CRA Update on Subsection 55(2) and Safe Income

Where are we Now?

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CRA UPDATE ON SUBSECTION 55(2) AND SAFE INCOME – WHERE ARE WE NOW?[1]

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Introduction

The CRA delivered its first paper on subsection 55(2) and safe income at the 1981 Canadian Tax Foundation conference.[2] That paper provided the CRA's perspective on safe income and other issues arising from the provision and came to be known as "the Robertson rules." Since then, the CRA has provided several updates and technical interpretations on subsection 55(2). As well, tax practitioners have written numerous articles and several decided court cases have expanded the body of knowledge on the safe income concept.

In 2015, subsection 55(2) was amended, introducing a shift in the focus of the provision. Hence, reliance on the safe income concept has become more important.

The legislation on safe income within subsection 55(2) is minimal. And so, the CRA at the outset recognized its stewardship role in providing taxpayers and their advisors with information and guidance to fulfill their tax obligations.

The CRA views, as outlined herein, continue in that regard, while following the textual, contextual and purposive interpretation of the provision as mandated by the courts. They are not just a one-sided and self-serving interpretation of the rules. Throughout this exercise, the CRA has striven for a balanced and

[1] The author would like to give special thanks to Stephane Prud'homme, Director of the Reorganizations Division of CRA's Rulings Directorate, for his review, approval, guidance, encouragement and unwavering support in the preparation of this paper and who has made this paper a reality. The author would also like to thank his colleagues Deen Olsen and Jennifer Smith from the Department of Justice, Lauchlin MacEachern from the Department of Finance, Patrick Bilodeau from CRA's Tax Avoidance Division and all his colleagues from the Rulings Directorate for their generous feedback.

[2] John R. Robertson, "Capital Gains Strips: A Revenue Canada Perspective on the Provisions of Section 55," *Report of Proceedings of the Thirty-Third Tax Conference*, 1981 Conference Report (Toronto: Canadian Tax Foundation, 1982), 81-109. Herein referred to as the "Robertson rules" or the "Robertson paper."

reasonable approach. However, some views adopted reflect practical realities and best efforts to give proper meaning to subsection 55(2) and the concept of safe income that underlies the provision.

Although this paper discusses several fundamental concepts at play within subsection 55(2) including safe income, it is not intended to be a "fresh-start" nor a comprehensive review of all aspects of the provision. CRA views previously expressed in the Robertson rules and other CRA publications and documents[3] remain valid. However, where the views expressed below differ from the views previously expressed, the below prevails.[4]

Subsection 112(1) Deduction on Taxable Inter-Corporate Dividends and the Concept of Cost

A review of basic principles helps establish the framework for the CRA views.

Inter-corporate dividends are described as tax-free because of the deduction provided in subsection 112(1). The underlying principle of subsection 112(1) is to eliminate duplication of tax on income moving through a corporate chain by exempting the income from additional tax when it was already subject to tax in another corporation.[5]

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[3] See, for example, Michael A. Hiltz, "Section 55: An Update," in Selected Income Tax Aspects of the Purchase and Sale of a Business, *1984 Corporate Management Tax Conference* (Toronto: Canadian Tax Foundation, 1984), 40-46; Robert J.L. Read, "Section 55: A Review of Current Issues," *Report of Proceedings of the Fortieth Tax Conference*, 1988 Conference Report (Toronto: Canadian Tax Foundation, 1989), 18:1-28; and Michael A. Hiltz, "Income Earned or Realized: Some Reflections," in *Report of Proceedings of the Forty-Third Tax Conference*, 1991 Conference Report (Toronto: Canadian Tax Foundation, 1992), 15:1-24.

[4] All views contained in this paper that constitute a change in position to what has previously been made public will apply prospectively to calculations of safe income for taxation years beginning after November 28, 2023.

[5] The Benson Report (Carter Commission) noted the following:

> 4.52 Under the present law, dividends received by one Canadian corporation from another taxable Canadian corporation are not taxed. If this exemption were not in the law, corporation tax could be collected twice, three times or even more often from the same profits before they are ultimately distributed to individual shareholders.
>
> (see E.J. Benson, *Proposals for Tax Reform* (Ottawa: Queen's Printer, 1969)).

The supplementary information on subsection 112(3.1) in the 2015 Budget confirmed the scheme of subsection 112(1) as follows:

> 2015: Synthetic Equity Arrangements
>
> The Income Tax Act permits a corporation to deduct, subject to certain exceptions, taxable dividends received in computing its taxable income. This inter-corporate dividend deduction is intended to limit the imposition of multiple levels of corporate taxation on earnings distributed from one corporation to another.
>
> (see *Budget Supplementary Information* from the federal Budget of April 21, 2015)

Also, the supplementary information on subsection 112(5.2) in the 2018 Budget stated the following:

> Stop-Loss Rule on Share Repurchase Transactions
>
> The Income Tax Act generally permits a corporation to deduct dividends received on a share of a corporation resident in Canada in computing its taxable income. This inter-corporate dividend deduction is available for dividends actually received; it is also available for dividends that are deemed to have been received on a share, which can arise on a repurchase of the share. The deduction is intended to limit the

However, the inter-corporate deduction for dividends under section 112 does not always align with the treatment to be accorded to the cost of property received as a dividend.

One could rightfully question whether the property received as a dividend should have full cost when the dividend itself is not taxed because of the section 112 deduction. As one author puts it, "cost is a key element in many calculations necessary under the Act in the determination of, or as a step in the determination of, a taxpayer's liabilities for tax. In fact, cost is one of the principal determinants in establishing the tax liability…"[6]

Generally, the cost that a taxpayer has in a property reflects the price paid to acquire the property with after-tax funds[7] and there are rules in the Act to ensure that cost is not created without incurring tax.[8] For example, if a shareholder of a corporation transfers property it owns (other than shares of the corporation) to the corporation or to another person, a taxable gain will be realized if the cost amount of the consideration received on the transfer is greater than the cost amount of the property transferred. The result: there is no creation of tax-free cost base.

Property received by a shareholder as a dividend generally has, by virtue of subsection 52(2), a cost equal to the fair market value of the property. This ensures that the value of the property that was included in income as a dividend under paragraph 12(1)(j), even if offset by a corresponding deduction under subsection 112(1), is not included in income a second time on the disposition of the property. The recognition of cost equal to the amount of the dividend that was included in the income of the dividend recipient under paragraph 12(1)(j) ensures that only the future increase in the value of the property is taxed, thereby preventing the duplication of tax paid by corporations.

When a property is received by a corporate shareholder as a dividend, the payment of the dividend is normally made with after-tax money of the corporate payer and the cost on the property to the dividend recipient would be attributable to after-tax money. The result in such case would be appropriate and in accordance with tax policy.

> imposition of multiple levels of corporate taxation on earnings distributed from one corporation to another.
> (see *Budget Supplementary Information* from the federal Budget of February 18, 2018)

A tax author also identified the scheme of subsection 112(1) as follows:

> The policy underlying the rule that dividends between Canadian corporations should flow through on a tax-free basis is to avoid multiple taxation of income as it passes through a chain of corporations.
> (See Vern Krishna, *The Fundamentals of Canadian Income Tax*, 9th ed. (Toronto: Thomson/Carswell, 2006), Chapter 21 – IV.4.(a))

[6] D. Keith McNair, *The Meaning of Cost in Canadian Income Tax*, Canadian Tax Paper no. 69 (Toronto: Canadian Tax Foundation, 1982).

[7] Considering the whole scheme of the Act, including subsection 52(1). Exceptions can be found where cost is deemed to be a certain amount under certain provisions of the Act, such as section 13, 52, 69, 88, 97, 98, 128.1, etc.

[8] See, for example, subsections 85(1), 85.1(3), 86(1) and the rules of deemed disposition and reacquisition in paragraph 13(7)(a), subsection 50(1) and paragraph 111(4)(e), etc. This concept has been reaffirmed in the decision *Quebecor Inc. v. the King* ([2018-979(IT)G] at paragraphs 237, 238, 239).

However, there would be a lack of corporate tax integration where a corporate shareholder receives property on payment of a dividend that is not taxable and the cost of the property received is greater than the amount on which tax is paid, either by the dividend payer or the corporate shareholder.

The concept of cost and subsection 55(2) share the common objective of preventing the duplication of corporate tax while ensuring that tax is paid on an amount of cash or other property received in the form of a dividend, where such dividend is not supported by income that was subject to tax in the hands of the dividend payer.[9]

Even if its purpose is to eliminate duplication of tax, subsection 112(1) is broadly worded and, as a result, any dividend that is paid from a taxable Canadian corporation to a corporation resident in Canada is deductible under subsection 112(1), whether or not such dividend is derived from income that actually has been subject to tax.[10] Rather than limiting the application of subsection 112(1) to dividends that are actually paid out of after-tax money,[11] Parliament has instead chosen to restrict the application, or effect, of subsection 112(1) through specific provisions, such as the various deduction denial rules under section 112 and, notably, subsection 55(2).

Role and Purpose of Amended Subsection 55(2)

Prior to the 2015 amendments introduced in Bill C-15,[12] the focus of subsection 55(2) was on capital gain strips,[13] i.e., capital gain reductions via tax-free inter-corporate dividends.

The 2015 amendments brought about a renewed focus on subsection 55(2). It now applies if the following conditions are met:

- (a) the dividend recipient is entitled to a deduction in respect of the dividend under subsection 112(1) or (2) or 138(6);
- (b) it is the case that
  - (i) one of the purposes of the payment or receipt of the dividend (or, in the case of a dividend under subsection 84(3), one of the results of which) is to effect a significant reduction in the portion of the capital gain that, but for the dividend, would have been realized on a disposition at fair market value of any share of capital stock immediately before the dividend, or
  - (ii) the dividend (other than a dividend that is 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) is received on a share that is held as capital property by the

[9] CRA document 2016-0671501C6.
[10] See *Canada Safeway Ltd. v. Alberta* (2012 ABCA 232).
[11] As proposed in the Benson Report, supra footnote 5 at paragraphs 4.51 to 4.59. Presumably, the recommendations of the Benson Report were not followed because they would render the system too complex and not because they are not supported by tax policy, considering the objectives of subsection 112(1).
[12] Bill C-15, 2016, c. 7, subsec. 5(1).
[13] See the Robertson paper, supra footnote 2

dividend recipient and one of the purposes of the payment or receipt of the dividend is to effect

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

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

(c) the amount of the dividend exceeds 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 — 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.

The 2015 amendments were introduced to address concerns with corporations creating cost base on a tax-free basis to reduce capital gains that could be realized on potential dispositions. Such creation of cost base was made via a receipt of a taxable dividend that is deductible under subsection 112(1).

When a dividend, in the form of cash or any other type of property, is paid from income that has been subject to tax in the hands of the dividend payer, the dividend would normally be a safe income dividend. If so, it is appropriate for the corporate shareholder to obtain a deduction under subsection 112(1) in respect of that dividend to avoid the duplication of tax paid by corporations. As explained above, the cost to a shareholder of the cash[14] or any other type of property received as a dividend is equal to its fair market value on the basis that the dividend was included in income.

When a dividend is paid from a source that has not been subject to tax in the hands of the dividend payer, the dividend would normally not be a safe income dividend. Such dividend might be paid from borrowed cash, from share subscription proceeds or from any source of untaxed income. In addition to preventing the inappropriate reduction of a capital gain on any share, the role of subsection 55(2) now includes questioning whether one of the purposes of the payment or receipt of such dividend is to significantly reduce the fair market value of a share or to increase the cost amount of property of the dividend recipient. If so, the scheme of the provision is that such dividend should not be tax-free. The scheme of subsection 55(2), amongst other objectives, is to preserve the integrity of the corporate tax system by prompting an inclusion in income where there is an increase in the cost of property of the dividend recipient when such increase in cost has not been taxed either in the hands of the dividend payer or the dividend recipient and when a purpose of effecting such increase exists. Such inclusion results from the recharacterization of the dividend as proceeds of disposition or as a capital gain.[15]

[14] Even though cash is fungible, it remains a property under the scheme of subsection 55(2), i.e., one has to take into account the cost represented by the cash received as a dividend in order to determine whether subsection 55(2.1) would find application.

[15] Supra footnote 9.

One of the Purposes of Payment or Receipt of the Dividend

The Purpose Test

The Supreme Court in *Ludco*[16] stated that

> "in 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."

Ludco adopted the purpose test in respect of paragraph 18(1)(a) mandated by the Supreme Court in *Symes*: [17]

> "74 As in other areas of law where purpose or intention behind actions is to be ascertained, it must not be supposed that in responding to this question, courts will be guided only by a taxpayer's statements, *ex post facto* or otherwise, as to the subjective purpose of a particular expenditure. Courts will, instead, look for objective manifestations of purpose, and purpose is ultimately a question of fact to be decided with due regard for all of the circumstances. For these reasons, it is not possible to set forth a fixed list of circumstances which will tend to prove objectively an income gaining or producing purpose."

Recently the Supreme Court in *MacDonald*[18] reaffirmed:

> A long line of jurisprudence supports the conclusion that the characterization of a derivative contract as a hedge turns on the contract's purpose. Purpose is ascertained objectively (*Ludco Enterprises Ltd. v. Canada*, [2001] 2 S.C.R. 1082, at para. 54). While subjective manifestations of purpose may sometimes be relevant, the taxpayer's stated intention… is not determinative. The taxpayer's conduct is generally more revealing than "*ex post facto* declarations" of the taxpayer.

The test provided in *Symes*, *Ludco* and *MacDonald* is the benchmark in determining purpose or intent and has been applied in a long line of cases.[19]

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[16] *Ludco Enterprises Ltd et al v. The Queen*, 2001 DTC 5505 (SCC)

[17] *Elizabeth C. Symes v. The Queen*, 1994 DTC 6001 (SCC)

[18] *MacDonald v. The Queen*, 2020 DTC 5027 (SCC), at paragraph 22

[19] See, for example,

- *Petro-Canada* v. *The Queen*, 2004 DTC 6329 (FCA): qualifying of expenses as CEE.
- *Makuz* v. *The Queen*, 2006 DTC 3201 (TCC): existence of a partnership.
- *McPherson* v. *The Queen*, 2007 DTC 326 (TCC): whether a gift is a genuine gift.
- *Canada Safeway Ltd.* v. *The Queen*, 2008 DTC 6074 (FCA): secondary intention (income vs. capital gain).
- *Groupe Honco Inc.* v. *The Queen*, 2013 DTC 1032 (TCC): application of subsection 83(2.1).
- *Perera* v. *The Queen*, 2014 DTC 1172 (TCC): expenses incurred for the purpose of earning employment income.
- *Standard Life Assurance Co of Canada* v. *The Queen*, 2015 DTC 1113 (TCC): designated insurance properties.
- *Lyn Kew* v. *The Queen*, 2015 DTC 1172 (TCC): purpose of a relocation expense.
- *Mariano* v. *The Queen*, 2015 DTC 1209 (TCC): intent of donation.

The decision of the Federal Court of Appeal (FCA) in *Placer Dome*[20] was in response to the Crown's argument that "purpose" in subsection 55(2), based on Australian case law, does not embrace the motivation of each of the participants and that the term is to be understood in an objective, not a subjective sense, particularly when a dividend and a disposition of a share are inextricably linked and where the transaction has the effect of reducing substantially a capital gain. The Crown lost the argument and the FCA indicated that the "purpose" test in subsection 55(2) is a subjective test. This has to be differentiated from the standard established by *Ludco*, *Symes* and *MacDonald* on the determination of purpose.

At paragraph 20 of the FCA decision in *Placer Dome*, the Court did make the comment that "it is not necessary that the taxpayer adduce corroborative or additional evidence which shows or tends to show that his or her testimony is true." Such comment was derived from *McAllister Drilling,*[21] where the Court made the following comment at paragraph 8 of the decision:

> "In the somewhat unusual circumstances of this case where credibility is conceded, if I agree that the taxpayers' evidence is credible, it will not require the bolstering or corroboration afforded by external facts". [Our emphasis]

In both *Placer Dome* and *McAllister Drilling*, the court determined the "purpose" of the taxpayers by not only listening to their testimony but also by examining all the facts and corroborating their testimony with the objective facts and the evidence. The comments made by both courts and quoted above only meant that a court does not need to probe further if the facts and evidence presented to them are sufficient to establish the credibility of the taxpayer's testimony.

Viewed in this light, the courts in *Placer Dome* and *McAllister Drilling* do not contradict *Ludco*, *Symes* and *MacDonald* but rather follow the standard established therein that "courts should objectively determine the nature of the purpose, guided by both subjective and objective manifestations of purpose." Accordingly, where a dispute arises under subsection 55(2) as to "purpose", to make that determination Courts will review all the relevant facts and evidence, the objective manifestations of purpose and the credibility of the testimony of the taxpayers.[22]

The "purpose" of the payment or receipt of the dividend, as contained in subsection 55(2.1), is to be determined from the viewpoint of either the dividend payer or the dividend recipient. Accordingly, a purpose can be found to be present from the viewpoint of the dividend recipient even if the dividend payer has no such purpose, or vice versa.

- *3488063 Canada Inc.* v. *The Queen*, 2016 DTC 5099 (FCA): application of section 94.1.
- *Edison Transportation LLC* v. *The Queen*, 2016 DTC 1063 (TCC): section 9 and paragraph 18(1)(a).

[20] *The Queen v. Placer Dome*, 96 DTC 6562 (FCA)
[21] *McAllister Drilling et al v. The Queen*, 95 DTC 5001 (FCTD)
[22] CRA document 2017-0724021C6.

One of the Purposes

There are three separate types of purpose that may prompt the application of subsection 55(2). They are to effect:

- a significant reduction of the capital gain of any share (subparagraph 55(2.1)(b)(i)),
- a significant reduction in the fair market value of any share (clause 55(2.1)(b)(ii)(A)), or
- a significant increase in the cost of property (clause 55(2.1)(b)(ii)(B))

The technical notes to the 2015 amendments stated that the "one of the purposes" test in subparagraphs (b)(i) and (ii) are to be applied separately to each dividend. For example, subparagraph (b)(ii) could apply to a dividend one of the purposes of which is to significantly increase the cost of any property even if subparagraph (i) applies (or does not apply because one of the purposes was not to reduce significantly a gain on any share)." As such, the purpose tests in subparagraph 55(2.1)(b)(ii) could apply even if the dividend does not satisfy the purpose in subparagraph 55(2.1)(b)(i) (i.e., there is no gain on the shares).

A dividend that is directly or indirectly instrumental in the creation of an accrued loss on any share that may be used, or has the potential to be used, to shelter a gain on some other property provides an indication that the FMV reduction purpose exists.

Example 1

> Holdco owns shares of Opco with an ACB of $500 and a FMV of $500. Holdco owns a property ("Property A") with an ACB of $0 and a FMV of $300 that it wants to sell to a purchaser. Opco pays a dividend of $300 (with the issuance of a promissory note payable to Holdco of $300) on the shares held by Holdco. The FMV of the shares of Holdco is reduced to $200, giving rise to an accrued loss of $300. Holdco subsequently transfers Property A to Opco on a tax-deferred basis. Shares of Opco are subsequently sold to the purchaser for $500. No gain is realized by Holdco on the sale of the shares of Opco. In this situation, the purpose in paragraph 55(2.1)(b)(i) would not be applicable because there was no accrued gain on the shares of Opco immediately before the dividend. The payment of the dividend gives rise to an ACB increase on properties held by Holdco of $300. Whether or not there is a purpose of cost increase would have to be ascertained by taking into consideration all the facts. In this example, the facts would support the conclusion that there is a purpose of significantly reducing the FMV of the shares of Opco in order the shelter the accrued gain on Property A.

Note that the cost increase purpose can be met even when the cost is not used within the series of transactions that includes the dividend, since the cost could be used or has the potential to be used to shelter or reduce a gain at any time. As discussed earlier, one of the purposes of subsection 55(2) is to counter the deliberate creation of cost on a tax-free basis.

Subsection 55(2) could apply where any one of the purposes described in paragraph 55(2.1)(b) is present and, therefore, it is important to demonstrate that the payment or receipt of the dividend has no purpose described in paragraph 55(2.1)(b) to avoid the application of subsection 55(2).

A payment or receipt of a dividend can have a purpose described in paragraph 55(2.1)(b) even if it has another purpose. It is a question of fact whether the non-55(2.1)(b) purpose can be viewed as the sole and exclusive purpose for the payment or receipt of the dividend. For example, a dividend paid can have a purpose of purifying the corporation by distributing surplus assets so that the shares in the capital stock of that corporation are “qualified small business corporation shares” within the meaning of subsection 110.6(1) (“QSBCS”). Whether such a purpose of maintaining QSBCS status can be viewed as the sole purpose to the exclusion of any purpose of reducing the accrued gain or value of the shares or increasing the cost of property of the dividend recipient is a determination that can only be made in light of all the relevant facts and circumstances.

Where the dividend is paid with assets other than surplus assets to maintain the QSBCS status, it might signal that the payment of the dividend could have a purpose referred to in paragraph 55(2.1)(b). Or, if the removal of the surplus assets from the corporation through the payment of a dividend is made in contemplation of a possible disposition of the shares of the corporation, that may also indicate that there is a purpose referred to in paragraph 55(2.1)(b).[23]

Example 2

> A dividend is paid by an operating company (“Opco”) to a parent company (“Holdco”) to “creditor-proof” Opco. Holdco would lend money to Opco prior to or after the payment of the dividend. The main purpose of such transaction is to allow Holdco to own a debt in Opco that ranks above all other liabilities of Opco such that other creditors of Opco can only access a reduced value in Opco, because of the debt due by Opco to Holdco. Holdco would have succeeded in reducing the value of the shares held in Opco by essentially converting a significant amount of accrued value on a share of Opco into full ACB debt that could be sold or repaid without any tax implication. In such situation, where the creditor-proofing dividend exceeds safe income, the CRA’s view is that it would be challenging to accept the argument that the “creditor-proofing” dividend payment has the sole and exclusive purpose of creditor-proofing such that the dividend does not include any purpose of reducing the value of the shares of Opco. The difficulty in accepting such argument is that a reduction of the overall value of Opco that could otherwise be accessed by the creditors constitutes essentially a reduction of value of the shares of Opco. The creditor-proofing purpose equates to and, in fact, is the same as a value reduction purpose because one needs to do a reduction in value of the shares to achieve a creditor-proofing.

Since each corporation in a corporate chain is taxed separately, the purpose test is applied at the level of each dividend payment in the chain. There is no consolidated approach in determining whether the purpose test is met.

[23] Supra footnote 22.

Significant Reduction of Capital Gain or Fair Market Value or Significant Increase in Cost

The CRA had been of the view that a "significant reduction in the portion of the capital gain" is measured in dollars not percentage. No line was drawn. A few hundred dollars would not be enough. A few thousand might."[24] However, in *VIH Logging*[25], the court stated that

> 49 Whether a dividend causes a reduction in a capital gain that is "significant" must be determined contextually, taking into account all of the relevant facts and circumstances. The amount of the reduction in this case was approximately $45,000, in the context of a series of transactions involving dividends totalling over $1.7 million. In my view, it was open to the Judge in the circumstances of this case to characterize the $45,000 capital gain reduction as not "significant". It follows that she was correct to conclude that the purpose test in subsection 55(2) was not met for the stock dividend.

The CRA does not dispute the court's view on this matter.

The significant reduction in the capital gain is based on the hypothetical capital gain that would be realized if the shares were disposed of for fair market value immediately before the dividend, without taking into account the dividend in question.[26] Therefore, the fair market value of the shares is to be measured immediately before the payment or declaration of the dividend and not before the series of transactions. Such fair market value could be affected by events that could occur between the beginning of the series and the time of payment or declaration of the dividend, such as an offer received for the sale of the shares.

Some might be tempted to argue that the fair market value determined for purposes of subparagraph 55(2.1)(b)(i) may differ from the fair market value determined for purposes of paragraph 55(2.1)(c). In paragraph 55(2.1)(c), the fair market value is to be determined immediately before the dividend but the determination does not make abstraction of the dividend[27] and, therefore, the value could be affected by the declaration of dividend which should occur before the payment of the dividend. For example, if a share is worth an unspecified amount and a declaration of dividend on the share would crystallize the value of such share to a certain amount, say $1,000, then the fair market value of such share immediately before the dividend would be $1,000 for purposes of the application of paragraph 55(2.1)(c).

Although the argument might have merit in some circumstances,[28] it is not in accordance with the scheme and intent of the provision. Paragraph 55(2.1)(c) does not make abstraction of the dividend simply because it is about the determination of safe income that is before the safe income determination time. Since the safe income determination time is a time that is before the dividend, there is no need to make abstraction of the

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[24] Supra footnote 2, at page 93
[25] *The Queen v. VIH Logging Ltd.,* 2005 DTC 5095 (FCA)
[26] Subparagraph 55(2.1)(b)(i) measures the capital gain that, but for the dividend, would have been realized on a disposition at fair market value of the share immediately before the dividend. Subsection 55(2.5) and paragraph 55(2.1)(b) all require a determination either immediately before or immediately after the dividend.
[27] The qualification "but for the dividend" is not present in paragraph 55(2.1)(c).
[28] For example, it has been argued that safe income can be allocated to discretionary-dividend shares because the declaration of dividend would increase the value of such shares.

dividend as is the case in subparagraph 55(2.1)(b)(i). If the fair market value in paragraph 55(2.1)(c) is to be determined immediately before the payment of the dividend but after the declaration of the dividend, it could produce an anomalous result. For example, suppose a taxpayer owns shares of Opco with an ACB of nil and a FMV of $1,000. The safe income on the shares is $400. A dividend of $1,000 is declared and paid on the shares. If the argument is that the FMV is determined after the declaration of the dividend and before its payment, then the FMV of the shares would be nil.[29] In such situation, it would be difficult to argue that the shares are entitled to safe income because there is no gain on the shares to which the safe income can be considered to contribute. Thus, even for purposes of paragraph 55(2.1)(c), the determination of FMV has to be made prior to the declaration or payment of the dividend, as is the case in subparagraph 55(2.1)(b)(i).

With respect to the "significant reduction in fair market value" test in clause 55(2.1)(b)(ii)(A), the technical notes to the 2015 amendments stated that "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." Furthermore, the FMV reduction is based on a reduction that is caused by the dividend, whether declared or paid, and not only caused by a paid dividend, because it does not make sense that clause 55(2.1)(b)(ii)(A) would not apply to a situation where a declared dividend has reduced the FMV but its subsequent payment does not. Subsection 55(2.5) is only there to ensure that clause 55(2.1)(b)(ii)(A) applies where the FMV was already nil before the declaration or payment of the dividend and is not meant to infer that the determination of the reduction of FMV has to be measured against the FMV immediately before the payment of the dividend.

As for the "significant increase in the cost of property" test in clause 55(2.1)(b)(ii)(B), the wording of the provision seems to invite a measure in dollar terms and not in percentage. However, an argument for a measure in percentage can also be justified. The CRA will follow the court's view in *VIH Logging* that both may be relevant.[30]

Example 3

> Opco has made a final disposition of its assets for cash consideration of $1,000 and realized income of $1,000. Opco had no safe income accumulated before the disposition of the assets. The amount of income taxes that would be payable by Opco on the disposition of the assets is $300. The FMV of Opco (based on cash inside Opco of $1,000 and the accrued liability for income taxes of $300) is $700 and the safe income of Opco is also $700. The ACB of the shares of Opco to its shareholder is nil. The shareholder of Opco receives an offer to sell Opco for $900 because the buyer has a plan to eliminate the income previously realized with tax deductions. Opco pays a dividend of $900 to its shareholder after the offer has been received and prior to the realization of tax deductions for Opco.
>
> In this situation, the CRA's view is that the safe income of Opco before the safe income determination time is at most $700 (income realized of $1,000 minus accrued tax liability of $300).[31]

[29] To the extent the right to receive the declared dividend has vested with the shareholder.
[30] Supra footnote 25.
[31] Safe income calculated at the safe income determination time has to be reduced by accrued tax liabilities on the income even if those tax liabilities may be eliminated at the end of the taxation year. See, for example, *626468 New Brunswick v. the Queen*, 2019 DTC 5141 (FCA). There is also an alternative argument that the safe income

The FMV of the shares for purposes of subparagraph 55(2.1)(b) is $900, based on the offer received from the buyer. The payment or receipt of the dividend of $900 would have the following purposes:

- to effect a significant reduction in the portion of the capital gain ($900) that would have been realized on a disposition of the shares at FMV immediately before the dividend (55(2.1)(b)(i))

or

- to effect a significant reduction in the FMV ($900) of any share (55(2.1)(b)(ii)(A))

The condition under paragraph 55(2.1)(c) would also be met because the dividend exceeds the amount of income ($700) that could reasonably be considered to contribute to the capital gain that could be realized on a disposition at FMV ($900) of the shares.

Under the legislation that was in effect prior to the 2015 amendments, the application of subsection 55(2) was based on the following:

The dividend of $900 was to effect a significant reduction in the portion ($200) of the capital gain ($900) that would have been realized on a disposition at FMV ($900) of any share and that could reasonably be considered to be attributable to anything ($200) other than income earned or realized before the safe income determination time ($700).

Consequently, subsection 55(2) would apply, under the current legislation, to recharacterize the excess dividend of $200 as a capital gain.[32]

Example 4

Shares of Opco have a FMV of $1,000. A dividend of $1,000 is declared on the shares of Opco. The dividend is paid 10 days after its ex-dividend date. In this situation, if the FMV of the shares is determined immediately before the payment of the dividend, it would arguably and theoretically be nil because a purchaser who would want to purchase the shares immediately before the dividend payment would not be entitled to the dividend. Could subparagraph 55(2.1)(b)(i) or alternatively clause 55(2.1)(b)(ii)(A) apply to the payment of the dividend?

As discussed above, the FMV of the shares for purposes of subparagraph 55(2.1)(b)(i) is to be determined without taking into consideration the impact of the dividend. Therefore, the FMV should be $1,000 and the dividend would have the purpose of significantly reducing the gain on the shares.

With respect to the potential application of clause 55(2.1)(b)(ii)(A), as discussed above, it is obvious that the dividend declared or paid has reduced the FMV of the shares and subparagraph 55(2.1)(b)(ii)

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should be nil if the net income of the year is nil because of a pre-ordained use of deductions to eliminate the income for the year.

[32] Provided that the argument described in footnote 31 has not been pursued.

should apply. Furthermore, under subsection 55(2.5), even though one might try to argue that the FMV has already been reduced to nil at the time that is immediately before the payment of the dividend, because, arguably, the FMV has to be determined immediately before the payment of the dividend and not before the declaration of the dividend (which argument, in the CRA view, is incorrect), such FMV would be increased by the amount by which the FMV of the dividend that is received on the shares ($1,000) exceeds the FMV of the shares (nil) determined immediately before the payment of the dividend and, therefore, the FMV of the shares immediately before the payment of the dividend is $1,000 and the dividend would be viewed as causing a significant reduction in the FMV of the shares.

The 55(3)(a) exemption

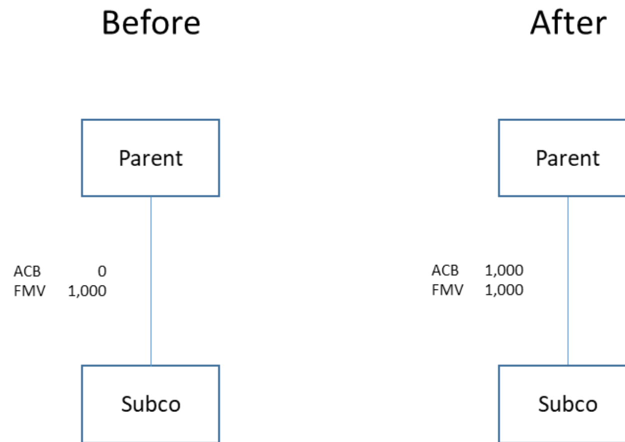
The 2015 amendments no longer allow the paragraph 55(3)(a) exemption to apply to actual dividends (as opposed to deemed dividends under either subsection 84(2) or 84(3)) paid between related persons. That's because those actual dividends have to be subject to the purpose test under paragraph 55(2.1)(b). This does not mean that a deemed dividend under either subsection 84(2) or 84(3) should automatically be exempt from the application of subsection 55(2) by virtue of paragraph 55(3)(a) even where it has a purpose under paragraph 55(2.1)(b).

As indicated in the technical notes to the 2015 amendments to paragraph 55(3)(a), it was necessary to preserve the paragraph 55(3)(a) exemption to facilitate bona fide reorganizations by related persons since those reorganizations would typically require transfers of property that are followed by a redemption of shares under subsection 84(3). It is believed that subjecting the 84(2) or 84(3) dividend to an additional purpose test (such as in subparagraph 55(2.1)(b)(ii)) on top of the existing capital gain reduction result test would be rather confusing because a subsection 84(2) or 84(3) dividend would always result in a reduction of FMV and increase in cost (especially a reduction in FMV compared to an actual dividend that is not a subsection 84(2) or 84(3) dividend) and it would be too easy to conflate purpose and result in the context of such dividend, making the application of the paragraph 55(3)(a) exemption rather difficult. Therefore, the technical notes clarified that the amendments to paragraph 55(3)(a) and the introduction of subsection 55(2.1), although the text being silent on the consequent restriction of the application of paragraph 55(3)(a), should not be interpreted as a green light to use paragraph 55(3)(a) to manufacture basis. As indicated in the technical notes, the paragraph 55(3)(a) exemption is "not intended to be used to accommodate the payment or receipt of dividends or transactions or events that seek to increase, manipulate, manufacture or stream cost base." Clearly, the application of the paragraph 55(3)(a) exemption should be consistent with the scheme of subsection 55(2) and an attempt to use the paragraph 55(3)(a) exemption to circumvent the application of paragraph 55(2.1)(b) would be subject to a challenge under GAAR.

Furthermore, as discussed at the 2015 CTF Round Table, an attempt to artificially create or unduly preserve ACB in a reorganization that would be exempt under either paragraph 55(3)(a) or 55(3)(b) would frustrate the object, spirit and purpose of the provision and the CRA would seek to apply GAAR to such situation.[33]

Example 5

Parent owns shares of Subco with ACB of $0 and FMV of $1,000 and no safe income. Parent wants to increase its cost in the shares of Subco or other property held in Subco. Shares of Subco are redeemed for a note and the note is either held by Parent or subsequently reinvested back in the shares of Subco held by Parent. The redemption for a note that is kept by Parent or reinvested back into the shares of Subco held by Parent has no purpose other than to effect an increase in cost for Parent of any property that is contrary to the scheme of subsection 55(2). Paragraph 55(3)(a) is used to circumvent the restriction in subsection 55(2.1). In this situation, the CRA would seek to apply GAAR to the redemption of the Subco shares.

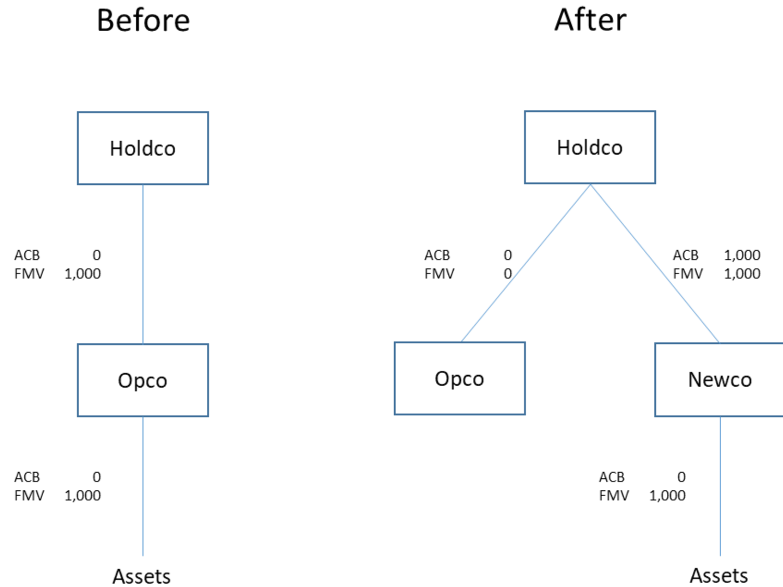


Example 6

Holdco owns shares in Opco with an ACB of $0 and a FMV of $1,000.

1. Holdco forms Newco.
2. Opco transfers assets having an ACB of $0 and FMV of $1,000 to Newco for preferred shares of Newco worth $1,000.
3. Newco redeems its preferred shares held by Opco for a note of $1,000.
4. Opco redeems its shares held by Holdco in consideration for the Newco note of $1,000.
5. Newco issues shares of $1,000 to Holdco in consideration for the Newco note.

[33] See CRA document 2015-0610681C6



At the end of the day, Holdco has exchanged shares held in Opco with an ACB of $0 for shares in Newco with an ACB of $1,000.

In particular, the redemption of shares of Opco held by Holdco creates a deemed dividend which is a proxy for an actual dividend that would otherwise have been caught by subsection 55(2.1). In this situation, the CRA would consider the application of GAAR to the attempt to obtain an increased ACB in the shares of Newco in the course of the reorganization.

What is Safe Income?

Legislation on safe income

If a taxpayer is entitled to a deduction under subsection 112(1) or (2) or 138(6) on a dividend received, and the dividend meets one of the purpose tests in paragraph 55(2.1)(b), the dividend is subject to subsection 55(2) to the extent that it exceeds safe income determined before the safe income determination time as specified in paragraph 55(2.1)(c).

"Safe income determination time" is defined in subsection 55(1).

Finally, subsection 55(5) contains additional rules on the calculation of safe income.

The relevant legislation on safe income is reproduced in the Annex.

Subsection 55(5) in general provides mechanical rules for the calculation of "income earned or realized" while the definition of "safe income determination time" and paragraph 55(5)(a) provide for some cut-off times.

Compared to the foreign affiliates surplus calculation rules, the legislation on safe income is minimal. The reason is that perhaps a detailed legislation on this subject would be very complex, where such complexity would be viewed as unwarranted by Parliament especially when it is expected that all parties take a reasonable approach on the calculation of safe income. It is incorrect to argue that the legislation on safe income is a complete code for its calculation particularly given its legislative and jurisprudential history; nor would a strict textual approach, ignoring its context within the scheme of subsection 55(2), be correct.

Income considered to "contribute" to a gain

Notion of safe income on hand

The entitlement to safe income under section 55 as presently set out in the legislation hinges on whether the income earned or realized could "reasonably" be considered to contribute to the accrued gain on the shares.[34] the underlying premise is that the income earned or realized by the corporation could somehow contribute to the increase in the value of the shares and, since such income earned or realized has already been subject to tax, a dividend paid by the corporation that reduces the portion of a capital gain on a share that represents such increase should not be subject to additional tax.

The concept of safe income is paramount because subsection 55(2) does not apply to a distribution from safe income since such income has already been subject to tax. Furthermore, it is not intended that corporations could make tax-free distributions that have a purpose of reducing value or increasing cost when such distributions are made from amounts that have not previously been subject to tax. So, a proper calculation of safe income would help avoid double taxation as well as non-taxation. It is recognized by *Kruco*[35] that

> [45] It is apparent from this brief analysis that Brown and McDonnell correctly identified the intent behind subsection 55(2) when they wrote the passage quoted by the Tax Court Judge at paragraph 82 of his reasons: The intent of subsection 55(2) is to permit a tax-free, intercorporate dividend to be paid to reduce a potential capital gain to the extent that the gain is attributable to the retention of post-1971 income. Conversely, it is intended to block a dividend payment that goes beyond this amount to reduce capital gains attributable to anything other than retained post-1971 income.

The main crux of the safe income determination is contained in two words of paragraph 55(2.1)(c): "reasonably" and "contribute." A proper interpretation and application of those two words, based on the respect of the scheme and intent of subsection 55(2), is therefore crucial.

The main interpretative difficulty resides in the fact that the safe income exception in paragraph 55(2.1)(c) crosses the boundary between the "real" and the "unreal."[36] The FMV of the shares is "real," whereas the

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[34] In *The Queen v. Nassau Walnut Investments Inc*. 97 D.T.C. 5051 (FCA), the court agreed with the following submission by the crown: "assuming that the other requirements of that provision are satisfied, so long as the approach taken by the Minister in allocating safe income is reasonable, subsection 55(2) should apply regardless of whether the method chosen by Nassau could also be considered reasonable."
[35] *The Queen v. Kruco Inc.* 2003 D.T.C. 5506 (FCA), at paragraph 45. Note that the *Kruco* decision was on the application of subsection 55(2) prior to the 2015 amendments.
[36] See *Kruco Inc. v. The Queen* 2001 D.T.C. 668 (TCC), at paragraphs 88 and 89.

income for tax purposes, the ACB and the capital gain realized on a hypothetical disposition could be considered "unreal" since they are based on tax fiction. How can an amount of income, that is a tax fiction, be considered to contribute to a hypothetical gain, which is also a tax fiction but based on some "real" (i.e., the FMV) and "unreal" (i.e., the ACB) elements?

Therefore, questioning whether the income for tax purposes has contributed to a gain is a significant exercise in judgment that requires reasonability, fairness and restraint, as assumed by Parliament.

In the past, the CRA has attempted to resolve the issue by taking the position that each dollar of income contributes to one dollar of gain[37] and that a gain is only attributable to the income if the income is kept on hand to support the gain, thus the adoption of the concept of safe income on hand, which was subsequently embraced by the courts.[38]

The position taken by the CRA was based on a logical and practical approach in order to bridge the gap between the "real" and the "unreal," i.e., for the gain to be considered to be attributable to the income, the income has to reflect something that is "real." It is the CRA's view that the "real" portion of the income represents the tangible portion of the income that will continue to exist to support the value of, and therefore the gain on, the shares.

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[37] The genesis of that position was in the version of paragraph 55(5)(a) and the preamble of subsection 55(2) that was introduced in the August 28, 1980 Draft Income Tax Amendments and that read as follows:

> 55(5)(a): the portion of any capital gain attributable to any income of a corporation shall be determined on the assumption that the portion of the fair market value of all the shares of the corporation that is attributable to any income of the corporation does not exceed the amount of that income.
>
> 55(2): Where a corporation resident in Canada has … received a taxable dividend to which subsection 85(10) does not apply and in respect of which it is entitled to a deduction under subsection 112(1) or 138(6) as part of a series of transactions or events, one of the purposes of which (or, in the case of a dividend under subsection 84(3) received after April 21, 1980, one of the results of which) was to effect a significant reduction in the portion of the capital gain that, but for the dividend, would have been realized on a disposition at fair market value of any share of capital stock immediately before the dividend and that could reasonably be considered to be attributable to anything other than income earned by any corporation after 1971, notwithstanding any other section of this Act, the amount of the dividend (other than the portion thereof, if any, subject to tax under Part IV)…

Note, however, that such position is no longer needed under the current legislation. Prior to the 2015 amendments, the question was whether more than $1 of gain could be viewed as attributable to $1 of income earned or realized, and if safe income is $1, some may have argued that a reduction of gain of, say $5, would not be caught by subsection 55(2) because such gain could be viewed as attributable to the $1 of the income earned or realized. Ignoring the merit of such argument, that question is no longer applicable under the current legislation. If there is $1 of income earned or realized, whether that $1 contributes to a gain of $1 or a gain of $5 is no longer relevant because the question to be asked today is whether the dividend exceeds the income earned or realized that contributes to the gain. On that basis, the issue is now the reverse of what existed prior to the 2015 amendments, i.e., it is no longer possible to argue that a reduction of gain could be exempt under subsection 55(2) if it exceeds the income earned or realized, but it is possible to be in a situation where the amount of income earned or realized (as calculated under section 3 and subsection 55(5)) exceeds the amount of such income that contributes to the gain on the shares.

[38] Supra footnote 35 at paragraphs 36-38: "there can be no doubt that this exercise calls for an inquiry as to whether "the income earned or realized" was kept on hand or remained disposable to fund the payment of the dividend."

The CRA recognizes that the use of the concept of "safe income on hand" may have been confusing, inviting differing views on its meaning. The CRA views that the post – 2015 amendments legislation as basically rendering such concept irrelevant.

What was referred to as "safe income on hand" should now be simply referred to as "safe income," and the "safe income" is the income that is calculated under subsection 55(5) and that can reasonably be viewed as contributing to the gain on the shares.

The confusion created by the concept of "safe income on hand," which was based on the pre – 2015 amendments legislation, led the court in *Kruco*[39] to establish a two-stage inquiry as follows:

> 38 There can be no doubt that this exercise calls for an inquiry as to whether "the income earned or realized" was kept on hand or remained disposable to fund the payment of the dividend. It follows, for instance, that taxes or dividends paid out of this income must be extracted from safe income (see *Deuce Holdings Ltd*., supra and *Gestion Jean-Paul Champagne Inc.,* supra).
>
> 39 The appellant argues that the phantom income in issue must be removed from "income earned or realized" on the same logic as dividends or taxes. Simply put, as this income does not correspond to any cash inflow, it is not (and can never have been) disposable or on hand. Hence, the appellant submits that it should also be removed from "income earned or realized".
>
> 40 The problem with this argument is that it runs squarely against the fact that "income earned or realized" for purposes of subsection 55(2) is, in the case of a private corporation, deemed to be income computed in conformity with paragraph 55(5)(c). This provision is not merely presumptive; it is framed in mandatory terms and the state of affairs which it deems must be taken as a given.
>
> 41 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".
>
> 42 However, what the appellant proposes is a modification in the actual computation of income under the Act on the basis that part of this income, although computed and made subject to tax in conformity with the Act, was in fact never on hand or disposable. This adjustment alters the amount which paragraph 55(2)(c) deems to be a private corporation's "income earned or realized". While the use made of this income once computed in conformity with this provision must be analysed to determine whether it remains disposable, the fact that this income is fixed by way of a deeming provision precludes an inquiry as to whether it was ever on hand or disposable. In short, it is not

[39] Supra footnote 35 at paragraphs 38-42.

> open to the Minister to modify the amount which Parliament has deemed to be a corporation's "income earned or realized" for purposes of subsection 55(2).

The reasoning in *Kruco* was predicated not only on the concept of "safe income on hand" but also on the wording of the safe income exception to subsection 55(2), as it then read, that required a gain to be attributable to the income earned or realized. As reasoned in *Kruco*, the income earned or realized as calculated under section 3 and then under subsection 55(5), is the first step of the inquiry and, once so calculated, the second step is to question whether that income has remained on hand after its computation. That led the court to decide that the income in step one cannot be modified to exclude "phantom" income since it was already fixed by legislation.

The CRA clarified its view in ITTN-37 as follows:

> We believe that safe income on hand reductions made to reflect the impact of cash outflows (such as non-deductible expenses), which are not deducted in the computation of the corporation's net income for tax purposes but still have the effect of reducing the amount of disposable after-tax income by an equivalent amount, are in line with the general principles set out by the FCA.
>
> Accordingly, we are now of the view that the amounts that must reduce a corporation's "safe income on hand" are not limited only to taxes and dividends. The use of the terms "for instance" in paragraph 38 of the FCA's decision supports this view. Furthermore, one would think that the statement by the FCA that the second step in the process of determining a corporation's safe income requires an "inquiry" as to whether the income earned or realized was kept on hand, is evidence that such second step implies more than the mere reduction of a corporation's net income by taxes and dividends paid only.
>
> We are also of the view that an interpretation of the *Kruco* decision that allows the reduction of safe income by the amount of non-deductible expenses incurred by a corporation is in accordance with the intent of subsection 55(2), which is to permit a tax-free intercorporate dividend to be paid to reduce a potential capital gain, to the extent however that such gain is attributable to the retention of "post-1971" income.

However, the conducting of the 2-stage inquiry as suggested in *Kruco* is no longer necessary or relevant in light of the 2015 amendments for the following reasons:

- The 2-stage inquiry as determined in *Kruco* to the effect that income is fixed by legislation and that fixed income is only reduced by cash outflows taking place after the computation of income is no longer supported by the wording of new paragraph 55(2.1)(c).
- Instead, the simple question is to what extent the amount of the income, as calculated under subsection 55(5), can reasonably be viewed as *contributing to the value, hence to the gain*, on the shares. And it can be determined, in some circumstances, that only a portion of the income can reasonably be viewed as contributing to the gain.

Thus, for the income to be reasonably considered to contribute to the gain, the income has to reflect something that is “real” since only the “real” portion of the income could be viewed as contributing to the “real” value of the shares. To the extent that the shares have an inherent accrued gain, an income that contributes to the fair market value of the shares is considered to contribute to its capital gain since the adjusted cost base is already a fixed amount. As stated above, the amount of income that may reasonably be considered to contribute to the fair market value would be the “real” portion of the income, i.e., the tangible portion of the income that will continue to exist to support the value of, and therefore the gain on, the shares.

To summarize, the calculation of safe income starts with section 3 and then subsection 55(5). From the income calculated under subsection 55(5), portions of such income are excluded in the calculation of safe income if they do not contribute to the gain on the shares. To the extent that a portion of the income does not contribute to a gain, such portion is not part of the safe income, whether or not it is a cash outflow that takes place before or after the computation of income in accordance with subsection 55(5) and whether or not it alters the amount computed under subsection 55(5). Obviously, an amount of income that is no longer disposable for the purpose of paying a dividend should not be viewed as contributing to the gain on the shares, but the essential question is not whether the income is on hand or disposable for the purpose of paying a dividend after its calculation, but rather whether an income that is calculated, or a portion of such amount, can reasonably be viewed as contributing to the gain.

Subject to the restrictions discussed below, the total income earned or realized by the corporation, as calculated under subsection 55(5), would be considered to contribute to a gain on all the shares of the corporation to the extent of the tangible portion of the income that will continue to exist to support the value and therefore the gain on the shares.

Example 7

Opco was incorporated with no capital contribution. Opco realized a total amount of income of $1000 during a period of activity. At the end of such period, the balance sheet of Opco shows assets (all of which are derived from the income earned) that are composed of $200 of cash, $500 (which represents cost) of real property and $300 of inventory and no liabilities. The real property lost value and its FMV at the end of the period is $250. The off-balance sheet intangibles assets of Opco are valued at $400 at the end of the period. Thus, the shares of Opco are worth $1,150 at the end of the period.

One can clearly see in this example that the $1,000 of income earned has not retained its value and, from such income, only $750 can reasonably be viewed as contributing to the gain on the shares. The remaining $400 of the gain on the shares is due to intangibles that do not constitute income earned or realized.

Nevertheless, the CRA recognizes that it is practically impossible to establish the amount of safe income that contributes to the gain on the shares to this level of precision in the circumstances described above, as it requires a valuation of assets, amongst other things. Therefore, where the

loss on a property is accrued and not realized, it should not reduce safe income. In this situation, the safe income of Opco at the end of the period is considered to be $1,000. However, if the real property was sold and the loss was realized, then the safe income would be reduced by the amount of deductible capital loss, whether or not it was claimed in the year it was realized.[40]

Contingent liabilities, reserves, losses, phantom income, non-deductible expenses and prepaid expenses

If they reduce or have the potential of reducing the income of the corporation on materialization at the time of calculation of safe income, the CRA is of the view, for the reasons expressed above, that contingent liabilities and reserves[41] have to be excluded from safe income along with non-deductible expenses and prepaid expenses since they do not represent the tangible portion of the income that will continue to exist to support the value and therefore the gain on the shares.[42]

Phantom income, i.e., income for tax purpose that is not supported by any tangible cash inflow, cannot be viewed as contributing to the gain on the shares.

As for losses that are not on account of capital and that are realized by the corporation, arguments had been made by some tax practitioners that they should not reduce safe income since the terms "income earned or realized" does not refer to losses. This approach does not constitute a reasonable interpretation of the provisions that is in accordance with the scheme of the provisions.

The CRA is of the view that losses have to reduce safe income for the following reasons:

- The calculation of annual income under section 3 requires a deduction of losses against income. The calculation of safe income is on a cumulative basis. As such, it is logical that the income for the cumulative period is an aggregation of all income and losses for the period and it is unreasonable that the calculation would allow for an inclusion of income realized within the holding period while ignoring the losses that have been realized in the same period.
- Income realized in previous taxation years would presumably be used to finance current year losses. Therefore, losses of a current year have to reduce safe income since the income of the previous years can be viewed as no longer existing to support the value, and therefore the gain, on the shares. See Example 7 above. If losses of a current year are financed with debts, the result would be the same since the corporation has to pay off the debts and it would be reasonable to assume that the

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[40] For private corporations, the non-deductible portion of the capital loss that has been realized reduces the capital dividend account. For non-private corporations, the non-deductible portion of the capital loss would, under subparagraph 55(5)(b)(ii) reduce safe income only to the extent of the non-taxable portion of the capital gains that have been realized.

[41] We understand that a contingent liability is recognized for accounting purposes as a provision when it is probable that the future event will occur and the amount of the liability can reasonably be estimated. In that situation, work has been done to quantify the amount of the liability.

[42] In other words, contingent liabilities and reserves do not reduce safe income when the income is not reduced on their realization.

previous years' income would no longer exist to support the value on the shares. What if a corporation has realized a loss prior to realizing any income? The corporation would theoretically have "negative safe income" because the losses have reduced the gain on the shares or future income that would be needed to bring the capital back to its original level or to repay the debt. However, "negative safe income" for a corporation by itself is irrelevant since nothing can be done with it. It is only relevant if the safe income of the corporation is to be consolidated with safe income of other corporations, which will be discussed below.

- Consider the following simplified example:

Example 8

> A shareholder incorporates a corporation with an ACB of nil. The corporation realizes $100 of income over the years and also $100 of losses that were offset against the income in the holding period. The value of the shares goes up to $20, due to goodwill being generated. The corporation has no hard assets that support its value. Is it logical in this situation to say that the gain on the shares of $20 is attributable to safe income and could be realized tax-free? First, the goodwill contributes to the gain and the income does not. The income translated into assets has been used to pay for the losses, with the result that no hard assets remain inside the corporation. The use of the assets generated by the income to pay for the losses has effectively eliminated the value of the shares. Second, there is no income that has been subject to tax that can support the gain on the shares. All income has been wiped out by the losses, resulting in no tax payable. A literal reading of the provision that ignores the losses is contrary to the scheme of section 55.

Having said that, there is one instance where income that has not been subject to tax may be allowed to be distributed as safe income: when a shareholder acquires a corporation with losses and the acquisition is not part of a loss-trading transaction and subsection 111(5) applies to allow for the losses to be deducted, the income realized in the holding period, i.e., after acquisition, can be offset by the losses and no taxes would be paid on that income. In such instance, the CRA's view is that the income, prior to the loss deductions, is nevertheless safe income because it is income realized by the corporation in the holding period. From a conceptual point of view, this does no violence to the scheme of safe income.[43] From the point of purchase, the income realized by the corporation contributes to the gain on the shares. Losses carried forward only helped to reduce taxes paid on that income. To the extent the use of losses respects the scheme of subsection 111(5), the income realized in the holding period could constitute safe income even when no tax has been paid on such income.[44]

Regarding capital losses, as Example 7 above has demonstrated, they should logically reduce safe income when accrued. However, as discussed above, it is practically impossible to sustain this view and, therefore,

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[43] To the extent the current scheme of section 88 continues to exist, i.e., this position can find support in the current scheme of section 88 where the losses are not taken into consideration in the determination of a potential gain under clause 88(1)(d)(i)(A).
[44] See also CRA document 2018-0780041C6.

the CRA would consider that the losses should reduce safe income when realized, whether or not they were claimed in the year they were realized.[45]

Example 9

Investment tax credit on SR&ED:

Aco has income of $300 before SR&ED expenditures. After the deduction for SR&ED expenditures of $100 under section 37, the net income of Aco was $200 for Year 1.

Aco receives an investment tax credit ("ITC") of $35 on the SR&ED expenditures under subsection 127(5). The taxes paid in Year 1 by Aco before the ITC were $80. After deduction for ITC of $35, the net taxes paid in Year 1 were $45.

In Year 2, Aco includes $35 in its income under 12(1)(t). Assume that Aco has no other income in Year 2.

Regarding the calculation of safe income for Year 1, the CRA was[46] and is of the view that the safe income should be increased by the amount of income realized of $200, which was reduced by the net tax paid of $45. Therefore the safe income for Year 1 should be $155. This result is proper. The income earned or realized by Aco was $200 but only $155 should be viewed as contributing to the gain on the shares because $45 has been disbursed for the payment of taxes.

Regarding Year 2, although the income earned or realized was $35, such amount should not be viewed as contributing to the gain on the shares since it is phantom income that is not supported by any increase in the value of assets to the corporation. Furthermore, such amount was already included in safe income in Year 1 because it has reduced the amount of taxes that were deducted from the calculation of safe income.

Phantom income and "double-taxation"

As stated above, the key question is whether an amount of income can reasonably be viewed as contributing to the gain on the share. Underlying this question is that it is possible that less than 100% of the income could be viewed as contributing to the gain on the share.

Logically, the amount of income that may reasonably be considered to contribute to the fair market value of the shares would be the "real" portion of the income, i.e., the tangible portion of the income that will continue to exist to support the value of, and therefore the gain on, the shares. Therefore, phantom income, i.e., income for tax purpose that is not supported by any tangible cash inflow, cannot reasonably be considered as contributing to the gain on the share.

The safe income concept shares the same objective as the section 112 deduction regarding double-taxation, i.e., eliminate duplication of tax on income moving through a corporate chain by exempting the income from

[45] Supra footnote 40.
[46] See CRA document 2004-0061041I7.

additional tax when it was already subject to tax in another corporation. The emphasis here is on the income that has been subject to tax and that moves to another corporation. The movement of such income can only occur via the movement of tangible assets (or assets substituted for such assets) generated by that income.

For example, a corporation realizes income of $100 that is reflected in cash of $100. The income was subject to tax of, for example, $20. The remaining cash of $80 can be distributed to the shareholder. The corporation can choose to distribute the remaining cash of $80 or borrow $80 to make the distribution to the shareholder. That distribution would be viewed as a distribution of income that has been subject to tax and should not again be subject to tax in the hands of the shareholder.

If, on the other hand, the income earned of $100 is strictly a phantom income, i.e., a tax income that is not supported by any tangible asset or cash inflow, then there is nothing that would support a subsequent distribution to the shareholder, let alone causing double-taxation.

Viewed from a different angle, the calculation of safe income will help avoid double-taxation to the extent the income has been translated into tangible assets with a cost. For example, if an income earned is $100 and the $100 has been invested in acquiring a property with a cost of $100, that income can clearly be viewed as supporting the value on the shares because it is reflected in the assets of the corporation. If the property is sold for $130, only $30 will be subject to tax. Also, assume that there are no other assets in the corporation and the shares of the corporation are worth $130 based on the value of the property owned, a sale of the shares for $130 would only result in a gain of $30 with the use of $100 of safe income. There is no double-taxation.[47]

Where the income of $100 is not reflected in the cost of tangible assets of the corporation, it cannot be expected that such income be used to offset a gain that is realized elsewhere or a gain on shares that is not attributable to anything that is supported by such income, or to possibly generate a loss on a sale of shares.

Example 10

Holdco incorporates Aco and owns shares of Aco with an ACB of nil.

Since incorporation, Aco has a phantom income of $100 that has been subject to tax. Aco has no assets and the value of the shares of Aco is nil.

If Holdco sells the shares of Aco for $0 because there is no value on the shares of Aco and because there are no assets in Aco, there is no gain or loss to Holdco.

Although $100 has been subject to tax in the hands of Aco, that income is not added to the ACB of the shares of Aco owned by Holdco and, therefore, is not available to create a loss at the shareholder

[47] Some double-taxation may arise if assets inside the corporation are sold after the sale of the shares. Such double-taxation is not present if the order of transactions is reversed or could be partially mitigated by the bump under paragraph 88(1)(c), to the extent allowable. However, if such double-taxation existed, it existed within the "normal" framework of corporate tax integration and has nothing to do with safe income.

level. In other words, it cannot be expected that the sale of Aco by Holdco should result in a loss of $100 to offset the income realized and taxed in the hands of Aco.

Unlike partnerships, the income of a corporation is not added to the ACB of the shares and cannot be used to offset a possible gain realized on the sale of the shares, simply because the income of the corporation is not allocated to the shareholder and taxed in its hands.

This example and Example 11 ignore the financing for the taxes paid by Aco. If Holdco has invested money in Aco for the payment of the taxes, a loss equal to such money invested may be realized when the shares of Aco are sold to an arm's length person for $0. This is how the corporate tax integration rules work and the safe income mechanism is not there to change the integration rules.

Example 11

Same as above, except that Aco has phantom income since incorporation of $100 that has been subject to tax and Aco has generated an intangible worth $30. As a result, the shares of Aco are worth $30.

First situation: Aco sells the intangible for $30.

Second situation: Holdco sells the shares of Aco for $30.

In the first situation, Aco realizes a gain of $30 on the sale of the intangible. The income of $100 previously realized by Aco has no effect on the gain realized by Aco.

In the second situation, Holdco realizes a gain of $30, equivalent to the gain that Aco would have realized if it sold the assets directly. The income previously realized in Aco cannot be used as safe income to offset the gain on the shares of Aco, clearly because the income of $100 does not contribute to the gain on the shares, because such gain is attributable to the intangibles of Aco.

As can be seen in the above two examples, the calculation of gain realized by either Aco or Holdco follows the corporate tax integration principles and there is no double-taxation. The argument that the exclusion of phantom income or non-deductible expenses from the calculation of safe income results in double-taxation does not hold.

Reduction by income taxes paid or accrued

Income taxes paid or accrued have to reduce safe income since the amount that has to be set aside to pay the taxes cannot reasonably be considered to contribute to the gain on the shares, as the amount of the taxes would result in a discount in the value of the shares should the shares be sold to an arm's-length person.

In the same vein, the portion of refundable taxes on such income taxes paid or accrued that will be reimbursed due to a payment of dividend before the end of the taxation year will be considered to be a reduction of such income taxes paid or accrued on the amount of income that constitutes safe income. The

refundable taxes not reimbursed due to a payment of dividends after the end of the taxation year will be included in safe income if and when it is received by the corporation.

Reduction by dividends

Dividends paid in excess of safe income may be taxed as a capital gain under subsection 55(2) in the hands of the corporate recipient. The CRA would not view the portion of the dividend that is subject to the application of subsection 55(2) to reduce safe income of the corporate payer. Similarly, a dividend in excess of safe income that is paid to an individual shareholder and taxed in the hands of the individual would not be viewed as reducing the safe income of the corporate payer should the individual subsequently transfer the shares of the corporate payer to another corporation.

However, where a dividend is not subject to the application of subsection 55(2) or taxed in the hands of an individual shareholder, it is the CRA's view that the dividend should reduce safe income on the basis that the assets paid out as a dividend no longer exist in the corporation to support the value of the shares.

Where a dividend paid is in excess of safe income, the portion that exceeds the safe income should be viewed as reducing safe income and would give rise to negative safe income for the holding period to the extent that it exceeds the difference between the net value of the assets owned by the corporation immediately before the dividend and the amount of the dividend that is covered by safe income. The reason is that any income that is subsequently earned or realized would ultimately be used to finance the dividend payment and would not reasonably be viewed as contributing to the gain on the shares.

Where shares held by a particular shareholder are redeemed or purchased for cancellation, the CRA remains of the view that the safe income entitlement of other shares of the corporation will not be affected if the redemption does not reduce the fair market value of the other shares and if the redemption is not part of a plan to avoid tax.[48]

Example 12

> In Year 1, Holdco1 transferred assets into Opco on a rollover basis in consideration for preferred shares with a fixed redemption amount and nominal dividend entitlement. The value of the preferred shares of Opco issued to Holdco1 was $500. The assumption is made that the assets transferred by Holdco1 to Opco consisted of a goodwill with a value of $500 and a nominal cost amount.
>
> Also in Year 1, Holdco2 subscribed for common shares of Opco for a nominal amount. During the holding period of the common shares of Opco by Holdco2, Opco earned a safe income of $500 that is represented by cash held by Opco. Assume that the value of the common shares is established to be $500 at the time of the redemption of the preferred shares, as discussed below. The safe income of $500 can be considered to contribute to the gain on the common shares held by Holdco2 in Opco.

[48] Michael Hiltz, supra footnote 3, page 41-42

Opco redeems the preferred shares held by Holdco1 in consideration for the $500 of cash that it had generated with its earnings. There are no assets remaining in Opco after the redemption of the preferred shares, except for the goodwill transferred to Opco by Holco1.

In this situation, although the cash that has been generated by Opco with its safe income no longer supports the value of the common shares held by Holdco2, the safe income of $500 that is considered to contribute to the gain on the common shares of Opco held by Holdco2 has remained unchanged for the following reasons:

- A redemption of the preferred shares for its fixed redemption amount should not affect the entitlement to safe income of the common shares. Since the preferred shares do not participate in the income earned or realized by Opco, no safe income should be considered to have been paid to Holdco1 on the redemption of the preferred shares.
- The cash or assets generated by safe income have been retained to support the value of the common shares up to the time of redemption of the preferred shares. Although the cash has been used to redeem the preferred shares, such use has not reduced the value of the common shares because the value of the common shares is still supported by other assets of Opco.
- Opco could have borrowed money to redeem the preferred shares and the question of whether there was a reduction of safe income that contributed to the gain on the common shares would not have been raised. A use of existing cash to avoid the borrowing should not affect the amount of safe income that contributes to the gain on the common shares.
- The principle that safe income is the tangible portion of income that continues to exist to support the value and therefore the gain on the shares does not invite a strict tracing to the exact assets that are generated by the income, since the corporation is not static. Assets generated by safe income can also be used to acquire other assets. For example, the $500 of cash generated by the safe income can be used to acquire goodwill. In such situation, the safe income is reflected in assets that are retained in other forms than the original form in which they were generated. The key test is whether the safe income earned by Opco has contributed to the gain on the common shares, and not whether the gain on the common shares could be supported by assets owned by Opco at any specific moment in time. In summary, in this situation, the safe income earned in the form of cash of $500 still contributes to the value of the common shares after the redemption of the preferred shares because the cash generated by the safe income has been substituted for other assets of Opco.

Example 13

Opco is wholly-owned by Holdco.

Opco owns assets with a net value of $1,000. Opco has realized safe income of $600.

Opco pays a dividend of $2,500 to Holdco.

A portion ($600) of the dividend reduces the safe income to nil. To the extent that subjection 55(2) does not apply to the portion of the dividend that exceeds safe income,[49] the excess portion of $1,900 will result in a negative safe income of $1,500 (1,900 – (1,000 – 600)) because Opco was put in "the hole" for $1,500 as a result of the payment of the dividend and future income realized would be viewed as contributing to the value of the shares only to the extent that it exceeds the amount required to fill the hole.

Realization of gain that was accrued at time of acquisition

When shares of a corporation are acquired for proceeds equal to fair market value, any accrued gain on a property of the corporation, at the time of acquisition of the shares, would be reflected in the ACB of the shares acquired. A subsequent realization of such accrued gain on the property by the corporation could not reasonably be viewed as contributing to the gain on the shares acquired by the shareholder.

However, where a shareholder acquires preferred shares of a corporation as consideration for a transfer of a property (other than shares) on a tax-deferred basis to the corporation, it is now the CRA's view that the accrued gain on the property at the time of transfer and that would subsequently be realized by the corporation would be viewed as contributing to the gain on the preferred shares and would be included in the safe income of the preferred shares as it would be unreasonable to allocate the safe income realized on the disposition of the property to other shares.

In Example 12 above, if the goodwill that was transferred to the corporation in consideration for preferred shares had been sold for $500 or less prior to the redemption of the preferred shares, the income realized on the sale of the goodwill would be safe income that contributes to the gain on the preferred shares. If the sale was for more than $500, the gain on the excess over $500 would constitute safe income on the common shares.

In no circumstances would the gain realized on a sale of the goodwill for $500 or less constitute safe income on the common shares, simply because such gain does not contribute to the gain on the common shares, even when the goodwill was sold after the redemption of the preferred shares. In Example 12 above, the common shares which have a value of $500 are still entitled to a safe income of $500.

The CRA recognizes that this position requires tracking of safe income in this limited situation, however any practical inconvenience is outweighed by the reasonability of the approach.

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[49] Which is doubtful, in light of these sole facts. As discussed earlier, if a dividend was subject to the application of subsection 55(2), it would not be considered to reduce the safe income of the corporate payer.

Calculation of safe income

What is “income earned or realized by *any* corporation”?

Given the wording “income earned or realized by *any* corporation,” it has long been the CRA’s view that a corporation can consolidate safe income of other corporations in which it has significant influence. The reason for the condition of “significant influence” was simple and practical: how could one expect to be able to access financial and other information to calculate safe income of corporations in which one does not have significant influence?

In 1984, the CRA expanded its position as follows:

> In 1981, Revenue Canada (subsequently referred to as "the Department") indicated that the word "any" in the phrase "income earned or realized by any corporation" permits the consolidation of safe income within a corporate group. In cases where a corporation does not exercise significant influence over another corporation in which it owns fully participating shares, the safe income of the corporation should include only dividends received from the other corporation to the extent that they were paid out of safe income of the payer corporation**. After facing this issue in many factual situations, the Department is prepared to make an exception in cases where a corporation does not exercise significant influence, if it can be clearly demonstrated that the income of the other corporation contributed to the unrealized gain on the shares.** [emphasis added].[50]

The position adopted in 1984 is still valid and relevant today. One can consolidate safe income of a corporation over which there is no significant influence if it can be clearly demonstrated that the safe income of such corporation contributes to the gain on the shares, bearing in mind that, in the case of portfolio investments in public corporations, what would be considered to contribute to the value of the shares held by the shareholder of the corporation is not the income of the public corporations but rather the trading value of the shares of the public corporations on the stock exchange.

The above discussion would also apply to consolidation of income from foreign corporations that are not foreign affiliates of the shareholder, as confirmed in *Lamont*.[51]

With respect to negative safe income, the CRA is of the view that the negative safe income of corporations would reduce the safe income of a holding corporation only to the extent that it can be considered to result in a reduction in the value of the shares of the holding corporation, for example, either because of a guarantee made by the holding corporation, or because of an actual payment for the losses by the holding corporation. This position is in line with *Brelco*.[52]

[50] Michael A. Hiltz, supra footnote 2.
[51] *Lamont Management Ltd. v. the Queen* 2000 D.T.C. 6256 (FCA).
[52] *Brelco Drilling Ltd. v. the Queen* 99 D.T.C. 5253 (FCA).

What is “income earned or realized” – should it include income that is not taxable?

As explained above, the proper interaction between subsections 112(1) and 55(2) suggests that “income earned or realized” is the income on which tax is payable.[53] Inasmuch as cost cannot be created out of nothing, safe income can also not be created out of nothing.

Income that is not taxable under section 81 does not constitute income for tax purpose and, therefore, is not included in safe income.

Taxable dividends from Canadian corporations for which a deduction under subsection 112(1) is available would be treated as follows:

- If the safe income of the dividend payer was consolidated with the safe income of the dividend recipient,
    - The payment of the dividend is considered to come from safe income of the dividend payer only to the extent of the amount of safe income of the dividend payer that has been consolidated into the safe income of the dividend recipient.
    - Such portion of the dividend (equal to the amount of safe income that was consolidated) is added to the safe income of the dividend recipient (referred to herein as “direct safe income”) and reduces the amount of safe income of the dividend payer that has been consolidated in the hands of the dividend recipient (referred to herein as “indirect safe income”).
    - If the dividend exceeds the portion of the consolidated safe income of the dividend payer, the excess portion is not added to the safe income of the dividend recipient and could be subject to the application of subsection 55(2). If subsection 55(2) applies, the gain realized would be included in the safe income of the dividend recipient, as determined under subsection 55(5). As already discussed, where subsection 55(2) applies to a portion of the dividend received by the dividend recipient, the safe income of the dividend payer is not considered to have been reduced by such portion.
- If the safe income of the dividend payer was not consolidated with the safe income of the dividend recipient,
    - If it is reasonable to consider that a dividend received by a corporation came out of safe income of the dividend payer, it will be added to the safe income in the recipient.
    - In the case of portfolio investments only, dividends received should be included in the safe income of the corporation receiving the dividend and there will not be any consolidation of underlying safe income for portfolio investments.

[53] See the discussion above in the section “Role and Purpose of Amended Subsection 55(2).”

See Example 29 below for an illustration and discussion of some of the above concepts.

Subsection 55(5)

Subsection 55(5) contains additional rules for the computation of safe income where paragraph 55(5)(a) deals with the timing or cut-off aspect and other paragraphs provide for mechanical rules for its computation.

Paragraph 55(5)(a)

Some redundancy in paragraph 55(5)(a) was noted in the Robertson paper[54] since the income earned or realized before the dividend should normally exclude the income that is expected to be earned or realized:

> “paragraph [55(5)](a) deems income earned after the time the dividend is received to be "attributable to anything other than income." Subsection 55(2) already accomplishes this by virtue of the words "and before the dividend was received" in the preamble.”

Whatever the exact purpose of paragraph 55(5)(a) was, its wording has not been updated with the 2015 amendments and would have little, if any, relevance in the context of the legislation currently in force.

Paragraphs 55(5)(b), (c) and (d)

Paragraphs 55(5)(b), (c) and (d) are mechanical rules for the calculation of safe income. They have been discussed elsewhere[55] and need not be addressed here.

Paragraph 55(5)(f)

The amendment to paragraph 55(5)(f) that was introduced in Bill C-15[56] replaced the paragraph 55(5)(f) designation mechanism with an automatic rule that separates the amount of a taxable dividend into two separate taxable dividends. The technical notes to paragraph 55(5)(f) stated that the “change is consistent with the objective of subsection 55(2), which is an anti-avoidance rule directed against dividends paid in excess of safe income to unduly reduce a capital gain on any share, and is meant

- to ensure that a corporation's safe income is treated as a taxable dividend and is not recharacterized as a capital gain by subsection 55(2), and
- to prevent a conversion of what would otherwise be a distribution of safe income into a capital gain.”

[54] Supra footnote 2.
[55] See for example Michael A. Hiltz, "Income Earned or Realized: Some Reflections," in *Report of Proceedings of the Forty-Third Tax Conference*, 1991 Conference Report (Toronto: Canadian Tax Foundation, 1992), 15:1-24.
[56] Supra footnote 12

In light of the above, any transaction that circumvents the application of paragraph 55(5)(f) in order to allow for a realization of capital gain in the hands of a shareholder that would otherwise be a safe income dividend to such shareholder could be subject to the application of GAAR.

Example 14

> Holdco owns common shares of Opco with ACB of $100 and FMV of $1000. Opco has $500 of safe income. A dividend of $500 is to be paid by Opco to Holdco. Prior to the dividend payment, Holdco exchanges the common shares of Opco for new preferred shares with an ACB of $100 and a fair market value of $100, and new common shares with an ACB of nil and a fair market value of $900. Opco then pays a dividend of $500 on the new preferred shares held by Holdco. Holdco would take the position that the preferred shares are not entitled to any safe income because there is no accrued gain on the preferred shares and, therefore, the dividend would meet one of the purpose tests under subparagraph 55(2.1)(b)(ii) and subsection 55(2) would convert the dividend into a capital gain.
>
> The CRA could consider the application of GAAR to a series of transactions that would include the transactions described above.

Interaction between the carve-out in paragraph 55(5)(f) and subsection 55(2.1)

Prior to the 2015 amendments, it was well understood then that paragraph 55(5)(f) was a relieving provision and a designation under paragraph 55(5)(f) allowed the taxpayer to only report the portion of the dividend that exceeds safe income as a gain under subsection 55(2).

A question was asked on the interaction between paragraph 55(5)(f) and subsection 55(2.1) in relation to the following example:

Example 15

> Opco pays a dividend of $1,000 on the shares held by Holdco in Opco. The shares have a fair market value of $1,500 prior to the dividend and the safe income that can reasonably be viewed as contributing to the gain on the shares of Opco held by Holdco is $900. Paragraph 55(5)(f) deems the portion of safe income of $900 to be a separate dividend and the portion of $100 that exceeds the safe income to be another separate dividend.

The question was: are both dividends subject to a separate test under subsection 55(2.1) such that the portion of $900 of the dividend is exempt because it does not exceed safe income and the portion of $100 of dividend may be exempt if its purpose is not to significantly reduce the gain or the value of the shares on which it is paid?

The new rules introduced by Bill C-15 to paragraph 55(5)(f) and subsections 55(2) and 55(2.1) have not changed anything with respect to the operation of paragraph 55(5)(f) as it read prior to the 2015

amendments, except that paragraph 55(5)(f) now operates automatically to segregate the dividends between "safe" dividends and "non-safe" dividends instead of requiring the taxpayer to make a designation for that purpose. Except for such automatic segregation, the scheme of the application of paragraph 55(5)(f) to subsection 55(2) remains the same before and after the 2015 amendments.

Hence, there is no reason why the deemed separate dividend of $100 in Example 15 should be subject to a separate test under paragraph 55(2.1)(b) and the words of paragraph 55(5)(f) and their application to subsections 55(2) and 55(2.1) should not lend themselves to an interpretation that is contrary to its object and spirit. Since paragraph 55(5)(f) does not contain an ordering rule for the dividends, one may be tempted to argue that both deemed separate dividends under paragraph 55(5)(f) could be protected by the safe income that existed immediately prior to the payment of the whole dividend, as each separate dividend is subject to 55(2) under paragraph 55(2.1)(c) only if it exceeds the safe income immediately before the dividend.

However, such interpretation would result in a duplication of the safe income protection and is inappropriate as the purpose of paragraph 55(5)(f) is to bring into income the amount of the dividend that exceeds safe income.

An appropriate reading of the relevant provisions, in conformity with the purpose of the legislation, would be as follows, using the same numbers as in Example 15:

- The "taxable dividend" referred to in the preamble of paragraph 55(2.1) is the whole $1,000 of dividend;
- The "dividend" referred to in paragraphs 55(2.1)(a) and (b) is the whole $1,000 of dividend;
- The "amount of the dividend" referred to in paragraph 55(2.1)(c) is the portion of the dividend that exceeds safe income and that is deemed to be a separate dividend under paragraph 55(5)(f), which is $100;
- The "taxable dividend" referred to in the preamble of subsection 55(2) is the whole $1,000 of dividend; and
- The "amount of the dividend" referred to in the preamble of subsection 55(2) that is deemed not to be a dividend and to be a gain is the amount referred to in paragraph 55(2.1)(c) as described above, being $100.[57]

Before the "safe income determination time"

The "safe income determination time" is meant to provide a cut-off point where safe income no longer accrues to a share after such point.

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[57] CRA document 2017-0726381C6.

Although the cut-off point has been made more generous than that applicable prior to the introduction of Bill C-28 in 1998,[58] care should nevertheless be exercised to avoid an undue early triggering of the "safe income determination time" if taxpayers want to avail themselves of the safe income to reduce a portion of a capital gain.

Consider the following example:

Example 16

> Aco, a shareholder of Opco, would like to receive a payment of safe income from Opco. Some property of Opco would be disposed of by Opco and the income realized from the disposition of property would be included in the dividend payment. However, because there is a potential of realizing a loss on the disposition of some property, a capital dividend is paid by Opco to Aco as a first step, prior to the disposition of property by Opco. In this situation, the capital dividend payment would constitute a "safe income determination time" and the gain realized on the subsequent disposition of property would not be included in the safe income that could be received by Aco.

The CRA has however demonstrated some flexibility, where possible in a ruling context, so that taxpayers are not unduly penalized in certain situations: [59]

- The CRA has, in the circumstances of a ruling request, taken the view that regular, recurring annual dividends would not be part of a series of transactions. Accordingly, a ruling confirmed that the safe income determination time in respect of certain dividends was immediately before each such dividend.
- In addition, in a technical interpretation, the CRA considered the situation where a corporation sold its depreciable properties and its eligible capital property before the end of a taxation year and paid a dividend after the sale of the assets but before the end of the year of the sale. Applying a textual, contextual and purposive approach, the CRA indicated that it would accept that the safe income immediately before the safe income determination time would include the income computed pursuant to subsections 13(1) and 14(1) if the sale of the assets occurred before that safe income determination time even though the income under subsections 13(1) and 14(1) is computed at the end of the taxation year. However, the CRA would also take the position that the portion of the safe income that can reasonably be viewed as contributing to the capital gain on a share would be reduced by the amount of income taxes payable with respect to the income inclusion resulting from that sale.

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[58] Bill C-28 (Chapter 19) that received Royal Assent on June 18, 1998. Prior to the amendment introduced in Bill C-28, the cut-off point was "before the transaction or event or the commencement of the series of transactions or events referred to in paragraph (3)(a)" (see the preamble of subsection 55(2) in Bill C-139 (Chapter 140) that received Royal Assent on March 30, 1983).
[59] See CRA documents 2016-0672321c6 and 2016-0633961e5.

Pro-rata calculation and participation to safe income

The court in *Nassau Walnut* stated that "the only acceptable method for allocating safe income is on a pro rata basis as was done in *The Queen v. Placer Dome* (5 November 1996), A-259-96 (F.C.A.)." [60] The method of allocation of safe income to various shares of a corporation, including the calculation of safe income on rollover and tax-free exchanges, and discretionary dividend shares, has also been detailed in the Robertson paper[61] and numerous documents and publications of the CRA[62] and need not be repeated here.

Stub period calculation

A payment of a dividend at any time in a taxation year triggers a safe income determination time by virtue of paragraph (b) of the definition of "safe income determination time" in subsection 55(1). The dividend would be exempt from the application of subsection 55(2) to the extent it constitutes a dividend from safe income that is determined prior to the safe income determination time. Safe income determined for the taxation year of the dividend payment and that ends at the safe income determination time is referred to as safe income of a stub period.

In a situation where a corporation obtains a deduction from income in the same taxation year but after the stub period and the deduction was not available to the corporation at the safe income determination time,[63] it is the CRA's view that the safe income computed for the stub period has to be reduced by accrued income taxes that are applicable to the income realized in such stub period for the following reasons:

- As discussed above, safe income is income determined on an after-tax basis, considering the scheme of subsection 112(1).
- There is a liability that accrues at the end of the stub period (the "cut-off time") even though the tax liability is only determined at the end of the taxation year. The use of tax shelter after the cut-off time does not represent a reduction of income realized prior to the cut-off time[64] and the tax saving that results from such use would be a credit in the calculation of safe income for the portion of the year that is after the cut-off time. Consider Example 3 above. In that example, even if it is argued that a deduction obtained after the safe income determination time that reduces the income to nil should not be taken into account in the calculation of safe income at the safe income determination time, it remains that the reduction of accrued income taxes that is caused by such deduction from income would be equivalent to an amount of income earned or realized after the safe income determination time. Therefore, even if the income taxes of the corporation have effectively been reduced to nil because of the subsequent deduction, the safe income calculated at the safe income determination time has to be reduced by the accrued income taxes that apply to the income that existed at that time.

[60] Supra footnote 34, at paragraph 21.
[61] Supra footnote 2.
[62] Supra footnote 3. See also CRA document 2018-0780061C6 regarding discretionary-dividend shares.
[63] Such deduction would have been available if it was a loss carried forward from earlier taxation years.
[64] Subject to the above comment, supra footnote 31.

- Accrued taxes payable by the corporation reduce the value of the shares of the corporation.[65] If shares of the corporation were to be sold to an acquirer at the cut-off time, the purchase price would normally take into account the accrued taxes on the income realized up to the cut-off time. A purchaser does not increase the price offered to a vendor because the purchaser itself has tax shelter to reduce the taxes on the income realized by the corporation up to the cut-off time. The use of tax shelter that is available to a purchaser, and that was not available to the corporation at the cut-off time, does not translate into an increase in value of the shares of the acquired corporation since it represents a use of the purchaser's own tax attributes. If there was an increase in the price offered for the shares of the corporation that is based on the tax savings because of a deduction that is available to the purchaser, the gain on the shares that is represented by such increase in price is attributable to something else, i.e., the tax savings available to the purchaser. The gain is not attributable to the income earned or realized by the corporation, i.e., only the income after accrued taxes can be viewed as contributing to the gain on the shares.

Safe income on reorganization and Inappropriate cost increase due to misalignment of ACB (and safe income)

As discussed above,[66] cost reflects the price paid to acquire property with after-tax funds and one should not be entitled to create cost without incurring tax.

Safe income allows for tax-free distributions between corporations since income subject to tax inside a corporation should not again be subject to tax upon distribution. Hence, safe income represents a potential increase in cost in the hands of the beneficiary without tax consequences. However, there must be a proper allocation of safe income on a corporate reorganization so as not to create an inappropriate increase in cost.

The examples below will discuss certain reorganization possibilities and the CRA's views on the allocation of safe income that would be required by those reorganizations. The CRA's views are based on logic and reasonableness, in accordance with the integration of the concept of cost and the scheme of subsection 55(2).

Safe income on corporate reorganizations

As discussed earlier, safe income can be consolidated. Safe income realized by a corporation will be referred to as "direct safe income" ("DSI") while safe income consolidated from another corporation will be referred to as "indirect safe income" ("ISI").

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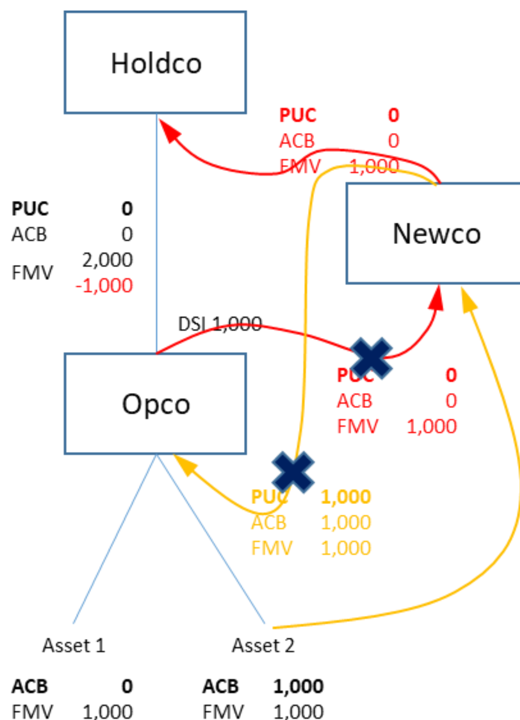
[65] *626468 New Brunswick,* supra footnote 31. See also *The King v. Microbjo Properties Inc.,* 2023 DTC 5062 (FCA)
[66] See the section "Subsection 112(1) Deduction on Taxable Inter-Corporate Dividends and the Concept of Cost" above.

Example 17 – Basic example that illustrates split of DSI[67]



In this situation, Opco was wholly-owned by Holdco.

Opco realized after-tax income of $1,000. The income is reflected in the cost of Asset 2 owned by Opco (i.e., Opco purchased the Asset 2 with the income realized, after tax). Thus, the DSI of Opco to Holdco was $1,000. The DSI of Opco contributed to the gain on the shares of Opco. There was an accrued gain of $2,000 on the shares of Opco held by Holdco.

Opco proceeded to spin out Asset 2 to Newco, a corporation that is wholly-owned by Holdco, in a reorganization that qualified for the paragraph 55(3)(a) exemption. To effect the spin-off, Holdco transferred shares of Opco with an ACB of nil and a FMV of $1,000 to Newco in consideration for shares of Newco. Opco then transferred Asset 2 to Newco in consideration for shares of Newco. The shares held by Newco in Opco and by Opco in Newco are redeemed for notes and the notes are cross-cancelled.

After the spin-off, Holdco owned shares of Opco with an ACB of nil and a FMV of $1,000 and Opco owned Asset 1 with an ACB of nil and a FMV of $1,000. Holdco also owned shares of Newco with an ACB of nil and a FMV of $1,000 and Newco owned Asset 2 with an ACB of $1,000 and a FMV of $1,000.

[67] See Example 1 in CRA document 2020-0861031C6

How should the safe income of Opco be allocated after the reorganization?

In this scenario, the Asset 2 with the ACB of $1,000 was transferred to Newco. The DSI of Opco was used to acquire the ACB in Asset 2. It would not be appropriate that the DSI of $1,000 or a portion thereof remains with the shares of Opco held by Holdco.

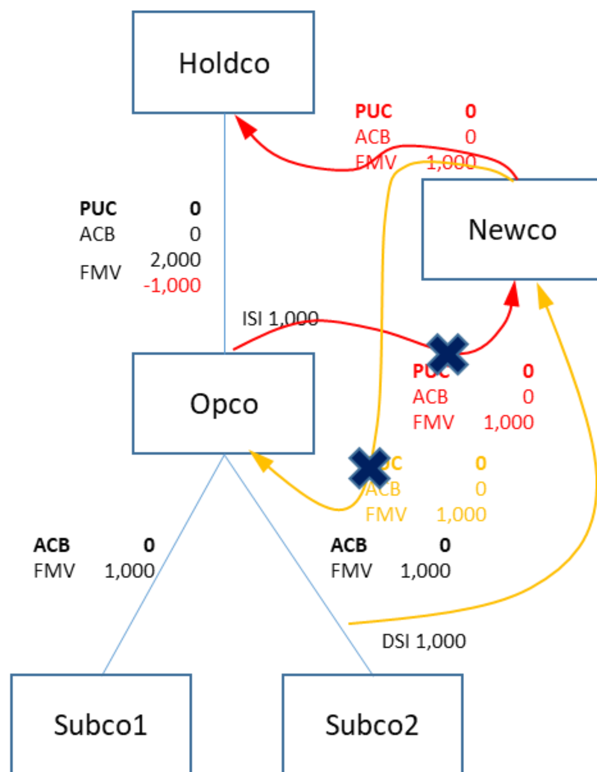
In this scenario, although 50% of the shares of Opco are transferred to Newco to achieve the reorganization, all the DSI of Opco held by Holdco has been transferred over to Newco because it is reasonable to view that the DSI of $1,000 contributes to the gain on the shares of Newco held by Holdco after the reorg and that the DSI of $1,000 does not contribute to any gain on the shares of Opco retained by Holdco since the unrealized gain remains in the assets retained by Opco.

However, one is not required nor expected to do strict tracing to arrive to the proper allocation of safe income since such tracing is not practically feasible in real life. The allocation of DSI should be done via the following formula:

> DSI on the shares of Newco: DSI of Opco prior to reorg X net cost amount[68] of assets transferred to Newco / total cost amount of assets of Opco prior to reorganization
>
> DSI on the shares of Opco after reorg: DSI of Opco prior to reorg X net cost amount of assets retained by Opco / total cost amount of assets of Opco prior to reorganization

[68] Cost amount minus liabilities

Example 18 – Basic example that illustrates split of ISI[69]



In this situation, Opco did not realize any income. The income was realized in Subco2. Thus, the DSI of Subco2 held by Opco was $1,000 and Holdco had an ISI of $1,000 in Opco (due to the DSI of $1,000 in Subco2 held by Opco).

Opco transferred Subco2 to Newco in a reorganization that qualifies for an exemption under paragraph 55(3)(a). To effect the spin-off, Holdco transferred shares of Opco with an ACB of nil and a FMV of $1,000 to Newco in consideration for shares of Newco. Opco then transferred the shares of Subco2 with an ACB of nil and a FMV of $1,000 to Newco in consideration for shares of Newco. The shares held by Newco in Opco and by Opco in Newco are redeemed for a note and the notes are cross-cancelled.

In this scenario, Subco2 was transferred over to Newco with an ACB of nil.

Since the shares of Subco2 are transferred to Newco on a rollover basis, the DSI of $1,000 that Opco had in Subco2 is transferred over to Newco. Newco will have DSI of $1,000 on the shares of Subco2.

On a consolidated basis, the shares of Newco held by Holdco have an ISI of $1,000.

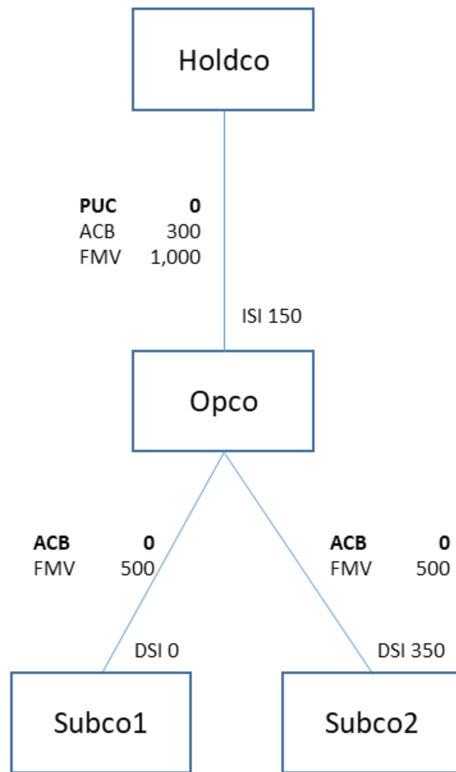
[69] See Example 2 of CRA document 2020-0861031C6

Since the ISI of Holdco in Opco is now fully transferred over to Newco, Holdco should no longer have ISI in the remaining shares owned in Opco. The unrealized gain on the remaining Opco shares held by Holdco is supported by the unrealized value of the shares in Subco1, with no underlying safe income.

The reasonable formula for calculating ISI (below the Newco level) should be as follows:

> ISI on the shares of Newco: ISI to Holdco on the shares of Opco (that excludes the DSI of Opco) prior to reorg X ISI to Holdco of entities held by Opco that are transferred over to Newco / total ISI to Holdco of all entities held by Opco prior to reorg
>
> ISI on the shares of Opco after reorg: ISI to Holdco on the shares of Opco prior to reorg X ISI to Holdco of entities held by Opco that are retained by Opco / total ISI to Holdco of all entities held by Opco prior to reorg

Example 19 – Illustration of the interaction between outside ACB and inside ACB[70]



In this scenario, Holdco acquired Opco for $300 a few years ago. At that time, the DSI that Opco had was 0 and the DSI of Subco2 was $200 (Subco2 had a value of $300 and Subco1 had no value and no DSI at that time). Subco2 realized an additional DSI of $150 since the acquisition of Opco by Holdco and its value increased to $500. Subco1 realized no additional DSI after the acquisition of Opco by Holdco and its value increased to $500.

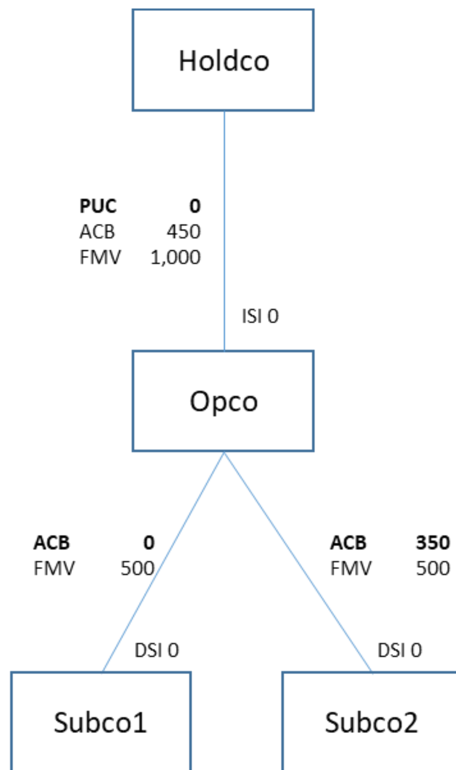
[70] See Example 3 of CRA document 2020-0861031C6

Therefore, even though the shares of Subco2 owned by Opco now have a DSI of $350, the ISI of Opco with respect to the shares of Subco2 is $150. The DSI of $200 of Subco2 pre-acquisition of control is reflected in the ACB of the Opco shares held by Holdco.

The shares of Opco held by Holdco have an ACB of $300 and a FMV of $1,000.

The shares of each of Subco1 and Subco2 held by Opco have an ACB of nil and a FMV of $500.

If safe income were to be capitalized by Holdco and Opco before the reorganization, Subco2 would be able to pay a DSI of $350 to Opco and Opco would be able to pay an ISI of $150 to Holdco. Therefore, after capitalization of safe income, the situation would be as follows:



In this situation, Holdco has an ACB of $450 in the shares of Opco and, if Opco were to be wound-up, Holdco would directly own shares of Subco1 and Subco2 with an aggregate ACB of $350. Therefore, in this situation, the maximum ACB that Holdco could have in its subsidiaries does not exceed $450.

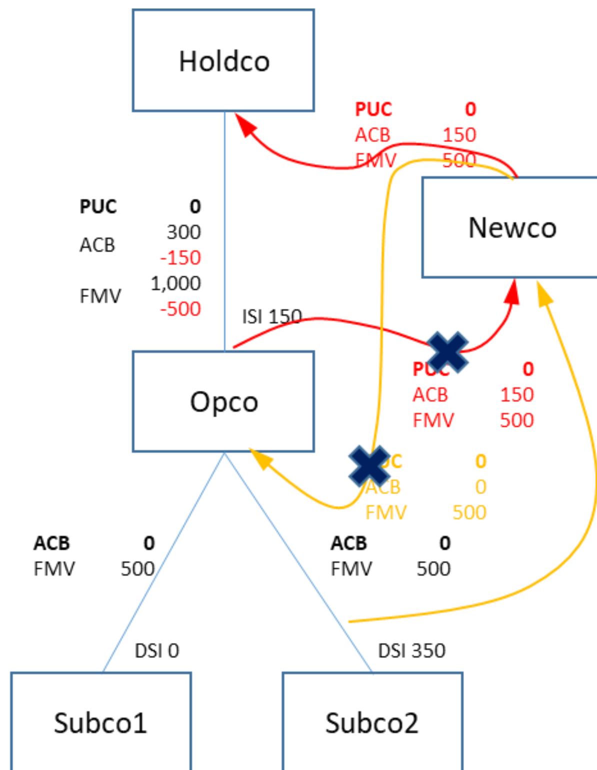
<u>First reorganization possibility</u>:

Without going through the capitalization of safe income, Opco transferred Subco2 to Newco in a reorganization that qualified for the exemption under paragraph 55(3)(a). To effect the spin-off, Holdco transferred shares of Opco having an ACB of $150 and a FMV of $500 to Newco in consideration for shares of Newco. Opco then transferred shares of Subco2 having an ACB of nil and a FMV of $500 to Newco in consideration for shares of Newco. The shares held by Newco in Opco and by Opco in Newco are redeemed for a note and the notes are cross-cancelled.

Since the shares of Subco2 are transferred to Newco on a rollover basis, the DSI of $350 that Opco had in Subco2 is transferred over to Newco. Newco will have DSI of $350 on the shares of Subco2.

On a consolidated basis, the shares of Newco held by Holdco have an ISI of $150 since it represents the ISI of Opco that was transferred over to Newco.

Since ISI of Holdco in Opco is now fully transferred over to Newco, Holdco should no longer have ISI in the remaining shares owned in Opco. The unrealized gain on the remaining Opco shares held by Holdco is supported by the unrealized value of the shares in Subco1, with no underlying safe income.



However, the reorganization results in an inappropriate duplication of ACB because of the misalignment of outside and inside ACB.[71] If the ISI that Holdco has in the shares of Newco and the DSI that Newco had in the shares of Subco2 were to be capitalized after the reorganization, Holdco would have an ACB of $300 in the shares of Newco and Newco would have an ACB of $350 in the shares of Subco2. On a possible wind-up of Newco, Holdco would own shares of Subco2 with an ACB of $350. Holdco would have an aggregate ACB of $500 in the shares of Opco and Subco2 after the wind-up of Newco. This situation would not be acceptable within the scheme of the legislation.

[71] See discussion in Question 1 of the 2020 CTF conference Round Table – CRA document 2020-086099

Second reorganization possibility:

Instead of transferring to Newco shares of Opco having an ACB of $150, Holdco should transfer to Newco shares of Opco having a FMV of $500 and an ACB of at least $200 to avoid the misalignment of outside and inside ACB. A transfer of the full $300 of ACB of the shares of Opco held by Holdco to Newco is also acceptable since the ACB reflects the cost of indirect acquisition of the shares of Subco2.

Since the shares of Subco2 are transferred to Newco on a rollover basis, the DSI of $350 that Opco had in Subco2 is transferred over to Newco. Newco will have DSI of $350 on the shares of Subco2.

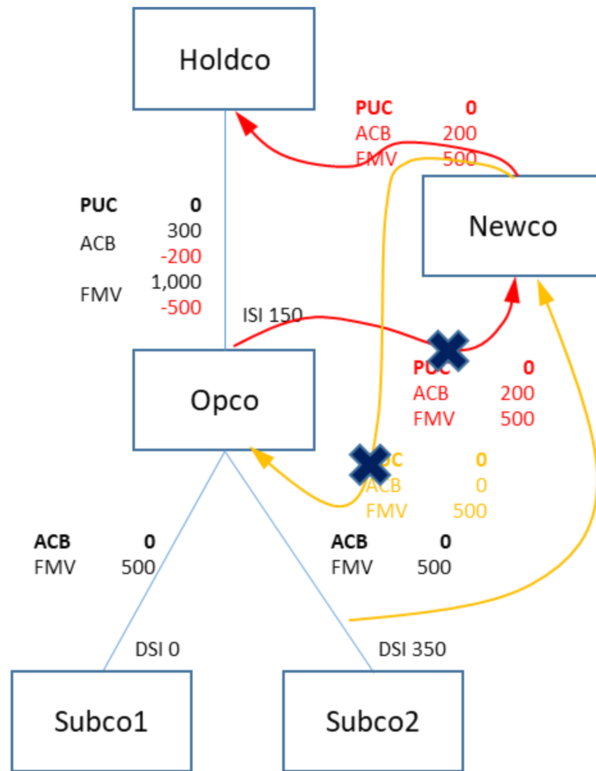
On a consolidated basis, the shares of Newco held by Holdco have an ISI of $150 since it represents the ISI of Opco that was transferred over to Newco.

Since ISI of Holdco in Opco is now fully transferred over to Newco, Holdco should no longer have ISI in the remaining shares owned in Opco

The formula for calculating ISI (below the Newco level) as reflected in slide #2 should still be valid and the calculation would be as follows:

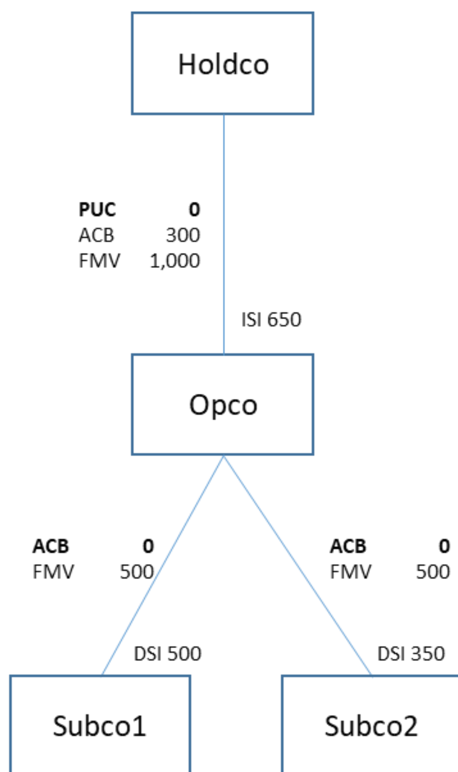
ISI on the shares of Newco: ISI of Opco (that excludes the DSI of Opco) prior to reorg X ISI of entities transferred over to Newco / total ISI of all entities held by Opco prior to reorganization

ISI on the shares of Opco after reorg: ISI of Opco prior to reorg X ISI of entities retained by Opco / total ISI of all entities held by Opco prior to reorganization



Holdco
PUC 0
ACB 200
FMV 500
Newco
PUC 0
ACB 300
-200
FMV 1,000
-500
ISI 150
PUC 0
ACB 200
FMV 500
Opco
PUC 0
ACB 0
FMV 500
ACB 0
FMV 500
ACB 0
FMV 500
DSI 0
DSI 350
Subco1
Subco2

Example 20 – Interaction between outside ACB and inside ACB[72]



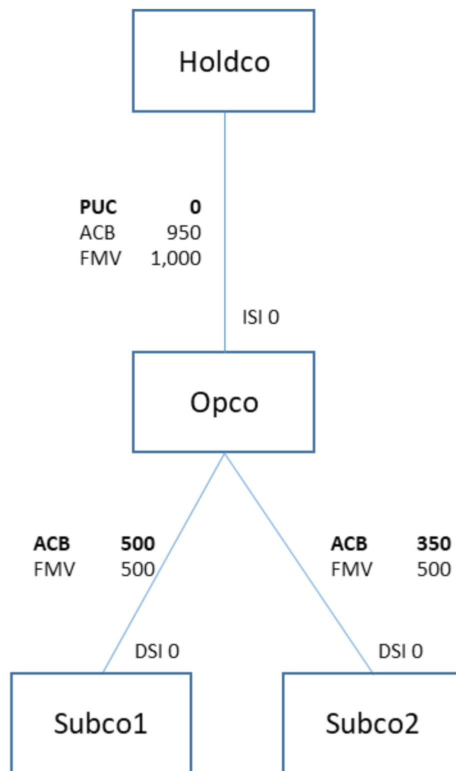
This is the same as Example 19, except that Subco1 has realized DSI of $500 after the acquisition of Opco by Holdco.

Opco would therefore have a total ISI of $650, being $500 in the shares of Subco1 and $150 in the shares of Subco2 (post-acquisition of Opco by Holdco). Note that the DSI of $200 of Subco2 pre-acquisition of control is reflected in the ACB of the Opco shares held by Holdco.

The FMV of Subco1 was $500 and the FMV of Subco2 was also $500 prior to the reorganization.

If safe income were to be capitalized prior to the reorganization, Subco1 would pay a safe income dividend of $500 to Opco, Subco2 would pay a safe income dividend of $350 to Opco and Opco would pay a safe income dividend of $650 to Holdco. After capitalization of safe income, the situation would be as follows:

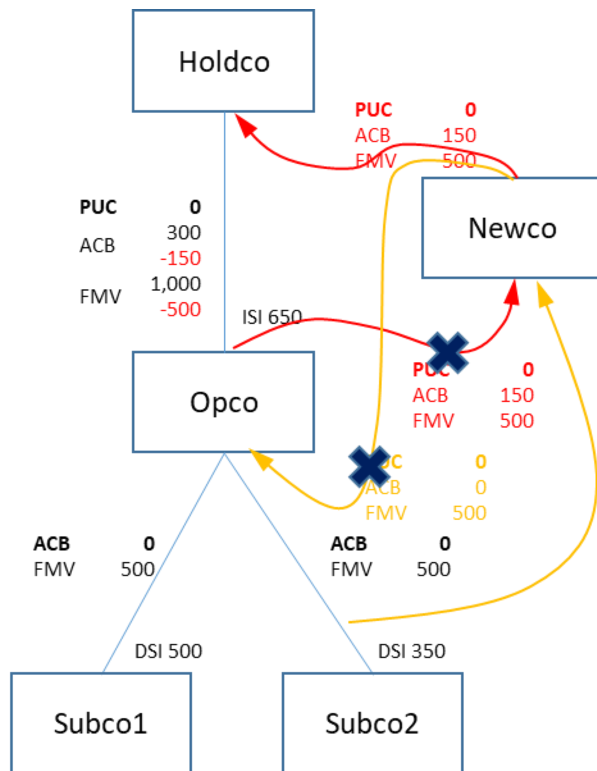
[72] See Example 4 of CRA document 2020-0861031C6. This is the same as Example 19 – Illustration of the interaction between outside ACB and inside ACB above, except that Subco has realized DSI of $500 after the acquisition of Opco by Holdco.



In this situation, Holdco has an ACB of $950 in the shares of Opco and, if Opco were to be wound-up, Holdco would directly own shares of Subco1 and Subco2 with an aggregate ACB of $850. Therefore, in this situation, the maximum ACB that Holdco could have in its subsidiaries does not exceed $950.

Reorganization possibility:

Without going through the capitalization of safe income, Opco transferred Subco2 to Newco in a reorganization that qualified for the exemption under paragraph 55(3)(a). To effect the spin-off, Holdco transferred shares of Opco having an ACB of $150 and a FMV of $500 to Newco in consideration for shares of Newco. Opco then transferred shares of Subco2 having an ACB of nil and a FMV of $500 to Newco in consideration for shares of Newco. The shares held by Newco in Opco and by Opco in Newco are redeemed for a note and the notes are cross-cancelled.



Since the shares of Subco2 are transferred to Newco on a rollover basis, the DSI of $350 that Opco had in Subco2 is transferred over to Newco. Newco will have DSI of $350 on the shares of Subco2.

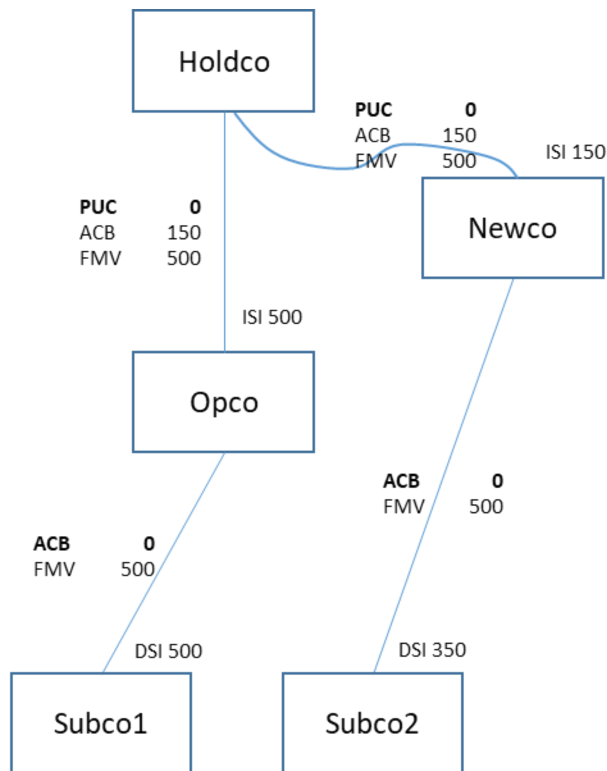
On a consolidated basis, the shares of Newco held by Holdco have an ISI of $150 since it represents the ISI of Opco that was transferred over to Newco.

Since $150 of ISI of Holdco in Opco is now transferred over to Newco, Holdco should have ISI of $500 in the remaining shares owned in Opco, which reflects the DSI of $500 of Subco1.

The formula for calculating ISI (below the Newco level) would be as follows:

> ISI on the shares of Newco: ISI to Holdco on the shares of Opco (that excludes the DSI of Opco) prior to reorg X ISI to Holdco of entities held by Opco that are transferred over to Newco / total ISI to Holdco of all entities held by Opco prior to reorganization
>
> ISI on the shares of Opco after reorg: ISI to Holdco on the shares of Opco prior to reorg X ISI to Holdco of entities held by Opco that are retained by Opco / total ISI to Holdco of all entities held by Opco prior to reorganization

The situation after the reorganization would be as follows:



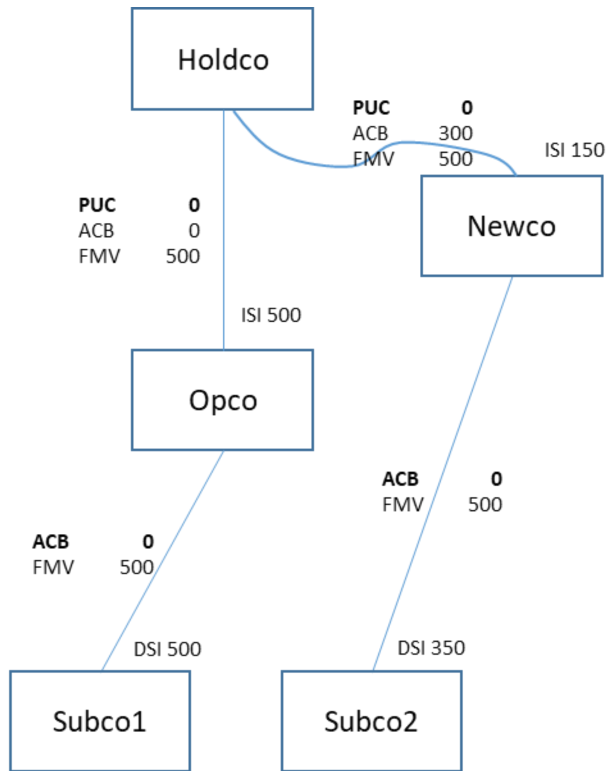
If safe income at all levels were to be capitalized after the reorganization, Holdco would have an ACB of $650 in the shares of Opco and an ACB of $300 in the shares of Newco. Opco would have an ACB of $500 in the shares of Subco1 and Newco would have an ACB of $350 in the shares of Subco2.

A subsequent disposition of the shares of Opco by Holdco after the dividend would result in a loss, but such loss is denied under subsection 112(3). On the other hand, if a safe income dividend of only $350 is subsequently paid on the shares of Opco held by Holdco, a disposition of the shares of Opco by Holdco would not result in a loss, but the portion of $150 of safe income has been lost.

This result is caused by the fact that only $150 of ACB of Opco has been transferred to Newco on the reorganization. If the ACB of Opco held by Holdco was streamed and transferred over to Newco for purposes of the reorganization, there would be no loss of ACB.

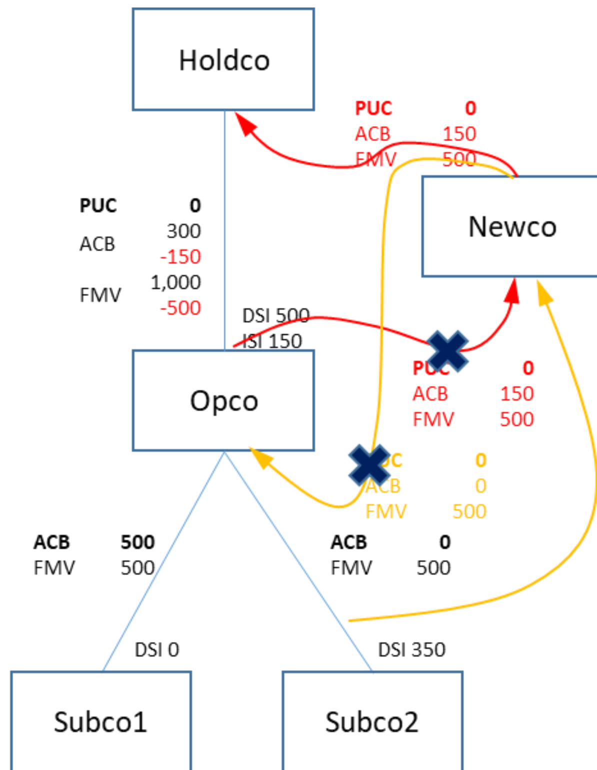
In this situation, it would be appropriate to stream the ACB of Opco and transfer the whole ACB of Opco to Newco in the course of the reorganization.[73] The result would be as illustrated below:

[73] ACB streaming could be challenged if offensive. However, it would be acceptable if its sole purpose is to avoid misalignment of basis as illustrated in these examples.



Holdco
PUC 0
ACB 300
FMV 500
ISI 150
Newco
PUC 0
ACB 0
FMV 500
ISI 500
Opco
ACB 0
FMV 500
ACB 0
FMV 500
DSI 500
DSI 350
Subco1
Subco2

Example 21 – Potential loss of safe income



In this scenario, Holdco acquired Opco for $300 a few years ago. At that time, the DSI that Opco had was 0 and the DSI of Subco2 was $200 (Subco2 had a value of $300 and Subco1 did not exist at that time).

Subco2 realized an additional DSI of $150 since the acquisition of Opco by Holdco.

Therefore, even though the shares of Subco2 owned by Opco now have a DSI of $350, the ISI of Opco with respect to the shares of Subco2 is $150. Note that the DSI of $200 of Subco2 pre-acquisition of control is reflected in the ACB of the Opco shares held by Holdco.

Opco has realized income of $500 after its acquisition by Holdco. Such income was used to acquire the shares of Subco1.

Opco would therefore have a DSI of $500 and an ISI of $150.

The shares of Opco owned by Holdco had an ACB of $300 and a FMV of $1,000.

The shares of Subco1 owned by Opco had an ACB of $500 and a FMV of $500 and the shares of Subco2 owned by Opco had an ACB of nil and a FMV of $500.

Subco2 was transferred to Newco in a paragraph 55(3)(a) reorganization. To realize the spin-off, Holdco transferred to Newco shares of Opco having an ACB of $150 and a FMV of $500.

Since the shares of Subco2 are transferred to Newco on a rollover basis, the DSI of $350 that Opco had in Subco2 is transferred over to Newco. Newco will have DSI of $350 on the shares of Subco2.

On a consolidated basis, the shares of Newco held by Holdco have an ISI of $150 since it represents the ISI of Opco that was transferred over to Newco.

Since $150 of ISI of Holdco in Opco is now transferred over to Newco, Holdco should have no ISI in the remaining shares owned in Opco, and should have a DSI of $500.

The formula for calculating ISI (below the Newco level) would be as follows:

> ISI on the shares of Newco: ISI to Holdco on the shares of Opco (that excludes the DSI of Opco) prior to reorg X ISI to Holdco of entities held by Opco that are transferred over to Newco / total ISI to Holdco of all entities held by Opco prior to reorganization
>
> ISI on the shares of Opco after reorg: ISI to Holdco on the shares of Opco prior to reorg X ISI to Holdco of entities held by Opco that are retained by Opco / total ISI to Holdco of all entities held by Opco prior to reorganization

The formula for calculating DSI of Opco after the reorganization would be as follows:

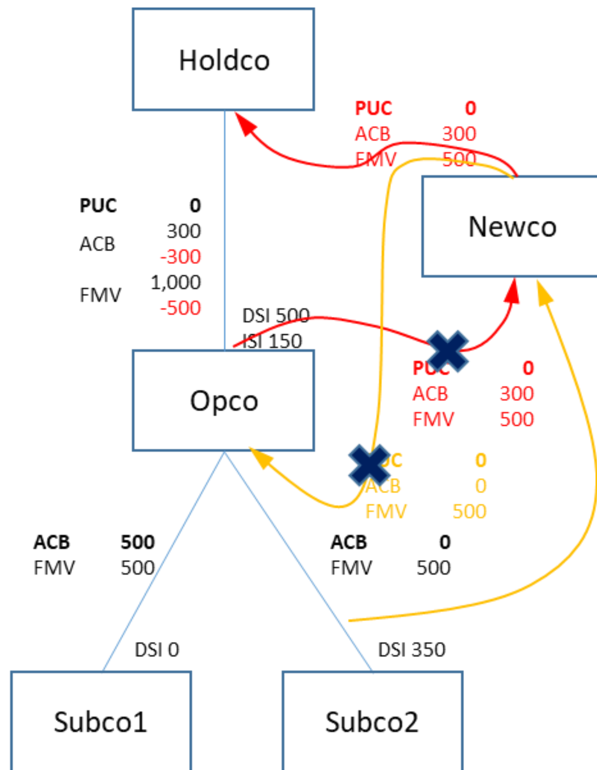
> DSI on the shares of Opco after reorg: DSI of Opco prior to reorg X net cost amount of assets retained by Opco / net total cost amount of assets of Opco prior to reorganization

Here, because the ACB of Opco was not streamed and transferred over to Newco, Holdco would have an ACB of $150 and a FMV of $500 in the remaining shares of Opco and an ACB of $150 and a FMV of $500 in the shares of Newco. Holdco is entitled to an ISI of $150 on the shares of Newco and a DSI of $500 on the remaining shares of Opco.

There would be a potential loss of $150 in either the ACB of Opco or the ISI of Opco. For example, if a safe income dividend of $500 is subsequently paid on the shares of Opco held by Holdco, a disposition of the shares of Opco by Holdco after the dividend would result in a loss, but such loss is denied under subsection 112(3). On the other hand, if a safe income dividend of only $350 is subsequently paid on the shares of Opco held by Holdco, a disposition of the shares of Opco by Holdco would not result in a loss, but the portion of $150 of safe income has been lost.

In this situation, it would be appropriate to stream the ACB of Opco and transfer the whole ACB of Opco to Newco in the course of the reorganization.

Example 22 – Variation of Example 21 – Potential loss of safe income



This is the same as Example 21 except that shares of Opco that are transferred by Holdco to Newco have an ACB of $300 and a FMV of $500.

Since the shares of Subco2 are transferred to Newco on a rollover basis, the DSI of $350 that Opco had in Subco2 is transferred over to Newco. Newco will have DSI of $350 on the shares of Subco2.

On a consolidated basis, the shares of Newco held by Holdco have an ISI of $150 since it represents the ISI of Opco that was transferred over to Newco.

Since $150 of ISI of Holdco in Opco is now transferred over to Newco, Holdco should have no ISI in the remaining shares owned in Opco, and should have a DSI of $500.

The reasonable formula for calculating ISI (below the Newco level) would be as follows:

> ISI on the shares of Newco: ISI to Holdco on the shares of Opco (that excludes the DSI of Opco) prior to reorg X ISI to Holdco of entities held by Opco that are transferred over to Newco / total ISI to Holdco of all entities held by Opco prior to reorganization
>
> ISI on the shares of Opco after reorg: ISI to Holdco on the shares of Opco prior to reorg X ISI to Holdco of entities held by Opco that are retained by Opco / total ISI to Holdco of all entities held by Opco prior to reorganization

The formula for calculating DSI of Opco after the reorganization would be as follows:

> DSI on the shares of Opco after reorg: DSI of Opco prior to reorg X net cost amount of assets retained by Opco / total net cost amount of assets of Opco prior to reorganization

Here, because the ACB of Opco was streamed and transferred over to Newco, the results are more appropriate. Holdco has an ACB of 0 in Opco with an accrued gain of $500 and should be able to access the whole DSI of $500.

Example 23– Allocation of safe income on corporate reorganization – a case study

Opco is an operating corporation that has the following assets and liabilities:

			Business 1 allocation		**Business 2 allocation**	
	ACB	**FMV**	**ACB**	**FMV**	**ACB**	**FMV**
Current assets – Business 1	300	300	300	300		
Current assets – Business 2	500	500			500	500
Fixed assets - Business 1	200	700	200	700		
Fixed assets – Business 2	200	300			200	300
Intangible assets – Business 1	0	600	0	600		
Intangible assets – Business 2	300	400			300	400
Total assets	1,500	2,800	500	1,600	1,000	1,200
Short-term liabilities	400	400	400	400		
Long-term liabilities	200	200	100	100	100	100
Total liabilities	600	600	500	500	100	100
Net assets	**900**	**2,200**	**0**	**1,100**	**900**	**1,100**

Opco has realized safe income (direct safe income or "DSI") of $400.

Situation 1:

Opco is wholly-owned by Holdco 1.

The ACB in the shares of Opco held by Holdco 1 is $500. The safe income of Opco that contributes to the gain on the shares held by Holdco 1 is $400.

All Business 2 assets and $100 of liabilities of Opco are to be transferred to Newco that will be wholly-owned by Holdco 1, for a net value of $1,100. The transfer will be done on a pure rollover basis in the following manner:

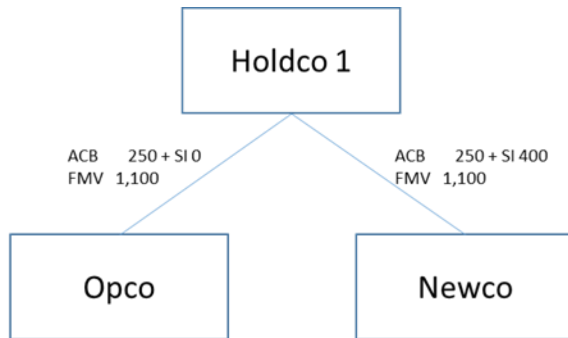
- Holdco 1 transfers 50% of the shares of Opco to Newco on a rollover basis in consideration for shares of Newco.
- Opco transfers Business 2 assets to Newco in consideration for an assumption of $100 of liabilities of Opco by Newco and an issuance of $1,100 of shares of Newco to Opco. The transfer will be on a rollover basis.
- Shares held between Opco and Newco are cross-redeemed for a note and the notes are cross-cancelled.
- No safe income will be capitalized prior to the reorganization.
- Either paragraph 55(3)(a) or paragraph 55(3)(b) will apply to the reorganization.

In this situation, the DSI of Opco to be allocated post-reorganization between Opco and Newco is based on the following formula:

> DSI on the shares of Newco: DSI of Opco prior to reorg X net cost amount of assets transferred to Newco / total net cost amount of assets of Opco prior to reorganization
>
> DSI on the shares of Opco after reorg: DSI of Opco prior to reorg X net cost amount of assets retained by Opco / total net cost amount of assets of Opco prior to reorganization

Under such formula, the DSI to be allocated to Newco should be $400 (400 X 900/900) and the DSI remaining in Opco should be 0 (400 X 0/900).

The situation after the reorganization would be as follows:

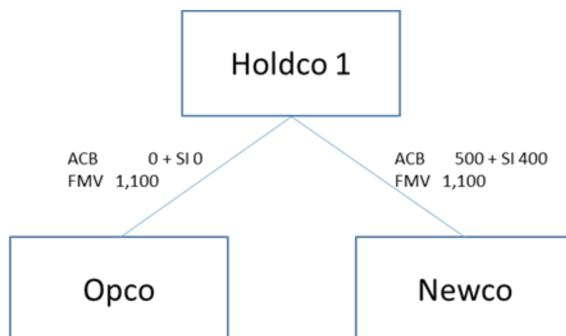


Assets		
	Cost	FMV
Assets	500	1,600
Liabilities	500	500
Net	0	1,100

Assets		
	Cost	FMV
Assets	1,000	1,200
Liabilities	100	100
Net	900	1,100

Because of the misalignment of inside and outside ACB,[74] Holdco 1 should stream the ACB in the shares of Opco and transfer all such ACB to Newco on the reorganization.

With streaming of ACB, the post-reorganization situation would be as follows:



Assets		
	Cost	FMV
Assets	500	1,600
Liabilities	500	500
Net	0	1,100

Assets		
	Cost	FMV
Assets	1,000	1,200
Liabilities	100	100
Net	900	1,100

[74] Supra footnote 71

Situation 2:

Opco is owned equally by 2 unrelated shareholders: Holdco 1 and Holdco 2.

The ACB in the shares of Opco held by Holdco 1 is $100. The safe income of Opco that contributes to the gain on the shares held by Holdco 1 is $300.

The ACB in the shares of Opco held by Holdco 2 is $400. The safe income of Opco that contributes to the gain on the shares held by Holdco 2 is $100 (Holdco 2 became a 50% shareholder of Opco by investing $400 in the shares of Opco at the time Opco was worth $400 and the safe income realized by Opco prior to that time was $200, which was allocated to Holdco 1).

All Business 2 assets and $100 of liabilities of Opco are to be transferred to Newco that will be owned equally by Holdco 1 and Holdco 2, for a net value of $1,100. The transfer will be done on a pure rollover basis in the following manner:

- Holdco 1 and Holdco 2 transfer 50% of the shares of Opco owned by them to Newco on a rollover basis in consideration for shares of Newco.
- Opco transfers Business 2 assets to Newco in consideration for an assumption of $100 of liabilities of Opco by Newco and an issuance of $1,100 of shares of Newco to Opco. The transfer will be on a rollover basis.
- Shares held between Opco and Newco are cross-redeemed for a note and the notes are cross-cancelled.
- No safe income will be capitalized prior to the reorganization.
- Paragraph 55(3)(b) will apply to the reorganization.

In this situation, the DSI of Opco to be allocated post-reorganization between Opco and Newco is based on the following formula:

DSI on the shares of Newco: DSI of Opco prior to reorg X net cost amount of assets transferred to Newco / total net cost amount of assets of Opco prior to reorg

DSI on the shares of Opco after reorg: DSI of Opco prior to reorg X net cost amount of assets retained by Opco / total net cost amount of assets of Opco prior to reorg

Under such formula, the DSI to be allocated to Newco should be $400 (400 X 900/900) and the DSI remaining in Opco should be 0 (400 X 0/900).

The split of safe income between Holdco 1 and Holdco 2 in each corporation would be based on their respective ratio of safe income that they had in Opco prior to the reorganization.

Therefore, since the safe income of $400 is allocated to Newco post-reorganization, the share of Holdco 1 and Holdco 2 in such safe income is as follows:

DSI on the shares of Newco held by Holdco 1: DSI allocated to Newco post-reorg X DSI on shares of Opco held by Holdco 1 pre-reorg / total DSI of Opco pre-reorg

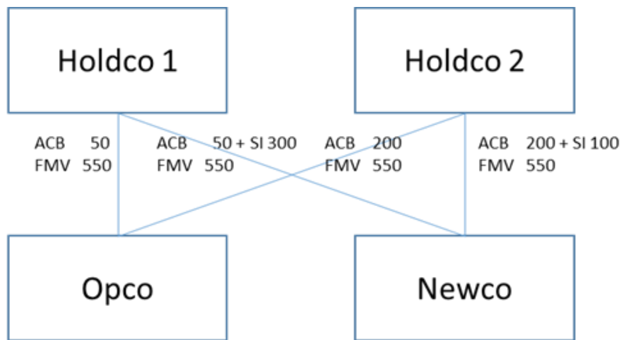
DSI on the shares of Newco held by Holdco 2: DSI allocated to Newco post-reorg X DSI on shares of Opco held by Holdco 2 pre-reorg / total DSI of Opco pre-reorg

Therefore,

the DSI on the shares of Newco held by Holdco 1 post-reorg would be 400 X 300/400 = 300, and

the DSI on the shares of Newco held by Holdco 2 post-reorg would be 400 X 100/400 = 100.

The situation after the reorganization would be as follows:

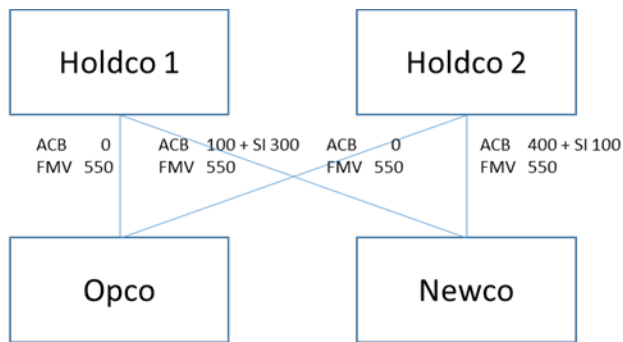


Assets		
	Cost	FMV
Assets	500	1,600
Liabilities	500	500
Net	0	1,100

Assets		
	Cost	FMV
Assets	1,000	1,200
Liabilities	100	100
Net	900	1,100

In this situation, because of the misalignment of inside and outside ACB, Holdco 1 and Holdco 2 should stream the ACB in the shares of Opco and transfer all such ACB to Newco on the reorganization.

With streaming of ACB, the post-reorganization situation would be as follows:

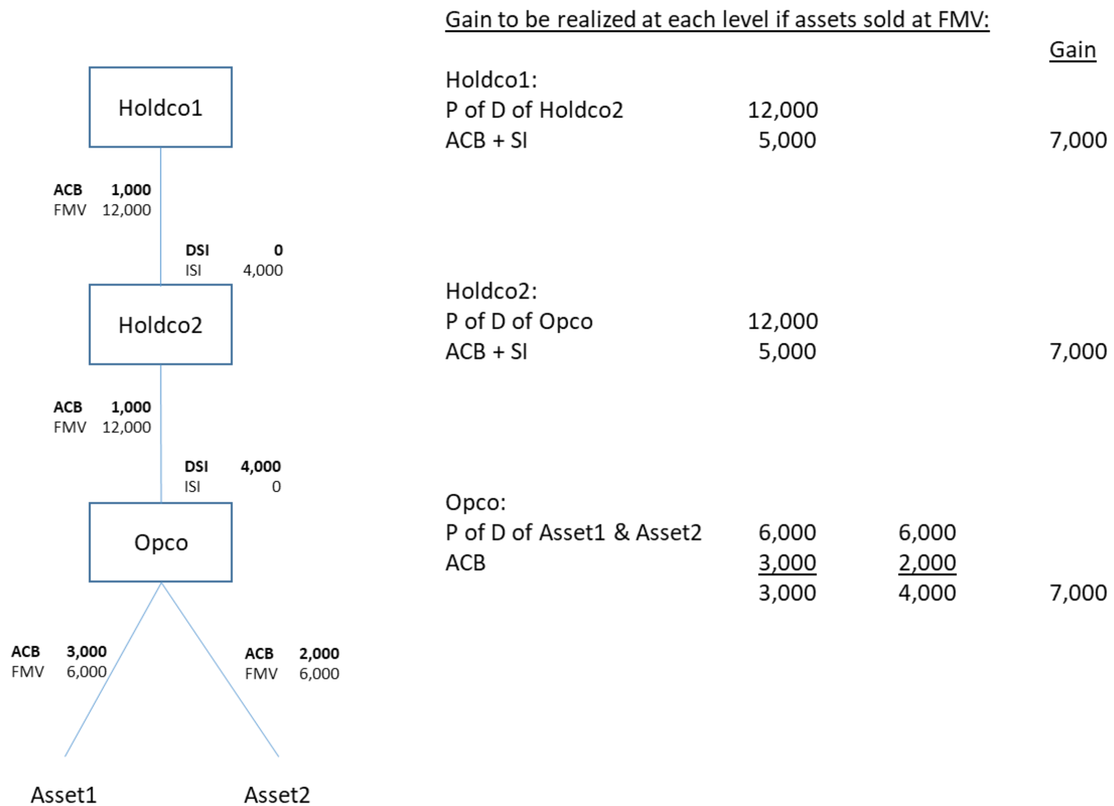


Assets		
	Cost	FMV
Assets	500	1,600
Liabilities	500	500
Net	0	1,100

Assets		
	Cost	FMV
Assets	1,000	1,200
Liabilities	100	100
Net	900	1,100

Example 24 – ACB and allocation of safe income on corporate reorganization (transferring property up a chain of corporations)

Let's assume the following situation:

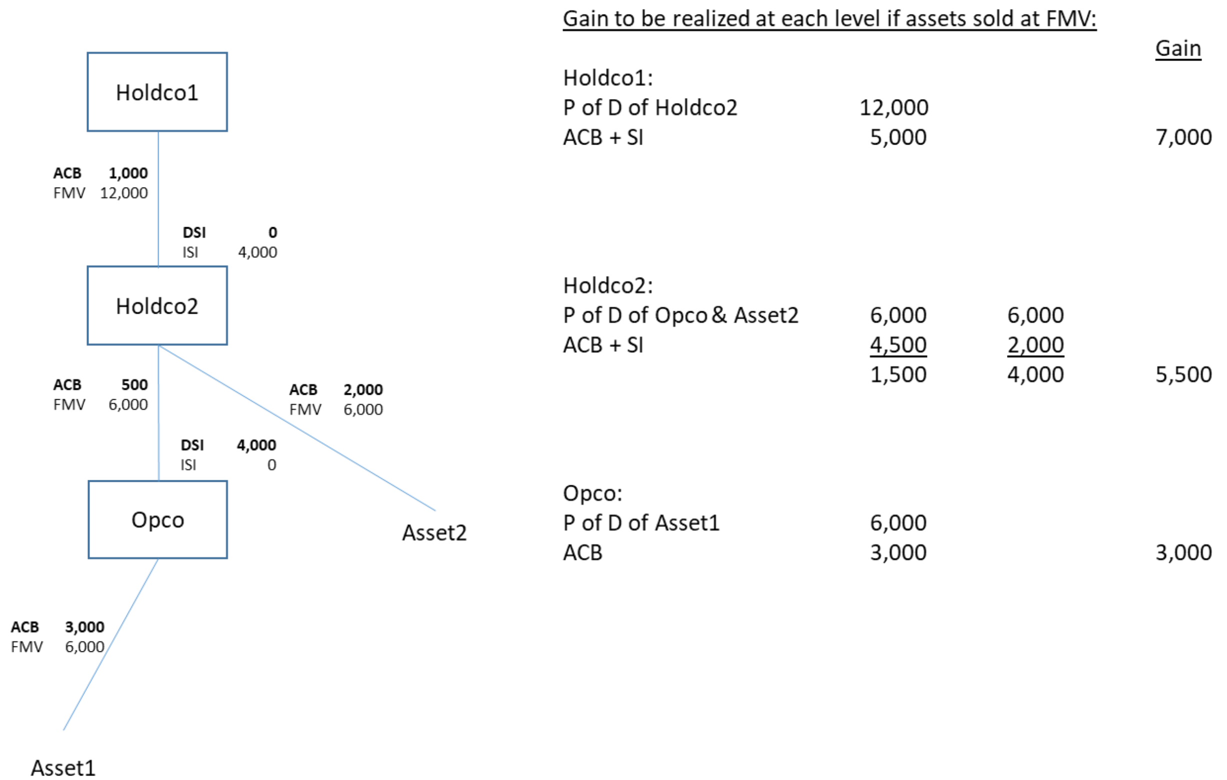


In this situation, Holdco1 has invested $1,000 in Holdco2 which in turn has invested $1,000 in Opco. Opco has realized income of $4,000 and has used its income and capitalization from Holdco2 to purchase Asset1 and Asset2.

Now Opco wants to transfer Asset2 to Holdco2 on a tax-deferred basis. The transfer is effected in the following manner:

- Holdco2 forms Newco and transfers to Newco shares of Opco with a FMV of $6,000 and an ACB of $500 (= $1,000 x 6,000/12,000)
- Opco transfers Asset2 to Newco in consideration for shares of Newco having a FMV of $6,000 and an ACB of $2,000
- The shares held between Newco and Opco are redeemed for notes that are cross-cancelled
- Newco is wound-up into Holdco2

Without any adjustment in the ACB and safe income of the shares of Opco held by Holdco2, the situation would be as follows after the reorganization:



The result here is neither reasonable nor appropriate within the scheme of the legislation. Regarding Opco, its only remaining asset is Asset1 and a disposition of such asset would result in a gain of $3,000, which was the accrued gain on Asset1 before the reorganization.

Regarding Holdco2, it now holds Opco and Asset2 directly. The combined FMV of the shares of Opco (that has been stripped of Asset2) and Asset2 is $12,000, which is the FMV of the shares of Opco prior to the reorganization. However, the gain to be realized if both properties of Holdco2 were disposed of after the reorganization would be $5,500 instead of the accrued gain of $7,000 that existed prior to the reorganization. The reason is that Holdco2 has received an additional ACB of $2,000 for Asset2 whereas there was only a reduction of $500 of ACB in the shares of Opco, which reduced the net gain by $1,500 on a disposition of assets by Holdco2.

To obtain an appropriate result, an adjustment of safe income and the ACB on the shares of Opco held by Holdco2 is required, which will be discussed below.

Regardless of the form of the transactions, the impact of the reorganization on the safe income of each corporation and on the required elimination of ACB on shares held in the corporations should be as follows:

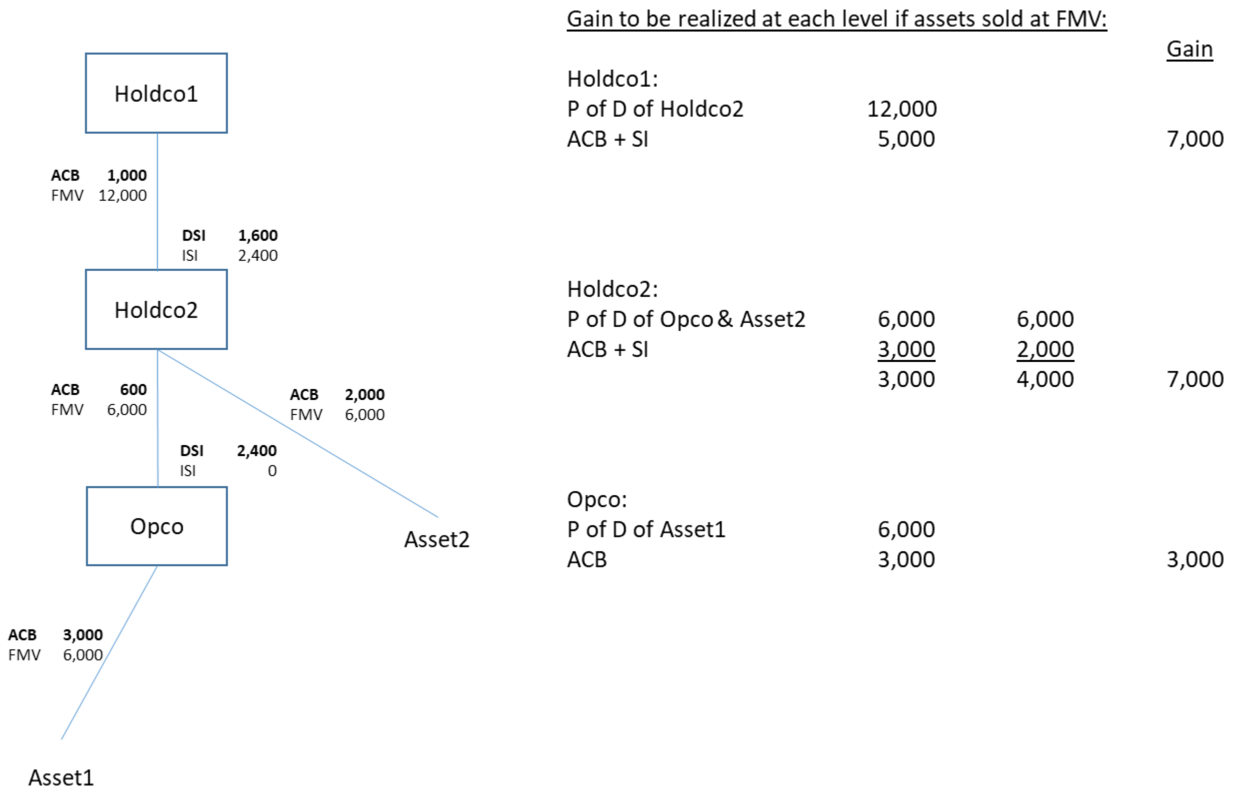
- Prior to the reorganization, the cost on the shares of Opco held by Holdco 2 ($1,000) and the safe income realized by Opco ($4,000) have contributed to the acquisition of property held by Opco with a total cost of $5,000 (cost in Asset1 of $3,000 and cost in Asset2 of $2,000).

- As discussed above, when Opco has transferred Asset2 out on a tax-free basis, its DSI should be reduced.
- The DSI and ISI of each corporation and the required ACB transfer to avoid misalignment of outside and inside cost would be calculated as follows:
    - DSI on the shares of Opco after reorg: DSI of Opco prior to reorg ($4,000) x net cost amount of assets retained by Opco ($3,000) / total cost amount of assets of Opco prior to reorg ($5,000) = $2,400
    - DSI of Opco considered to be transferred to Holdco 2: $4,000 - $2,400= $1,600
    - The ACB of shares of Opco held by Holdco 2 that is required to be eliminated on the reorg is $400, resulting in a remaining ACB in the shares of Opco held by Holdco 2 after the reorg of (1000-400) $600. In the current situation, this ACB of $600, combined with the remaining safe income of Opco of $2,400 would be the correct amount required to support the cost of the remaining assets (Asset1) of Opco of $3,000.
    - DSI of Holdco 2 after reorg: (DSI of Holdco 2 prior to reorg ($0) + amount considered to have been received from Opco ($1,600)) = $1,600
    - ISI of Holdco 2 after reorg: equal to DSI of Opco after reorg = $2,400
- Because of the chain of corporations involved, in the situation where Asset2 is transferred by Opco up the chain to Holdco 1 on a tax-free basis, the CRA will consider that Opco has transferred Asset2 to Holdco 2 and Holdco 2 has in turn transferred Asset2 to Holdco 1 for purposes of the calculations described above. In that situation, Opco is considered to have transferred a portion of its DSI to Holdco 2 and Holdco 2 is considered to have transferred a portion of its DSI to Holdco 1.

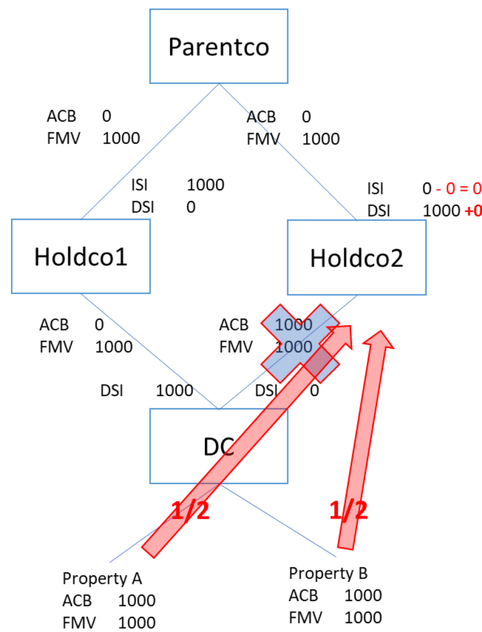
In a situation where property is transferred up the chain in a tax-free manner, the reduction in the safe income and ACB in the shares of the transferor corporation follows one simple principle:

- To preserve corporate tax integration, the reduction in the safe income and ACB in the shares of the transferor corporation has to be equal to the ACB of the asset received by the transferee on the transfer. In the above example, the ACB of Asset2 to Holdco2 is $2,000. The combined reduction in the safe income ($1,600) and ACB ($400) on the shares of Opco held by Holdco2 is equal to the increase in cost of Asset2 to Holdco2.

With a proper adjustment to the safe income and ACB on the shares of Opco held by Holdco2, the situation would be as follows after the reorganization:



Example 25 – One-wing split-up – related group – situation 1



Holdco1 has invested in DC on day 1.

DC earned safe income of $1,000 when it was wholly-owned by Holdco1.

Safe income was used to acquire Property A with a cost of $1,000.

Holdco2 earned safe income of $1,000 in the form of Property B (e.g., cash) and transferred Property B to DC with a cost and FMV of $1,000.

DC does a one-wing butterfly to Holdco2.

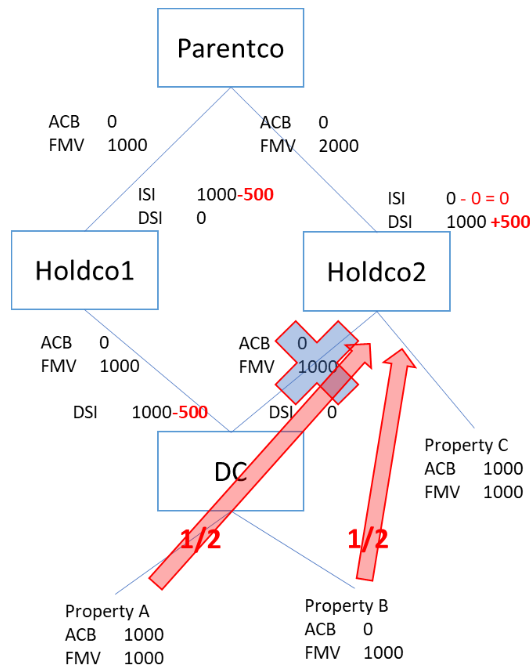
Holdco2 receives a prorata share of Property A and Property B.

Even though Holdco2 has received ½ of the cost amount of assets of DC, ½ of the total safe income of DC does not move up to Holdco2 in this situation.

The ACB in the shares of DC held by Holdco2 is simply replaced by the ACB in the properties received from DC.

Since Holdco2 had a DSI of 0 in DC, that DSI disappears and replaces the ISI that Parentco had in Holdco2. In this situation, Parentco will not have an increase in DSI in Holdco2.

Example 26 – One-wing split-up – related group – situation 2



Holdco1 has invested in DC on day 1.

DC earned safe income of $1,000 when it was wholly-owned by Holdco1.

Safe income was used to acquire Property A with a cost of $1,000.

Holdco2 earned safe income of $1,000 which is used to invest in Property C.

Holdco2 invested in a different class of shares of DC afterwards with an ACB of 0. DC used the investment of Holdco2 to buy Property B for an ACB of 0. The value of Property B was subsequently increased to $1,000.

DC does a one-wing butterfly to Holdco2.

Holdco2 receives a prorata share of Property A and Property B.

Holdco2 has received one-half of the cost amount of assets of DC. Its total cost amount of assets has increased to $1,500.

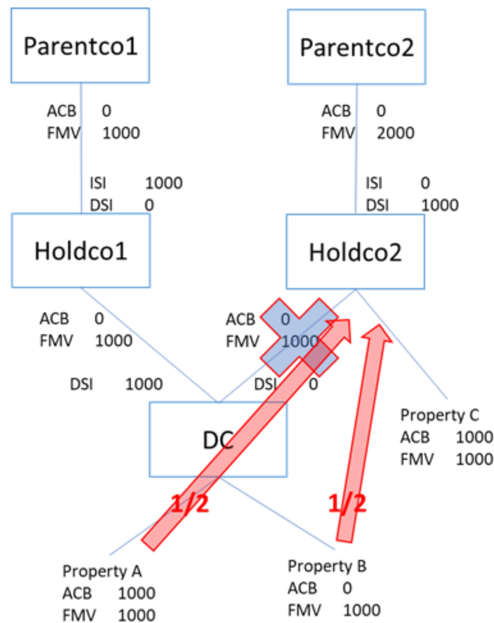
On Holdco1 side, the ACB on the shares of DC would be $1,000 (including capitalization of safe income of $1,000) and the inside ACB (i.e., ACB of property owned by DC) is $500.

There is a misalignment of basis in this situation if there was no allocation of safe income as per the formula described in Example 17.

With application of the safe income allocation formula, the safe income that Holdco1 has in DC is reduced by one-half, which is the right result because DC has lost one-half of its cost amount in assets after the reorganization.

Regarding Holdco2, it has received one-half of DSI (i.e., $500) from DC because it has received one-half of the ACB in the assets of DC. At the end of the day, Parentco has increased its ACB in the shares of Holdco2 by $500 (including safe income) and Holdco2 has increased the ACB in its assets by $500. It's as if there is a shifting in ACB from the Holdco1 side to the Holdco2 side, but the result is not abusive in this particular situation.

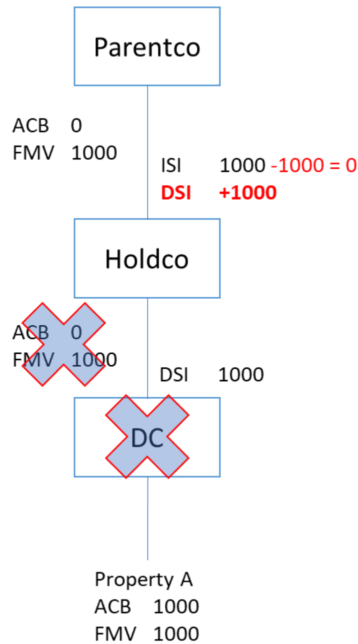
Example 27 – One-wing split-up – Arm's length situation



This example uses the same numbers as in Example 26. However, where the reorganization is a bona-fide split-up between arm's length persons (Parentco1 and Parentco2 are unrelated and deal with each other at arm's length, as well as Holdco1 vis-a-vis Holdco2), there is no requirement to allocate safe income as per the formula described in Example 17. The safe income that Parentco2 had in Holdco2 should not change as a result of the split-up.

Regarding Parentco1, a subsequent disposition of the assets remaining in DC would generate a DSI for Holdco1 in the shares of DC of $500 and, therefore, an ISI for Parentco1 in the shares of Holdco1 of $500.

Example 28 – Safe income on wind-up of a wholly-owned subsidiary



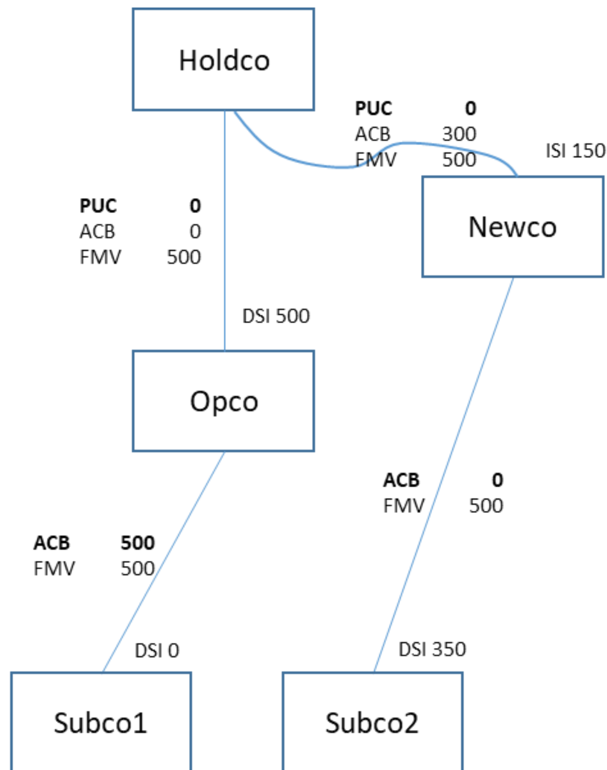
In this situation, Parentco owned shares of Holdco that owned 100% of DC. The DSI on the shares that Holdco had in DC was $1,000.

Where DC is wound-up, the DSI that Holdco had in DC should be considered to move up to the shares that Parentco had in Holdco and replaces the ISI that Parentco had in Holdco.

At the end, Parentco would have ISI of 0 in Holdco and DSI of $1,000 in Holdco.

Other examples

Example 29 – Illustration of the movement of safe income



This is the situation at the end of Example 22.

It illustrates one important principle:

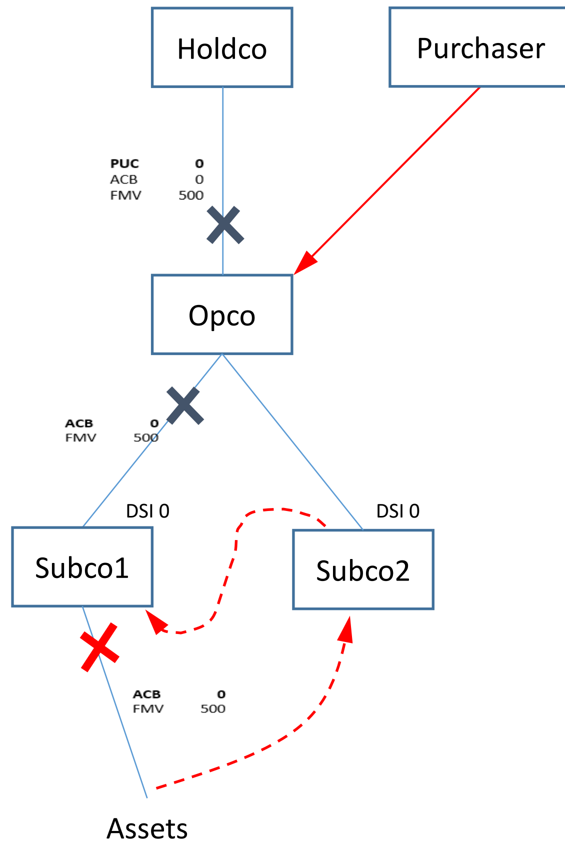
Safe income is determined at each level separately. The DSI that Newco has in the shares of Subco2 is $350. However, the ISI that Holdco has in the shares of Newco that is derived from the DSI of Subco2 is only $150, because that's the safe income realized by Subco2 after the acquisition of Opco by Holdco.

Subco2 can pay a safe income dividend of $350 up to Newco. But that does not mean that the DSI of the shares of Newco held by Holdco will be increased by $350. The safe income dividend paid by Subco2 to Newco is not and should not be added to the DSI of the shares of Newco held by Holdco. The safe income of Subco2 that contributes to the gain of the shares of Newco held by Holdco (i.e., its ISI vis-à-vis Subco2) is and remains at $150. The balance is reflected in the ACB of the Newco shares.

Therefore, Newco can only pay a safe income dividend of $150 up to Holdco.

Example 30 – what is “income earned or realized”

Illustration of the concepts discussed in the section “What is “income earned or realized” – should it include income that is not taxable?”



In this situation, Holdco owned the shares of Opco with an accrued gain of $500 (ACB= 0 and FMV=$500). Opco owned Subco1 and Subco2. Shares owned by Opco in Subco1 had an ACB of 0 and a FMV of $500. Shares owned by Opco in Subco2 had no value.

There was no safe income in Subco1, Subco2 or Opco.

Purchaser would like to acquire shares of Opco held by Holdco. However, the acquisition will be achieved through the following steps in the order described:

1. Subco1 transfers on a rollover basis assets having an ACB of 0 and a FMV of $500 to Subco2 in consideration for shares of Subco2.
2. Purchaser acquires $500 of shares of Opco from treasury.
3. Subco2 redeems shares held by Subco1, resulting in a dividend deemed received by Subco1 for $500. The dividend is deductible under subsection 112(1).

4. Subco1 repurchases shares held by Opco for $500, resulting in a dividend of $500 deemed received by Opco. The dividend is deductible under subsection 112(1).
5. Opco repurchases the shares held by Holdco for $500, resulting in a dividend of $500 deemed received by Holdco. The dividend is deductible under subsection 112(1).

In this situation, the dividend received by Subco1 on the redemption of shares held in Subco2 would be exempt under paragraph 55(3)(a) by virtue of the application of paragraph 55(3.01)(g). However, the dividend received by Opco on the redemption of shares held in Subco1 and the dividend received by Holdco on the redemption of shares held in Opco do not benefit from the exception in paragraph 55(3.01)(g) and would therefore not benefit from the paragraph 55(3)(a) exemption. Although the dividend received by Subco1 on the redemption of shares held in Subco2 is included in income under paragraph 12(1)(j), it does not result in safe income for Subco1 as it is not "income earned or realized" by Subco1 for the following reasons:

- The amount of the dividend is not paid from tax-paid earnings of Subco2 and it is not subject to tax in the hands of Subco1. The accrued gain on the shares of Subco1 and Opco was, at the beginning of the series, attributable to unrealized gain on the assets held by Subco1. That unrealized gain has not been realized. The exchange of that unrealized gain for an accrued gain on the shares of Subco2 held by Subco1 (on the transfer of the assets in consideration for shares of Subco2) does not result in any gain being realized even though the shares held by Subco1 in Subco2 have been redeemed. The redemption of the shares of Subco2 held by Subco1 results in a dividend that is deductible to Subco1 and does not result in any "income earned or realized" by Subco1.
- Allowing for such dividend to qualify as safe income of Subco1 would result in a non-taxation of the dividends received by Opco and Holdco and would defeat the scheme of subsection 55(2).[75]

[75] See the discussion above in the section "Role and Purpose of Amended Subsection 55(2)." This comment would be relevant in the situation where the dividend received by Subco1 on the redemption of shares of Subco2 is not part of the series that includes the described transactions and would not be excluded because of the safe income determination time.

Annex – legislation on safe income

Paragraph 55(2.1)(c) reads as follows:

> (c) the amount of the dividend exceeds 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 — 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.

"Safe income determination time" is defined in subsection 55(1) as follows:

> "safe-income determination time" for a transaction or event or a series of transactions or events means the time that is the earlier of
> (a) the time that is immediately after the earliest disposition or increase in interest described in any of subparagraphs (3)(a)(i) to (v) that resulted from the transaction, event or series, and
> (b) the time that is immediately before the earliest time that a dividend is paid as part of the transaction, event or series;

Subsection 55(5) contain the following additional rules on the calculation of safe income:

> (5) Applicable rules — For the purposes of this section,
>
> (a) where a dividend referred to in subsection (2) was received by a corporation as part of a transaction or event or a series of transactions or events, the portion of a capital gain attributable to any income expected to be earned or realized by a corporation after the safe-income determination time for the transaction, event or series is deemed to be a portion of a capital gain attributable to anything other than income;
>
> (b) the income earned or realized by a corporation for a period throughout which it was resident in Canada and not a private corporation shall be deemed to be the total of
>
> (i) its income for the period otherwise determined on the assumption that no amounts were deductible by the corporation by reason of section 37.1 of this Act or paragraph 20(1)(gg) of the Income Tax Act, chapter 148 of the Revised Statutes of Canada, 1952,
>
> (ii) the amount, if any, by which
>
> (A) the amount, if any, by which the total of the capital gains of the corporation for the period exceeds the total of the taxable capital gains of the corporation for the period
>
> exceeds
>
> (B) the amount, if any, by which the total of the capital losses of the corporation for the period exceeds the total of the allowable capital losses of the corporation for the period,

(iii) the total of all amounts each of which is an amount required to have been included under this subparagraph as it read in its application to a taxation year that ended before February 28, 2000,

(iv) the amount, if any, by which

(A) ½ of the total of all amounts each of which is an amount required by paragraph 14(1)(b) to be included in computing the corporation's income in respect of a business carried on by the corporation for a taxation year that is included in the period and that ended after February 27, 2000 and before October 18, 2000,

exceeds

(B) where the corporation has deducted an amount under subsection 20(4.2) in respect of a debt established by it to have become a bad debt in a taxation year that is included in the period and that ended after February 27, 2000 and before October 18, 2000, or has an allowable capital loss for such a year because of the application of subsection 20(4.3), the amount determined by the formula

$$V + W$$

where

V is ½ of the value determined for A under subsection 20(4.2) in respect of the corporation for the last such taxation year that ended in the period, and

W is 1/3 of the value determined for B under subsection 20(4.2) in respect of the corporation for the last such taxation year that ended in the period, and

(C) in any other case, nil, and

(v) the amount, if any, by which

(A) the total of all amounts each of which is an amount required by paragraph 14(1)(b) to be included in computing the corporation's income in respect of a business carried on by the corporation for a taxation year that is included in the period and that ends after October 17, 2000,

exceeds

(B) where the corporation has deducted an amount under subsection 20(4.2) in respect of a debt established by it to have become a bad debt in a taxation year that is included in the period and that ends after October 17, 2000, or has an allowable capital loss for such a year because of the application of subsection 20(4.3), the amount determined by the formula

$$X + Y$$

where

X is the value determined for A under subsection 20(4.2) in respect of the corporation for the last such taxation year that ended in the period, and

Y is 1/3 of the value determined for B under subsection 20(4.2) in respect of the corporation for the last such taxation year that ended in the period, and

(C) in any other case, nil;

(c) the income earned or realized by a corporation for a period throughout which it was a private corporation is deemed to be its income for the period otherwise determined on the assumption that no amounts were deductible by the corporation under section 37.1 of this Act, as that section applies for taxation years that ended before 1995, or paragraph 20(1)(gg) of the Income Tax Act, chapter 148 of the Revised Statutes of Canada, 1952;

(d) the income earned or realized by a corporation (referred to in this paragraph as the "affiliate") for a period ending at a time when the affiliate was a foreign affiliate of another corporation is deemed to be the lesser of

(i) the amount that would, if the Income Tax Regulations were read without reference to their subsection 5905(5.6), be the tax-free surplus balance (within the meaning of their subsection 5905(5.5)) of the affiliate in respect of the other corporation at that time, and

(ii) the fair market value at that time of all the issued and outstanding shares of the capital stock of the affiliate;