TAX FOR THE Owner-Manager

When Does Subsection 129(1.2) Apply To Deny a Dividend Refund?

Subsection 129(1.2) prevents a corporation that otherwise would obtain a dividend refund, as a result of paying a taxable dividend, from obtaining the dividend refund. Only one case has interpreted this provision in any depth. In *Canwest Capital Inc. v. R* ([1996] 1 CTC 2974 (TCC)), a frustrated Bell J had this to say:

> A provision in a self-assessing taxation system should be clear and capable of ready comprehension. Subsection 129(1.2) falls short of this standard. Subsection 129(1) entitles a taxpayer to a dividend refund on the payment of taxable dividends. Subsection 129(1.2) disentitles a taxpayer to such refund without any description of circumstances justifying that result. The Court should be able to interpret legislation and to apply it to the facts without the task of having to divine meaning from an assemblage of words whose intended objective could hardly be better disguised. In such circumstance the Court must reluctantly resort to other materials in an effort to glimpse the creature concealed. . . .
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> How can subsection 129(1.2), without more, characterize the ability of a subsidiary corporation to receive a dividend refund, the normal result of paying a taxable dividend, as one of the main purposes for the acquisition of its shares by that related shareholder? Surely it is the combination of the normal ability to receive a dividend refund together with *something else* that is the target of subsection 129(1.2). Why does it not describe what that something else is? This is an anti-avoidance section that does not indicate what structures and/or transactions it seeks to redress. [Emphasis in original.]

The CRA's longstanding interpretation of the provision is reflected in paragraph 6 of *Interpretation Bulletin* it-243R4 ("Dividend Refund to Private Corporations," February 12, 1996). In the CRA's view, subsection 129(1.2) applies to deny a dividend refund when the share on which the dividend was paid (or a substituted share) was acquired by the holder in a transaction or as part of a series of transactions and one of the main purposes of the transaction or series was to obtain a dividend refund. But is that really the case?

The text of subsection 129(1.2) indicates that it applies only if "one of the main purposes of [the transaction or series] was to enable the corporation to obtain a dividend refund." Therefore, on a purely textual interpretation, it is not sufficient for a transaction or series to have a main purpose of obtaining a dividend refund. Instead, on a textual interpretation, the purpose condition is satisfied only if the transaction or series *enables* the corporation to obtain the dividend refund. When a share is acquired, the acquisition usually does not enable the corporation to obtain a dividend refund. In most circumstances, the corporation could obtain a dividend refund merely by paying a dividend; although there may be an acquisition of shares as part of the series, the acquisition or series of transactions generally is not needed to obtain that result.

When might an acquisition of a share, or a series of transactions in which a share is acquired, enable a corporation to obtain a dividend refund? If a corporation has no assets, it will have no legal capacity to pay a dividend. In that case, someone might choose to subscribe for (low PUC) shares, which would provide the corporation with equity with which to pay a dividend and thereby recover its refundable tax. In that circumstance, it can fairly be said that the acquisition of the shares enabled the corporation to obtain a dividend refund.

The CRA's interpretation is essentially a verbatim reproduction of the 1988 technical notes to subsection 129(1.2); those notes do not use the word "enable," which is found in the legislation.

If one moves beyond a textual interpretation, the context of subsection 129(1.2) is very helpful in discerning its meaning. Subsection 129(1.2) was introduced at the same time that subsection 83(2.1) was introduced. The latter provision functions similarly to subsection 129(1.2), but it operates to deny capital dividend treatment if the share was acquired in a transaction or as part of a series one of the main purposes of which was to receive the dividend. Unlike subsection 129(1.2), subsection 83(2.1) contains no enabling condition. However, also unlike subsection 129(1.2), subsection 83(2.1) is regulated by specific exceptions in subsections 83(2.2) to (2.4). Those exceptions help to ensure that the anti-avoidance rule (subsection 129(1.2)) does not apply to circumstances that would be inappropriate from a policy perspective. It seems unlikely that Parliament would have failed to draft similar exceptions to subsection 129(1.2) if it were as broad as one might be led to believe by the technical notes and the CRA's published positions. Instead, it seems reasonable to infer that Parliament believed that similar exceptions were not necessary because, unlike subsection 83(2.1), subsection 129(1.2) imposes the additional "enable" requirement, which arguably prevents that provision from applying in most circumstances that are inappropriate.

A September 25, 1987 Department of Finance press release in relation to subsection 83(2.1) contained an implicit reference to subsection 129(1.2) and provided the following description of the type of transaction that subsection 129(1.2) was introduced to prevent:

> Such arrangements typically involve the issue of shares by a private corporation to a tax-exempt entity or other shareholder that receives ordinary dividends on a non-taxable basis with the main purpose of enabling the corporation to obtain a dividend refund of its "refundable dividend tax on hand"—that is, the portion of the tax paid by a private corporation on its investment income and capital gains that is repayable to the corporation when it distributes its earnings to shareholders. The dividend refund provisions are also part of the mechanism in the Act for integrating the corporate and shareholder tax on distributed earnings. The arrangements against which the new rules are directed seek to arrange the shareholding in such a way as to avoid the shareholder tax.

Unlike the technical notes to subsection 129(1.2), the press release explicitly refers to the "enabling" requirement that is contained in the legislation itself. More importantly, the example in the press release suggests that the rule was intended to prevent a fairly narrow circumstance of trading in RDTOH balances by having a defunct corporation issue shares to a third party, thereby providing the corporation with equity with which to pay a dividend and recover its refundable tax. As a practical matter, such trading will likely occur only if the purchaser of the defunct corporation's shares is a tax-exempt entity or otherwise is not subject to part IV tax on the dividend—although the CRA has indicated that if the purpose test in subsection 129(1.2) is met, that provision "could technically apply" even if tax was paid by the shareholder (CRA document no. 2013-0480361C6, June 10, 2013).

In theory, an existing shareholder might subscribe for new high-low shares of a defunct corporation to enable the corporation to obtain a dividend refund. There is no obvious policy reason why such a step would not be permitted, but nevertheless such a transaction technically appears to be subject to subsection 129(1.2). Alternatively, the existing shareholder could contribute capital to the corporation and then, if necessary, reduce stated capital to permit a dividend to be paid as a matter of corporate law. Because there is no acquisition of a share in the latter situation, subsection 129(1.2) appears to be inapplicable. However, the offensive tax attribute trading aspect is not present in the case of an existing shareholder that enables a dividend refund; therefore, using a capital contribution rather than a share subscription does not seem to offend the apparent purpose of subsection 129(1.2).

Indeed, it seems to make little sense for subsection 129(1.2) to be so broad as to prevent the proper integration of corporate and personal taxes other than in fairly narrow circumstances (as in the above example of trading in tax attributes of defunct corporations), given that such a broad interpretation would frustrate a key purpose of the refundable tax regime as a whole and lead to the interpretive difficulties observed by the court in *Canwest Capital* that are described above. The technical notes confirm this very point by stating that the provision is not intended to interfere with the normal operation of subsection 129(1).

To summarize, ignoring the "enable" requirement appears to be at odds with the text, context, and purpose of subsection 129(1.2). In contrast, if a taxpayer pays attention to the need for an acquisition of shares or a series of transactions in which such an acquisition occurs to "enable" the corporation to obtain a dividend refund, subsection 129(1.2) arguably should not interfere with the normal operation of subsection 129(1) in most circumstances (even if a share happens to be acquired as part of the series), and it will still be effective in preventing the tax attribute trading transactions against which it appears to have been directed.

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