<u>28,800</u>		
	Holdco - Total CDA	<u>156,800</u>		
	Holdco cash (without further iterations)			
	Dividend received from Opco	399,999		
	Dividend paid	(160,000)		
	Corporate tax on 55(2) gain	(15,599)		
	Corporate tax on 55(2) gain	(9,360)		
	Corporate tax on 55(2) gain	(5,616)		
	Unrecovered RDTOH	<u>(19,872)</u>		
	Holdco cash	<u>189,553</u>		