FEDERAL BUDGET 2015:
PROPOSED AMENDMENTS TO SECTION 55

Christopher J. Montes
Felesky Flynn LLP
June 16, 2015

FELESKY FLYNN LLP
TAX COUNSEL

TOPICS

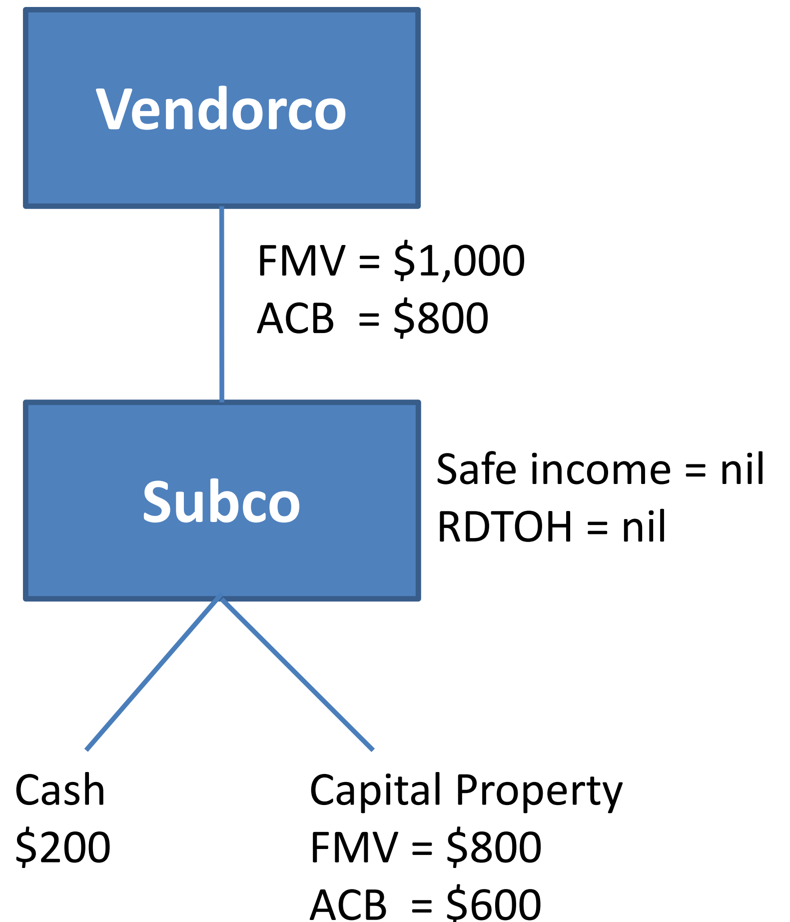
- Subsection 55(2)
- Paragraph 55(3)(a) exception
- Stock dividends
- Cost/ACB rules for stock dividends and PUC increases

SUBSECTION 55(2)

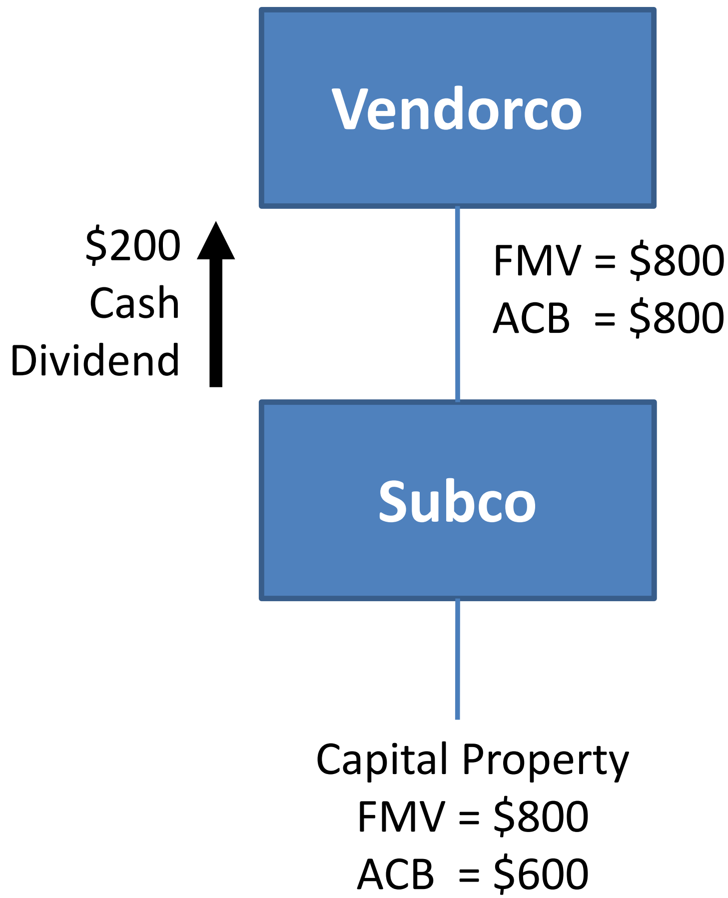
S.55(2) – OLD RULES

- Purpose is to prevent capital gains stripping
  - Converting a capital gain into a tax-free intercorporate dividend
  - Tax-free sales to an unrelated person

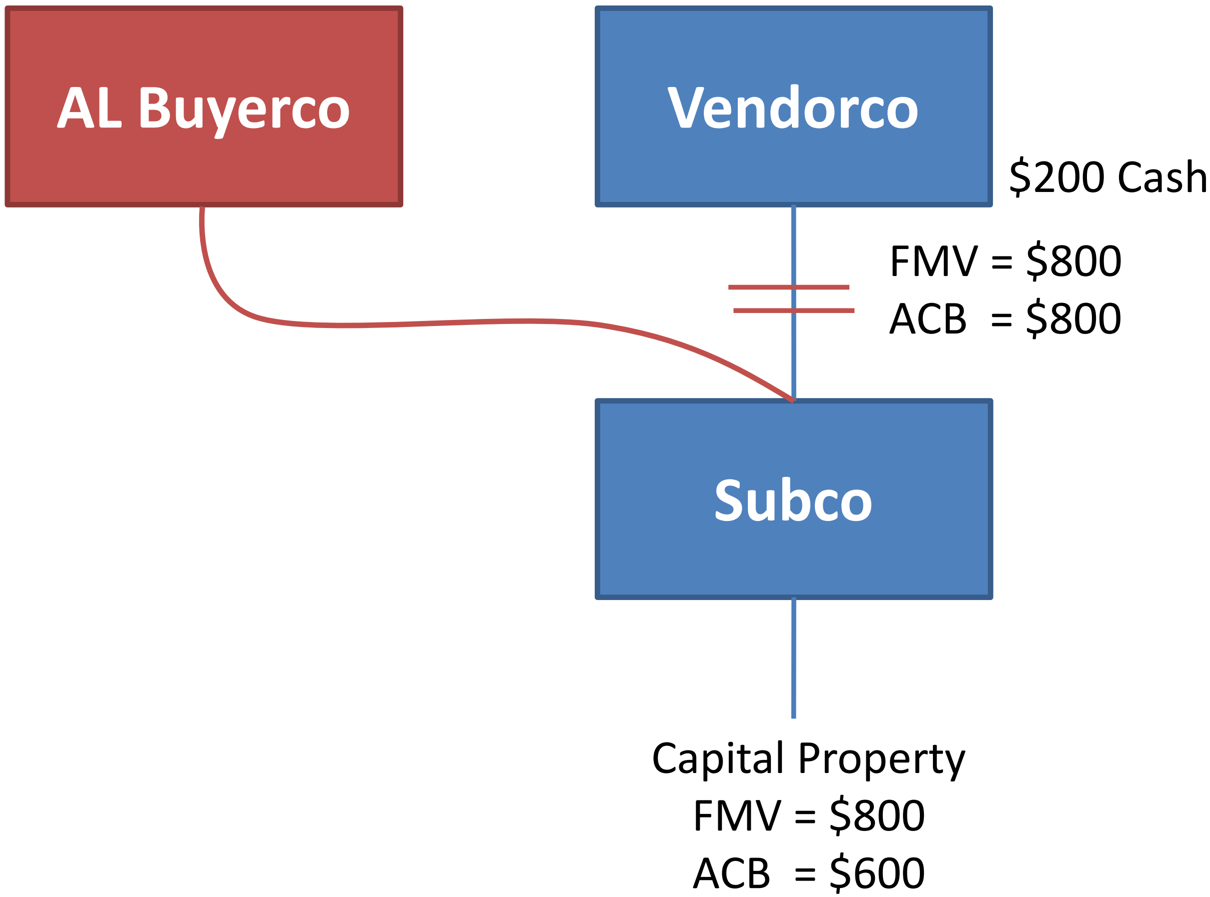
S.55(2) – WHAT THE OLD RULES WERE INTENDED TO STOP



S.55(2) – WHAT THE OLD RULES WERE INTENDED TO STOP



S.55(2) – WHAT THE OLD RULES WERE INTENDED TO STOP



FELESKY FLYNN LLP
TAX COUNSEL

S.55(2) – WHAT THE OLD RULES WERE INTENDED TO STOP

- Similar results could be achieved with either
  - a stock dividend
  - a PUC increase (which results in a deemed dividend)
- Rather than reducing the value of Subco by paying a cash dividend, the intent is to get an increase to the ACB of the Subco shares prior to a sale of such shares

S.55(2) – OLD RULES

Conditions for the application of s.55(2):

- Canadian-resident corporation receives a <u>taxable dividend that is deductible</u> as part of a transaction/event/series
- <u>One of the purposes</u> (or, for a deemed dividend under s.84(3), one of the results) <u>of the transaction/event/series was to effect a significant reduction in the portion of the capital gain</u> that, but for the dividend, would have been realized on a disposition of any share at FMV immediately before the dividend

S.55(2) – OLD RULES

Exceptions to the application of s.55(2):

- If the capital gain is reasonably attributable to safe income realized before the safe-income determination time
- Any portion of the dividend that is subject to Part IV tax that is not refunded as a consequence of the payment of a dividend to a corporation as part of the series
- Related party transactions (para. 55(3)(a))
- Butterfly transactions (para. 55(3)(b))

S.55(2) – OLD RULES

If s.55(2) applies, the result is that the dividend amount is:

- deemed not to be a dividend received by the corporation (para. 55(2)(a))
- if the corporation has disposed of the share, treated as proceeds of disposition unless already included as such (para. 55(2)(b))
- if the corporation has not disposed of the share, treated as a gain from the disposition of a capital property (para. 55(2)(c))

S.55(2) – MAIN CHANGES

- New purpose test (and interpretive rule)
- Results of the application of s.55(2) have changed
- Rewording of safe income exception
- Narrowing of Part IV tax exception

S.55(2) – NEW RULES

- Purpose/result test changes
  - Purpose/result of the <u>payment or receipt</u> of the dividend is considered, not the transaction/event/series
  - <u>New purpose test</u> – if the dividend is received on a share held as capital property and one of the purposes of the payment or receipt of the dividend (other than a deemed dividend under s.84(3)) is to effect
    - a significant reduction in the FMV of any share; or
    - a significant increase in the total of the cost amounts of all properties of the dividend recipient

FELESKY FLYNN LLP
TAX COUNSEL

S.55(2) – NEW RULES

- S.55(2.5) – Interpretive rule
  - Whether a dividend causes a significant reduction in the FMV of <u>any</u> share is to be determined as if the FMV of <u>the</u> share, immediately before the dividend, was increased by an amount equal to the FMV of the dividend received on <u>the</u> share

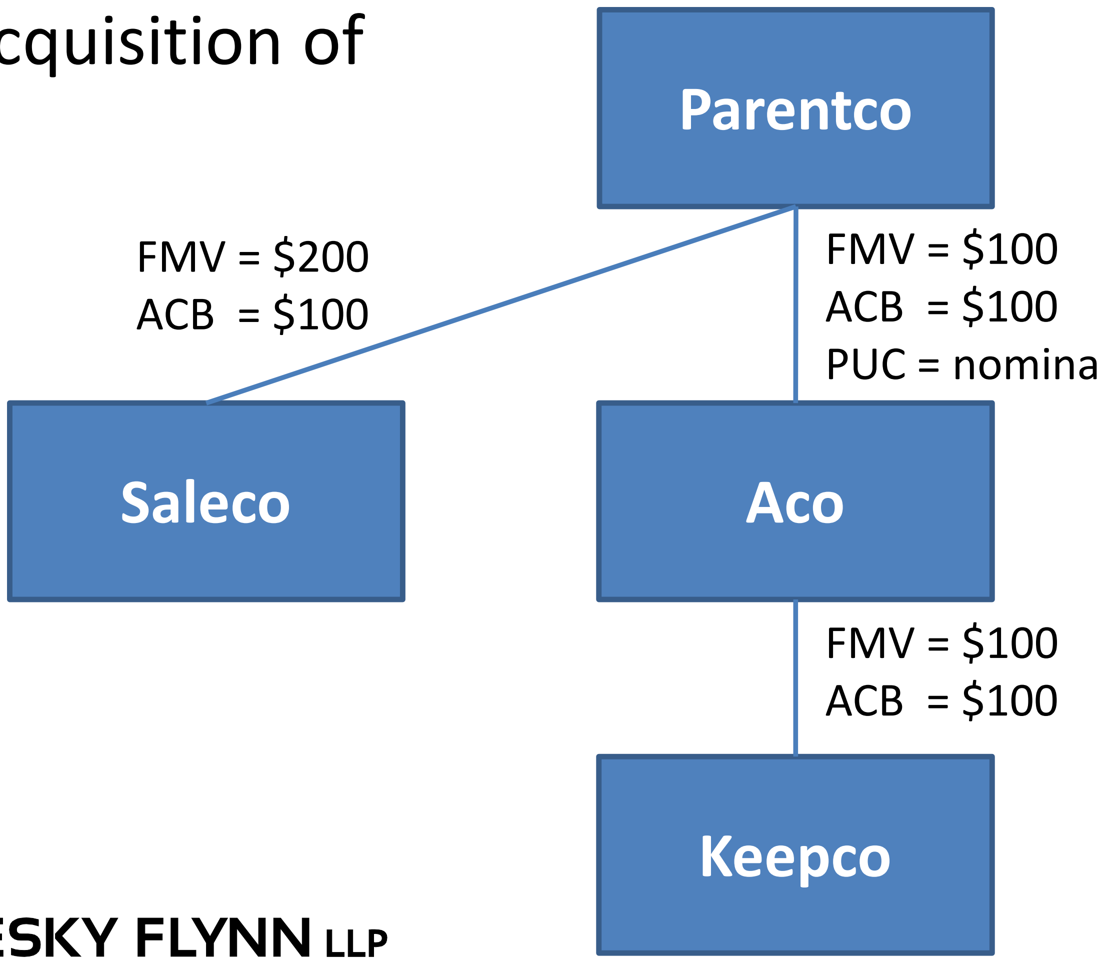
S.55(2) – WHAT THE NEW RULES TRY TO STOP

- The duplicate use of tax cost, facilitated by the payment of a dividend
  - Part of the planning in *D & D Livestock*

FELESKY FLYNN LLP
TAX COUNSEL

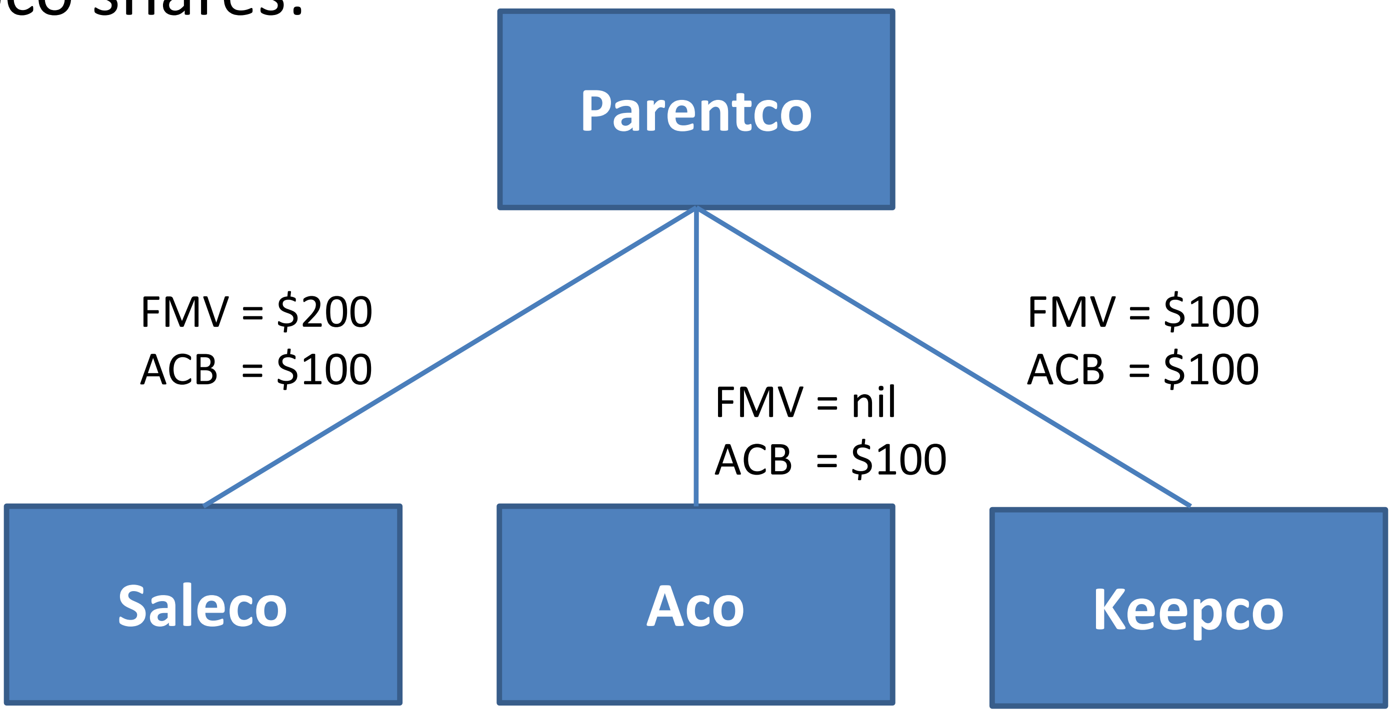
S.55(2) – WHAT THE NEW RULES TRY TO STOP

Initial Acquisition of Keepco:



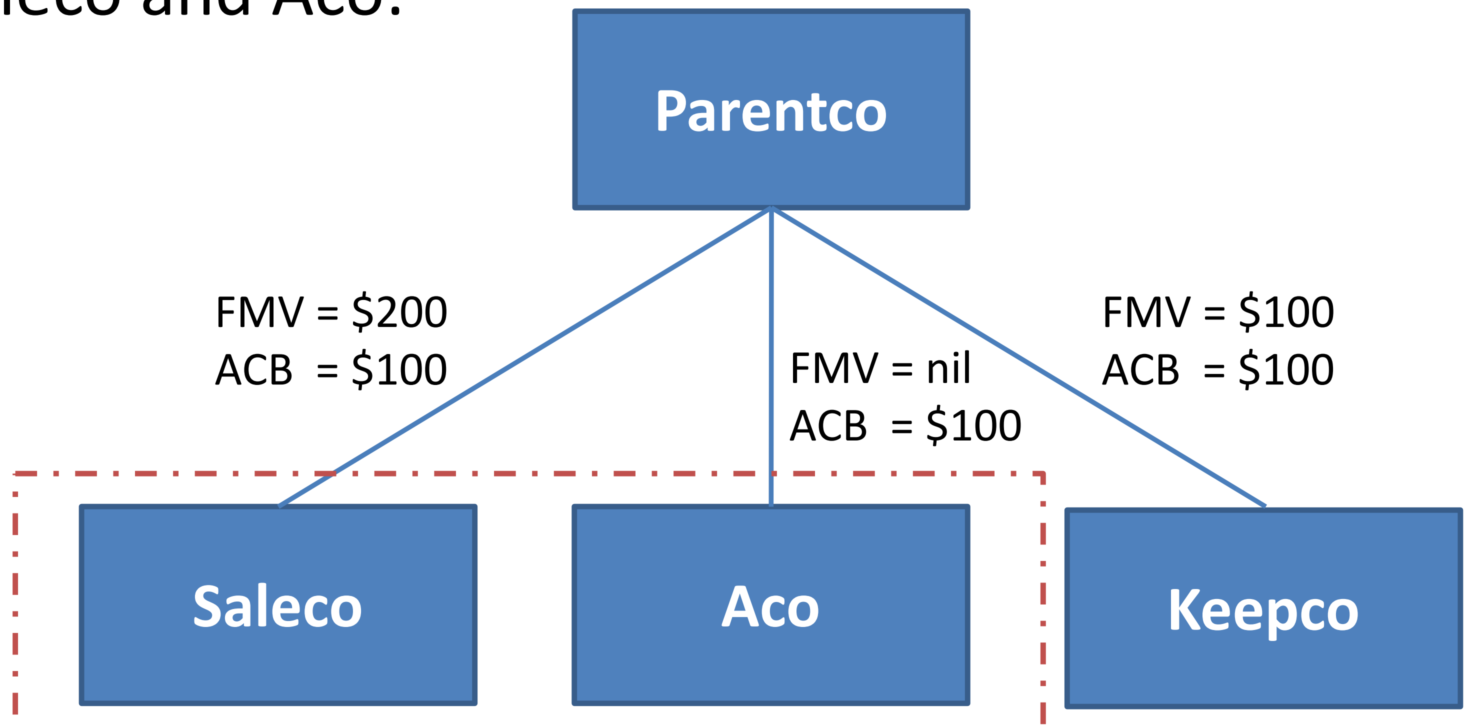
S.55(2) – WHAT THE NEW RULES TRY TO STOP

Dividend-in-Kind of
Keepco shares:



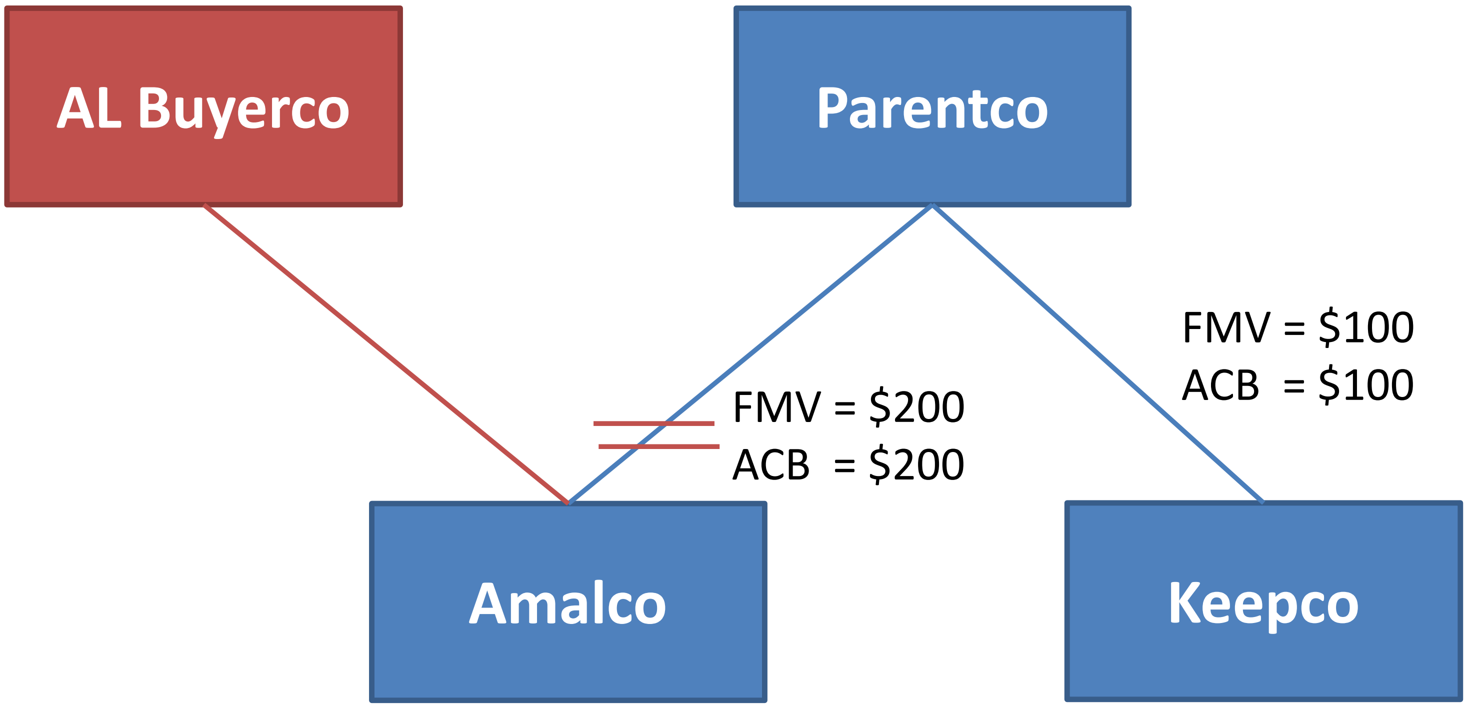
S.55(2) – WHAT THE NEW RULES TRY TO STOP

Amalgamation of Saleco and Aco:



S.55(2) – WHAT THE NEW RULES TRY TO STOP

Sale of Amalco:



S.55(2) – WHAT THE NEW RULES TRY TO STOP

- S.55(2.5) presumably intended to catch situations where dividend > FMV reduction of share
  - *e.g.*, where value of share is nominal before the dividend is paid; dividend sprinkling shares

S.55(2) – POTENTIAL ISSUES WITH NEW RULES

- What is a “significant” reduction in FMV or increase in cost? Which dividends are caught?
- Which share does the fictional value increase in s.55(2.5) apply to?
- If the new purpose test applies, there may be no capital gain – implications for safe income exception

S.55(2) – NEW RULES

- Results of the application of s.55(2) have changed
  - still deemed not to be a dividend received by the recipient
  - regardless of whether the dividend recipient has disposed of the share, the amount of the dividend is treated as a capital gain for the year in which the dividend was received, not proceeds of disposition

S.55(2) – POTENTIAL ISSUES WITH NEW RULES

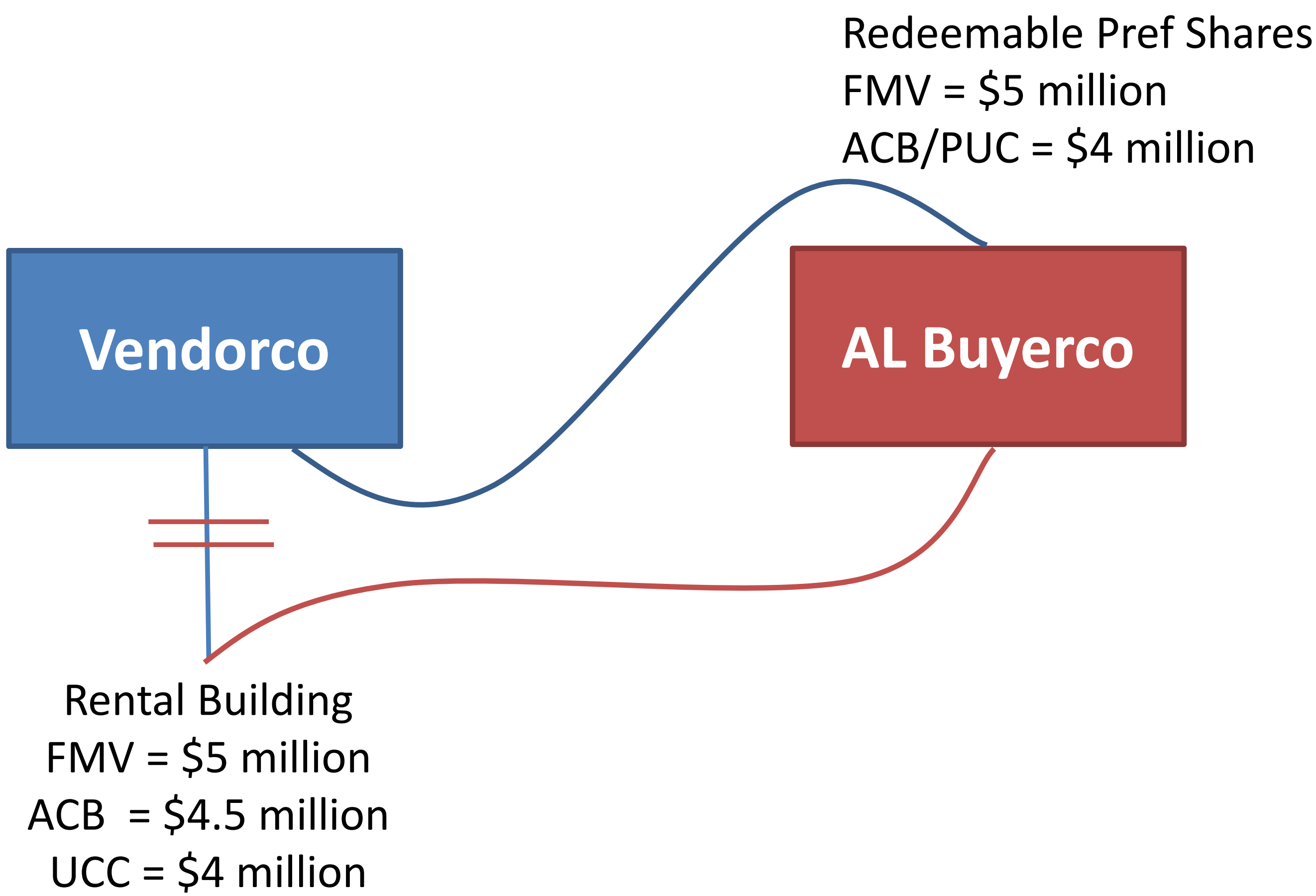
- Potential timing issue – CDA / safe income additions
- Unclear why para. 55(2)(b) was removed
- Over-taxing capital gain on redemption of shares where PUC < ACB
- Double tax on redemption of shares
  - s.248(28) likely solves this problem for the time being

S.55(2) – POTENTIAL ISSUES WITH NEW RULES

Vendorco

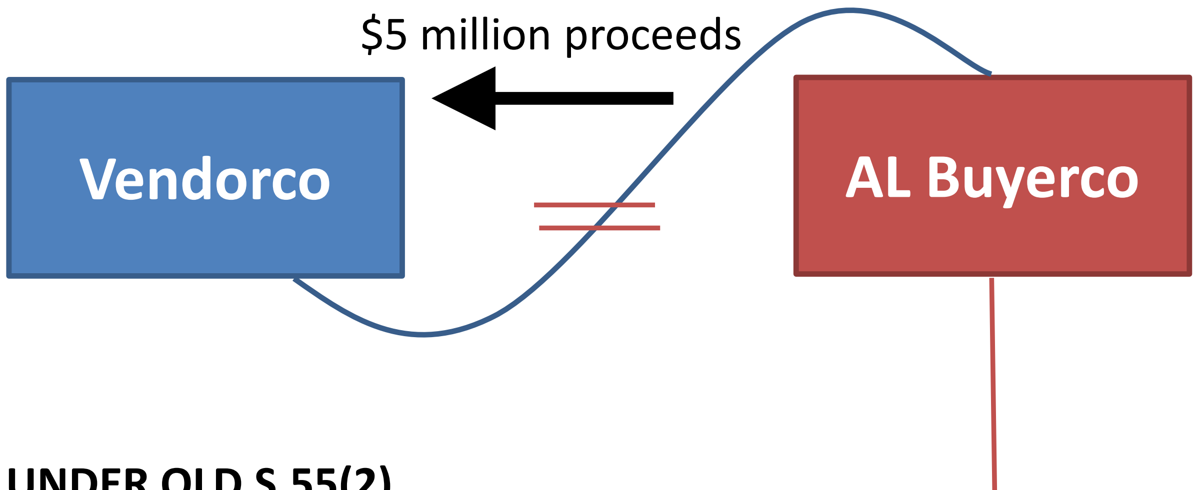
Rental Building
FMV = $5 million
ACB = $4.5 million
UCC = $4 million

S.55(2) – POTENTIAL ISSUES WITH NEW RULES



S.55(2) – POTENTIAL ISSUES WITH NEW RULES

Redeemable Pref Shares
FMV = $5 million
ACB/PUC = $4 million



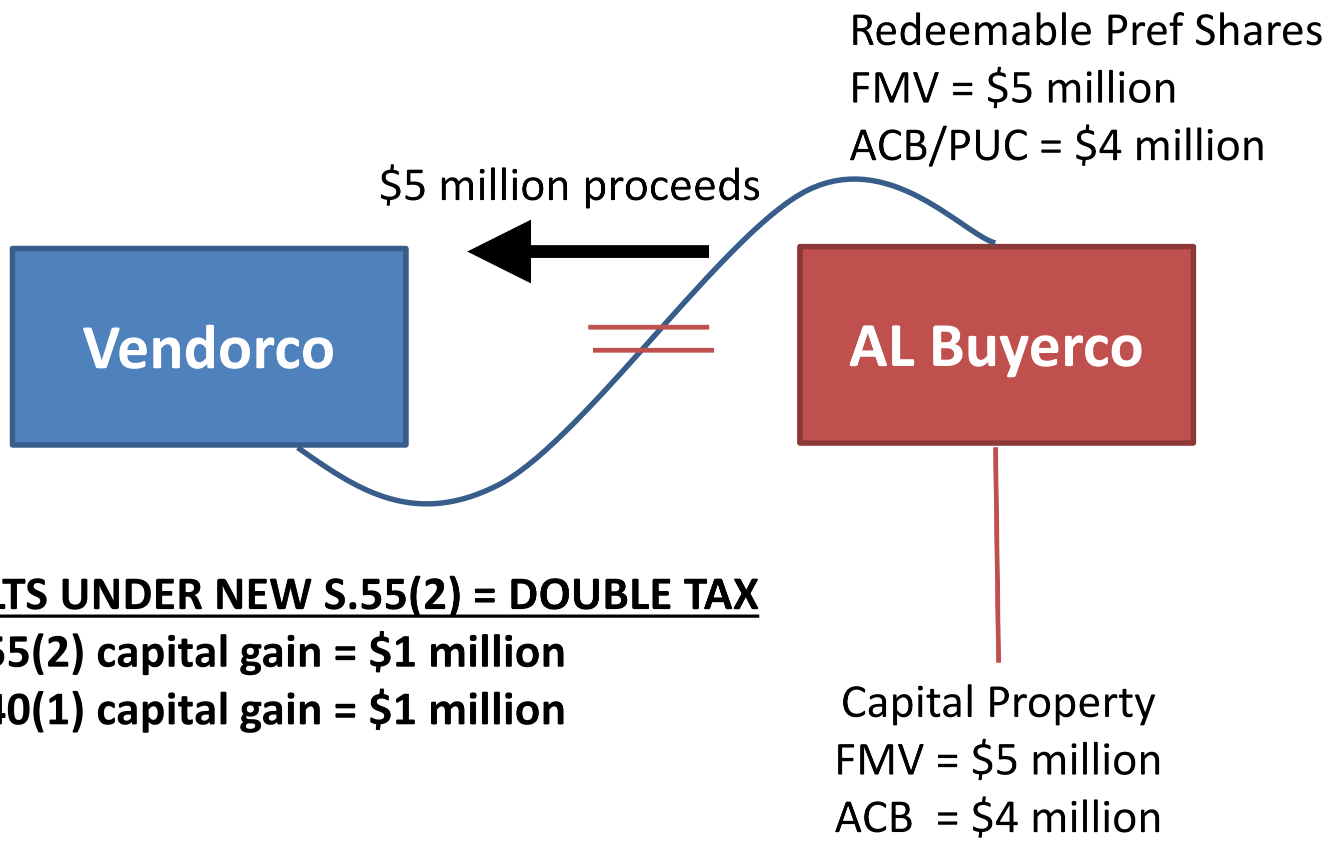
<u>RESULTS UNDER OLD S.55(2)</u>

(1) S.55(2)(b) – no additional proceeds

(2) S.40(1) capital gain = $1 million

Rental Building
FMV = $5 million
ACB = $4.5 million
UCC = $4 million

S.55(2) – POTENTIAL ISSUES WITH NEW RULES



RESULTS UNDER NEW S.55(2) = DOUBLE TAX

(1) S.55(2) capital gain = $1 million

(2) S.40(1) capital gain = $1 million

FELESKY FLYNN LLP
TAX COUNSEL

S.55(2) – NEW RULES

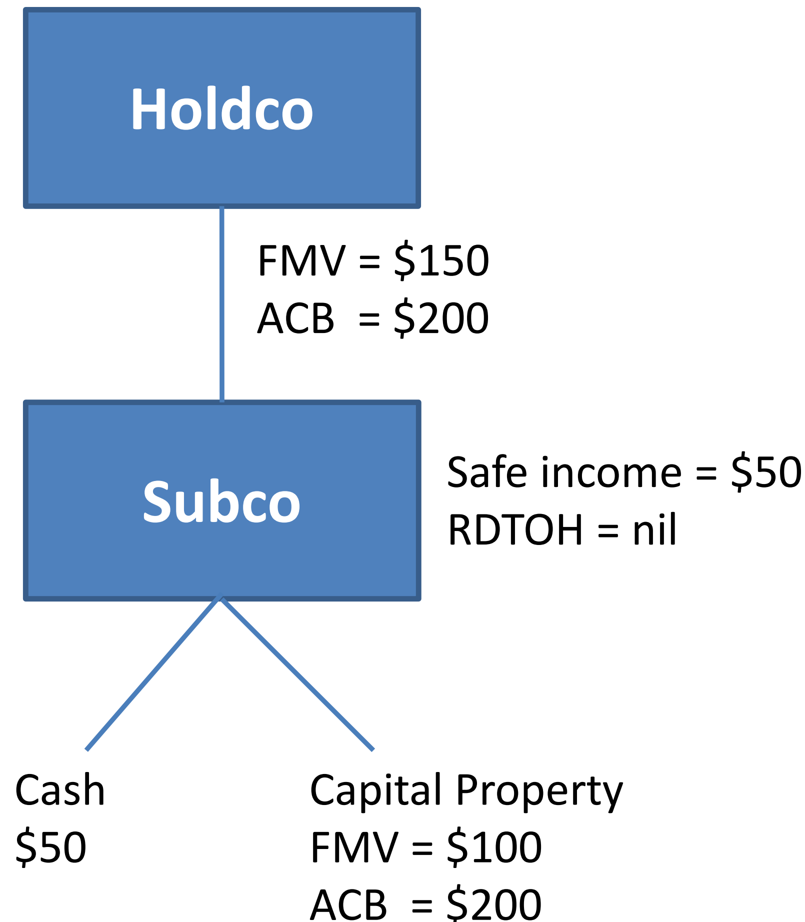
- Rewording of the safe income exception
  - s.55(2) applies if, among other things, the amount of the dividend exceeds safe income that could reasonably be considered to contribute to the <u>capital gain</u> that could be realized on a FMV disposition, immediately before the dividend, of <u>the share on which the dividend is received</u>

FELESKY FLYNN LLP
TAX COUNSEL

S.55(2) – POTENTIAL ISSUES WITH NEW RULES

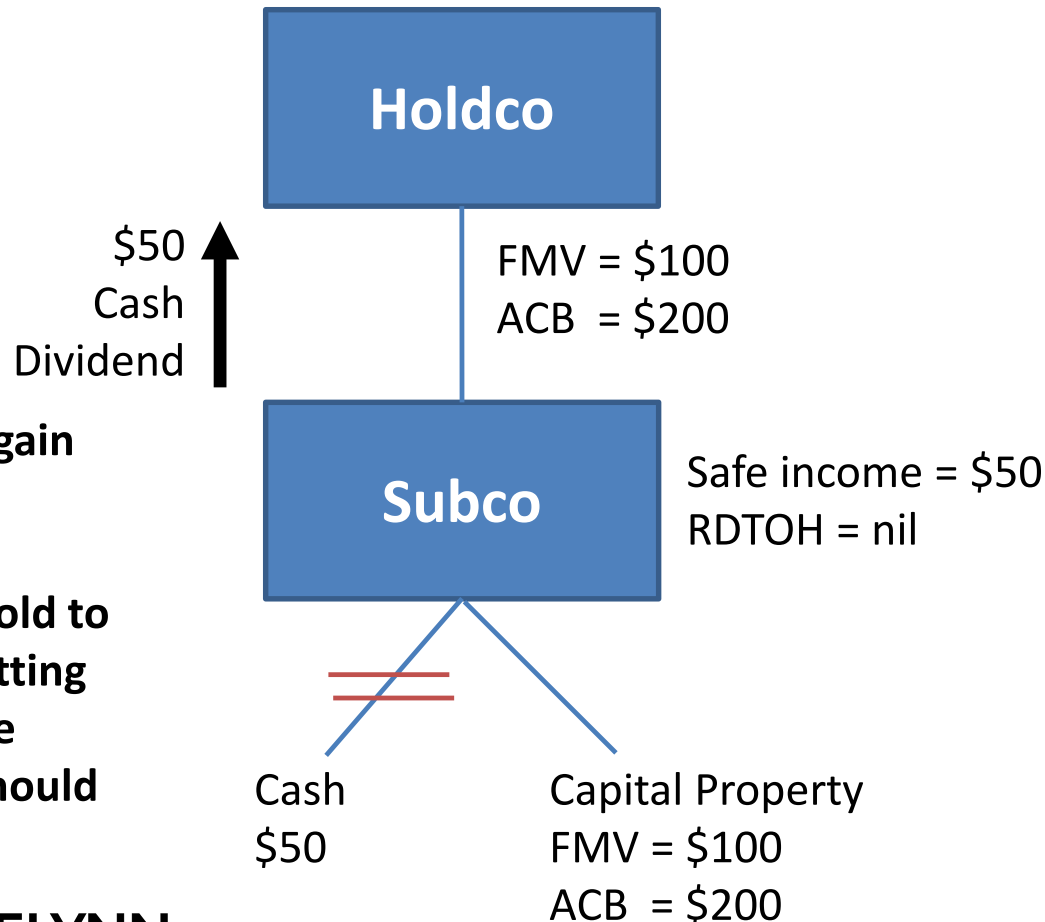
- Change from capital gain on "any share" to "share on which the dividend is received"
- Safe income exception only available if the share on which the dividend is received is in a gain position
  - May get an offsetting capital loss when the share is sold to an unaffiliated party

S.55(2) – POTENTIAL ISSUES WITH NEW RULES



FELESKY FLYNN LLP
TAX COUNSEL

S.55(2) – POTENTIAL ISSUES WITH NEW RULES



<u>RESULT</u>

$50 deemed capital gain under s.55(2)

If Subco shares are sold to AL Buyerco, an offsetting capital loss should be available (s.112(3) should not apply)

S.55(2) – NEW RULES

- Narrowing of the Part IV tax exception
  - Do not qualify if Part IV tax refunded as a result of the payment of a dividend to an individual
- Old: “other than the portion of it, if any, subject to tax under Part IV that is not refunded as a consequence of the payment of a dividend <u>to</u> a corporation…”
- New: “other than the portion of it, if any, subject to tax under Part IV that is not refunded as a consequence of the payment of a dividend <u>by</u> a corporation…”

PARA. 55(3)(a) EXCEPTION

PARA. 55(3)(a) – OLD RULES

- Exception to the application of s.55(2) - applies if none of the events in para. 55(3)(a) occur as part of the series of transactions
- Facilitates transfers of property within a related group

PARA. 55(3)(a) – NEW RULES

- Para. 55(3)(a) now only applies to deemed dividends under s.84(3) (*i.e.*, where a corporation redeems, acquires or cancels its shares)
- It does not apply to dividends actually declared

PARA. 55(3)(a) – POTENTIAL ISSUES WITH NEW RULES

- Not clear why this change was introduced
  - Elimination of tax cost in the shares?
- Creates potential issues for standard transactions
  - Moving cash up a corporate chain
  - Creditor proofing
  - Certain loss consolidation transactions
  - Purification of Opco prior to QSBC share sale
  - Freeze using stock dividends
- Trap for the unwary
- Unnecessary costs on related party transactions
  - Structure as a redemption
  - Greater need for safe income calculations

STOCK DIVIDENDS

STOCK DIVIDENDS – OLD RULES

- S. 248(1) "amount" of a stock dividend generally is the PUC increase as a result of the dividend, subject to certain exceptions
- A stock dividend paid out of safe income only reduces safe income by the "amount" of the stock dividend

STOCK DIVIDENDS – NEW RULES

- S.55(2.2) – for the purpose of applying s.55(2) to (2.4), the amount of a stock dividend and the dividend recipient's entitlement to a deduction is determined as though the amount of the stock dividend were the greater of
  - (i) the increase in PUC as a result of the dividend, and
  - (ii) the FMV of the shares issued as a stock dividend at the time of payment

STOCK DIVIDENDS – NEW RULES

- S.55(2.3) and (2.4)
- IF:
  - the FMV of the stock dividend > PUC increase as a result of the stock dividend; and
  - S.55(2) would apply but for the safe income exception
- THEN:
  - amount of stock dividend is deemed to be a separate dividend to the extent it does not exceed safe income that could reasonably be considered to contribute to the capital gain on a FMV disposition, immediately before the dividend, of the share on which the stock dividend was received; and
  - this separate dividend is deemed to reduce that safe income

STOCK DIVIDENDS – WHAT THE NEW RULES TRY TO STOP

- Value shifts (*e.g.*, *Triad Gestco, 1207192 Ontario, Global Equity Fund*)
- Duplicate use of safe income
  - Hi-lo stock dividends
  - New stock dividend rules would not have applied to stock dividends paid in *D & D Livestock*

STOCK DIVIDENDS – POTENTIAL ISSUES WITH NEW RULES

- S.55(2.3) and (2.4)
  - Safe income reduction does not apply if no capital gain is reduced
  - Not clear when safe income reduction happens
  - Other timing issues
- Effect on stock dividend DRIPs likely not material

COST/ACB RULES FOR
STOCK DIVIDENDS AND PUC INCREASES

STOCK DIVIDENDS – OLD COST RULES

- Para. 52(3)(a) – generally, a corporate shareholder is deemed to acquire a share received as a stock dividend at a <u>cost equal to the amount of the stock dividend that is attributable to safe income</u>
- Before 2013 amendment, it was simply the amount of the stock dividend

STOCK DIVIDENDS – NEW COST RULES

- Para. 52(3)(a) - generally, a shareholder is deemed to acquire a share received as a stock dividend at a cost equal to
  - if the shareholder is an individual, the amount of the stock dividend
  - in any other case, the total of all amounts each of which is
    - the lesser of the amount of the stock dividend and its FMV
    - the reduction of safe income under para. 55(2.3)(b) upon the payment of a hi-lo stock dividend **PLUS** the amount of the deemed gain under s.55(2) as a result of the payment of the stock dividend **LESS** the lesser of the amount of stock dividend and its FMV

PUC INCREASE – OLD ACB RULES

- Para. 53(1)(b) – ACB increase to share equal to <u>dividends deemed received under s.84(1)</u> that are <u>attributable to safe income</u>
- Before 2013 amendment, it was simply the amount of the s.84(1) dividend

PUC INCREASE – NEW ACB RULES

- S.53(1)(b)(ii) – change to match new safe-income exception wording

POTENTIAL ISSUE WITH NEW COST/ACB RULES

- Only get the benefit of safe income if it contributes to a capital gain
- Effect on stock dividend DRIPs likely not material

CONCLUSION

- Changes apply after April 20, 2015
- Related amendments also will be made
- Many technical issues that will need to be fixed by Finance
- Joint committee submission made on May 27, 2015
- From a policy perspective, is Finance trying to do too much with s.55?