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Are Dividends Between Related Corporations Still "Safe"?

By Ian V. MacInnis LL.B. and Shaun M. Doody LL.B.

The 2015 Federal Budget proposed changes that contain a hidden danger which may significantly impede the ability to move cash and other assets between related corporations on a tax-free basis. Draft legislation was released on July 31, 2015 (the "**Draft Legislation**") that contain numerous amendments to section 55 of the *Income Tax Act* (Canada) (the "**Act**"). If passed, the amendments will be retroactive to dividends received after April 20, 2015.

Section 55

Section 55 is an anti-avoidance provision that is intended to prevent "**capital gains stripping**" through the payment of intercorporate dividends. Where the provision applies, subsection 55(2) operates to convert an otherwise tax-free intercorporate dividend into a (taxable) capital gain. The following very basic example illustrates the operation of subsection 55(2) of the Act.

Holdco intends to sell shares of its subsidiary corporation ("**Opco**") to an unrelated third party (the "**Purchaser**") for $100, which would result in a capital gain of $75 to Holdco. Opco operates an active business but has never earned any taxable income. Prior to the sale of Opco shares by Holdco, the Purchaser lends $75 to Opco. Opco then pays a $75 dividend to Holdco out of the borrowed monies from the Purchaser. In the absence of subsection 55(2) of the Act applying, this intercorporate dividend would be tax-free to Holdco pursuant to section 112 of the Act.

In this example, the dividend has the effect of reducing the fair market value of the Opco shares to $25, meaning that, when Holdco subsequently sells the Opco shares to the Purchaser for $25, Holdco does not realize a capital gain on the sale. This is the so-called "capital gain strip". In order to prevent such result, subsection 55(2) of the Act will generally recharacterize the dividend that Holdco receives from Opco as a capital gain.

Related Corporation Exception

There has been a longstanding exception to the application of section 55 in the case of dividends paid between related corporations. This exception is found in paragraph 55(3)(a) of the Act. Under the existing rule, it is possible to pay cash dividends or to spin-out assets to related corporations without having to consider whether subsection 55(2) would apply to convert dividends into capital gains. The Draft Legislation proposes to limit this exception only to deemed dividends between related corporations arising by virtue of the redemption, acquisition or cancellation of shares of the dividend-paying corporation. Ordinary cash dividends paid to a related corporation will not qualify for the related-party exception under the Draft Legislation. Accordingly, the payment of cash dividends within a related corporate group will now have to take into account the potential application of section 55 to the intercorporate dividends. The following example illustrates the potential effects of the proposed rules under the Draft Legislation.

As part of an asset protection plan, an operating company ("**Opco**") pays a cash dividend to its parent holding company ("**Holdco**"), which in turn lends the funds back to Opco to be secured by a general security agreement. In this case, the dividend received by Holdco is not a deemed dividend (i.e. because no shares are redeemed, acquired or cancelled). As a result, the related party exception in paragraph 55(3)(a) will not apply under the new rules, despite the fact that no unrelated persons are involved in the transactions.

In this example, the cash dividend received by Holdco would be recharacterized as a capital gain if the amount of the dividend exceeds the "**safe income**" of Opco.[1] "**Safe income**" is the post-1971 after-tax retained earnings determined on a tax basis (and subject to certain adjustments in the Act). If the safe income of Opco immediately before the dividend was $100,000, but the amount of the cash dividend paid was $300,000, than the entire $300,000 dividend would be

Tammy J. Anklewicz

Partner

t: 416.365.3710
tanklewicz@foglers.com

Leonard P. Bosschart

Partner

t: 416.864.7600
lbosschart@foglers.com

Shaun M. Doody

Associate

t: 416-941-8826
sdoody@foglers.com

John M. Fuke

Counsel

t: 416.464.5552
jfuke@foglers.com

recharacterized as a capital gain and taxed as such to Holdco.

Accordingly, it will now be necessary to perform safe income calculations in most cases where cash dividends are paid between related corporations. If the amount of a dividend might (or would) exceed safe income, then it will be necessary to redeem or purchase for cancellation the Opco shares held by Holdco so as to result in a deemed dividend to fit within the more narrow related party exception in paragraph 55(3)(a) of the Act.

Safe Income Exception - Discretionary Dividend Shares

As noted, the narrowing of the related party exception will now generally require that cash dividends between related corporations not exceed "**safe income**". The Draft Legislation also contains an amendment which stipulates that the safe income in question must be considered to contribute to a capital gain which would be realized on the share on which the dividend was paid. Accordingly, it appears that, even if there is sufficient safe income, this still does not protect a dividend from the application of subsection 55(2) if there is an insufficient accrued capital gain on the shares on which the dividend is paid.

In many related party corporate groups, a corporation may hold a nominal value share (a so-called "**discretionary dividend**" share) to enable dividends to be paid within a corporate group in a flexible manner. If a discretionary dividend share has a nominal fixed value, it will be difficult to establish that the safe income (i.e. after-tax retained earnings) of the dividend-paying corporation can be said to contribute to a capital gain on those particular shares. Even in cases where discretionary dividend shares are also equity shares that have a real value, it will still be necessary to assess whether the amount of the cash dividend would contribute to a capital gain on the shares on which the dividend is paid and the manner in which the safe income of the dividend-paying corporation is allocated among the various classes of shares.

New Purpose Tests

As mentioned above, there are other significant changes to section 55 under the Draft Legislation, including the expansion of the "purpose" tests. Under the current legislation, subsection 55(2) requires that one of the purposes of a cash dividend be to effect a significant reduction of the portion of the capital gain that would be realized on a disposition at fair market value of any share. The Draft Legislation expands this by adding two new purpose tests. Subsection 55(2) will now apply if one of the purposes of a dividend is to effect: (1) a significant reduction of the fair market value of any share; or (2) a significant increase in the cost of property owned by the dividend recipient.

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The proposed changes to section 55 will add complexity and cost in paying intercorporate dividends in any related corporate group structure. It will likely be necessary to maintain updated "safe income" calculations of dividend-paying corporations and to consider alternate structures to achieve a tax-free movement of cash or other assets between related corporations.

1. As discussed further below, another requirement for the recharacterization of the dividend is that "one of the purposes" of the payment of the dividend must be (stated somewhat simply) to reduce the fair market value of Holdco's shares of Opco or to increase the cost of property owned by Holdco. While the payment of the dividend will certainly reduce the fair market value of Holdco's shares of Opco and increase the cost of Holdco's property, some have suggested that subsection 55(2) should not apply in this situation because neither of these results was "one of the purposes" of the dividend. It is not clear at this time whether the Canada Revenue Agency will agree with this interpretation so, until the CRA opines on the issue, prudence would suggest assuming that 55(2) would apply to the dividend in any situation where it exceeds safe income.

Peter K. Guselle

Partner

t: 416.941.8818
pguselle@foglers.com

Suzanne I.R. Hanson

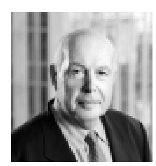
Partner

t: 416.941.8865
shanson@foglers.com

Ian V. MacInnis

Partner

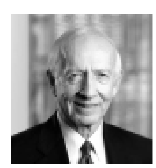
t: 416.941.8813
imacinnis@foglers.com



William T. Perks

Partner

t: 416.941.8864
wperks@foglers.com



Sheldon Silver

Partner

t: 416.365.3734
ssilver@foglers.com

Fogler, Rubinoff LLP
Lawyers
77 King Street West
Suite 3000, PO Box 95

TD Centre North Tower
Toronto, ON M5K 1G8
t: 416.864.9700
f: 416.941.8852
foglers.com