CRA comments on proposed amendments to subsection 55(2): a new planning era and new opportunities

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It is no surprise that the proposed legislation on subsection 55(2) released on July 31, 2015 was a hot-button topic at the Canadian Tax Foundation's 67th Annual Tax Conference last week in Montreal. What *is* a surprise was the Canada Revenue Agency's (CRA) increasing willingness to comment on this draft legislation in Round Table sessions (both at this conference and the APFF Conference on October 9, 2015), when they have largely refrained from doing so with proposed legislation in the past. Accordingly, we will discuss these invaluable comments from the CRA, as well as some insights and planning ideas with respect to proposed subsection 55(2).

Existing subsection 55(2) is an anti-avoidance rule against "capital gains stripping", a technique whereby a tax-free inter-corporate dividend is used as part of a series of transactions or events to reduce a subsequently realized capital gain. For owner-managed businesses, the risks of subsection 55(2) applying can usually be managed and mitigated because routine inter-corporate dividends are, in most cases, within the paragraph 55(3)(a) related-party exception, or not done with a purpose of reducing capital gain.

However, the Department of Finance has proposed a complete revamp of subsection 55(2) that will severely limit the scope of the paragraph 55(3)(a) related party exception for inter-corporate dividends received after April 20, 2015. One of the most notable differences between current subsection 55(2) and the proposed rules is an expanded purpose test in addition to the current purpose test. The expanded purpose test looks to whether one of the purposes of a dividend is to effect: (A) a significant reduction of the fair market value (FMV) of any share; or (B) a significant increase in the cost of property in the hands of the dividend recipient. Other unexpected proposed changes include the narrowing of the Part IV tax exception and a new regime for the treatment of stock dividends in applying subsection 55(2).

Considerable discussion on these proposed changes has occurred in the tax community since their release – each of the CBA/CPA Canada Joint Committee on Taxation (see its May 27 and November 12 submissions), the Society of Trust and Estate Practitioners (STEP), and the Conference for Advanced Life Underwriting (CALU) have made submissions on the issue, expressing the tax communities' grave concerns about several aspects of the revised legislation, not the least of which is the expanded purpose test. While the tax community was engulfed in debate over the interpretation and boundaries of these rules over the last few months, many business owners across the country were forced to either halt their regular inter-corporate cash movement or proceed with little comfort over the potential re-characterization of the otherwise tax-free inter-corporate dividends into taxable capital gains under proposed subsection 55(2).

While more questions than answers remain on the final reading of this legislation and in its administration by the CRA, the CRA did respond to some of the more pressing issues in its round table discussion at the conference. Many tax practitioners will no doubt be pleased to hear about the CRA's confirmation on taxpayers' ability to self-assess subsection 55(2), and the planning opportunity this offers – while keeping in mind that Finance may propose new rules to prevent this.

Here is a brief rundown of the round table discussion on proposed subsection 55(2):

Question 4. When asked again[1] about the deliberate triggering of subsection 55(2) without a corresponding separate-dividend designation under paragraph 55(5)(f), which could provide for the extraction of corporate surplus by an individual effectively at capital gains rates, the CRA responded that the GAAR Committee recently recommended that the GAAR not be applied having regard to the current state of the jurisprudence. This is a *significant* departure from the CRA's previously issued responses that it would apply GAAR to a taxpayer who self-assesses subsection 55(2) to extract corporate surplus at capital gains tax rates.[2] The CRA reiterated its concern that this type of tax planning is "contrary to the integration principle." The CRA however cautioned that it has brought its concerns respecting this type of tax planning to the attention of the Department of Finance (for legislative amendment presumably) and that it will continue to apply GAAR to *Descarriers* and *MacDonald*-type transactions and will seek to apply specific anti-avoidance provisions such as section 84.1 and 212.1 where appropriate.

Question 6 (a): The CRA was asked to describe the factors or tests they will consider in deciding whether the expanded purpose test has been met, and specifically what would be considered 'significant'. The CRA advised that they will consider the actions taken by the parties and their motivation. In what may have been an attempt to alleviate concerns that the expanded purpose tests may be inadvertently applied as a results test, the CRA stated, "it is not the result that drives a purpose test, it is the purpose, and the motivation behind the purpose," and later on reiterated, "a purpose test, is a purpose test, is a purpose test." As an example, a dividend that creates a capital loss on a share which could be used to shelter a gain on another property would be viewed by the CRA as an indication of a fair market value reduction purpose. On the other hand, a dividend paid pursuant to a well-established dividend policy where the amount represent a reasonable return on equity for the specific industry, will likely not be considered to fall within the expanded purpose test. Also, the CRA advised that, consistent with the current application of subsection 55(2), 'significant' will be read to mean both in dollar amounts and on a percentage basis.

Question 6 (b): The CRA was asked about the application of proposed subsection 55(2) to traditional in-house loss consolidations. In its most basic form, such plans usually involve a Lossco making an interest-bearing loan to a Profitco, and Profitco using the loan proceeds to subscribe for dividend-bearing preferred shares in Lossco. This arrangement shifts profits from Profitco to Lossco by taking advantage of the dividend deduction under subsection 112(1), and under existing rules, subsection 55(2) normally does not apply due to the existing purpose test and the related-party exception for dividends under existing paragraph 55(3)(a). The CRA advised that those related-party loss consolidation measures that were previously permitted in CRA rulings, should not be considered to have a fair market value reduction purpose and therefore should not run afoul of proposed subsection 55(2). The CRA advised generally that the hallmark of an acceptable plan is whether any tax cost created under such a plan will be eliminated when the loss consolidation is unwound.

Question 6 (c): The CRA confirmed that where a dividend is paid on non-participating, discretionary shares with no accrued gain (practitioners often referred to these as 'skinny' shares and they are sometimes used to move cash between an Opco and a Holdco, while allowing most of the capital gain to accrue in the hands of the holders of participating shares – typically a family trust or an individual), it is clear that no safe income can be considered to contribute to the shares' capital gain, and thus no safe income will be available on such shares. Therefore, the dividend on such share will be subject to the purpose tests in proposed subsection 55(2). If a dividend on a non-participating, discretionary share falls into any one of the purpose tests and proposed subsection 55(2) applies, the CRA will accept that the safe income associated with the participating share(s) will not be impacted.

As background, the new ‘safe-income’ exception under proposed subsection 55(2) appears to only apply where there is an accrued gain on the share which could be realized on a disposition at fair market value. This CRA response confirms this interpretation, which is unfortunate as we frankly do not see a compelling policy reason behind making this a new prerequisite to accessing safe income. In a depressed economy such as that we have here in Alberta, we often encounter businesses with Holdco-Opco structures that have ample safe income built up from profitable years, but are now prevented from accessing this safe income in the Opcos because the value of the shares are under-water. The fact that the CRA will not reduce safe income on participating shares on a subsection 55(2) dividend on non-participating shares may be cold comfort to many.

Question 6 (d): When asked of situations where corporations are undertaking share redemptions as an alternative to dividend declarations – resulting in deemed dividends under subsection 84(3) and therefore providing access to the narrowed subsection 55(3)(a) related-party exception – the CRA reiterates its view that the exceptions under subsection 55(3) should not be used to manipulate or manufacture tax cost. The CRA provided their opinion on what it considers to be offensive actions, including i) a share redemption, that is exempted under 55(3)(a), for a promissory note that is used to generate tax basis in excess of the tax cost of the share redeemed, and ii) cost-basis streaming under a reorganization where the low basis shares are redeemed and the high basis shares are preserved.

To expand on the somewhat finer point of the question, not only is there the broadened scope of the revised purpose tests, there is *also* a significantly narrowed related-party exception. The heavily relied upon paragraph 55(3)(a) exception for movements of property within a corporate group under the current legislation will now only apply to subsections 84(2) or (3) deemed dividends on a share redemptions, acquisition or cancellation under the proposed legislation. In other words, one can no longer simply disregard subsection 55(2) if paying cash, stock or in-kind dividends within a related corporate group. As for stock dividends, it is critical to note that for the purpose of proposed subsection 55(2), the resulting dividend is deemed to be the greater of the PUC and the fair market value of the stock issued. Therefore in the case of ‘high-low’ preferred share stock dividends, the resulting capital gain under revised subsection 55(2) will be the redemption amount and not the PUC of the share.

Question 6 (e): One of the primary concerns of owner-manager businesses over proposed subsection 55(2) is its potential application to regular creditor-proofing transactions such as where Opco pays a dividend to Holdco, which then loans the proceeds back to Opco taking security against Opco’s assets. These transactions are usually done without any tax planning motivation, and these businesses most often have never attempted to keep track of safe income. When asked about this, the CRA commented that where an Opco pays a “lumpy” dividend for creditor-proofing, the apparent purpose will be considered to be the reduction of the fair market value of the Opco shares and that subsection 55(2) will therefore apply to the extent the dividend exceeds safe income on hand.[3] The CRA further added that it would be good practice for businesses to regularly keep track of safe income going forward. While not entirely a surprise, this response may come as a disappointment to many.

In sum, while we cautiously hope that Finance will further revise its proposed amendments to subsection 55(2) in response to the tax communities’ concerns, it is certain that subsection 55(2) as we know it has changed and we can no longer simply ignore it in the context of inter-corporate payments or reorganizations. Although the proposals were announced while the previous federal government was in power, it is not expected that the change in government will impact their enactment.

Practitioners will be well-served to revisit any planning involving inter-corporate dividends post April 20, 2015, and to get comfortable with the concept of safe income on hand attributable to a share. Best practices going forward should include determination of a corporation’s current safe income (easier said than done particularly for complex organizations) and keeping track of it annually, as well as documentation of the purpose and motivation behind each inter-corporate cash, stock or in-kind dividend. This applies as well to a deemed dividend under a share redemption as the CRA has stated that it will not blindly accept the application of the paragraph 55(3)(a) exception and will consider whether the exception is used to manipulate or increase tax basis. The CRA also indicated its willingness to issue advanced tax rulings on the expanded subsection 55(2) purpose test, so businesses planning on significant inter-corporate dividends may be well-advised to take advantage of this process where appropriate. There are other traps and pitfalls which are beyond the scope of this blog, such as the Part IV exception no longer applying if the Part IV tax is refunded on payment of taxable dividend to an individual as part of the same series as the inter-corporate dividend.

On the other hand, the CRA's comments regarding the self-assessment of subsection 55(2) also presents interesting tax planning opportunities. Beginning 2016, an Alberta individual at the top marginal rate bracket will be subject to a tax rate of approximately 40% on the receipt of an ineligible dividend.[4] If careful planning is done to convert this distribution to a corporate capital gain by intentionally tripping into subsection 55(2), the fully-distributed effective tax rate could drop to approximately 26% – an astonishing 14% absolute tax saving. Such planning becomes even more powerful when combined with strategies that convert Canadian-controlled private corporations ("CCPCs") to non-CCPCs, which could add an additional 13% tax deferral opportunity if not all of the funds are required personally. The comment by the CRA that this type of planning is now on Finance's radar screen may mean that there is a limited window to execute these plans.

These are interesting times to be a tax practitioner – new roadblocks to navigate, but also new planning opportunities glimmering at the horizon for those who look hard enough. We think it is appropriate to close off with the often-cited quote from the 1936 English case of *IRC v. Duke of Westminster*:

> "Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax."

[1]See question 15 of the APFF CRA round table discussion held on October 9, 2015.

[2]See question 7 of the 2014 STEP Canada round table discussion held on July 6, 2014.

[3]This is also consistent with the CRA's response in question 12 of the APFF CRA round table discussion held on October 9, 2015.

[4]Rates include expected increases based on the federal Liberal's platform.