BUDGET 2015 – "SURPLUS STRIPPING" ANTI-AVOIDANCE RULE

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Section 55 of the *Income Tax Act* (Canada) (the "**Tax Act**") contains an anti-avoidance rule that prevents a corporation from converting what would otherwise be a taxable capital gain into a tax-free inter-corporate dividend. Section 55 deems a dividend not to be a dividend, but rather a capital gain, where the purpose of the dividend, or its effect in the case of a share purchase or a redemption, is to reduce the capital gain that would otherwise have been realized if the share had been sold for its fair market value. The rule has two important exceptions – it does not apply to dividends that are paid out of taxable income (usually called "safe income") that has been earned by a corporation after 1971 and before the date of the dividend, and it does not apply to dividends paid in the course of a series of transactions or a corporate reorganization where no property or shares are acquired by persons who were not related to the owner of the corporate group before the series of transactions or reorganization.The impact of the rule is best demonstrated by an example. Assume a parent company is about to sell its subsidiary for $1 million at a time when the cost base of the shares is only $600,000. This would ordinarily trigger a taxable capital gain of $200,000 (1/2 of the $400,000 capital gain). If, instead, the parent company causes its subsidiary to pay it a stock dividend of $400,000 before the sale of the shares, the amount of the stock dividend is included in the parent company's income, but then is deducted under section 112 of the Tax Act (effectively making the dividend tax-free). However, the shares received by reason of the stock dividend have a cost base of $400,000, which, when combined with the original cost base of $600,000, results in the parent company having a total cost base of $1 million in the shares of the subsidiary, and these shares can then be sold for the $1 million dollar purchase price with no gain. Provided that the dividend is paid out of taxable income previously earned by the subsidiary, this type of transaction is generally accepted on the basis that the distributed income has been subjected to the taxation regime of the Tax Act; however, to the extent the dividend is attributable to unrealized gains accruing in the subsidiary, the purpose of section 55 is to prevent the distribution of these gains as taxable dividends in the context of the sale of shares or property to unrelated persons.

The current rules to implement this anti-avoidance rule are complex, and the Government has identified the following example where the existing rule is not applicable, but, in the Government's view, should be:

> *Corporation A wholly owns Corporation B, which has one class of shares. These shares have a fair market value of $1 million and an adjusted cost base of $1 million.*

> *Corporation A contributes $1 million of cash to Corporation B in return for additional shares of the same class, with the result that Corporation A's shares of Corporation B have a fair market value of $2 million and an adjusted cost base of $2 million.*
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> *If Corporation B uses its $1 million of cash to pay Corporation A a tax-deductible dividend of $1 million, the fair market value of Corporation A's shares of Corporation B is reduced to $1 million although their adjusted cost base remains at $2 million.*
>
> *At this point, Corporation A has an unrealized capital loss of $1 million on Corporation B's shares.*
>
> *If Corporation A transfers an asset having a fair market value and unrealized capital gain of $1 million to Corporation B on a tax-deferred basis, Corporation A could then sell its shares of Corporation B for $2 million and take the position that there is no gain because the adjusted cost base of those shares is also $2 million.*

To combat this and other types of tax planning, in Budget 2015, the Government announced its intention to amend section 55 of the Tax Act so that it applies not only when a dividend is used to reduce a capital gain on a share disposition, but also when the effect of the dividend is to cause a significant reduction in the fair market value of any share, or a significant increase in the cost base of any property.

As indicated above, the existing anti-avoidance rules in section 55 do not apply if the dividend in question is paid in the course of a series of transactions or a reorganization that does not result in a person that was unrelated to the dividend recipient receiving a transfer of property or a greater interest in a corporation. However, the proposed amendments announced in Budget 2015 will also result in the exception for related party transactions being limited to only those dividends that arise from the purchase, cancellation or redemption of shares. The Government did not explain why it is now proposing to prohibit cash or stock dividends being part of a related party reorganization.

Generally, when a corporation pays a stock dividend, the amount of the dividend is considered to be the amount that is added to the stated capital of the corporation as a result of the stock dividend. Under the existing rules, a corporation could issue a stock dividend with a high fair market value, but a low taxable dividend amount, by issuing a share with a high redemption value, but only adding a small amount to the stated capital account of the corporation maintained for the stock dividend share. Such shares, frequently referred to as "high-low" shares, allow a corporation to defer the taxation of the value of a stock dividend until the shares are redeemed or sold. While the proposed amendments will still allow for the issuance of "high-low" shares, for the purposes of applying certain provisions of the anti-avoidance rule in section 55, the amount of the stock dividend will be deemed to be the greater of the fair market value of the shares issued as a stock dividend and the amount of the increase in paid-up capital arising from the stock dividend.

The proposed amendments, if enacted, will apply to dividends paid after April 20, 2015.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.