CORPORATE TAXATION

TAX TREATMENT OF PARTNERS AND PARTNERSHIPS

- Partnership is not a person however, income is calculated as though it were.
- Income calculated at the partnership level and then allocated to the partners annually (partners then pay tax on their share of the partnership as income earned) – **conduit approach** (ie calculate income as if partnership were a separate person and then allocate to partners – income flows through and tax at the partner's level)
- Transfer of property to and from the partnership is treated as if partnership were a separate entity from partners (non-conduit approach – historical note: seems to have been done this was for administrative simplicity when the ITA was drafted)
    - **Section 97(1)**: basic rule for transfers to partnerships – provides that any transfer from a person to a partnership is a disposition of property for tax purposes. Note however three rollover rules (tax deferral – transferor steps into transferer's shoes) in 97(2), 98(3), 98(5)
    - Note: **s 96(2)**: when person disposes of property to person then deemed between two people
    - Wrt to property, no partner has a direct interest in any particular asset

In most cases, transfers to and from partnerships are tax-deferred:
– Transfer to partnership under subsection **97(2):** permits a tax-deferred transfer to a partnership by a person if that person receives a partnership interest in consideration for the transfer (these are similar to 85(1)); – Winding-up of partnership under subsection **98(3)**: provided that members receive at dissolution then can receive the property as a member but the tax wont be imposed until the partner disposes of the proeprty**;** or– Dissolution by operation of law under subsection **98(5)** applies when the partnership has only one member left and that one partner (following dissolution) continues to carry on the business – will simply be accrued gain to the partner)
→However, transfers to and from partnership are taxable if conditions are not met.

- Partners own a *partnership interest*—which is separate from the underlying partnership assets—and may be acquired/disposed of in same manner as shares in a corp.
    - Adjustments to cost base of partnership interest to preserve conduit approach of income taxation as earned through the partnership – adjustments designed to ensure that income/loss is taxed once in hands of partners and not again on disposition of partnership interest.
- Rationale is largely simplicity as can examine transactions for the perspective of one person rather than each individual (also historically, partnerships preceeded the ITA)

Advantages & Disadvantages of Partnership Taxation

- Advantages: partners receive benefit of flow-through losses which can be deducted against other income earned by the partner outside the partnership (particularly useful at the start-up phase); taxation only once (whereas with corporations one level of taxation is not necessarily the case between corporations and SHs); tax-free rollovers are generally more readily available on transfer of property from partnership to partner than corporate property transfer to SHs; ss 98(3) and 93(5) useful on dissolution; flexibility in how allocate income (as oppose to corporations where very specific classes of SHs)
- Disadvantage: partnership is not entitled to preferred tax rates on active business income or manufacturing and processing profits; more difficult to defer income (with corporation can defer by simply not providing dividends)

Generally 4 types of partnerships: (i) limited partnership; (ii) Canadian partnership; (iii) professional partnership; and (iv) specified investment flow-through partnership (SIFTs)

1. Limited partnerships taxed for the most part like general partnerships: two notable exceptions: (i) **s 96(2.1)**: "limited partnership losses" ["at-risk" rule] added to ITA to preclude a limited partner's ability to deduct losses in excess of his capital "at risk" in the partnership (develop to counteract certain aggressive tax shelter schemes (people were generating tax losses where there were no real economic losses) and (ii) **s 53(1)(e), 43.11** (**??????)** – causes to realize a capital gain where the ACB goes negative
    a. A lot of limited partnerships in real estate due to 97(2): allows transfer of land to a partnership on a tax deferred basis
    b. Also seen where have a tax-exempt investor
2. "Canadian partnership" is defined in **s 102(1)** as partnership where all members are residents of Canada. Important because rollover provisions for the transfer of property to and from a partnership are only available to Canadian partnerships. Note also, GST definition is different than the definition in the ITA
3. Professional partnerships are in **s 34** (though not defined in the act) – essentially one where computes income without reference to its work-in-progress (as oppose to businesses)
4. SIFT defined in **s 197(1)** as a Can-resident partnership that holds "non-portfolio property" (defined in 197(1)) where investments in the partnership are listed for trade on a stock exchange or other public market. Dividend treatment is applied to income from the non-portfolio properties of a SIFT (see 197(2) and 96(1.11)).
    a. Idea is to capture publically traded limited partnerships that are being used as a substitute for public corporations. Prior to 2008 people were trading this way instead because more tax efficient not to have corporate level of taxation – therefore people were converting into partnerships to increase value of shares due to increase cost of taxation → lead to creation of SIFT definition (therefore not really used anymore)

What is a Partnership for the purposes of the ITA?: See Appendix, Tax Folio S4-F16-C1

Handout #2: Taxation of Income or Loss Realized through a Partnership

- Under conduit approach, intermediaries (such as corp or partnership) are ignored

- Actual distribution does not affect allocation of income for tax purposes
- Why is a partnership not a taxpayer?: not a "person in 248(1) and "taxpayer" only applies to persons

When does **96(1)** apply? Where a person is a member of a partnership

(a) requires partnership to compute income as though person resident in Canada
(b) sets taxation year as its fiscal period
(c) requires partnership to calculate capital gain and allowable capital loss from the disposition of property and (ii) income gain and loss from other sources
(f) deems the partner to have earned income from the sources that the partnership earned the income (that is then allocated to the partner)
(g) mirror to (f): same thing but wrt losses

Calculation of Tax Credits

118.1(8): deems any charitable donation made by the partnership as allocated to an individual partner to have been made by the partner (done because donations have a tax credit; since the partnership doesn't have any tax there is nothing that the partnership could use this against. Also, because the tax credit is allowed as a percentage payable to maximum of 75%, then at partnership level then a partner who has losses could actually be claiming more credit then they actually have income to credit against)
110.4: does the same thing but with corporations. Little bit less important here because donations to corporations are a deduction rather than a credit
127(8): does the same thing with other tax credits that would be realized by the partnership

Taxation Year

Section 34.1(1): provides method fro calculating an individual's income for the year where part of the income is derived from a business that has a non-calendar fiscal year. Essentially requires to make a contribution based on expected income
Section 34.2(1): provides method for calculating a corporation's income from a partnership where they have different year ends and where the corporation has "significant interest" (ie more than 10%) in the partnership

→ in both cases the effect is to prevent tax deferral

Handout #3: The Partnership Interest

- Interest in the partnership is considered property separate from the assets of a partnership
- Partnership interest may be disposed of with the difference between the proceeds of disposition and the ACB and expenses of disposition giving rise to a capital gain/loss.
- The property of a partnership is owned by the partnership, not the partners and any gains or losses on the disposition of that property are included in the net income of the partnership.
- Partnership interest is similar to a share. It is generally capital property

Question 7: X acquired a (general) partnership interest in XYZ partnership for a $10,000 cash contribution. The fiscal period of the partnership is January 1 - December 31. For the 2015 fiscal period (January 1 - December 31, 2015) of the partnership, X's partnership account reads as follows.

Business income share	30,000
Taxable capital gain	7,500
Share of capital dividends received	5,000
Charitable donation share	5,000
Withdrawals	10,000

(a) What is the ACB of X's partnership interest as of December 31, 2015 and January 1, 2016?
(b) What if X is permitted to make $75,000 in withdrawals for the 2015 fiscal period?

Answer: so on Dec 31 changes are going only wrt things that will hit immediately: CDivi (53(1)(e)(ii)) and W (53(2)(c)(v)). BI, CG, CD hit after.

December 31: ACB (10,000) + CDivi (5,000) – W (10,000) = 5,000
Jan 1: ACB (new = 5,000) + BI (30,000) + CG (15,000 (7,500/.5)) – CDon (5,000) = $45,000

- incentive to sell partnership units absent 96(1) on Jan 1.

Part 2: Negative ACB

- **Section 40(3) and 40(3.1)**: ACB may be a negative amount for partnership interest (negative ACB wrt all other capital property is deemed to be a capital gain at the end of the year in which it arises, even if there is no actual disposition of the property at the time.
- December 31: -$60,000; Jan 1: -$20,000
- Therefore if X were to sell on Jan 1, would realise a capital gain of $20,000 even if interest sold for nil. If sold for $10,000, we would have a $30,000 capital gain
- Note: if X was a limited partner, on Dec 31, there would be a deemed capital gain of $60,000 and the ACB would stay at 0 – would then have a positive ACB on Jan 1. (take away: make sure you time your withdrawals so that you always have ACB)

Question 8

Assume that X disposes of his partnership interest to A on July 1, 2016 for $75,000. At the time of the sale X's share of the partnership business income for the 2016 fiscal period was $15,000. On the basis that all other facts are the same as set out above (including a $10,000 withdrawal prior to this date), what are the income tax consequences of the sale?

- Under 53(1)(e)(i), that income does not get allocated until the fiscal year end. Therefore the 2016 income to date will not get added to the ACB before the sale. Therefore there would be a $30,000 capital gain (75 – 45).
- However **96(1.01)** – special deeming rule: deems X to have received the $15,000 income and in respect of tax, the fiscal year will end immediately before the sale. Therefore does get added to 53(1)(e)(i) – reduces capital gain to $15,000.

Handout #4: The Corporation as a Separate Taxable Entity

- "Taxpayer" defined as person whether or not liable to tax and includes a corporation → unlike a partnership, corporation is a taxpayer for ITA purposes and income earned/loss, and property transfers are calculated as such
- Two similarities between individuals and corporations: (i) income taxed on the basis of residency, and (ii) tax period is a taxation year (however difference **249** defines taxation year for a corp as "fiscal period" (defined in **249.1(1)**)
- Different tax rate to individuals; taxed a second time when distributed to a SH → subject to 2 levels of tax (unlike partnerships)
- Losses can only be deducted at the corporation level – don't flow-through to SHs (also unlike partnerships)
- **248(1)**: "taxpayer"; "person"
- **"tax incidence"**: the person who is actually being taxed in the end. 4 people who can bear the incidence of tax: (i) SHs (lower rate of return); (ii) EEs (lower wages); (iii) owners of the natural resources (lower return); and (iv) the consumers (higher prices)
- Disadvantages: In Canada we are a small import – foreign investors are simply chasing a rate of return so if the corporate tax eats in to return such that they can obtain a higher return by doing that thing somewhere else, then they will just do that somewhere else. Also, global competition means there is really not much room to increase → point is that increase in corporate taxes typically doesn't result in the same increase in revenues as expected (however this doesn't result as much wrt owner-manager)
- Advantages: difficult to determine who is a SH at any point in the year (though relatively easy with a private corp – trickier with a public corp); could earn all income through a corp and be able to defer until need to pull; public perception; limited liability for corps is a benefit conferred by the government and corporate tax is a means of clawing back liability (weak justification bc the LL benefit is actually enjoyed by the SHs not the corp – also not a great rationale for taxing income bc those that are making losts fo income are unlikely to need LL – if anything this seems to be an argument in favour of taxing SHs); corporate tax can be seen, if structured correctly, as just a tax on the rate of return on capital that's above what you call a "safe" rate of return on capital – however this isn't strongest rationale given that corp can still move if can get more elsewhere)

1 or more of the following approaches typically taken wrt taxation of income earned through corp:

i. taxed only when distributed to SHs or when SHs dispose of their shares, with the accrued gain representing retained income.

ii. taxed in the same manner as a partnership, with income calculated at the corporate level and allocated to SHs to be taxed in their hands.

iii. SHs could be taxed only on actual distributions of corporate income as well as accrued gains on shares held in the year.

iv. Income tax could be imposed on the corporation only, with distributions to SHs ignored

v. Income could be taxed as earned in the corporation and again on distribution to SHs without any integration of the two levels of tax ("classical system" US method – similar to Canada pre-1971)

vi. tax could be imposed on income as earned in a corporation and again when distributed to SH, but with a credit for tax paid at the corporate level on behalf of the SHs. (Canadian method – essentially corp tax is like a withholding tax on the SH)

Policy: Why tax Corporations?

- Any tax on a corporation is ultimately being born on individuals → corporations are not "real people" → "tax incidence": looking fot the actual person who is actually bearing the economic impact of a tax. 4 persons that bear corporate tax:
  1. SHs through a lower rate of return
  2. EEs through lower wages
  3. The owners of the natural resources in the countries that impose that tax, in the form of a lower return on those natural resources
  4. Customers in the form of higher prices

Handout #5: Classification of Corporations

- Several ways to classify: "closely-held" vs "widely-held" share ownership; resident vs NR; if CH, active vs passive business income
- Implication of corporate tax: Corporation is taxed at corp rate regardless of the status of the SH - can be big impact where low income person - also if corp losses to corporation, then the losses to the corporation are not going to go against the income of the individual who might be funding it (will be considered capital losses)

Common element to all is whether the corporation is a **resident** or not.

1. Statutory deeming rule **- s. 250(4)(a):**
   - If a corporation was incorporated in Canada after April 26, 1965, then deemed to be resident corporation for each year subsequent to the date of corporation
     - Exception: if the corporation is continued into another country (essentially tax inversion)
   - **250(c)** - if incorporate before or on April 26 1965, then in addition to being incorporated way back then, it must satisfy one of 2 requirements: (i) at any time since was a resident under common law test or (ii) if it ever carried on business in Canada – trigger test. Once pulled, forever deemed as such
2. Common Law Test – *De Beers'* **"central management and control" test**
   - The Court tries to adopt the common law test for individual to corporations in a modified manner: suggests asking where the central management and control of that company exercised – generally look to where the board of directors meet and make decisions about corporate policy
   - If someone else is making the key decisions, then courts have looked beyond the boards (also applied to trusts)

Six major types of corporations:

i. "public corporation": defined in **s 89(1)** as:
(a) R at the same time that shares are listed on a designated stock exchange in Canada,
(b) R any time after 18 June 1971 and
(i) before 1971 elected to be a public corporation, OR
(ii) was designated to be a public corporated by minister at least 30 days before that time it became resident (after 1971) and complied with conditions in (i)
unless after the designation it ceased to be a public corp based on (c)
(c) essentially will be a pub corp if (a) or (b) UNLESS:
(i) elected not to be before the prescribed time (that being the time it would have become a pub corp) (election requirements are in the regs – something about 150 SHs) OR
(ii) at least 30 days before the particular time it was designated by the Minister to not be a pub corp
AND in year where become a public corporation, is deemed to have been so from the beginning of the year (if it so elects)

ii. "private corporation": (*de jure*) defined in **s 89(1)** as: R at particular time, not a public corp, not controlled by any public corp(s) or fed Crown corps. (a) if private at start of 1972 tax year and uninterrupted thereafter, **deemed** to have become a private corp at the end of 1971, AND (b) if incorporated after 1971, and private since, then **deemed** to have last become a private corp immediately before incorp

iii. "non-public/non-private corporation": if controlled by a public corporation but not itself a public corporation (same rules apply except that if there sia a provision that states that something only applies to a private or public corporation but can still be a Canadian corporation and a taxable Canadian corporation)

iv. "Canadian corporation" **s 89(1)**: R and (a) incorporate in Canada, or (ii) was resident in Canada since 18 June 1971. Note: if a merger, then by (c) and (d), only a CDN corp if the reorganization took place under Canadian laws, and each of the corps was a Canadian corp before the reorganization

v. "taxable Canadian corporation" **s 89(1)**: (a) Canadian corp, and (b) not exempt from by statutory provision (other than 149(1)(t)) from tax under this Part (Part I)

vi. "Canadian-controlled private corporation": defined in **s 125(7)**: private + Canadian corp, other than (a) if controlled directly or indirectly in any manner whatever by one or more NR persons, public corps, or corp described in (c); (b) if each share of the capital stock that is owned by any of NR, pub corps or (c)s were considered to be owned by particular person, would be controlled by that person; (c) if any class of shares is listed on a designated stock exchange; or (d) (see statute… refers to several other sections)

Classification based on concepts of control and residence. Control can be either:

i. *de jure*: control based on the legal rights of particular persons – interpreted to mean sufficient ownership of shares to elect the majority of the BOD (ie ultimately in control of the corp); "controlled" (not defined in the Act)

ii. *de facto* (**s 256(5.1)**): looks at facts other than ability to elect majority; "controlled directly or indirectly in any manner whatever"

Section 251(5) "Control by related groups": for purposes of **definition of CCPC**, **(b)** provides that where a person has a right (with exceptions):

(i) to (or to acquire) shares in corp or to control voting rights of those shares, deemed to have the same position wrt control as if owned shares at time
(ii) to cause a corp to redeem/acquire/cancel any shares owned by other SHs, wrt control of corp, deemed to have this position
(iii) to (or to acquire or control) voting rights in respect of shares, deemed to have same position wrt control as if could exercise those voting rights
(iv) cause reduction of voting right wrt shares owned by other SHs, deemed to have same position wrt control as if voting rights were so reduced at time

- Purpose of 251(5)(b): important for *de jure* control - quite narrow (more narrow than *de facto*) because only applies for determination of if a **CCPC** or if **two corporations are related**. Deems options to acquire shares, to cause a redemption of shares, or to exercise another person's voting rights, to have been exercised for the purposes of determining relatedness or

CCPC. Rationale: absent this rule you can get into avoidance behaviours by using options (Ex. could have a CCPC with only one SH who is an employee of target corporation, and target has option to buy for nominal amount – effect is that really they have control bc could fire the EE or exercise the option – want to treat as related). → Note Exception: applies to options that exist only because of the death, disability or bankruptcy of the SH (reason is bc these kinds of options are in almost every SH agreement – would mean that all these corps would be deemed controlled by all the SHs)

- How does this tie into *de facto* control?: they are complementary – driving at the same thing – where rights are tantamount to have control. Reason have these rules is that relatedness turns on de jure

Vineland Quarries & Crushed Stone Ltd v MNR ([1966] Ex CR 417): ***de jure*** control: a person who controls a particular corporation will be considered to control all other corporations controlled by the particular corporation (ie "control" includes both direct and indirect control). [35] "In my view the word "controlled",… in fact, brings about a control by virtue of majority voting power, no matter how that result is effected, that is, either directly or indirectly."

Parthenon Investments Ltd v R (97 DTC 5343): corporation is controlled by the person who controls any parent corp; ignores mid-tier control. In response, Parliament enacted **Section 256(6.1)** to modify this rule: a chain with a Canadian corp at the bottom, a NR corp in middle, and a Canadian parent on top is considered to be "controlled" by a NR (therefore will not be a CCPC). Must look at every corporation up the chain → must be at every level

Corporate Residence:

- Residence of corporations important to determine if taxable in certain countries.
  - For **non-res**, could still potentially be taxed but it would be **a source-based** taxation.
  - If it's active business income, one set of rules, if investment income, another set of rules.
- Other reasons why residence also relevant:
  - To determine applicability of tax treaty. Ties in to first two reasons, but one of the critical issues to be determined is if a person is res in one country or another. Whether resident in both countries based on domestic laws of each country. If res in both, maybe some tie breaker rules.
    - Sometimes corporations resident in country with which Canada not have a treaty. Then no tie-breaker rule.
  - Last reason: foreign affiliate rules. Near end of semester get to complex set of rules. Apply where Canadian SHs control corporations res outside Canada. Those corporations referred to as foreign affiliates if all rules apply.

History of Residence for Corporations:

- Corporate res used to just be **common law rule**. Residence of corporations, leading case is ***De Beers*** from UK. UK still doesn't have a statutory residence rule.
- De Beers rule: **central management and control** (CMC) (or mind and management). Where the actual business and carried out. Courts used to say CMC was where directors reside. Then cases would say where directors hold their meetings. Now with modern communication and transportation, you'll typically say CMC is where directors make their decisions. Still hard to determine where decision is made esp if people from different countries conference call and a decision is made on the call.
- Swedish Railway case (HL): Like an individual, a corp may have more than one residence. In today's context, may well be that corporation could be resident in all of the different countries where the directors all live. Not much jurisprudence on this, Don doesn't think it's a burning issue.
- In 1960s, Canadian government (specifically the tax authorities) thought that CMC rule was easily manipulated. Corporations could just put people in certain countries. Dept of Finance in 1965, brought in statutory rule to augment the CMC rule: **s 250(4).**

Taxation Notes:

Determining the Residence of a Corporation of Trust

- As with the determination of the residency of individuals, there is a common law test and a statutory deeming rule
- Unlike test for individuals, will typically start with the statutory deeming rule

Corporations

3. Statutory deeming rule - s. 250(4)(a):
   - If a corporation was incorporated in Canada after April 26, 1965, then deemed to be resident corporation for each year subsequent to the date of incorporation
     - Exception: if the corporation is continued into another country (essentially tax inversion)
   - 250(c) - if incorporate before or on April 26 1965, then in addition to being incorporated way back then, it must satisfy one of 2 requirements: (i) at any time since was a resident under common law test or (ii) if it ever carried on business in Canada – trigger test. Once pulled, forever deemed as such
4. Common Law Test – *De Beers'* **"central management and control" test**
   - The Court tries to adopt the common law test for individual to corporations in a modified manner: suggests asking where the central management and control of that company exercised – generally look to where the board of directors meet and make decisions about corporate policy
   - If someone else is making the key decisions, then courts have looked beyond the boards (also applied to trusts)

Practice tip:

- Where located but more importantly where the board is making decisions
- Generally speaking then residence of the individual board members and shareholders is not important. This being said, the residence of the shareholders can be important as well (will discuss later on in the course) – if you are a Canadian controlled private corporation there are several significant taxes accorded to you as you will generally qualify for the small business deduction
- With private therefore need to also look at who are the shareholders and who controls the corporation

Note about tie-breaker treaties

- OECD – model treaty: tie-breaker is "place of effective management" which is essentially the same as our central management control rule
- US – doesn't like this tie-breaker rule and have insisted that the rule be the place of the corporation because easily determined and less open to interpretation and methods of trying to get around it

Income Tax Act:

- **S. 248(1) "corporation incorporated in Canada"**: includes a corporation incorporated in Canada before or after it became part of Canada

- **S. 250(4)**: statutory deeming rules (see tax notes above)
- **S**. **250(5)**: "Deemed non resident [by treaty]": Notwithstanding any other provision of this Act (other than paragraph 126(1.1)(a)), a person is deemed not to be resident in Canada at a time if, at that time, the person would, but for this subsection and any tax treaty, be resident in Canada for the purposes of this Act but is, under a tax treaty with another country, resident in the other country and not resident in Canada.

HANDOUT #6: CORPORATE TAX RATES

- Under ITA, corporations calculate income and taxable income using same rules as individuals. Significant difference however in tax rate and available tax credits
    - Note: corps get deductions rather than credits for charities

Calculation: Start with default federal tax rate (**s. 123(1)** 38).

1. Subtract provincial abatement. (**s. 124(1)** 10)

2(a). Subtract general rate reduction percentage, if applicable. (**s. 123.4(2)**13 – applies to "full rate taxable income" (**123.4(1)**)

2(b). Subtract small business deduction, if applicable. (17.5 instead of 13)

3. Add investment income tax, if applicable. (if earning non-biz income then remain at 28% (instead of getting one of the step 2s; if property income then add 6.67% on to 28 therefore 34.67%)

4. Add provincial tax rate . (applies to all corps. If qualify for SBD then add 3%; if not, then 12% (effective rate 27 for BI and 46.67 for property income)

Note: if you have a personal services business you end up with 40%

Subsection 123(1): rate on taxable income or taxable income earned in Canada (as the case may be) is 38% (except where otherwise provided)

Provincial Abatement: subsection 124(1): provides "provincial abatement": allows deduction of 10% of the corporation's taxable income earned in a province. – rationale is to give provinces room to levy provincial corporate tax (imposed on income attributed to PE in the province) → to qualify all that you need is that the income has been earned in the province (assigns to **regulations 400-402** to allocate based on where corp has PE's – divide based on the proportion of revenue attributed to each PE) → in order to not have to deal with these regulations we assume all income earned/attributable to AB → note: will not get the provincial abatement if carried on biz in a foreign PE

General Rate Reduction: subsection 123.4: reduces the tax payable on "full rate income" (123.4(1)) by the "general rate reduction percentage" (13% after 2011 (123.4(1))) – generally applies to reduce corp's portion of income that is not otherwise exempt from tax and has not benefited from various rate reductions.

- Excludes PSBs (defined in 125(7)) (result is that typically under-integrated) and CCPCs (para 123.4(1)(b) applies to CCPC → for CCPCs amounts qualifying for the SBD (125(1)) and AII (129(4)) are subtracted
- 123.4(2) provides the actual deduction whereas (1) provides the definition

Small Business Deduction – section 125(1): effect is to decrease first 500K of active business income earned by CCPCs by 17.5% (results in effective fed rate of 10.5). Note: where there are associated groups, this amount must be shared (later in course).

- CCPC: what happens to the investment income tax? – doesn't qualify for the GRR or the SBD because not active BI. Instead, subject to additional tax under 123.3 – adds an extra 6.67% (38-10+6.67 = 34.67%). Encompasses most income form property including taxable capital gains however it does not include any inter-corporate dividends → however most of this income is deductible once it is paid out to SHs (so this is essentially a deferral avoidance)

Personal Services Businesses – 125(7): Service business carried on by a corporation where:

a) The individual who performs services on behalf of the corporation ("incorporated employee" in **s. 18(1)(p)**) (or anyone related to the individual) is a **"specified shareholder"** (s. 248(1)) AND
b) The incorporated employee would reasonably be considered an employee of the service recipient but for the existence of the corporation, UNLESS:
c) The corporation legitimately employs in its business throughout the year more than 5 full-time employees

- "specified shareholder" defined in 248(1) is a person, who together with all NAL persons, owns more than 10% of the shares of any class in the capital stock of the corporation
- Test is based on whether the payer corporation has a high level of control over the person – ie, are they essentially treating as an EE
- 123.4(1)(a)(iii) excludes PSB from GRR and the definition of an active business in 125(7) excludes a PSB from AB → will never get either the GRR or the PSBs!!! → essentially get 28 (fed) + 12 (prov) = 40%

Specified Investment Business Income – 125(7):

- principal purpse is to derive income from property however does not include business of leasing personal property.
- 2 exceptions: (i) if employ more than 5 FT EEs or (ii) even if does not have >5 FT EEs, if it provides services to an associated corporation that would otherwise have to employ >5 FT EEs to do the work

business carried on by a corp (other than a business carried on by a credit union or a business of leasing property other than real or immovable property), with a principal purpose of earning income (including interest, dividends, rents, and royalties) from property, but does not include (a) corporation employing >5 EEs, or (b) another corp associated with the corp provides, in the course of carrying on active business, services that would reasonably be expected to require >5 FT EEs had the services not been provided.

- Example is if you have biz that derives income from renting apartments, question si whether employs more than 5 FT employees in the particular business – if yes, AB, if no, SIB.
- **Note**: case law says that 5FT + 1PT is enough but exactly 5FT is not enough

- **Problem**: definition of AB excludes SIB and PSB → AB is required in 125(1)(a)(i) in calculation of SBD
- **Note**: because of the definition of AII, income from SIB is taxed as property income and therefore instead of having potential low corporate rate and deferral, you put yourself into the anti-deferral regime

Provincial Tax Rates:

- ***Alberta Corporate Tax Act* section 21(2)(q)**: AB rate = 12%
  - Applies to property income regardless of CCPC, and general rate biz income (i.e. any that doesn't apply for SBD)
- ***ACTA* 22(2.1294) SB rates**: rate reduction of 9% for SBD → effective rate of 3% (combined with fed rate of 10.5 → 13.5% SB tax rate for first 500K)

HANDOUT #7: general overview of taxable income and Part I Tax Payable for Corps – just see handout

HANDOUT #8: TAXATION OF INCOME OR LOSS AT CORPORATE LEVEL

	(1) Business Income	**(2) Investment Income (including taxable capital gains & allowable capital losses BUT excluding intercorporate dividends)**	**(3) Intercorporate Dividends**
(1) Public Corp. & Non-Public/ Non-Private Corp.	general corp. rate with general rate reduction	general corp. rate with general rate reduction	no Part IV tax UNLESS recipient a "subject corp."
(2) CCPC	income from active business carried on in Canada eligible for SBD up to business limit. ABI not eligible for SBD taxed at general corp. rate	dividend refund and RDTOH mechanisms provide low-rate for investment income on distribution as a taxable dividend; non-taxable portion of capital gain included in capital dividend account; special 6⅔% tax under section 123.3	Part IV tax possible; refundable through dividend refund and RDTOH mechanisms
(3) Private Corp.	general corp. with general rate reduction rate UNLESS CCPC	general corp. rate with general rate reduction (if non-CCPC); non-taxable portion of capital gain included in capital dividend account	Part IV tax possible; refundable through dividend refund and RDTOH mechanisms

Handout #9: Small Business Deduction – Availability and Amount

Policy rationale: three main rationales:

1. Capital market inefficiencies: small firms may not have as much access to capital markets as large firms due to less information being available about small firms that the proportionately higher costs of providing capital for smalls firms (and a lack of adequate collateral and credit collateral) → theory is that SBD allows increased retained earnings which can be reinvested into relevant operations
2. Social returns: argument that SBs increase things like employment, economic competition, technological advancement and individual initiative → theory is that SBD helps to correct market mechanism given the societal benefits → note however that this is not necessarily how money will get used → not a very targeted measure → also find that often SBs actually employ mostly just family → also not a lot of evidence that business considerations turn on tax rates but moreso things like regulatory considerations → job creation has already occurred before the tax implications → also, PCs can access the SBD despite the fact that they don't really employ anyone
3. Integration: theory that trying to realize 13.5% on corporate income which may be seen as integration mechanism **?????**

- Strong arguments that inefficient allocation of capital: (i) likely that will probably structure a business to be able to access the SBD even if another structure would give a better pre-tax return, and (ii) dead weight costs for where people try to restructure to get greater access

Conditions:

- Main restriction: must be a CCPC throughout the year in which the SBD is claimed (**125(1)**); other restrictions essentially do is effectively place a cap on the amount of SBD that can be claimed by a corp → SBD is going to be equal to the least of the 3 amounts in paras (a)-(c)
    - Bit weird because if you look at **s 249(3.1)** a corporation as a deemed year end on becoming or ceasing to be a CCPC → what you expect is that would just say is that SBD is available to a corporation that is a CCPC at the end of the relevant tax year because it is not actually possible to not be a CCPC throughout a tax year
- **125(1)(a)**: profits have to be ABI from business carried on in Canada either by a corp or partnership (this is where you get into defn of "specified business income")
- **125(1)(b)**: (not going to cover in much detail bc goes into accounting software): caps the SBD at the amount the of the corp's taxable income that is not exempted from Canadian tax either due to stat exemption or because the income qualifies for a foreign tax credit. **See handout question 7 for example** (actually don't…) Interpretation Bulletin:

¶ 22. In computing the small business deduction of a CCPC, paragraph 125(1)(*b*) requires the determination of the corporation's taxable income for the taxation year in excess of the total of:

- 10/3 of the corporation's foreign tax credit deductible under subsection 126(1) for the year without reference to sections 123.3 and 123.4;
- 10/4 of the corporation's foreign tax credit deductible under subsection 126(2) for the year without reference to section 123.4; and
- any portion of the corporation's taxable income for the year that is exempt from tax under Part I because of an Act of Parliament.

The amounts deducted from the corporation's taxable income represent income on which no Canadian income tax was paid because the income is exempt from tax or because of the foreign tax credit.

- **125(1)(c)**: simply caps at the amount of the business limit
    - **125(2)**: defines the limit as 500K => the absolute cap is going to be this amount

Rates: rate on SBD is 13.5%; excess of cap is 27%

Associated Corporations:

- **125(3)** reduces the biz limit in 125(2) where the corp is a part of a group of an associated corps → have to allocate the 500K between members of the group. Note in 125(3) has to total to 100% or less or else everyone will be deemed to be nil. If no allocation is made then deemed to be nil
- **125(4)** - governs where the associated group has failed to make an allocation of their SBD and gives the Minister the discretion to allocate as sees fit.
- Why have restriction: to prevent people from splitting your business into separate corps so as to increase SBD

Specified Partnership Income:

- SBD limits could be easily circumvented by non-associated persons using partnerships.
    - Each partner carries on business as separate PC and then creates a partnership, so result could be that more than $500,000 of income from partnership business taxed at SBD rates.
        - Note: 96 – the BI of the partnership deemed to have been realized by the corporations to the extent that allocated to the corps → each corp is then in position to claim a 500K SBD
- Prevented via "specified partnership income" mechanism: **125(1)(a)** separates BI into two categories: (i) ABI directly earned by the corp, and (ii) SPI earned through by corporation as a member of a partnership.
    - **To calculate SBD, you then subtract from the lesser of (a) (i) + (ii) less the sum of (iii) (loss from ABI in Canada other than loss from a business carried on by it as a member of a partnership) + (iv) (specified partnership loss of the corp); (b) (associated with s 126 – read later); (c) limit (500K)**
- A corp's partnership income is eligible for SBD only to the extent that it is SPI (125(1)(a)(i) excludes partnership income generally and 125(1)(a)(ii) includes SPI only)

125(7): **"specified partnership income"** defined by reference to formula **= A + B**:

- **A** is lesser of: (a) partner's net partnership income allocation (ie the corp's share of the income from all AB carried on by it in Canada as a member of the partnership less the amount of partner-level deductions claimed); and (b) that proportion of 500K that the corp's share of the PI is of the total income of the partnership (ie take (income allocation/total income)*500K – note that exception is less than 365 day year)
    - **A** is the lesser of **(G – H)** and **((K/L) X M))**
        - **G** = the corporation's share of the income of the partnership
        - **H** = all amounts deducted in computing the corporation's income from the business (other than amts deducted in computing the income of the partnership from the business) – partner-level deductions
        - **K** = corporation's share of the income of the partnership
        - **L** = total ABI earned by the partnership in Canada
        - **M** = lesser or (i) 500K or (ii) pro rata calculation where not a full year
- **B** (purpose is to allow greater SPI amt where there have been biz losses by first applying losses to income that is not eligible for SBD) is lesser of: (a) partner's specified partnership losses and business losses; and (b) the amount by which the partnership's income allocation exceeds its prorated share of $500,000 (ie A(a) – A(b) – but no less than 0 (section 257 deems negative amounts to be nil)
    - **B** is the lesser of **(125(1)(a)(iii) + (iv))** and **(N – O)**
        - **125(1)(a)(iii)** = total losses in respect of AB carried on in Canada (not including the losses incurred through

partnership)
        - **125(1)(a)(iv)** = **"specified partnership loss"** = **(A +B)** where:
            - **A** = corporation's share of the loss of the partnership from AB in Canada
            - **B** = **G – H**
                - **G** = **H** in calculation of **A**
                - **H** = **G** in calculation of **A**
        - **N** = **(G – H)** from calculation of **A**
        - **O** = **((K/L) X M))** from calculation of **A**
- **See Bleiwas 6:68 for sample calculation**
- **125(6) Anti-avoidance (AA)**: it prevents the creation of addition SPI by creating a business that's carried on by multiple partnerships. Elements to fall under subsection: (i) corporation is in a partnership, (ii) the corp or an associated corp is member of another partnership, and (iii) may reasonably be considered that one of the main reasons for the separate partnerships is to increase available SBD → the SPI of the corp will be considered nil for all those corps except the one with the largest SPI.
- **125(6.1) Partnership Lookthrough Provision**: prevents stacking of partnerships to maximize SBD → deems the partners of the upper-tier partnership to be members of the lower-tier partnership, and then deems every partner's allocation from the lower tier partnership to be equal to its share of the lower-tier partnership income that was allocated to it by upper-tier partnership (stacked partnership is where the partnership itself is a member of a second partnership)
- **125(6.2) Partnerships Controlled by NRs of Public Corps (AA)**: prevents a CCPC from claiming the SBD on its share of ABI from a partnership that is controlled (*de facto*) by NRs or public corps – SPI will be deemed to be nil → rationale: if it were NR or public corp then would not be entitled to a SBD
- **125(6.3) Supporting rule for 6.2**: defines "control of a partner": if the income of the corporation is allocable to NR or public corp or any combination thereof.
- **125(5.1)**: provides reduction in the SB limit (500K) based on a formula – what it does is reduces your limit by 10cents for ever dollar that the corp's taxable capital exceeds 10 million dollars → phase out on SBD → so by 15 million you will have no SBD. **Associated group** rules built in:
    a. if a member of AG in the preceding year but not the particular year → look at the corp's taxable capital for the particular year
    b. if member of AG in both preceding year and the particular year → look at the taxable capital of the AG for the preceding year
        → essentially aggregating taxable capital for AGs once incorporation is thoroughly embedded in that AG
    - rationale for 5.1: want to ensure actually somewhat "small" business
        - **"taxable capital"** defined in **s 181.2(2-4)**: excess of capital over an investment allowance
            - **"capital"**: total of share capital, retained earnings, non-deductible reserves, debt and unpaid dividends
            - **"investment allowance"**: shares of debts, unpaid dividends of other corporations…

Handout #10: SBD - ASSOCIATION AND RELATIONSHIP

- **Policy**: looks at where economic interests are more or less aligned – could be that we don't want to have undue access to benefits, or, on the other hand, want to permit them to do things without tax consequences → ultimately looking at economic efficiency

RELATEDNESS

Basic rules found in **251(2)**: (2) For the purpose of this Act, "related persons", or persons related to each other, are

(a) individuals connected by blood relationship, marriage or common-law partnership or adoption;
(b) a **corporation and**
    (i) a **person who controls** the corporation, if it is controlled by one person,
    (ii) a person who is a **member of a related group that controls** the corporation, or
    (iii) any **person related to a person** described in [(i) or (ii)]
(c) any **two corporations**
    (i) if they are **controlled by the same person or group of persons**,
    (ii) if **each** of the corporations is **controlled by one person** and the person who controls one of the corporations is **related to the person** who controls the other corporation,
    (iii) if **one** of the corporations is **controlled by one person** and that person is **related** to **any** member of a **related group** that controls the other corporation,
    (iv) if **one** of the corporations is **controlled by one person** and that person is **related** to **each** member of an **unrelated group** that controls the other corporation,
    (v) if **any member** of a **related group** that controls **one** of the corporations is related to **each** member of an **unrelated** group that controls the other corporation, or
    (vi) if **each member** of an **unrelated group** that controls **one** of the corporations is related to at least **one** member of an **unrelated** group that controls the other corporation.

Section 251(3): Where two corporations are related to the same corporation within the meaning of subsection 251(2), they shall, for the purposes of subsections 251(1) and 251(2), be deemed to be related to each other.

Section 251(5)(b): deems that all options and contingent rights are exercised for the purposes of determining if two corporations or a corporation and an individual are related (see page 4)
"Control" for this section is based on *de jure* control: ie the ability to control the BoD through ownership of sufficient voting shares

ASSOCIATION

- Looser standard than for relatedness – reason is that it is based on *de facto* or *de jure* control (by virtue of 256(5.1))
- 256 contrains technical rules that cause corporations to automatically become associated. **256(2.1)** adds to this as an AA provision that will deem two corps to be associated
- Effect of association: if one or more CCPCs are associated, **125(3)** states that must split 500K SBD limit between the corps
- Need only find that the corporations meet the requirements at any point in the year (however remember the deemed year end in 249(4)). Note also that 128(1)(f) deems a corp not to be associated when goes bankrupt

When are two corporations associated?: **256. (1)** For the purposes of this Act, one corporation is associated with another in a taxation year if, at any time in the year,

(a) **one** of the corporations controlled, directly or indirectly in any manner whatever, **the other**;
(b) **both** of the corporations were controlled, directly or indirectly in any manner whatever, by the **same person or group of persons**;
(c) **each** of the corporations was controlled, directly or indirectly in any manner whatever, by a **person** and the person who so controlled one of the corporations was **related to the person who so controlled the other**, and either of those persons owned, in respect of each corporation, **not less than 25%** of the issued shares of any class, other than a specified class, of the capital stock thereof;
(d) **one** of the corporations was controlled, directly or indirectly in any manner whatever, by a person and that **person** was **related to each** member of a group of persons that so controlled the other corporation, and that person **owned**, in respect of the other corporation, **not less than 25%** of the issued shares of any class, other than a specified class, of the capital stock thereof; or
(e) **each** of the corporations was controlled, directly or indirectly in any manner whatever, by a **related group** and **each** of the members of one of the related groups was **related to all** of the members of the other related group, and **one or more** persons who were **members of both** related groups, either alone or together, **owned**, in respect of each corporation, **not less than 25%** of the issued shares of any class, other than a specified class, of the capital stock thereof.

Note: just ignore "specified class" shares for the purposes of this class

"control": **256(1.2)**: (a)-(c) override rules applicable to *de jure* control whereas (d)-(f) contain share ownership look-through rules (meant to deal with tier shareholdings):

a) "a group of persons in respect of a corporation means any two or more persons each of whom owns shares of the capital stock of the corporation"
b) (i) if one member of group is considered to control then all members of the group are considered to control; (ii) corporation controlled both by subset of group and by larger group (note: under the common law would just go based on smallest group); and
c) Control can exist based on share value (so value counting rather than vote counting).
d) For holding corporations based on proportionate FMV of shares (deems the SHs of a holding corporation to own shares of the lower tier based on their proportion to the relevant FMV of all of the shares of the corporation);
e) For partnerships based on current fiscal period income allocation (deems the partners of a partnership to own shares in proportion to their share of the income of the partnership for the current fiscal period on the assumption that the income

Figure 1

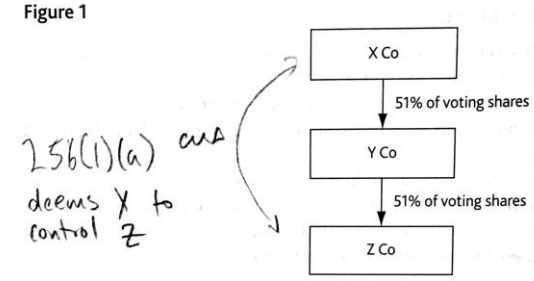


Figure 2

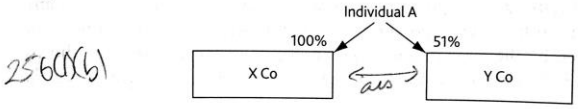


Figure 3

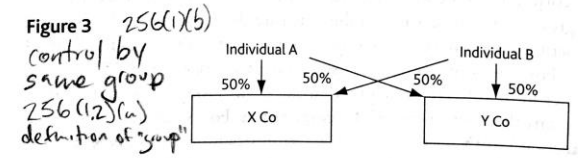


Figure 4

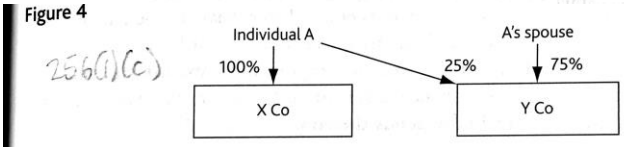


Figure 5

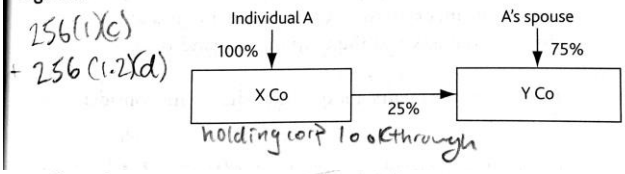


Figure 6

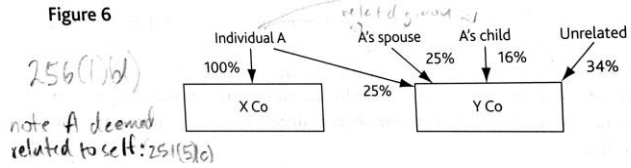
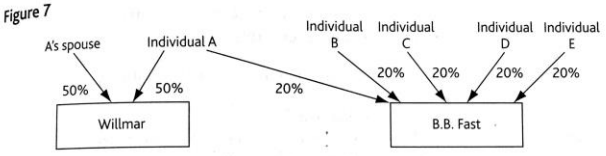


Figure 7



Under the current wording of paragraph 256(1)(e), Willmar and B.B. Fast would not be associated, because there was only a 20 percent cross-ownership interest. However, assuming that A owned 25 percent or more of the shares in B.B. Fast, Willmar and B.B. Fast would now be associated for the following reasons: the As form a related group that controls Willmar; A, B, C, D, and E form a related group that controls B.B. Fast; and the As, as one of the related groups, are related to each member of the related group that controls B.B. Fast.

was 1 million $ (this is so that doesn't allow to say not associated bc loss for the year));

f) For fixed trusts based on the proportionate FMV of the trust interests (essentially treated like a corporation – based on proportionate FMV); and For discretionary trusts, 100% to every beneficiary. (deems each beneficiary of a discretionary trust to own 100% of the shares owned by the trust)

Note: wrt to (c) and (d), for the purposes of determining portion of FMV, all shares are deemed to be non-voting. Rationale: if there is some kind of control premium for the voting rights, this instead looks at value for things like dividend rights

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(1.2) For the purposes of this subsection and subsections 256(1), 256(1.1) and 256(1.3) to 256(5),

(a) a **group** of persons in respect of a corporation means any two or more persons each of whom owns shares of the capital stock of the corporation;

(b) for greater certainty,

(i) a corporation that is controlled by one or more members of a particular group of persons in respect of that corporation shall be considered to be controlled by that group of persons, and

(ii) a corporation may be controlled by a person or a particular group of persons notwithstanding that the corporation is also controlled or deemed to be controlled by another person or group of persons;

(c) a corporation shall be deemed to be controlled by another corporation, a person or a group of persons at any time where

(i) shares of the capital stock of the corporation having a fair market value of more than 50% of the fair market value of all the issued and outstanding shares of the capital stock of the corporation, or

(ii) common shares of the capital stock of the corporation having a fair market value of more than 50% of the fair market value of all the issued and outstanding common shares of the capital stock of the corporation

256(5.1) For the purposes of this Act, where the expression "**controlled, directly or indirectly in any manner whatever**," is used, a corporation shall be considered to be so controlled by another corporation, person or group of persons (in this subsection referred to as the "**controller**") at any time where, at that time, the controller has any direct or indirect influence that, if exercised, would result in control in fact of the corporation, except that, where the corporation and the controller are dealing with each other at arm's length and the influence is derived from a franchise, licence, lease, distribution, supply or management agreement or other similar agreement or arrangement, the main purpose of which is to govern the **relationship** between the corporation and the controller regarding the manner in which a business carried on by the corporation is to be conducted, the corporation shall not be considered to be controlled, directly or indirectly in any manner whatever, by the controller by reason only of that agreement or arrangement.

Subsection 256(1.3) deems parents to own shares held by minors in some circumstances (note this could be a very big trap with a discretionary trust); EXCEPTION where the child actually runs the business of the corporation where they own the shares

Subsection 256(1.4) deems certain options and rights to be exercised (exception wrt death, bankruptcy, and disability (also see 251(5)(b))

Subsection 256(1.5): for purposes of (1)-(5), a person who owns shares of 2 or more corps is deemed to be related to themselves wrt to being a SH of the corps

Subsection 256(2.1) deems corporations to be associated if there is no reason for their separate existence (AA) – just to show that **one of the main reasons** for their separate existence was to avoid tax (so need to show that would exist regardless of the tax)

Subsection 256(2): IF two corporations are unassociated but are associated with a **third corporation**, corporations are deemed to be associated with each other; EXCEPT THAT, for the purposes of section 125, the corporations will not be associated if the third corporation is not a CCPC or elects not to be associated and to have a nil business limit (what happens if make election? the third corp has to file not to be associated and its SBD will be deemed to be nil → the other two corps then free to claim SBD separately; rationale with CCPC is that if not a CCPC then couldn't get a SBD anyway – so just don't care).

Subsection 256(5.1): control in fact provision – another way that we can cause two ppl to be associated by applying these rules – cases *de facto* control even if otherwise not a SH or would not control the corporation

Handout #11: INVESTMENT INCOME – DIVIDEND REFUNDS AND RDTOH

- **Purpose**: to ensure that tax is the same whether investment income is earned through a corporation or by an individual, and (ii) that the tax is payable at the same time that it would be if earned directly by the individual
- **Mechanism**: investment income is taxed at the general corporate rate when earned but when paid as a dividend, a refund is provided to the payer (corporation) to achieve integration
- Deferral can arise if the highest marginal tax rate for individuals exceeds the general corporate rate → solution is that **section 123.3** imposes an additional 6.67% corporate tax on investment income of CCPCs (other than from inter-corporate dividends) → intention of 123.3 is to more closely approximate the top marginal rate – this amount gets added to the corps RDTOH account.
- Problems arise wrt to integration due to the different provincial rates (In AB until 2016 you're always better paying out dividends whereas in ON you were always better off deferring bc integrated rate was 46 but the top individual rate was 48 —> get into inter-provincial planning - have them pay out to trusts)

Implementing Provisions:

129(1): Dividend refund mechanism – provides that where a return is made within 3 years of a dividend being paid, a private corporation can get a dividend refund that is the lesser of (i) 1/3 of taxable dividends paid on shares of its capital stock (while it was a private corp) and (ii) its RDTOH at the end of the year

129(3): defines RDTOH – computed at the end of the tax as the total (below) less the (d) corp's dividend refund for its preceding tax year:

(a) where CCPC, the least of:

(i) **A – B**

A = 26.67% of the corp's AII for the year

B = amount by which deduction under 126(1) exceeds 9.33% of FII for the year

(ii) 26.67% of the amount that the corp's taxable income exceeds the total of (essentially SBD + foreign tax credits)

(A) least of the amounts under 125(1)(a)-(c)
(B) 100/35 of amounts under 126(1)
(C) 126(2) by relevant factor

(iii) corp's tax under Part I

(b) the total taxes payable under Part IV

(c) where private corp at end of preceding tax year, the corp's RDTOH at end of the preceding year

➔ RDTOH is essentially the total of (a) 26.67% of AII (net certain foreign tax adjustments) if corp is a CCPC; (b) Part IV tax payable in year; and (c) the RDTOH balance at the end of the preceding year (if corp was a private corp at the end of that year); less (d) the dividend refund for the preceding year

Note: wrt **129(3)(a)** the corp must be a CCPC throughout the year however **s 249(3.1)** deems a year end when the CCPC status is lost

129(4) "AII": total of amounts below less total of corp's losses for the year from a source that is property:

(a) amount by which the eligible portion of the corp's taxable CGs exceed the eligible portion of its allowable CLs for the year and any amount deducted under 111(1)(b)

(b) the corp's income for the year from a source that is property other than exempt income, amounts included under 12(10.2), the portion of any dividend that was deductible in computing the corp's taxable income for the year, and income that, but for 108(5)(a), would not be income from property

➔ AII is essentially income from property + net taxable gains – certain adjustments: SUMMARY**:**

Next taxable CGs – Net taxable Losses (Div C) + Income$_{Property}$ – Dividends deducted under Div C – Losses$_{Property}$ (CND + For)

123.4(1)(b)(iii): for a CCPC the "full rate taxable income" excludes AII → no 123.4(2) rate reduction (GRR) from AII

129(6) deeming rule: income paid between associated corps that would otherwise be passive income, is going to be deemed ABI → if we allowed this to cause PI to be created in this kind of situation, we would be moving away from neutrality because we would be creating an incentive to have assets all be owned by single corp (so as to avoid cross payments) despite potentially good business reasons to keep these assets separated (such as liability considerations) → essentially puts into the same position as if the assets were owned by the same person who generates the business income (and as if the cross payments are effectively ignored)

Question 6

(a): What corps are eligible for a dividend refund?: Private corps

(b) Why is the amt limited to 1/3 of taxable dividends paid and its RDTOH? Because we don't want the dividend refund to exceed RDTOH so that was we are not refunding non-existent amounts against the other amounts payable (this seems rather obvious

(c) What does RDTOH represent? A notional amount equal to the corp's tax payable on investment income (passive income) in excess of 20% + its part IV tax payable in the year

(d) What kind of income earned and distributed as a taxable dividend generates a dividend refund? Passive income (interest, rents, royalties) + dividend income that is subject to Part IV tax (in an indirect way)

Question #11 – Change of Status of the Corporation:

- 129(3) applies to every corporation → RDTOH does not vanish because of a change in status but may be made inaccessible

CCPC to non-CCPC: if ceases to be a CCPC, under 129(3), no amounts will be able to be added anymore under subsection (a) wrt to investment income (so RDTOH will not accumulate as quickly)

- **note**: does not include a corporation that elects not to be a CCPC under 89(11) → still a CCPC for the purposes of 129(3). If wanted to lose for the purposes of 129(3) you would need to either cause the corp to be incorporated outside Canada or by acquisition of control by a NR or public corp that lists on a public exchange (I think)

Private to non-private: RDTOH balance at the end of the year will not be carried forward to the next taxation year under 129(3)(c) bc the corp is not a private corp at the end of the preceding year and 2. Will lose ability to obtain a dividend refund under 129(1) for any RDTOH balance existing at the time of the change of status because "must be paid at a time that was a private corporation" → very bad effect unless quickly goes back to being a private corp

Alleviation: pay large enough dividends prior to the time that ceases to be a private corporation

Handout # 12: CAPITAL CORPORATE STRUCTURE – DEBT AND EQUITY

Debt and Equity

What happens to a corporation that issues a bond or share?

- It's a non-event in most circumstances bc deemed not to have disposed of anything under **subparas (l)** (share) **and (m)** (debt) of the definition of **"disposition"** in **s 248(1)** (part of definition "but does not include")→ given that the ITA is based on trade therefore if no disposition its difficult to apply tax → no consequences

What are the tax consequences for the BH or SH for acquiring the bond/share?

- Shareholder might have tax consequences if share or debt acquired using property other than money.
- This is going to depend on what the SH/BH used to pay for the share – given that a corporation is a separate person, any transfer to a corp is a disposition in the meaning of para 248(1)(a) "disposition" therefore section 69(1), common law principles, and defn of "POD" in section 54 will deem that SH/BH to have received PODs up to the FMV of whatever was given up for that B or S → so its not really the acquisition that is taxed, but rather the disposition

Section 248(1) "disposition" of any property, except as expressly otherwise provided, includes

(*a*) any transaction or event entitling a taxpayer to proceeds of disposition of the property,

but does not include …

(*l*) any issue of a bond, debenture, note, certificate, mortgage or hypothecary claim,

(*m*) any issue by a corporation of a share of its capital stock, or any other transaction that, but for this paragraph, would be a disposition by a corporation of a share of its capital stock, and

Issuing options:

- Separate rules for debt and share
- For a corporation that issues an option to acquire a share, also non-event for corp based on **s 49(1)(b)** (as oppose to based on the definition of "disposition")
- Non-event for SH if option is acquired using money (same as the debt/equity above)
- Consequences arise on expiry (**s 49(2)**) or exercise (**s 49(3)**)
    - Exercise at NAL → If dealing with NAL, make sure accurate option value given
    - Where at AL, where expires, the corporation is deemed by 49(2) to have disposed of a property with ACB of nil for PROB equal to the amt paid by the person who acquired the option ➔ CG to the corporation → makes sense because the corporation has been enriched by that amt and never had to issue a share so should be taxing the increase in wealth
        - The SH is deemed by definition of "disposition" in 248(1)(b)(iv) to have disposed of their option for nil proceeds and therefore realize capital loss equal to the amount they paid for the option and therefore have an allowable CL (makes sense bc paid for an option that will never be exercised)
    - If option is exercised, then 49(3) – provides that the amt paid for the option is added to the corp's POD (however effectively meaningless bc corporation hasn't really done anything – for tax purposes non-event (but can have corp tax considerations)
        - For option holder 49(3)(b) provides that their cost in the option is added to the cost of the property acquired under the option (ex. if purchased option for 10, and strike price of 100, then ACB is 110 → when SH then disposes of the share, the extra 10$ will take into account re GC/L)

Cancelling Debts

- Depends on how and what was given in exchange for debt being cancelled
- If purchased debt on open market for FMV or if paid on time in usually way → nothing happens
- If corp paid the BH on a direct payment less than the face amount of debt, then the corp will have settled its obligation and under s 81, there will be a forgiven amount. Section 82 then has tax arising from that deemed settlement.
- If creditor bought debt on open market, subsection **39(3)** capital gain or loss.
    - Where corporation has acquired a bond on open market for an amount that was more than its face value, then deemed to have CL to extent of excess that it paid. If less than face value of debt then CG equal to shortfall
        - Same rationale as section 80
        - Why would a corp go on to open market and buy back own debt – interest rate variations
- Consequences for <u>creditor</u> too: "disposition" section **248(1)(b)** C has disposed for an amount received for it whether by repayment or by selling on the open market → CG if received more than they paid for the debt and vs.

Cancelling Shares

- Will make more sense once more class covered
- Corporation: if acquires share (that it issued) using money, it isn't disposing of anything other than money so there shouldn't be any tax consequences.
    - **18(1)(b)** will not allow any deduction by the corporation on account of the share repurchase on the basis that it's a capital outlay → effectively non-event
    - Note: only applies if repurchased with money
- Shareholders: 84(3), (9), and 54(j) "POD" → SH will be deemd to have disposed of the share for POD equal to the stated capital of the share and will have a CG/L if more or less than the ACB of the share. Any excess is deemed to be a dividend received by the SH on the share (can be unfortunate consequence on SH if its not an eligible dividend)→ need to watch for when doing share repurchases
    - Can be positive from corporation's perspective: deemed by 84(3) to have paid the dividend received by the SH → if corporation had RDTOH balance, then has paid a capital dividend that it can use to recover the RDTOH.

Paying Interest and Dividends

- Corporation has preference for paying interest over dividends:
- Corporations are usually permitted to deduct **interest**: paragraph **20(1)(c).** This effectively means that if a corporation can borrow money to finance its operation, then the corporation gets to deduct the interest that its paying on the debt instrument. (if don't fall under 20(1)(c) then usually considered to be a capital outlay in which case deduction denied by **18(1)(b)**)
- **Paragraph 20(1)(c)** allows a deduction in computing income from a business or property for a reasonable amount of interest paid or payable in respect of the year pursuant to a legal obligation to pay interest on the borrowed money in the following two circumstances:
    - **Subparagraph 20(1)(c)(i):** where the borrowed money is **used for the purpose of earning income from a business or property,** and
    - **Subparagraph 20(1)(c)(ii):** where the borrowed money is used to acquire property for the purpose of gaining or producing income from a business or property
- **Dividend** paid on a share is considered a capital outlay and will be denied deductibility by **18(1)(b)** → will just end up being an after tax cost to the corporation
- **Therefore the corporations after tax cost of debt financing is going to be lower than the after-tax cost to equity financing**

Receiving Interest or Dividends (from perspective of equity holder → probably a preference for dividends than interest)

- Shareholders taxed on **interest** received or receivable under paragraph **12(1)(c)** → Full income inclusion (full 44% rate)
  - Note: for the owner-SH type this is not bad because its offset by the fact that lower cost to corporation. If public company where SH has no personal interest then would prefer not to have interest payment
- In contrast, for an individual who owns shares, you'll have and income inclusion on dividends under paragraph **12(1)(j)** and subsection **82(1)** however there is an integration mechanism in these sections to lower the rate of tax
- Corporate SHs can deduct **dividends** received: subsection **112(1)** → inter-corporate dividends flow tax free (however interst will not)

Handout # 13: TAXABLE DIVIDENDS – INTEGRATION, RESIDENT INDIVIDUALS AND THE DIVIDEND TAX CREDIT

- Since dividends aren't deductible, necessary to have an integration mechanism to ensure total tax rates approximates individual rates.
- Policy: neutrality
- "Full integration": income is calculated at the corporate level and then allocated to SHs at the end of each tax year (ignores corporation as a separate entity) → this is system for partnerships in Canada
- "Partial integration": tax levied on retained income whereas income distributed as a dividend is either deductible by the payer or taxed at the corporate level but with a credit provided to SHs for the corporate tax paid on the income from which the dividend was paid. Attempts to integrate only when income earned is distributed as a dividend. Two types of partial integration:
  i. "Imputation system": dividends are taxed to individual SHs with some credit for tax paid at the corporate level → effectively treats corporate tax on the dividend income as a withholding tax; notional amount is imputed to the SHs
  ii. "Classical system": corporation taxed at the corporate level and again at the SH level on distribution as a dividend (without any credit for the corporate tax paid)
- Individuals resident in Canada must include income amount from dividends plus another **"gross up"** of 17% or 38% on those from taxable Canadian corporations. Gross up amount depends largely on the identity of payer corp as CCPC or non-CCPC as well as corporate tax rate applied to the income
- **"Eligible dividend"**: essentially dividends that were **not taxed at a lower corporate rate**. (defined in **s 89(1)**)
  - **Designation** Corporations have to designate each eligible dividend that they pay, before or at the time the dividends are paid, and notify shareholders in writing that the dividend is eligible, as required by **subsection 89(14)**
- **Election not to be CCPC**: a CCPC can elect not to be a CCPC for purposes of the eligible dividend treatment. If it so elects, it is deemed not to be a CCPC for the tax year in which it makes the election and all later tax years, until it revokes the election. The CCPC will lose its entitlement to the small business deduction. However, no other benefits of CCPC status will be affected.
- **"General rate income pool"** (GRIP): pool maintained by CCPS that is computed at the end of the tax year. Defined in **89(1)**: = (GRIP from prior year end) + (72% of adjusted taxable income) + (eligible dividends received) – (eligible dividends paid)
  - A CCPC may pay eligible dividends to the extent of its GRIP --- a balance generally reflecting taxable income that has **not** benefited from the SBD or any other special tax rate—without incurring Part III.1 tax. The GRIP is calculated at the end of the tax year. However, a corporation can pay eligible dividends over the course of the year as long as, at the end of the year, the eligible dividends paid do not exceed its GRIP.
- **"Low rate income pool"** (LRIP): pool maintained by non-CCPCs and computed at point in time. Defn in **89(1)** = (LRIP at end of prior year) + (non-eligible dividends received) + (if corp elected not to be a CCPC, 80% of AII) + (80% of an amt in respect of SBD income) – (non-eligible dividends paid)
  - A corporation resident in Canada that is not a CCPC will be able to pay eligible dividends in any amount unless it has an LRIP. The LRIP is generally made up of taxable income that has **benefited from certain preferential tax rates**. The corporation **will have to reduce its LRIP to zero by paying out ordinary dividends before it can pay an eligible dividend**, or it will be subject to Part III.1 tax. The LRIP must be **calculated at the time a dividend is paid or received** or any other event occurs affecting the LRIP balance in the year.

Dividend Integration – CCPCs	**Dividend Integration – non-CCPCs**
Default for a CCPC is that it pays a taxable dividend that is a non-eligible dividend. • Income inclusion: paragraph 82(1)(a); • 17% gross up: subparagraph 82(1)(b)(i); • 10.5% credit: paragraph 121(a); and • 2.9% Alberta credit: APITA paragraph 21(h). This also applies to non-CCPCs paying dividends from LRIP.	Default for a non-CCPC is that it pays a taxable dividend that is an eligible dividend. • Income inclusion: paragraph 82(1)(a); • 38% gross up: subparagraph 82(1)(b)(ii); • 15.02% credit: paragraph 121(b); and • 9.99% Alberta credit: APITA paragraph 21(h). This also applies to CCPCs paying dividends from GRIP.

Note: Must be very careful about ensuring there is adequate GRIP/no LRIP when dividends paid – otherwise results in Part III.1 tax of 20% of dividend under subsection 185.1(1). (though can elect out after but best to avoid)

Gross up and credit mechanism limited to SHs who are resident individuals, "taxable dividends", and "taxable Canadian corporation". Why need to be a "taxable Canadian corporation"?

- if not then prob hasn't been subject to tax on the icome on which the dividend was paid therefore no need to worry about integration

- where can run into difficulty – where a non-CCPC where not incorporated in Canada but is resident and has Canadian SH → not a "taxable Canadian corporation" – here there is no integration - -really easy fix is to transfer the stock into a Canadian corporation and make a 89(11) electino and then every dividend received from the non-CCPC to the CCPC will be deductible under 112(1)

Q9: why different DTC rates in 121: correspond to different underlying tax rates (eligible assuming 27% and non eligible assume taxed at 13.5%)

Q10

- **"unfunded"** – means there is not necessarily correlation between the amount of the credit and the amount of the tax actually paid – based on assumptions and not on actual payments
    - If have certain credits etc that were claimed then you could actually be taxed at lower rate (because the corporation was taxed at lower than 27 or 13.5); could also be higher
- Provincial DTC also complicates matters in terms of trying to achieve perfect integration – there is an assumption that the provincial tax credit will be sufficient to fully supplement (AB assumes a SB rate of 3% and GR of 10% - because now 12% tax, we have insufficientDTC)
- How can have unfunded if limited to GRIP – 121(b) is based on types fo taxable income not the amounts actually paid

Q11

Is DTC calculated net of any related expenses? Ie, if your SH incurred an expense in acquiring a Share, does the DTC take that into account? – no – it's a credit; based solely on the amount thats included in the individuals income under 82(1)(a) and (b) → makes sense because DTC is intended to credit tax paid – should only be related to things that actually incur tax not something totally unrelated

Is the DTC refundable? No (reinforces idea that the credit mechanism meant to be close not perfect)

Handout #14: INTER-CORPORATE DIVIDENDS AND PART IV TAX

- Corporation must include dividends received in income (**82(1)(a)** and **12(1)(j)**) but may deduct taxable dividends received in the year from a taxable Canadian corporation (**112(1)(a)**) (also if received from (b) not TCC, but was a corp res in Canada, was *not* subject to Part I tax, and was controlled *de jure* by the dividend recipient)
    - Purpose: ensure that taxed only once at the corporate level and then not taxed again until distributed to SHs
- Why is 112 limited to taxable dividends? Because want to make sure tax at least once. If not taxed then just create a tax shelter.
- Potential deferral: SHs could try to incorporate their "investment portfolios", and through the inter-corp dividend deduction, defer SH-level tax on dividends received. **Solutions**: **Part IV** taxes at a rate that approximates the highest marginal rate for individuals on dividend income – then refunds that tax when the corporate recipient pays out the dividend (RDTOH??).
- Part IV tax is imposed by **section 186(1)**:
    - If dividend recipient is a private corporation; THEN EITHER
      (a) Tax equal to 1/3 of assessable dividends from <u>non-connected</u> corporations; OR
        - "assessable dividend" defined in **186(3)** – AD if it was deductible by the recipient corporation under 112(1)

      (b) Portion of <u>connected</u> payer's RDTOH refund that the assessable received is of all taxable dividends paid in the year while the payer was a PC → essentially going to pro-rate: determine the amt of the dividends that the reciepient has received from the dividend payer in the year, and divide by total of all of the taxable dividends paid by the payer in the year at the time that it was a PC (ex of 186(b) on handout page
    - Reducible by recipient's non-capital losses (**186(1)(c)(d)**)
        - Losses that corporation carries forward if elects to use against the part IV tax (will reduce by 1/3 of the losses designated) (essentially convert non-capital losses into a deferral) (**c**)
        - Otherwise deductible losses for previous any previous 20 years or following 3 years (**d**)
- Part IV is integrated with RDTOH so that means refundable – Part IV tax added to RDTOH under **129(3)(b)** → Refunded pursuant to subsection 129(1) in amount equal to 1/3rd of all taxable dividends paid by the corporation in the year while a private corporation (review)

Meaning of "connected": see bullet #6 in CB

- Difference between being connected or non-connected can be significant wrt part IV under 186(a) and (b). If connected then section (b) and will only have to pay part IV tax to the extent that the dividend it received is responsible for some or all of the dividend payer's RDTOH refund for the year → essentially get continuing deferral.
    - In contrast, in (a), it doesn't matter what source the dividend income is being funded from at payer level, will have to pay part IV regardless
- "**Connected**" defined in **186(4)** – two means of connection (both **point in time** tests applied at time the divi is paid)
    (a) Dividend payer is controlled (*de jure* – however modified slightly by 186(2) to have both 50% voting shares AND if some combination of dividend recipient and all NAL together own more than 50% of dividend payer)) by dividend recipient; or
    (b) Dividend recipient owns more than 10% of the voting shares and more than 10% of the value of the shares of the dividend payer.

Question #4 – review

- What kinds of corps are subject to part iv and on what type of dividend:
    - Private or subject corp (186(3) definition); limit to these bc we assume that these are the ones that might be incorporated purely for the purposes of differing tax (investment vehicles)
- How does corporate status impact a refund of Part IV tax?
    - 129(1) - to qualify the divi must be paid by the corp at a time in year that it is a private corp —> can create problem where ceases to be private corp before time to give dividends and get RDTOH → result is dbl taxation
- How does status affect the creation of RDTOH from Part IV tax – ie once you have paid part IV tax does status matter re RDTOH? not really, bc if look at 129(3) it provides that any corp can have a RDTOH balance and the addition to RDTOH under 129(3)(b) doesn't require to be CCPC or private corp - helpful for a subject corp that has paid Part IV tax bc it can have an RDTOH – wont be able to recover at that point in time, but if at some time in the future becomes a private corporation, it can recover the RDTOH'

Question #10

What is the purpose of paragraphs 186(1)(c) and (d)?

- To permit corps to use their non-cap losses to shelter their part iv tax

Why are these amounts deductible in computing Part IV tax?

- Department has determined that a deferral of personal income tax on investment income should be permissible to the extent that the corporation has losses. Don't want dividend income to be treated less favourably than other forms of passive income
    - Because of the s 112(1) deduction there may be no income to use the Part I losses against therefore allow to use against Part IV

Question #11

When is Part IV tax due?

- 187(3): makes a number of part I provisions applicable for purposes of part IV tax. So under part I we know that tax is due on the corporations balance due day and since we are adopting the payment and collection provisions of part I the balance due date will be as defined in 248(1): generally the day that is **2 months after the end of the taxation year**

How might a one-year deferral arise?

- By staggering year ends for corporations (have one corporation pay dividend on Jan 1 (with Jan 1 year end such that pay before year end) to corporation created with Dec 31 year end – doesn't have to do anything until then.

Handout #15: CAPITAL DIVIDENDS AND THE CAPITAL DIVIDEND ACCOUNT ("CDA")

- Sometimes corporations receive tax-free amounts – in order to maintain neutrality, this tax-free aspect is integrated by way of a capital dividend → will be tax free to SH (also does not reduce the ACB of the shares on which it was paid – if did then would only be a tax deferral)
- **Section 89(1)** specifically excludes "capital dividend" (by reference to 83(2)) from definition of "taxable dividend"
- **Section 83(2)** provides that a "capital dividend" refers to dividend between a PC and SHs, where the PC so elects (must be entire amount of the dividend) (must be at a time before election is made or day any part of the dividend is paid → as soon as declared must elect on same day). Following rules apply: (a) deemed to be a CD to the extent of the corp's CDA immediately before the particular time; and (b) no part of the dividend shall be included in computing the income of any SH
    - Requires the filing of CRA Form T2054 on the earlier of the date the capital dividend was elected or the date the dividend was paid.
- Like eligible dividends and GRIP, a CDs are linked to CDA → must have sufficient amount of CDA to cover the entire amount of the dividend → electing to pay in excess results in Part II tax → imposed on dividend payer by **184(2)** equal to 3/5ths of amount by which capital dividend exceeds CDA (can elect out, but better to avoid – 184(3) – however limitation wrt SHs)

Question #4:

What kind of corp may pay a CD and why? Look at 83(2): only private corporations can pay CDs (however in theory all corps have it, but just can't access if public)

Question #5:

What are the elements of CDA? Add a-d and subtract the amt of the CDs paid by the corp before the particular time

- (a) the amt if any by which the corporation's non-taxable portion of its CGs exceed the non-allowable portion of the corporation's CLs
- (b) the amt if any of any CD received from another corporation
- (c.2) the amt included in the corporation's income under 14(1)(b) in respect of a business carried on by a corporation (that means ½ of the amount received on the dispassion of eligible capital property (ie if you receive an amount on ECP you are required under 14(5) to include 75% of that amount and if you have negative… ugh)
- (d) the amt receivable under a life insurance policy as consequence of death of another person

When is CDA calculated?

- Calculated from the date of incorporation until the time that it is calculated – subsequent events wont have any bearing (as oppose to, for ex, GRIP

When are each of the amounts added to CDA?

- In definition of "CDA" in 89(1) CG or CL, CD, or life insurance – these all hit CDA at the time the amount was realized or

received. In contrast, under 14(1)(b) (1/2 eligible capital property) which is included CDA under c.2 is not included until the day after the last day of the tax year in which it was disposed (however they can elect to have this counted under 14.1.1.1 → I think this is a tangent)

What happens if the corporation loses its private corporation status?

- Doesn't lose its CDA per se, but it loses the ability to pay CDs so what you should be doing with a private corp in the event that going to become a public corp is recover all the CDA before causing to become a non-private corporation

Is a negative CDA balance possible?

- 89(1): no, not possible, BUT CDA is essentially a series of pots and each is separate from another, and the CG pot can go negative in the sense that it won't be positive until your CGs exceed your CLs - so not really negative

Question #6

What does paragraph (a) of the CDA definition in subsection 89(1) represent?

- Essentially just the CG "pot" - represents the excess of the corporations non-capital Gs over the non-cap losses (as of January 1972)

Question #8

What does paragraph (c.2) of the CDA definition in subsection 89(1) represent?

- Relates to eligible capital receipts: ECRs are taxed in a manner that is substantially similar to dispositions of **depreciable capital property** in the sense that they will be recaptured to the extent that there was any deduction under 20(1)(b) as appreciating your CEC (cumulative eligible capital) pool
    - CEC and ECP see Appendix
    - Example is where you buy a customer list – because not defined in any property in the ITA, this would be an outlay – this allows to fall under ECP → ITA serves to depreciate these but also allows some amount of deductibility
    - Cumulative eligible capital pool – add ¾ of any ECP expenditure to the pool – then when you have any dispositions of ECP you add ¾ as well.
    - Two things happen based on whether positive or negative: if positive then you are entitled to deduct 7% (under 20(1)(b)) of the outstanding pool balance in a taxation year → essentially about 5% depreciation rate (7% of ¾); if negative, then (i) to extent you have claimed deductions, you have a straight income inclusion (to extent that negative) and (ii) 14(b) says take the rest of the negative pool and include 2/3 of that amount in income (note, 2/3 of the ¾ is 50% inclusion in business income (so can have against SBD and corp tax rates))
- C.2: it includes in the CDA, an amount equal to the 14(1)(b) inclusions for taxation period ending before that time (this is that 50% gain bit) → trick is that it requires the tax year to which the 14(1)(b) inclusion relates to have ended before that time. To circumvent, can elect under 14(1.01) to treat the disposition as a capital gain —> would have a cap gain on disposition of eligible cap property - no deferral but do get the CDA immediately —> usually not worth it
- Note: 20(4.2)(4.3): deal with cap losses on the disposition of debts that were connected with the disposition of good will (don't think this is examinable)

Tangent about "depreciable property": defined in section 13(21): "depreciable property" of a taxpayer as of any time in a taxation year means property acquired by the taxpayer in respect of which the taxpayer has been allowed… a deduction under paragraph 20(1)(a) in computing income for that year or a preceding taxation year;
→ 20(1)(a) is the "capital cost of property" deduction – this is maintained on a class by class basis

Question #10

What do paragraphs (b) and (d) of the CDA definition in subsection 89(1) represent? Why are these amounts here?

- (b) dividends received form other corporation that is not included in computing income of the corporation (due to 83(2)) - there bc if the individual SH received directly it would have been non-taxable - note this is immediate
- (d): a death benefit received under a life insurance policy as a consequence of death of individual - have it bc in section 148 if you have the interest in the death benefit in an exempt life insurance policy you would have no income inclusion - so if under 148 the individual and corporation could have received tax free, we shouldn't impose a divi tax on what was otherwise non taxable - must be an "exempt policy"

Question #11

How does the election mechanism in subsection 83(2) operate?

- Corporation is required to make an election in the prescribed manner in prescribed form – must be done before the CD is declared. (Form T2054 and a certified copy director's resolution authorizing the CD designation, and a computation fo the corporation's CDA immediately prior to the designation) → remember must be entire amount of the dividend that is designated – if want to pay more than you have CDA, will have to split into two dividends

What happens if a corporation elects an amount in excess of CDA?

- Liable for part III tax under 184(2) → taxes the dividend payer equal to 3/5 of the amount by which the designated CD exceeds the CDA at the time the dividend was paid

How does one go about fixing this?

- For the SHs who recieveve dividend to elect under 184(3) → deems the excess to be a separate taxable dividend that was paid by the corporation and received by the SHs at the time. Conditions: election must be made within 90 days of notice of assessment of Part III, and all the SHs receiving the dividend must agree to the election

Handout #16: Dividends in Kind and Stock Dividends

- Every relevant corporate law statute allows two types of non-cash dividends (*ABCA* section 43(1)) :
    i. In specie dividends: transfer of corporate property to shareholders; or
    ii. Stock dividends: issuance of new securities to shareholders with FMV equal to dividend.
- Paragraphs 12(1)(j) and 82(1)(a) do not distinguish between cash and non-cash dividends → must include "the amount" of the dividend in income in either case.
- The "**amount**" is defined in subsection 248(1): – Amount of in specie dividend is money value of thing received; Amount of stock dividend is the amount by which PUC is increased because of stock dividend.
- Subsection **52(2)** (essentially just clarifies how cost works) deems cost of property received in satisfaction of in specie dividend to be equal to FMV of the property received at time the dividend was paid.
- Subsection **52(3)** generally deems cost of stock dividend shares to be equal to amount of stock dividend as defined in paragraph (c) of the amount definition, being the stated capital addition of the shares
- Subsection **52(2)** also applies to the in specie dividend payer - payer corporation is deemed to have disposed of the distributed property for proceeds equal to FMV (at time distributed) → this is going to be a CG or CL
- No tax implications for dividend payer on issuance of stock dividend. Not a "disposition" within the meaning in subsection 248(1) (paragraph (m) deems to have disposed of nothing)
    - Even though no tax consequences to payer due to (m) because no CG/L, the corporation has still paid a dividend equal to the amt of the dividend as defined in 248(1) therefore can still recover its RDTOH to extent that a taxable dividend (benefit to the corporation) →benefit because effectively doesn't have to put out any cash but can recover RDTOH (however negative from SH perspective)
    - If a PC, can elect for a dividend to be a CD
    - Corporation receiving a dividend could be liable for part IV tax based on the amount of the taxable dividend and the amount of the RDTOH refund received by dividend payer as against amount of dividend as defined in 248(1)

Questions #4, 5

- Aco owns a parcel of land with an ACB of $500 and a FMV of $1,000. Aco declares a dividend of $1,000 on certain shares held by A, an individual. Aco pays the dividend by transferring the parcel of land to A.
    - → Aco deemed by 52(2) to have disposed of the land for FMV of 1000 which results in a CG of 500 and taxable CG of 250 which is added to CDA (89(1)(a) "CDA"), $66.75 is going to be added to RDTOH (129(3) (which should be refunded by the payment of the dividend to A (129(1)(a)) →see page 12 AII defn) → net result is that Aco should have tax payable of $100 (250x27% (as provincial and federal rates) less RDTOH refund);
      Note: cant elect that any part paid out as CD bc requires the that the entire dividend be claimed as CD and here the dividend paid is significantly more that the amount added to CDA
    - → A receives 1000 taxable dividend (12(1)(j) and 82(1)(a)) → will be liable for tax of 357.20 (after gross up mechanism) and cost in the land of 1000 (52(2)) (Note: this rate changes with new fed rates??)
- What if, in the above example, Aco sells the land to a third party and distributes the $1,000 of cash proceeds to A as a dividend?
    - → Aco realizes 250 taxable CG, 250 added to CDA (89(1)(a)"CDA"), 66.75 added to RDTOH
    - Difference is that Aco has some options
        1. Aco pays single dividend of 1000
        2. Aco pays 750 dividend and 250 CD
    - Assume the latter --> A has to add 750 to taxable income (12(1)(j) and 82(1)(a)) → tax of 281.40 and also receives 250 tax free
    - Takeaway – should not be better for Aco to sell the land but it is due to the CDA addition and distribution
        - Note: if sufficiently large, you could incorporate a corporation and sell the land to Subco at FMV, trigger the gain, and then wind up Subco → Aco then still has the land (but with ACB of 1000)

6. The provisions of the ITA governing the tax consequences of a stock dividend are intended to ensure that after-tax income earned by a corporation cannot be "capitalized" and returned to shareholders as a capital receipt. This rationale will become much clearer after we look at the deemed dividend rules and the concept of paid-up capital later in the course. For now, consider the application of the relevant provisions of the ITA to the following transaction.

Question #7

7. Aco declares a dividend of $1,000 on certain shares held by A, an individual. Aco pays the dividend by issuing to A more of the same shares. On the issue, Aco adds $1,000 to the paid up capital ("PUC") of the relevant class.
→ suppose that A had 100 common shares of Aco that had ACB of 100 and PUC of 100. Stock dividend of 100 shares added and PUC of 1000 added
→ amount of stock dividend is 1000 (2481(c)"amount" defines as the amount by which the PUC is increased by payment of dividend)
→ Aco: 248(1)(m)"disposition" excludes issue of shares of capital stock → non-event for Aco (don't know from this if can get RDTOH or CDA)
→ A: bc stock dividend of 1000, will receive a 1000 taxable dividend (12(1)(j) and 82(1)(a)) → liable for tax of 357.20. Also under 52(3) there is an addition of 1000 to the ACB of the shares - when then flip to ACB computation rules in section 47 it averages amounts (ACB = 1100, total shares is 200, therefore average ACB is 5.50/share; PUC averages across shares so also 5.50/share)

Note: may want to keep shares separated so that don't have averaging

Question #8 - (this is essentially same as question #4)
What if, in the above example, Aco transfers shares of its subsidiary, Bco, in payment of the dividend? The following are the relevant tax values of the Bco shares to Aco: ACB $500; PUC $500; FMV $1,000

- Trick question – you haven't actually paid stock dividend because that would have to be own shares → so here its in specie
  - Aco deemed by 52(2) to have disposed of the shares of Bco for FMV of 1000 which results in a CG of 500 and taxable CG of 250 which is added to CDA (89(1)(a) "CDA"); $66.75 is going to be added to RDTOH (129(3) (which should be refunded by the payment of the dividend to A (129(1)(a)) net result is that Aco should have tax payable of $100 (250x27% (as provincial and federal rates) less RDTOH refund **?????**);
    Note: cant elect that any part paid out as CD bc requires the that the entire dividend be claimed as CD and here the dividend paid is significantly more that the amount added to CDA
- → A receives 1000 taxable dividend (12(1)(j) and 82(1)(a)) → will be liable for tax of 357.20 (after gross up mechanism) and cost in the Bco shares of 1000 (52(2)) (Note: this rate changes with new fed rates??)
- → note: no change to stated capital (ie PUC)

Question #9:
What if, in the above example in paragraph 7, Aco splits its outstanding shares instead of issuing more shares in the form of a stock dividend? → no tax consequences (as long as nothing added to the stated capital amount)
Question #10:
What if in#7,Aco declares a dividend in the amount of $1 and satisfies the dividend by issuing to A preferred shares that are redeemable/retractable for $1,000 in the aggregate? Aco adds $1 to the PUC of the preferred shares. Is such a dividend permitted by corporate law? See subsections 26(2) and 43(2) of the ABCA.
→ yes permitted under ABCA 44(3).
→ amount of dividend will be ignores (248(1)"amount") – non-event for Aco (248(1)(m)"disposition"); don't need to worry about RDTOH or CDA bc such small amount; for A, has received a dividend of $1 which is included in income (12(1)(j) and 82(1)(a)) – goin through gross up, would be liable to .40 tax. ACB of $1 (52)(3))

Sidenote about section 15

- Problem where use a corporation to buy a house from policy perspective. Because no other SH theres not issue about having to share - so could just acquire property and appropriate for own use without ever paying out dividend or salary to owner manager
- 15(1) taxes a SH benefit (straight income inclusion – would actually be better off to have paid dividend) - puts into same position as if had paid themselves a salary - must have quantifiable, economic value. FMV is determined based on what a third party would have to pay for that thing - so SH benefit not a good thing because corporation will not be able to dedut (because not an expense incurred for business or will be a personal living expense therefore deduction denied under 18(1)(a) or (h)) => double tax
- 15(2) - applies for the most part to SHs who are individuals - if the corporation makes a loan to the SH, then the amt of the loan is included in income; exception in 15(2.6) that if you have repaid by the end of the year that made then turns off 2 (note this is tax year not necessarily calendar year) - unlike (1) you can repay and when repay they are entitled to deduction under 21(j)
- 15(1.1) - purpose: to prevent shifting value between SHs using high low stock divid. Consider Dco (with two SHs Dad (99%) and daughter (1%)) in order to reduce Dad's CG on death, Dco and daughter agree to exchange different class of shares to daughter and then pay shares to daughter → shift the value of the corporation to daughter in form of preferred shares → moves value off of dad's shares and can buy shares from dad → 15(1.1) is intended to stop this (in harsh manner): if any purpose of the payment of stock dividend is the reduction in the FMV of an interest in specified SHs, then there is a SH benefit equal to the difference between the FMV on the shares issued in the stock dividend and the amount included in the income under 82(1)(a) in respect of the dividend→ so with a H-L stock dividend you will have a big gap and therefore have a SH benefit equal to that gap - "specified SH" is defined term in 248(1) = a person who together all NAL person owns 10% or more of the capital stock of corp → SH benefit included in the income of the person who received the stock divi but not taxed at the divi income but rather at the 48% rate => really bad result relative to other options to get rid of specified SH interest
- If daughter just bought the shares off of dad for a promissory note, dad then just realize capital gain (at 24%)

Rule of thumb: if paying stock dividend, every common SH of the corporation has to receive the stock dividend in proportion to the SHs bc otherwise effect is a shift in value (and then get into this purpose test as to whether the purpose was to reduce the FMV interest of a specified SH)

Subsection 15(1.1)
- Anti-avoidance rule to prevent value shifting using stock dividends.
- Applies if one of the purposes of a stock dividend was to alter the value of the interest of a 10% shareholder.
- FMV of stock dividend in excess of paragraph 82(1)(a) inclusion included in income as shareholder benefit.

Handout # 17 SURPLUS STRIPPING: PUC AND THE DEEMED DIVIDEND RULES

1. ITA does not provide comprehensive definition of "dividend"
   - Old English case law provides that any *pro rata* distribution from corp to SHs is a dividend UNLESS the distribution is made on liquidation or an authorized reduction of corporate capital, in which case it is a **"capital payment"** not a "dividend" (*Hill v NSW* (1930 PC); *IRC v Burell* (1924 KB)
2. "Capital payments" give rise to CG/Ls rather than a dividend
   - "Surplus stripping" (aka "dividend stripping") occurs where a dividend distribution is converted into a capital gain – therefore the "strip" the corporate surplus at a rate that is more favourable than the dividend tax rate

The accurate determination of PUC is essential because the *Income Tax Act* stipulates that a corporation can return PUC to the shareholder as capital rather than income, and that return of capital is generally tax-free. Amounts returned in excess of PUC are considered dividend income to the shareholder. Obviously an incorrect PUC results in a misstatement of income, and generally that constitutes an under-declaration of income. Not surprisingly, this is not a situation clients are thrilled to find themselves in.

- Surplus Stripping: two things "tax avoidance" through the elimination of tax payable and (ii) rate arbitrage (doing things that are economically identical as what you would have done before but in way that gets preferred rate)
- Return of capital - not a divi; rather it's a tax deferred event to the extent that the amt of the share capital returned is not greater than acb - no tax imposed on return capital but the ACB of the shares is reduced to the extent of distribution; and if the capital that would be returned exceeds ACB, then there could be a capital gain when the ACB goes negative
- Surplus stripping - concern before carter in 1966 – definition: it involves attempts to extract or retain earning from a corp at capital gains rather than divi rates → why concern (note the slides are not updated): CGs are taxed at much better rates than taxable dividends:
  - 24% CG rate
  - 40.24% non-eligible dividend rate; and
  - 31.71% eligible dividend rate
- To prevent rate arbitrage, need a means of limiting returns of capital and reclassifying certain gains as dividends.
- PUC: means of measuring the total direct equity contributions to the corp by the SH - so it won't change when shares are exchanged between new and old SHs – it only goes up or down if money added or withdrawn - as result might be the same as the ACB of the shares at the time of incorporation but will cease to be the same of the ACB of shares passed between SHs
  - Important bc the PUC of the SH held is usually the limit of what we allow the SH to withdraw from corporation except by way of dividend → because PUC represents the SH's share of the investment in the corporation and don't want to allow ppl to withdraw on a tax-free basis more than their proportionate investment in the corp
- "PUC defined in **89(1)** – not a very useful definition; courts have held that basically just means corporate law "stated capital" → so the stated capitals accounts held based on s 26 of ABCA is your starting point

3 things that can have PUC:

1. Class of shares – subject to the adjustments in 89(1)(b)(iii) "PUC", the PUC of a class of shares is the ABCA stated capital of all the shares of that class.
2. Share of a class – determined by dividing the PUC of all of the shares of that class by all of the issued outstanding shares of that class (so if we have shares with $100 stated capital and 1000 shares of that class, then PUC of each share of that class is $.10/share
3. All of the shares of the coporation: just take the PUC of every class of shares and add them together

Question #5

What is the PUC of a share? PUC of the share is the pro rata proportion of the PUC of the entire class
Why does PUC matter for tax purposes? allows to track how much we can take out without going into retained earnings
What is the effect of subsection 248(6)? Provides that each series of a particular class is treated as a separate share of class – therefore in computing the PUC of a particular series of class, you don't aggregate all the series into one, you just treat that series as a separate class for the purposes of calculating PUC → ex if corp has issued several diff series in particular class then every one of those series despite all have the same rights, are treated as diff class for the purposes of calculating PUC

Question #6

- What is the relationship between the PUC of a share and ACB? → functionally no relationship; one determined in 89(1) and the other is just the SH's cost of the shares otherwise as determined by section 53. At start the same but as trade hands
- Can the two amounts be different? → yes
- Why would they be different? → PUC it is not attached to SH – averages over all the shares of the class; ACB is the amount paid or deemed to have paid regardless of how they were acquired

Question #6 Part II

(a) In 2005, A paid Aco $100 for the issue of 100 class A shares. The 100 shares were the only issued and outstanding class A shares until 2015, when a further 100 class A shares were issued to B for $200. What is the PUC and ACB of the class A shares owned by A

and B?

→ 2005 ACB =100; PUC = 100; PUC 1/share

→2015 ACB (for B) = 200; PUC = 300; PUC = 1.5/share

→A now has ACB of $100 and PUC of 150 and B has ACB of 200 and PUC of 150 → B has effectively lost the ability to extract 50 from the corporation tax free

What if the 100 shares issued to B were class A shares, series 2?

→ 248(6) result would be that A's PUC would be unchanged and the class A ii shares would have PUC of 2 per share and so B has 200 ACB and PUC and PUC of $2/share

(b) In 2016, C purchases all of the class A shares owned by A and B for their fair market value of $500. What are the income tax consequences to A, B and C, assuming that the class A shares are not issued in series? What if the shares are issued in series?

→ PUC has no bearing on the calculation of the CG on the sale (this is purely an ACB calculation)

→ need to identify that PUC doesn't change on shares changing hands – so the tax consequences don't change here regardless of whether or not the shares were in series (from A and B perspective) →both have POD of $250; A has CG of $100; B has CG of $50. If ther is only one class of shares then C will have ACB of $500 and PUC of $300. If separate series or classes, then the effect of 248(6) is that ACB 250, and PUC of 100 in class A shares; ACB of 250 and PUC of 200 in class A(ii) shares

Deemed Dividend Rules

- **Policy** needed to prevent surplus stripping by creating a deemed dividend

Subsection 84(1) applies to create a deemed dividend if a corporation (must be resident in Canada) has increased the PUC of a class except if:

- It has paid a stock dividend (because already taxable based on 82(1))
- The FMV of its assets less liabilities has increased or the amount of liabilities has decreased in connection with the PUC increase; (should only really see this in sole SH corporations)
- The PUC of another class of shares was reduced in connection with the PUC increase (ie you can shift stated capital between classes of shares – under *ABCA* it requires a special SHs resolution – unlikely to occur); or
- The PUC was formerly contributed surplus (ie where the corporation has converted its contributed surplus to PUC)

Effect of 84(1): corporation is deemed to have paid a dividend on that class of shares equal to the amount that the PUC increase in respect of a class exceeds 3 things:

1. The increase in the corporation's net assets or decrease in liabilities
2. The decrease of the PUC of shares in another class
3. The amt of contributed surplus at the time of the PUC addition

→ Shareholders of class deemed to receive dividend in proportion to shareholdings.

Note: you can at least still get RDTOH and CD

Subsection 84(2) applies if property of a corporation (res in Canada) is distributed or appropriated by shareholders on a winding-up, discontinuance or reorganization of a business of the corporation (this latter part makes it different than 15(1)) → can be reorganization of a business of the corporation (ie doesn't need to be the corp itself)

Effect of 84(2): corporation is deemed to pay dividend on class of shares equal to excess of appropriation over PUC reduction in respect of class. Two step process with amount be #1 minus #2:

1. Identify the amt of the distribution or appropriation of the SHs of a different class
2. Identify the amt of the PUC reduction in respect of the class in connection with the distribution or appropriation

→Shareholders deemed to received dividend in proportion to shareholdings immediately prior to the particular time (courts have said that this time means at the start of the process of transactions (pretty broad rule).

Subsection 84(3) applies if a corporation (res in Canada) has redeemed, acquired or cancelled any of its issued and outstanding shares (however does not apply to a transaction to which subsection 84(2) applies – for example if cancelled all of its shares on a straight up liquidation (84(2) then applies)).

Effect of 84(3): unlike (1) and (2), (3) only applies to the SHs whose shares were repurchased. Corporation is deemed to have paid a dividend on each class of shares repurchased equal to the amount that repurchase price for those shares exceeds PUC;

→ Former shareholder of repurchased shares is deemed to have received this dividend in proportion to their ownership of the repurchased shares of that class

→ note: **subsection 84(9)** accompanies section 84(3) deems the SH of the repurchased/redeemed shares to have disposed of the shares to the corp

Subsection 84(4) applies if a corporation has at any time reduced the PUC of the shares of a class in its capital. However, does not apply if the reduction occurs: (i) in relation to a redemption, cancellation or repurchase of shares (ie where 84(3) applies); or (ii) in relation to a transaction to which subsection 84(2) or (4.1) applies → essentially conditions of application are met as long as there is a straight up return capital without any changes in the shares as result

Effect of 84(4): Corporation deemed to pay a dividend on shares of the class equal to amount by which PUC reduction exceeds PUC of the class that is subject to the reduction

→Shareholders of class deemed to receive this dividend in proportion to shareholdings immediately before the reduction (ie at the time dividend deemed to have been paid).

Subsection 84(4.1): applicable to public corporations only. Generally, public corporation returns of capital are deemed to be dividends unless connected with a non-ordinary course transaction that occurred in the 24 months preceding the reduction of capital.

- Overrules (4) for a public corp - provides that any amt paid by a public corp in connection with a PUC (except on a repurchase of shares, winding up or share exchange (in s 86)) is deemed to be a dividend paid by corporation, and received by the recipient
- rationale: no SH has actually put capital in so it doesn't make sense to let ppl have returns of capital; also prevents some advantage wrt non-res

Exception: if realized POD fro a transaction outside its ordinary course of business in 24 months prior and has not yet distributed that amount to SHs. Example

Question #7 - Apply the deemed dividend rules to the following examples. In each case think about the "evil" that the particular rule is designed to address.

(a) A and B each own 100 class A shares of Aco with PUC and ACB of $1 per share. In 2015, A contributes $100 to Aco. No new shares are issued to A, while $200 is added to the stated capital of the outstanding class A shares.

- Addition to stated capital that exceeds the net increase in the assets of Aco (84(1)(b)) – excess of 100 -→ 84(1) will deem this to be a dividend → both A and B have deemed dividend of $50
- Evil: prevent over contribution of amounts to stated capital

(b) Assume in the above example that A is the sole shareholder of Aco. A originally contributed $200 for the issue of 100 class A shares, but on issue only $100 was added to the stated capital of the class. In 2015, A contributes a further $100 to Aco. No new shares are issued to A, but $200 is added to the stated capital of the outstanding class A shares.

- Because initially there was 100 contributed surplus within the meaning of 84(1)(c.3)(ii) so the amount added to the stated capital does not exceed the total of the increase in the corporation's net assets plus the contributed surplus on hand → amount of deemed dividend under 84(1) computes to nil

(c) and (d): (c) B owns 100 class B shares of Bco with PUC and basis of $1 per share. In 2015, Bco winds-up the operation of one of its divisions and distributes $2,000 to the class B shareholders. At the time of the distribution, there are 1,000 class B shares outstanding. There is no reduction in the PUC of the class B shares on the distribution. As well, none of the shares is purchased for cancellation by Bco.

84(2) - deemed dividend paid equal to the amount by which the 2000 distributed exceeds the PUC reduction (which was nil on these facts) therefore deemed dividend is 2000. B is a 10% SH therefore gets deemed dividend of $200

- evil - a distribution of money to SH other by way of return capital or dividend

(d) Assume in the above example that the PUC of the class B shares is reduced in full on the $2,000 distribution or, alternatively, that all of the outstanding class B shares are purchased for cancellation by Bco.

- Repurchase or PUC reduction shouldn't matter because both (3) and (4) exclude transaction described in (2) therefore they wont apply.
- If there was a PUC reduction, then the excess would be reduced to $1000 for the deemed dividend.
    - If there is a PUC reduction, then the ACB of B's shares is reduced by the amount of PUC reduction pursuant to 53(2)(a)(ii) → B now has PUC and ACB of nil.
    - If there was a repurchased then B is deemed to have disposed of the shares of Bco to Bco pursuant to 84(9), however 54(j) "POD" reduces the proceeds by the amount of any dividend under 84(2) or (3) → B will only have proceeds of $100 which is the amount of PUC and ACB of 100 without gain or loss
        - In theory when you have a disposition you have a CG – 54(j) deems any amount received as a dividend to not be POD → **effect is that on share repurchase your POD are going to be equal to the PUC** of the share → could still have a CG if the PUC was in excess to ACB (can get around this by reducing the stated capital and adding contributed surplus) → this is why SHs like anything other than a repurchase of their shares bc gives them often ACB greater than puc

(e) Assume in the example in 7(c) that the business which is wound-up is the only business of Bco and the cash distribution was made on the liquidation of the corporation. What if the cash distribution was made on the purchase for cancellation of shares by Bco other than on liquidation?

- It doesn't matter under 84(2) if it is liquidated or if just going to distribute cash on the termination of business— issue with applying 84(2) is whether there is a winding up, discontinuance or reorganization of *a* biz of the corp so should be the same whether a business or the business —> same result of (d): distribution of 200 to B and a deemed dividend received by B of 100
- What if there is a share repurchase otherwise than on a liquidation? dont think there is any diff if shares are cancelled or not or if they are cancelled outside a liquidation. Reason is (i) that 84(3) is subject to (2) so (2) prevails where conditions met; and (ii) conditions of 84(2) are silent as to whether or not there has been a repurchase of shares – so can apply whether or not repurchase – question is just whether there has been a reduction in stated capital→ result is 200 distribution to B, 2000 to class as whole and 1000 reduction in stated capital and therefore 1000 dividend for all the members of the class (B gets 100 deemed dividend)

(f) C owns 100 of the 1,000 issued and outstanding class C shares of Cco. C has PUC and ACB in the shares of $1 each. In 2015, Cco purchases for cancellation all 1,000 of the outstanding class C shares for $2,000.

(1) no facts that you cause (1) to apply

(2) does not apply bc not winding up/restructuring

(3) repurchase of shares by corp res in Canada so this is in (3).

- Step 1: 84(3)(a) Cco is deemed to have paid a divi of class C shares equal to the amount by which the repurchase price exceeds the PUC of the repurchased shares prior to repurchase (Cco deemed to have paid dividend of 1000)
- Step 2: 84(3)(b) applies to the owners of repurchased shares - deemed to have received a dividend equal to their pro rata ownership of the repurchased shares - so C is deemed to have received a dividend of 100$
    - 84(9) – C deemed to have disposed of her shares of Cco to Cco as result of the repurchase
    - POD calculation: 52(j) "POD" reduces the POD by the amount of the deemed dividend → C's POD reduced from 200 to 100 and ACB of 100 and therefore realizes no gain or loss on repurchase of these shares (only tax consequence is therefore the 100 deemed dividend)

What if the class C shares are traded on the Toronto Stock Exchange, and Cco effects the purchase for cancellation by buying the outstanding class C shares through the Exchange?

- 84(6): provides that 84(3) not applicable to purchase of public shares provided that the shares are acquired in a manner that the public generally could acquire those shares → if applies then we wont get deemed by 84(3) (also, 84(2) doesn't apply because no wind up etc) —> result the same as if purchased on the exchange sold their shares
    - Make sense form a commercial perspective bc the seller doesn't know who the buyer is so not fair to stick tax consequences on the seller when they don't know who the buyer is - certainty trumps otherwise good policy so will give allow SH a cap gain → capital gain of 100 (200 purchase price with ACB of 100) and a taxable CG of 50 (better because 24% rather than 40.24 (I think))

(g) Assume in the above example that, instead of purchasing the class C shares for cancellation, the directors of Cco pass a resolution to reduce the stated capital of the class in full on the $2,000 distribution.

- (2) no evidence of wind up+
- (3) no shares being repurchased
- (4) prevents corps form returning more stated cap in respect of a class of shares than the SHs actually have (bc this would be paid out at CG rate rather than dividend) - purpose is to get back to result of the entire class not just those that receive
- → effect is a deemed dividend to extent that the reduction in PUC exceeds the previous PUC (2000-1000=1000) ➔ 1000 dividend to shares of Class C → this is pro rata (84(4)(b)) (so 100 for C)
- 53(3)(ii) → deems ACB of a class of shares to be reduced by the amount of any capital return (explicitly does not include any amount that 84(4) deems to be a dividend) → ACB reduction of $100 (200 less 100 from 84(4)) therefore ACB of nil going forward
    - Note: 53 requires that not only reduce stated capital AND it has been returned to the SH (here there actually was cash distributed equal to the amount of reduction capital)

What if Cco is a public corporation?

- 84(4.1) applies (more restrictive) → the entire amount of the PUC reduction is deemed to be a dividend unless the amount distributed is attributable to previous POD from a non-ordinary course transaction completed in the last 24 months
    - Here looks like a routine distribution → going to deem the full amount of distribution to be a dividend → 2000 deemed dividend therefore C deemed to have a dividend of 200
    - For C personally we have to consider if any impact on ACB under 53(a)(ii) → should not be because entire amount is a deemed dividend and therefore excluded

Handout #18: SURPLUS STRIPPING – SECTION 84.1

Recall that surplus stripping is fundamentally about rate arbitrage → in all or substantially all provinces, cheaper to realize a capital gain than to receive eligible or non-eligible dividends. **Section 84.1** is intended to prevent situations where share sales to corporations would enable surplus stripping (applies to non-res SHs).

Question #2

A is the sole shareholder of Aco. A owns 100 class A shares of Aco with PUC and ACB of $100 and a FMV of $500. A incorporates Bco and transfers to it the class A shares of Aco in return for redeemable class B shares of Bco. The stated capital and redemption amount of the class B shares is $500. Immediately after the transfer of the Aco shares, Aco pays a $500 dividend to Bco. The dividend is then distributed to A on the redemption of the relevant Bco shares. What is the tax result of these transactions, ignoring section 84.1?

- A would realize a CG of 400$ and taxable CG of 200$ taxed at 24%
- Aco transfers dividend to Bco – because between two corporations, no tax (112(1)) → $500 cash and no tax liability.
- Since shares that Bco then buys with PUC of 500 this is a purchase to which 84(3) would apply --> PUC= POD therefore nil
- Under "proceeds" para (j), we have 0 reduction to proceeds → A has received $500 of proceeds on the redemption of Bco shares but also has $500 ACB therefore no CG → effective result is that A has 500$ in hand and that was held by Aco at the start of the transactions and our total tax payable is (24%)($400) which is less than A would have to pay if Aco had simply paid a $500 dividend to A – A has not parted with any property other than underlying retained earnings of Aco and no economic disposition.

What if, instead of issuing the class B shares to A on the transfer of the class A shares, Bco issues A a promissory note with a principal amount of $500, again ignoring section 84.1?

- Same as above but B just pays out the promissory note (which has 500$ ACB in it)

84.1(1) Conditions of Application – Bright-line (must satisfy all the conditions) :

- Taxpayer resident in Canada who is not a corporation (only applies to individuals);
- Disposes of shares of a corporation to another corporation;
- The shares disposed of were capital property;
- The shares disposed of are shares of a corporation resident in Canada;
- The taxpayer and purchaser corporation did not deal at arm's length; and
    - Under 251(1)(a) NAL if related; (b) beneficiary of trust and trust; and (c) matter of fact
        - Case law re (c): 1. One of the parties has *de facto* control over the other; or (2) whether there is a common mind that directs; and (3) where lack separate economic interests (ie inquiry into whether the dealings between the 2 parties are reflective of ordinary commercial dealings)
- After the disposition, purchaser corporation and subject corporation are "connected". (186(2) and 186(4) → two corporations can be connected if person/corporation controls the subject corporation or if owns more than 10% value and votes of shares or if same person controls both of the corporations after the disposition

Effect of 84.1(1): two results depending on what kind of consideration is received – if shares only then 84.1(1)(a); only debt then 84.1(1)(b)

84.1(1)(a) If share consideration is received, then PUC grind for class of shares issued.

- Grind is equal to increase in PUC addition for all shares as a result of transfer; LESS
    - Excess of greater of PUC or ACB of transferred shares over FMV of non-share consideration received; MULTIPLIED BY
- Fraction obtained when PUC addition for class is divided by PUC addition for all shares.
- → this amount is what is subtracted from the PUC otherwise determined
- Note: this is a case where the stated capital and PUC will be different
- Note: no immediate tax consequence (which makes sense because nothing has been done that should have triggered tax until after the PUC is returned

Above, when A transferred shares in Aco to Bco, the PUC otherwise determined would have been $500 for Bco – under **84.1(1)(a):** In calculating PUC, subtract **(A – B) X C/A** where **A** = increase in PUC of all shares of the capital stock of the purchaser corporation; **B** = amount by which greater of (i) and (ii) exceeds the FMV non-share consideration received [(i) = PUC of the transferred shares; (ii) = the ACB of the transferred shares]; **C** = increase in the PUC of the particular class of shares

- **A** = 500; **B** = no non-share consideration; (PUC = ACB = 100) →100; **C** only one class of shares (500)
- **= 400** PUC grind allocated to the 1 class of shares that was issued on the share transfer (the preferred shares of Bco) ➔ ACB = 500; PUC = 500 – 400 = 100)
- **Note**: A deals with Bco at NAL because A has de jure control under 251(1)(a) and 251(2)(b)(i); Aco and Bco connected immediately after under 186(4) for two reasons: Bco will own 100% of shares and also owns 10% of the votes and value (part of the conditions of application)
- **A** is the total stated capital additions in respect of the shares issued in the transaction (500 as preferred shares) → this was the only class of shares issued in this transaction (therefore C=A)
- **Result**: If A wants to purchase the Bco shares, the result would be a 400 deemed dividend, and a 400 CL; if Aco sold shares would be same result; Bco cant reduce the stated capital of those shares because of 84(4). → Makes it such that cant extract more than 100 from the corporations which is the same result as before the extra corporation
    - 400 CL: 54(k)"POD" can reduce the amount of POD received by the amount of any deemed dividend received uner 84.1. So here, because not realizing any deemed dividend because only 84.1(1)(a) applies, then A will still realize a CG of 400 on this transaction and there wont be any reduction in proceeds, but if Bco did redeem the preferred shares (there would be a 400 CL that could be carried back and apply to the CG) and the reason we have that CL on the repurchase is that (j)"POD" reduces the proceeds by the amount of the subsequently realized 84(3) deemed dividend so a POD of 100 and ACB of 500 therefore 400 CL

84.1(1)(b): effect is that the taxpayer is deemed to have received/been paid a **deemed dividend** by the purchaser corporation in amount determined by **(A + D) – (E + F)** where **A** = increase in PUC of all shares of the capital stock of the purchaser corporation; **D** = FMV of the non-share consideration received by taxpayer; **E** = the greater of (i) PUC and (ii) ACB of the transferred shares; **F** = amount of the PUC grind from section (a)

- Method: need to first figure out if there is a PUC grind in 84.1(1)(a) → if not then straight to (b)
- A = 0; D = 500; E = 100; F = nil (no shares issued therefore no (a) PUC grind) ➔ $400 deemed dividend (from A's perspective will not get dbl taxed because 84.1(1)(b) applies and (k)"POD" which is going to reduce POD by amount of 84.1 dividend
    - ➔ A only receives POD of 100 and ACB in shares prior to transaction was 100 therefore A realizes no gain or loss
- Note: possible to designate as a CD; if no CD then should be able to obtain RDTOH

Note: here it makes sense to trigger a tax consequence immediately because value of property immediately coming out

Question #5

Apply section 84.1 to the example in paragraph 2, but assume that A receives from Bco the following two types of consideration on the transfer of the class A shares of Aco: (a) class B shares of Bco with a stated capital amount, redemption amount and FMV of $300;

and (b) debt of Bco with a principal amount and FMV of $200. → on paper

Paragraph 84.1(2)(a.1): ACB for the purposes of 84.1 is determined based on this para. If this applies the result is that the ACB can be significantly lower than otherwise → this ACB is considered "soft ACB" (that is the amount of ACB that is effectively uselsess for 84.1) (capital gains deduction ACB) (I don't think this matters for this course)

- What this means in the context of 84.1 is htat if somebody in a NAL chain of persons who has passed the shares to the current SH claimed a CG deduction on a prior disposition of the shares, then the extent of the CG deduction claim is considered "soft" and doesn't count for the purposes of 84.1
- Evil addressed: don't want to give ppl credit for ACB that they haven't paid for

Paragraph 84.1(2)(b): **deems NAL** → deals with certain situations where might be trying to arrange parties to avoid falling into NAL. Provides that even if you would not be considered AL, NAL if a group of 6 or fewer persons, including the transferor, controls the person or corporation after the disposition and the same group of person controlled before. 84(2.2) provides supporting rules:

1) shares owned by taxpayer's minor child, spouse, trust in which one of these is beneficiary or a corp controlled by taxpayer, spouse, or minor child, are attributed to the taxpayer.
2) Further, like associated corporation rules, provides that a group means any two or more person regardless of whether sufficient common connection and that any corp is going to be controlled by both any of the smallest group possible and any of the largest group possible at the same time

Handout #19: TRANSFERS OF PROPERTY TO A CORPORATION – SECTION 85

- Rationale for section 85: Because corporations are separate taxpayers, any transfer to a corporation is, absent any other rule, a taxable transaction. We nevertheless do not want tax to be a barrier to incorporation, particularly since we extend tax benefits to CCPCs and their shareholders that we don't to sole proprietors or partners.
- Gifts and all transfers of property between NAL parties are subject to 69(1) – **section 85** however permits a transfer to corporation on rollover basis:
    - Transfer is still a disposition for tax purpose
    - Proceeds are deemed equal to the cost of the transferred property
    - Cost to transferor becomes the cost to transferee
    - Consideration is deemed equal to the cost of the transferred property

→ Effect is that tax is deferred; note the gain or loss to transferor will be locked in with the consideration of the shares

Conditions of 85:

- Taxpayer (transferor) must have disposed of an eligible property
    - "eligible property" defined in 85(1.1) – can vary based on whether Tor is a resident (for our purposes assume is a resident) → includes capital property, resource property, business inventory, financial instruments. Biggest problem is that land inventory is not included so real estate can only be transferred pursuant to 85(1) if it is also capital property
- Tee corp must be a taxable Canadian corporation within 89(1)
- Consideration must include at least one share in the capital stock of Tee corp
- Parties are required to file an election in CRA form T2057 on or before the earliest day that the Tor or Tee corporation is required to file their return for the taxation year in which the transfer occurred
- What if have multiple properties being transferred? - applies on a property by property basis therefore necessary that the consideration received to be allocated between the transferred properties and for the deeming rules in s 85(1) to be applied to ever property in a property by property basis.
    - 85(1)(e.1): will apply to require the taxpayer to designate an order that those properties were disposed of
- Note: does not apply to charities and few others

Question #3

85(1)(b)(c)(c.1)

85(1)(b): requires that the elected amount be at least as high as the FMV of the non-share consideration received UNLESS 52(1)(c) applies **(**if you try and elect at under the amount you received then (b) will automatically increase your elected amount to FMV of the boot (ie, non-share consideration) received)

85(1)(c) requires the elected amount not to exceed the FMV of the property that is transferred

- If the value of the boot exceeds transferred property, the elected amount is restricted to the FMV of the transferred property – pursuant to **15(1)** the excess is a taxable benefit, however, pursuant to **52(1)** this benefit is added to the cost base of the boot (c.1) - sets the min elected amt for most property

85(1)(c.1): sets the minimum amount for most property – usually going to be the lesser of FMV and cost (prevents any property with accrued loss from being transferred to a corporation under 85(1)????)

85(1)(e.3): provides an ordering - requires the elected amt to be the greater of the ACB (85(1)(c.1)) and the FMV (85(1)(b)) —> min elected amount becomes the boot (125K) therefore must be somewhere between 125-50K → if we assume that going to elect for the largest deferral possible, then elected amount is 125K

85(1)(a): deems SH A to have disposed of the land for elected amt of 125K and deems transferee Aco to have paid this amt (125K) for the land —> A realises 25K CG and when Aco disposes of the land, Aco will realize at least 25K CG (assuming holds value).

85(1)(f)-(h) value the consideration: the cost base of the transferred assets is allocated to various types of consideration (page 8:6):

- Apply in hierarchical order: f, g, h
- **85(1)(f)**: the boot that is received (but not in excess of the FMV or the property)
- **85(1)(g)**: any preferred shares that are received in consideration for the transfer, up to the FMV. More precisely, the elected amount is allocated to the preferred shares, up to the lesser of (a) the FMV (immediately after the disposition) of the preferred shares, and (b) the excess of the elected proceeds fo disposition for the particular asset over the FMV of the boot.
- **85(1)(h)**: common shares that are received in consideration for the transfer. More precisely, the elected PsOD, minus the FMV of the boot and the cost (determined in 85(1)(g)) of the preferred shares, is allocated to common shares.

Problem 3(c)

Capital cost of a depreciable property is what was actually paid for that property and is determined on a property by property basis; UCC is the combined undepreciated amount of property left after deductions paid.

85(3)(e): where property was **depreciable property**: the minimum is the least of (i) the UCC; (ii) ACB; and (iii) FMV

Question 4/5

Purpose of 85(1)(e.1): permits taxpayers to designate the order in which property is disposed of wrt property in (e) (ie when multiple eligible cap properties or depreciable cap properties) → by having separate, sequential dispositions, the UCC or cumulative eligible capital balance will be reduced after each disposition for the purposes of determining the minimum transfer price

Purpose of 85(1)(e.3): really just to create certainty and prevent conflict (subject to 85(1)(c))

Question 6 How is the cost of the consideration received by a transferor determined under subsection 85(1)? Why? Consider the following examples.

(a) X transfers land held as capital property to Xco. On the transfer, X receives a promissory note with a FMV of $300,000. At the time of the transfer, the ACB of the land for X was $100,000 and its FMV was $200,000.

- Conditions of application require share therefore not in 85(1) and fall in to ordinary tax principles
- POD = FMV of the consideration = 300K therefore 200K CG
    - HOWEVER **69(1)(a)** will deem **Xco** to have acquired the land for 200K rather than 300K.
        - 69 applies to NAL transfers fo property – do 3 things
            - where a person has disposed of property that is less than FMV, then 69(1)(a) will deem them to have disposed of the property for FMV
            - 69(1)(b) provides that if received property and has paid more than the FMV, then will deem the ACB to be the FMV (and will be one-sided – so POD not reduced but ACB is → this means dbl tax)
            - 69(1)(c) applies to gifts – where gift deemed to have paid the FMV of the gift received
- Therefore 200K CG to X; Xco has 200K cost in the property
    - However! Because now issued consideration to the SH that's worth more than the property that was exchanged, 15(1) could also apply to tax a SH benefit

What if X also receives one common share of Xco?

- Now will fall under 85(1) (this is in written notes)

Question #6 b/c

B(i)What if X received a $50,000 note and 100 Preferred Shares of Xco?

- 85(1)(b) = 50K; (c) = 200K; (c.1) = 100K → conflict between c.1 and b → **(e.3)** resolves in favour of c.1 therefore elected amount of 100K-200K.
- If max deferral, will elect 100K therefore POD of 100K; Xco has ACB in land = 100K
- No CG to X bc POD=original ACB
- Allocation of cost: first goes to boot (50K) then remainder to preferred shares (50K 85(1)(g))
    - Class A preferred shares have ACB of 50K and FMV of 150K → 100K CG essentially locked in to these shares

B(ii)What if the shares were instead shares of Yco?

- Conditions of application wont be met because it <u>has to be shares of the transferee</u> → ordinary tax principles → X has a fully taxable disposition and will have a CG with 100K realized; cost in note of 50K; cost in Yco shares of 150K. Xco has ACB in land of 200K.

What if X received a $50,000 note, 100 Preferred Shares of Xco (FM 25K) and 50 Common Shares of Xco (125K)?

- Essentially same as 6(a) and only change is allocation at end
    - (f) – gives 50K to note
    - (g) – allocate next to preferred shares (25K) → ACB 25K; FMV 25K
    - (i) – remainder to common shares → FMV 125K; ACB 25K

Paragraph 85(1)(e.2): anti-avoidance rule: prevents from using indirect transfer of property to related people on a tax deferred basis

- Applies where the greater of the elected amount & FMV(consideration (including shares)) < FMV(property transferred) AND one of the SHs of the transferee is related to the transferor
    - Does not include a corporation that was a wholly owned corporation of the taxpayer immediately after the

disposition within meaning of 85(1.3) → so e.2 does not apply where transferor is the only SH of the transferee

- **Result**: elected amount is increased by the difference so that deemed gain arises and (ii) the SHs obtain no corresponding increase in ACB of the shares

Subsection 85(5):

- **Applies** where **transferor's CC > POD**
- **Purpose**: to preserve our potential for CCA recapture after the transfer of depreciable property on tax deferred basis
- **Effect**: deems the corporation that acquires the property to have CC in the property = to the transfor's CC in the property; also deemed to have claimed the diff between the POD and the CC as CCA, so now accrued, captured income remains in the corp on a going forward basis because will have a UCC of 500 and CC of 1000.
- **Question #8 - answer**: so now, if Bco were to dispose of property for 1500, we would have same result as if B had disposed - recapture income of 500 being the gap between UCC (500) and capital cost (1000) and a CG of 500 being the difference between CC of 1000 and POD of 1500.

Subsection 85(2.1): anti-avoidance rule:

- Intended to ensure the PUC of shares issued does not exceed the elected amount less the cost of non-share consideration; without this section it would be possible to transfer shares to a corporation on a tax deferred basis but nevertheless extract surplus via a PUC reduction (based on FMV which is what you get to add to stated capital for corporate law purposes)
- Does not apply to a transaction to which 84.1 applies (ie if our property is being transferred to a corporation as shares of a corporation, then governed by 84.1 → reason is that **84.1(1)(a)** does essentially does the same thing as puc grind)
- Will not apply to every 85(1) exchange → where excessive boot, will be **15(1)** not 85(2.1); also not applied to internal transaction (ie where SH essentially exchanging shares under 85(1) election)
- **Applies** where property transferred to corporation is not shares, and elected amount exceeds the value of the boot?????
- **Effect**: requires the PUC of the shares to be reduced by amount (PUC – ACB – FMV(boot))?;
    - Application is essentially the same as 84.1
    - Amount determined by formula **(A – B) X C/A** will be the amount by which the PUC of the shares will be reduced where **A** = increase in PUC of all shares; **B** = ACB (elected amount) less the FMV(boot); **C** = increase in PUC of particular class of shares

Prevent transfer of losses – 13(21.2), 14(12), 40(3.4), 40(3.6)

- Prevent the accel of losses within corporate groups when the economic realities of something remains unchanged. Economic losses subject to these provisions are not denied but suspended. At some later time when the economic group no longer owns the property the original transferor realizes losses.
- **13(21.2)**: eligible depreciable property **(not going to look at this**)
- **14(12)**: eligible capital property **(not going to look at this**)
- **40(3.4)**: non-depreciable capital property
- **40(3.6)**: shares repurchases by an affiliated corporations
- **Section 251.1(a)-(c) Affiliated groups**: for our purposes:
    - An **individual** is affiliated with his/her **spouse**
    - A **corporation** is affiliated with the **person** or **affiliated group** that controls it
    - Two **corporations** are affiliated if the **persons who control** the corporations **are affiliated** with one another
- **251.1(3):** defines "control" for purposes of affiliated rules - both de facto and de jure control are relevant - however many sections that use 251.1 say that going to override subsection 251.1(3) anyway
- **40(3.4):** provides for the loss suspension and **40(3.3)** sets out the conditions of application – conditions:
    - Taxpayer other than ind
    - Dispose of non-depreciable capital property
    - Has a loss and no other stop-loss rules apply
    - 40(3.3)(b)-(c): timing – require that the transferor or affiliated person acquired the same property or identical property within the period beginning 30 days prior to and ending 30 days after to the disposition, and that the transferor/affiliated person owned that property at the end of the 61 day time period
- **40(3.6)**: requires a TP to dispose of his share of a corporation that remains affiliated and the person recieinv the share has to be the corporation (ie repurchase of the share) – because of 84(9) which deems a person who has had a share repurchased by a corporation is deemed to have disposed to the corporation – if the repurcahasing corporation remains affiliated at time of repurchase, then this section applies. **Effect**: the denied loss will be added to the SH's ACB of his other shares in the corporation – downside is that owns no other shares then the loss discontinues

Question 10 (written as well)

C is an ind not a corp - so instaed C has a superficial loss:
-Cco has acquired the property witin the 61 day period and at the end of the period, Cco still owns htat property and none of the other exceptions in defniniton of sup loss apply —> 42(g)(1) will apply to deem the loss that C realized due to 85(1)(c) to be nil and then para 53(1)(f) will apply to add the amt of 500 to Cco's ACB in the transferred property => Cco now has ACB in the property of 1K which is the total of the cost under 85(1)(a) plus the 53(1)(f) ACB addition --> when Cco disposes of the property, Cco willl realize that accrued capital loss. C just has 500 dollars shares of Cco and no loss.

Question 11 (also in notes)
13(7)(e): anti-arbitrage

- **Applies**: **NAL** transfer to corporation, and transfer of **depreciable property**
  - NAL transfer to corporation where elect at FMV (or other as well) where FMV(or elected amt) > CC
- Without, would be able to create CGs which are taxed at only 50% → also may result in tax planning if expect rates to increase in the future in which case best to realize gain in the short term
- **Effect**: **CC(Aco) = CC(A) + (1/2)(POD – CC(A))**
  - So essentially captures the 50% of CG that A did not pay the tax on (because CG only taxed at 50%)
- What if between **two corporations**? Effectively the same only now under **13(7)(e)(ii)**
- What if elect to transfer at UCC? Then no 13(7)(e)(i) is just going to compute to nil. However instead have to look at **85(5)** which in cases where **elected amt = UCC** < CC then Aco's CC will be deemed to be A's CC, and Aco will be deemed to have claimed that difference so that the recapture income is also preserved in Aco's hands
- What if at 150K? back into **13(7)(e)(i)** – same as above but CC of 125 rather than 150

Question 12:
Section 22: no real tie with 85, just often seen together

- Deals with sales of **accounts receivable**
- Person who accrues the AR will have an income inclusion, and will have to pay tax on it, but if you transfer it, the person actually collecting the money will be someone different than the person who has paid the tax
- **Effect**: if a TP carrying on a business has sold all, or substantially all of the property of the business including accounts receivable, and the buyer continues the business post sale, and parties make an election under form t4022, then to the extent that the person did not pay cash for the AR, the seller gets to deduct that amount in computing their income in year of sale, and the buyer is required to include a corresponding amount in the buyer's income → not connected to 85 but often see alongside because of the transfer of property

Handout #20: CAPITAL REORGANIZATIONS AND SHARE-FOR-SHARE EXCHANGES: SECTIONS 51, 86, AND 85.1

SHARE EXCHANGE RATIONALE: ALLOWS FOR A TAX DEFERAL

- Gains and losses should only be realized where there is a change in investment (like 85)
  - Should only tax where the economic investment starts to decrease or where switches from share investment to debt
- Taxing share exchanges would create liquidity problems for taxpayers who are not receiving cash (more applicable to 85.1).
- **Note**: these three provisions **automatically apply** where conditions of application are met

Section 51(1)

v **Convertible Properties**

¶ 1. Subject to ¶ 2 below, for exchanges occurring, and reorganizations commencing, after December 21, 1992,
subsection 51(1) permits a taxpayer to exchange convertible property issued by a corporation for shares of one or more classes of capital stock of the same corporation on the basis of a tax-free rollover, that is, the adjusted cost base of the convertible property becomes the adjusted cost base of the shares received. No consideration other than shares of the corporation may be received for the convertible property. "Convertible property" is capital property of a taxpayer that is a share of a corporation, or a bond, debenture, or note of a corporation that contains a conversion privilege. Before December 22, 1992, a share, to be a convertible property, had to contain a conversion privilege. Subsection 248(1) defines "share" in part, to mean "a share or fraction of a share of the capital stock of a corporation". Notwithstanding the inclusiveness of that definition, this bulletin discusses "shares" and "fractions of shares" as if they were different.

¶ 2. Subsection 51(2) denies the tax-free rollover under subsection 51(1) and restricts any capital loss where, as a result of the exchange of convertible property of a taxpayer for shares that have a fair market value that is less than that of the convertible property, a benefit has been conferred on a person related to the taxpayer. Subsection 51(4), which applies to exchanges occurring and reorganizations commencing after December 21, 1992, provides that subsections 51(1) and (2) do not apply where section 86 or subsection 85(1) or (2) apply.

¶ 3. The situation often arises in an exchange of convertible property that a taxpayer becomes entitled to a fraction of a share because of the particular conversion agreement. However, most corporations will not issue these fractional shares. In lieu of the fractional shares, the agreement will usually provide for the taxpayer to receive cash or other non-share consideration. The application of subsection 51(1) generally will not be denied in these circumstances, notwithstanding that the subsection requires that no consideration other than shares be received for the convertible property. In addition, if the value of the cash or other non-share consideration received by a taxpayer in this manner does not exceed $200, the taxpayer may either calculate and report the gain or loss on the amount received in lieu of the fraction of a share, or ignore that calculation and reduce, by the amount received, the adjusted cost base of the shares received. However, where the total amount or value of any non-share consideration received exceeds $200, the taxpayer must report, to the extent that total amount or value exceeds the paid-up capital of the fractional share that the taxpayer is entitled to receive on the exchange, a deemed dividend under subsection 84(3) and any gain or loss, as the case may be, from the disposition of its fractional share.[Footnote 1]

In either case, subsection 51(1) may be utilized for the convertible property exchanged for shares.

- **Conditions**: can apply to bond or share
  - Taxpayer must receive a share of the capital stock of the corporation;
  - In exchange for either:
    - Another share of the corporation that was taxpayer's capital property; or
    - A bond or debenture of the corporation that was the taxpayer's capital property and had terms granting the holder the right to convert;
  - No non-share consideration is received; and
  - Subsections 85(1) and (2) and section 86 don't apply to the exchange.
- **Effects**: For our purposes, there are two material effects of subsection 51(1) applying:
  - (c) Exchange is deemed not to be a disposition; and
  - (d) ACB of shares acquired is equal to prorated portion of ACB of property exchanged, with proration based on the

relative FMV of the shares acquired.

Subsection 51(2)

- Anti-avoidance rule similar to paragraph 85(1)(e.2) (works in substantially similar manner)
- **Application**: if there has been a 51 exchange and the property exchanged is worth more than received, then 51(2) applies if it is reasonable to conclude that some portion of the shortfall is a benefit conferred on a related person by the taxpayer (the "gift portion")
- **Effect**: (d) provides for a disposition for **proceeds** equal to the lesser of either (i) **ACB + gift** or (ii) **FMV** (values of shares immediately before disposition) → (e) any capital loss arising from this deemed disposition, is deemed to be nil
    - **(f)** provides that the ACB of shares received wont increase unless the FMV < ACB → so if the shares were in a gain position when you did something to trigger 51(2) then the effect is that in future there will be double tax (major downside) unless lift by some other provision ➔ can avoid with a price adjustment clause that will cause share consideration to increase or decrease if there is a gap between the FMV and ACB
- Will result in a disposition, so can also cause unanticipated tax consequences if a disposition would lead to other problems.

Subsection 51(3): (PUC before is PUC after with shares but not necessarily bonds) PUC reduction rule substantially similar to 85(2.1) however somewhat simpler bc there will be no non-share consideration. PUC reduction = **(A – B) X C/A** where **A** = increase of PUC of all shares; **B** = PUC of old shares; **C** = increase in PUC of particular class of shares

- Note: does not apply to on the conversion of a bond

Question 1

(a) What if the preferred shares are debentures of Aco with a principal amount and FMV of $130? → Should make no diff that using bond provided that the conversion feature is in terms of the bonds themselves, and that granted the BH the right to enforce the conversion → in that case 51(1) will apply and our exchange will not be a disposition – however, because the bonds have principal amount of 100 and ACB of 100 → under 51(1)(d) and 51(3), amount added to ACB and PUC will be 130 and 100. If the bonds had an ACB of 100 then your ACB in shares is 100 and the PUC is the →FMV of the bonds (130)

(b) What if A receives common shares of Aco (FMV and stated capital - $110) and $20 cash on the conversion? (51(1) does not apply but 86 might still)

(c) What if A receives only the common shares with a FMV and stated capital of $110? → question is whether or not that shortfall can reasonably be considered to be a benefit that A intended to confer on a related person → if so, then 51(2) would deem there to have been a disposition of the shares for proceeds of 30$ but A would only have ACB in Aco shares of 100 —> situation where use price adjustment cause to increase/decrease the number of shares to prevent shortfall consideration

(d) What if A is a trader or dealer in corporate securities? 51(1) requires that shares be capital property so pretty good chance that wont be able to rely on this section BUT can have some shares that are inventory and some shares that are capita property → question of fact as to whether a problem – if has some capital property then could use

(e) Is a conversion feature exercisable by the issuer within section 51? depends on what kind of property is being exchanged - para 51(1)(1)(b) provides that in the case of a debenture in exchange, the option to convert has to be exercisable at the option of the debenture holder, however silent as to what to do wrt shares

Subsection 86(1): same thing as 51 essentially, but less stringent because can still have non-share consideration

Conditions

- Exchange must occur in the course of a reorganization (ie change in the capital of the corporation); (**diff from 51**)
- Property disposed of must be capital property;
- Property disposed of must be *all of the shares* of any class owned by the taxpayer; (**diff from 51**)
- The property received from the corporation includes shares in the capital of the corporation; and
- **86(3)** Subsections 85(1) and (2) do not apply.
- **If taking any non-share consideration → 86 not 51**
- **If amend the share capital of the corporation → 86 not 51**
- **If otherwise in both, then prob section 51**

Effects

- Taxpayer is deemed to have cost in non-share consideration equal to FMV of the non-share consideration (just like boot under 85(1));
- Taxpayer is deemed to have cost in new shares equal to amount that ACB of old shares exceeds FMV of non-share consideration (like section 51 if you have a non-0 amount as ACB of the shares coming back, then pro-rata)
    - ACB of new shares allocated pro rata between classes based on relative FMV.
- Taxpayer is deemed to dispose of old shares for proceeds equal to cost of new shares plus cost of non-share consideration (ie unlike 85, you don't get to elect to transact at a higher cost→ 86 will always give max deferral possible in the circumstances)

Subsections 86(2) and (2.1)

- Subsection 86(2) provides for realization of a gain if there is a shortfall of consideration.
    - Deemed to have disposed for POD = lesser of (i) **ACB(boot) + gift** and (ii) **FMV**(old shares)
    - Materially similar to subsection 51(2), but also accounts for the value of boot (in addition to the value of the shares)
- Subsection 86(2.1) provides for a PUC reduction for the new shares → PUC grind in event that excessive amt gets added to stated capital - intention is that should only be allowed an amt to puc equal to the PUC of the old shares less the boot received

- Virtually indistinguishable from subsection 85(2.1)

Section 85.1: where acquiring shares of a different corporation

Conditions

85.1(1) requirements:

- Canadian corporation must issue shares to the taxpayer;
- The shares must be issued in exchange for shares of any particular class in the capital of a taxable Canadian corporation;
- The exchanged shares (shares sold) must be capital property of the vendor; and
- The vendor cannot include in its income any portion of the gain or loss otherwise attributable to the disposition of the shares.

85.1(2) requirements:

- Vendor and purchaser must deal at AL prior to exchange;
- After the exchange, vendor and persons not at arm's length with vendor cannot:
  - Control the purchaser; or
  - Own more than 50% of the FMV of the shares of the purchaser;
- No election can be made under section 85; and
- The vendor cannot receive non-share consideration for the exchanged shares.

Effects:

- Vendor is deemed:
  - To have disposed of the old shares for proceeds equal to ACB; and
  - To have acquired the new shares at a cost equal to the ACB of the old shares.
- Purchaser is deemed to have acquired the purchased shares at a cost equal to the lower of their FMV and PUC (of the vendor's shares before disposition).

Subsection 85.1(2.1)

PUC reduction provision that applies if PUC of new shares exceeds PUC of old shares.
– Materially similar to subsection 51(3).

Handout 21: AMALGAMATION AND WINDING-UP

Amalgamations

Conditions

Generally tax deferred under **section 87**, provided subsection 87(1) **conditions** are met:
– All property of predecessors becomes property of successor corporation;
– All liabilities of predecessors become liabilities of successor corporation; and
– All shareholders of predecessors become shareholders of successor corporation; and
– These things did not happen on an asset purchase or a winding-up.

Effects:

- Effects on corporation:
  - Predecessors have year end immediately prior to amalgamation and successor is new corporation with taxation year beginning on amalgamation date (87(2)(a))
  - Tax attributes of property of predecessors (ACB/UCC/CDA/RDTOH/losses) become attributes of successors.
- PUC adjustment under subsection 87(3).
  - Materially similar to subsection 85.1(2.1) (difference is the exclusion for PUC of a predecessor corporation owned by another corporation).
    - Class by class
    - Grind excess of PUC predecessor shares less PUC attributable to shares of a predecessor corporation owned by another predecessor corporation → prorated to shares
  - Requires inter-corporate PUC to be ignored in applying the grind.
- Rollover for **shareholders** of predecessors under subsection 87(4) → necessary bc the amalgamating corp is a new corporation; intended to prevent any tax consequences form arising as a result of disposition
  - Shares of predecessor must have been capital property of shareholder; and
  - Must not receive consideration other than shares on the amalgamation.
- If rollover applies, deemed to have disposed of old shares for proceeds equal to ACB and acquired new shares at cost equal to ACB of old shares.
  - If more than one class of successor issued, proration of ACB based on FMV of each class of successor.

Winding-Up

- 88(2) If a corporation winds-up and its **shareholders are individuals**, then the result is a **taxable** event for both the corporation and its shareholders.
  - Subsection **69(5)** deems the corporation to have disposed of all of its assets distributed on the winding-up for FMV proceeds; and
  - Subsection **84(2)** deems any distribution to the shareholders to be a dividend to the extent that it exceeds the corresponding PUC reduction (should be FMV property distributed – PUC priority to disposition)

- For the purpose of computing the corporation's CDA on winding-up, subsection **88(2):**
  - CDA calculation: Deems the disposition of property under subsection 69(5) to have occurred in a taxation year that ended immediately before the winding-up distribution; and
    - Result is that the non-taxable portion of the accrued CG realized on the application of 69(5) will be added to CDA and will be available at the wind up distribution, and moreover, the amount of any 14(1)(b) income includsion on the disposition of the capital property will also have been added to the corp's CDA at the time of the winding up distribution bc of that year end → 88(2) positive for SH
  - Allows *part* of the 84(2) dividend to tbe deemed a CD (as oppose to 83(2) which reqruies you to designate a whole dividend as a CD). Does this by deeming a portion of the subsection 84(2) deemed dividend equal to the CDA at the commencement of the new year to be a separate dividend.

Inter-Corporate Wind Up

- If the corporation is a taxable Canadian corporation and 90% or more of its shares are owned by another taxable Canadian corporation; and
- Provided the other 10% or less of the shares are owned by an arm's length person; then
- Subsection 88(1) permits a **tax-deferred** winding-up that is effectively the same as an amalgamation
- Note re **minority SH**: 88(1) does not apply – subject to 84(2) and 69(5) → best thing to do in this case is just to have the parent buy the shares of the subsidiary from minority SH and does as wholly owned winding up
- **Effect**: 88(1)(a) deems subsidiary to have disposed of all of its property for a cost amount of the property, and the parent is deemed (88(1)(c)) to have acquired the property for an amount equal to sub's POD. 88(1)(b) deems parent to have disposed of property of subsidiary for proceeds of the greater of (a) the lesser of (i) PUC of shares, or (ii) cost of subsidiary's property distributed + amount of money distributed or (b) the ACB of the shares disposed of on winding up
- **88(1.2)** causes 87(2) to apply to winding up as if amalgamation → parent will have tax attributes (CL, RDTOH, CDA)

88(1)(2.1) provides that 84(2) is inapplicable to parent - so no deemed dividend - idea is that 88(1) is meant to be a complete code for winding up once the conditions of application are fulfilled.
-one important exception: **bump rule** in 88(1)(c)-(d) - applies where the parent bought the shares in sub from unrelated person and the ACB of the shares exceeds the ACB of the non-depreciable capital property that's being distributed to the parent on winding up - reason we care about cost in those circumstances is that potentially creating double tax if don't have some sort of rule in these circumstances

Question 1(b)
88(2) then deems the 84(2) deemed divi to be two seperate 2.5k divi s as the CDA was 2500 at time
xco will make a 83(2) designation to cause one of the divis to be a capital divi

pursuant to para k"POD", 54, X will not have to include any amount of the s.84(2) deemed divi in computing the POD of shares of Xco
→ X has disposed of shares of Xco for 5k, resulting in no gain or loss. at end of day x has recieved Pubco shares with FMV and acb of 10k and has received capital divi of 2500 and taxable divi of 2500

Part II
What if Xco receives a dividend receives a dividend on the Pubco shares of 1K prior to winding up?
-point is to make you think about RDTOH and corp income tax - when

- when divi on pubco shares received by xco, it will be subject to part iv tax under 186(1)(a) equal to 1/3 of the dividend received (333.33 assuming not connected with pubco) → that amt will get added to xcos rdotoh (129(3)(b))
- also add 26.666% of taxable CG of 2500 on the 69(5) disposition, so we have a second RDTOH add of 666.75
  - → essentially 1000 RDTOH
- have to then compute part i tax payable by dissolving corp
  - divi itself is deducted under 112(1)
  - taxable CG gives rise to corporate income tax of 1166.75?? gets reduced to 500 on payment of sufficient divids to cover RDTOH

84(2) deemed dividend increases from 5k to 6k (because 1000 cash in hand
after apply 88(2) and make separate CD designation, the taxable portion of the dividend increases from 2500 to 3500 - whats going to happen is the corp will hang on to 500 and use that to pay non-refunedatble part
end up with taxable dividend 3000 which is getting paid to the SHs (which is exactly 3x the RDTOH balance of 1k) – no reason why 84(2) would not lead to recovery of RDTOH

X now actually recieving 5500 from Xco of which 2500 is a CD and 3000 is taxable divi (at rate of 40.2% after gross up mechanism)

→ point is that good that had the extra cash in the system form the tax dividend cause otherwise would have to pay out of pocket – so doesn't need to pay as much on the deemed dividend

Part 3: What if X was "Yco"
88(1)(a) Xco deemed to have disposed of Pubco shares for amount equal to ACB of 5K (no gain or loss)
then 88(1)(c) deems Yco to acquire the PUC of shares for an amount equal to xco's POD of 5k so Yco would own Pubco shares with that locked in 5k accrued CG
88(1)(b) deems yco to have disposed fo the shares of Xco for the greater of (i) the lesser of the PUC of Xco (5k) and the ACB of property distributed(5K) and (ii) the ACB of the Xco shares prior to winding up (5K) → POD =5K realized by Yco in respect of the Xco shares.
Since Yco had 5K of ACB no gain or loss
→ end of the day we have totally tax deferred winding up
moral - alsways wind up into a corporation adn then dont have to worry aboutrdtoh

Non-eligible dividends: 40.24
CG: 24%

Eligible dividends: 31.27

APPENDIX

CHAPTER 1

Income Tax Folio

S4-F16-C1: What is a Partnership?

Series 4: Businesses Folio 16: Partnerships Chapter 1: What is a Partnership?

The Canada Revenue Agency (CRA) issues income tax folios to provide technical interpretations and positions regarding certain provisions contained in income tax law. Due to their technical nature, folios are used primarily by tax specialists and other individuals who have an interest in tax matters. While the comments in a particular paragraph in a folio may relate to provisions of the law in force at the time they were made, such comments are not a substitute for the law. The reader should, therefore, consider such comments in light of the relevant provisions of the law in force for the particular tax year being considered. Income tax folios are available in electronic format only.

Application

This Chapter, which may be referenced as S4-F16-C1, is effective May 5, 2015 and replaces and cancels Interpretation Bulletin IT-90, *What is a Partnership*?

Any technical updates from the cancelled interpretation bulletin can be viewed in the Chapter History page.

Except as otherwise noted, all statutory references herein are references to the provisions of the *Income Tax Act*, R.S.C., 1985, c.1 (5th Supp.), as amended and all references to a Regulation are to the *Income Tax Regulations*, C.R.C., c. 945, as amended and as promulgated under the Act.

Links to jurisprudence are provided through CanLII.

Reference

Section 96

Summary

The Act does not define a partnership but it recognizes the existence of partnerships and sets out the income tax consequences of transactions involving partnerships and their members. Section 96 provides that the income of a member of a partnership is computed as if the partnership were a separate person resident in Canada. The purpose of this Chapter is to outline the factors that are relevant to determining whether a partnership exists.

Although the Act sets out a number of rules that apply to limited partnerships, which are a special type of partnership provided for under provincial law, this Chapter does not discuss the factors related to determining whether a limited partnership exists. Nonetheless, the discussion in this Chapter is relevant to limited partnerships insofar as a limited partnership cannot be established unless a partnership exists.

This Chapter also discusses some of the factors that indicate the existence of a joint venture, which is an arrangement that has attributes similar to a partnership.

Table of contents

- Discussion and interpretation
  - Provincial definition of a partnership
  - Common law jurisdictions
  - Determining the existence of a partnership
  - Characteristics of a partner
  - Quebec partnerships
  - Joint ventures

Discussion and interpretation

Provincial definition of a partnership

1.1 Each of the common law provinces or territories has a partnership statute that defines the term **partnership**. Similarly, the Civil Code of Quebec defines a **contract of partnership**.

1.2 In Continental Bank Leasing Corp. v. Canada, [1998] 2 SCR 298, 98 DTC 6505, and later in Backman v. Canada , [2001] 1 SCR 367, 2001 DTC 5149, and Spire Freezers Ltd. v. Canada , [2001] 1 SCR 391, 2001 DTC 5158, the Supreme Court of Canada confirmed that for purposes of the Act the existence of a partnership must be determined by reference to the partnership law of the relevant province or territory, and this is the case even when dealing with a partnership established in a jurisdiction outside Canada.

1.3 In the case of a foreign entity or arrangement, the CRA takes the following two-step approach to determine whether such entity or arrangement should be treated as a partnership for Canadian tax purposes:

i. Determine the characteristics of the foreign business entity or arrangement by reference to any relevant foreign law and the terms of any relevant agreements relating to the entity or arrangement; and

ii. Compare the characteristics of the foreign business entity or arrangement to the characteristics of business entities or arrangements under Canadian law in order to see which Canadian entity or arrangement it most fundamentally resembles.

If the foreign entity or arrangement more fundamentally resembles a partnership arrangement under Canadian law than a corporation, trust or co-ownership, it will be treated as a partnership for Canadian tax purposes.

Common law jurisdictions

1.4 Under Canadian provincial and territorial common law statutes, a **partnership** is defined as the relation (or relationship) that subsists (or exists) between persons carrying on a business in common with a view to profit.

1.5 These statutes generally also provide that:

- an incorporated company or association is not a partnership;
- a joint tenancy, tenancy in common, joint property, common property or part ownership does not, by itself, create a partnership as to anything so held or owned, whether the tenants or owners do or do not share any profits made by the use thereof; and
- the sharing of gross returns does not by itself create a partnership, whether the persons sharing such returns have or have not a joint or common right or interest in any property from which or from the use of which the returns are derived.

Determining the existence of a partnership

1.6 Whether a partnership exists is a mixed question of fact and law. The fact that a partnership is formally registered does not necessarily mean that a partnership actually exists. In partnership law, a declaration of this type does not prevail over the actual facts of a situation (see ¶1.10).

1.7 In *Continental Bank*, *Backman* and *Spire Freezers*, the Supreme Court of Canada used the provincial and territorial partnership statutes to identify three fundamental criteria for determining whether a partnership exists in the common law provinces. To conclude that a partnership exists in the common law provinces, the Court affirmed that one must demonstrate that two or more persons are:

- carrying on business;
- in common;
- with a view to profit.

Carrying on business

1.8 The determination of whether persons are **carrying on business** for purposes of the definition of a partnership is a question of fact and law. This issue was critical in the Supreme Court of Canada's decisions in *Spire Freezers* and *Backman*. In *Backman*, the Supreme Court of Canada held that there was no partnership since there was no business carried on. This same court decided in *Spire Freezers* that there **was** a partnership. The facts in that case were distinguished from those in *Backman* in terms of the degree of effort required of the appellants and expended by them in the management of the partnership.

In common

1.9 In *Backman*, the Supreme Court of Canada held that the common purpose required for establishing a partnership will usually exist where the parties have entered into a valid partnership agreement setting out their respective rights and obligations as

partners. However, even if a partnership agreement and other documentation indicate an intention to form a partnership, the fundamental criteria of a valid partnership must still be met in order to conclude that one exists.

1.10 In determining whether a business was carried on in common, the Supreme Court of Canada held in *Continental Bank* and *Backman* that the authority of any partner to bind the partnership is a relevant factor. However, the fact that the management of a partnership rests with a single partner does not mandate the conclusion that the business was **not** carried on in common. This differs from the fundamental requirements of a joint venture. As noted in ¶1.20(b), parties to a joint venture must have a right of mutual control and management.

A view to profit

1.11 In *Backman*, the Supreme Court of Canada held that determining whether a **view to profit** exists requires an enquiry into the intentions of the parties entering into the particular arrangement.

Elements of a partnership

1.12 In *Continental Bank*, the Supreme Court of Canada listed some of the elements of a partnership in the common law jurisdictions which included:

- the contribution by the parties of money, property, effort, knowledge, skill or other assets to a common undertaking;
- a joint property interest in the subject matter of the adventure;
- the sharing of profits and losses;
- a mutual right of control or management of the enterprise;
- the filing of income tax returns as a partnership;
- joint bank accounts; and
- correspondence with third parties.

Overall approach

1.13 In *Continental Bank*, the Supreme Court of Canada held that the existence of a partnership depends on the true contract and intention of the parties as determined by examining all of the facts of the case. In *Backman*, the Supreme Court of Canada confirmed this principle stating that an enquiry must be made into whether the objective, documentary evidence and the surrounding facts, including what the parties actually did, are consistent with a subjective intention to carry on business in common with a view to profit.

1.14 In *Backman*, the Supreme Court of Canada recommended a practical approach in determining whether a partnership exists. The court stated that whether a partnership has been established in a particular case will depend on an analysis and weighing of the relevant factors in the context of all the surrounding circumstances.

Characteristics of a partner

1.15 Except in certain cases, such as limited partnerships and limited liability partnerships, common law partners are generally jointly and severally liable for any debts that arise while carrying out the business of the partnership. Where the participants in a business arrangement are not jointly and severally liable for the debts of the business, it generally indicates that a partnership does not exist.

1.16 The type and extent of a person's involvement in the business is generally relevant in determining whether that person is a partner. Limited partners in a limited partnership are an exception to this rule.

1.17 In *Backman* and *Spire Freezers*, the Supreme Court of Canada held that in order for a person to become a new partner of a valid and pre-existing partnership, that person and the existing members of the partnership must satisfy the essential elements of a valid partnership at the time of the entry of the new partner. That is, the new partners along with the partners of the pre-existing partnership must be carrying on business in common with a view to profit.

Quebec partnerships

1.18 Article 2186 of the *Civil Code of Québec* defines a **contract of partnership** to be "a contract by which two or more parties, in a spirit of cooperation, agree to carry on an activity, including the operation of an **enterprise**, to contribute thereto by combining property, knowledge or activities and to share among themselves any resulting **pecuniary profits**."

Joint ventures

1.19 As with partnerships, the term **joint venture** is not defined in the Act. Whether a joint venture exists is a mixed question of fact and law which must be determined by reference to the law of the particular province or territory.

1.20 In *Woodlin Developments Ltd. v. MNR*, [1986] 1 C.T.C. 2188 (TCC), 86 DTC 1116, the Tax Court of Canada identified three distinctive requirements to conclude that a joint venture exists. There must be:

a) a joint property interest in the subject matter of the venture;

b) a right of mutual control and management of the enterprise; and

c) a limitation of the objective of the business to a single undertaking or a limited number of undertakings.

1.21 Since a joint venture is not recognized as a taxpayer under the Act, a joint venture cannot have its own fiscal period or claim capital cost allowance, among other things.

1.22 A joint venture agreement, whereby two or more persons agree that each provides their own property, performs a specific task and receives a specific division of profits from such a task, may be considered a partnership as regards such profits. However, if the property is not held under joint tenancy or tenancy in common, it is not considered to be partnership property. This means that the capital cost allowance provisions relating to partnership property would not apply.

Handout #2

Income Tax Technical News No. 30

Computation/Allocation of Partnership Income and Losses

Question 1

At last year's panel discussion on partnership issues, the CCRA stated that a "salary" paid to a partner would not be deductible in computing the income of the partnership. Some practitioners have questioned whether this position is consistent with the case law (namely, *Archbold v. The Queen* 8) and the partnership acts of the provinces (which do not prohibit the payment of remuneration to a partner if expressly agreed to between or among the partners). In view of these concerns, has the CCRA reconsidered its position on the tax treatment of a "salary" paid to a member of a partnership?

Response 1

The CCRA continues to stand by its assertion that a "salary" paid to a partner is not deductible in computing the income of the partnership. In our view, the earning of income from employment by a member of a partnership would be inconsistent with the legal relationships that define a partnership (i.e., two or more persons carrying on business in common with a view to profit). That is, a partner is a participant in the business of the partnership and not an employee.

Question 2

What is the legal basis for concluding that a member of a partnership cannot be an employee of the partnership?

Response 2

Each member of a partnership carries on business as both a principal and an agent of the other members of the partnership. Accordingly, an agreement between the members of the partnership to employ a particular partner would be an attempt by the particular partner to enter into a contract of employment with him or herself. Such an agreement would, at law, be a nullity. The Tax Court of Canada considered this issue in *Crestglen Investments Limited* 9 and reached the same conclusion:

The tax treatment of a partner's partnership income is the same whether it is a partnership distribution or monies allocated for partnership management services. Thus a partner cannot be an employee of a partnership that is capable of entering into a contract of employment with the partnership...

Question 3

Assume that a particular partner is not paid a salary as an employee of the partnership but is remunerated by reference to a formula (e.g., hours billed). Is the CCRA willing to treat this amount as deductible in computing the income of the partnership?

Response 3

A provision in the partnership acts of the common law provinces prohibits a partner from receiving remuneration for acting in the course of the partnership business, subject to any agreement between the partners. Accordingly, these statutes do not prohibit the members of a partnership from agreeing to remunerate one or more members of that partnership based on, among other things, hours billed or revenues generated.

Although the payment of remuneration to a partner acting in the course of the partnership business is not strictly prohibited, it does not necessarily follow that such remuneration would be a deductible expense of the partnership. There are at least two reasons why a deduction would be inappropriate.

First, if a deduction were available, the partner would have two sources of income from carrying on one business:

1) the remuneration (which would not be income from carrying on the partnership business since it would be an expense of the partnership); and
2) the partner's share of the income or loss from the partnership.

Second, to allow a deduction in computing the income from the partnership business would be to allow the recipient partner a deduction for an amount paid to him or herself.

Thus, in our view, any remuneration paid to a partner for work performed in the course of the partnership business is properly treated as a distribution of income or a draw against capital and would not be deductible in computing partnership income.

Question 4

Are there any circumstances where an amount paid to a partner would be deductible in computing the income of the partnership?

Response 4

There are some circumstances in which we would allow a partnership to deduct an amount paid to a partner. For example, we would be prepared to allow a deduction in computing the income of a partnership for fees paid to a partner if the fees are paid in consideration for services provided to the partnership by the partner acting other than in his or her capacity as a partner (i.e., the services are not related to the ownership of the partnership interest). That is, the services are provided by the partner in the course of carrying on a business separate from the business carried on by the partnership. Accordingly, the problem of deriving two sources of income from one business does not arise since the amount paid to the partner is included in that partner's income from the separate business. In addition, in the circumstances where a partner is providing services to the partnership other than in the capacity as a partner, we would be willing to accept that the agreement under which the services are provided does not offend the rule against contracting with oneself. However, to avoid uncertainty as to the deductibility of these payments, we would encourage taxpayers not to enter into service contracts directly with the partnership but to enter into these contracts through a separate entity.

Question 5

The Tax Court of Canada held in the 1995 informal procedure case *Archbold v. The Queen* that an amount paid to a partner as "salary" was deductible in computing the income of the partnership. What is the CCRA's view of this decision?

Response 5

The *Archbold* case involved a husband and wife partnership under which the wife was given a commission on gross sales made by the partnership. The Court accepted that the payment of this amount, referred to as a salary, was deductible in computing the income of the partnership thus creating a loss for the husband. In reaching her conclusion, Lamarre Proulx, J.T.C.C. focused on the fact that the relevant provincial partnership act did not present a legal impediment to a partner drawing a salary from a partnership.

In our view, the Court in *Archbold* did not establish a legal basis for treating the amount as an expense of the partnership. As we stated in our response to Question 4, the fact that law does not prohibit the payment of remuneration is not sufficient, in and of itself, to ensure that the payment is deductible in computing the income of the partnership. It is our position that remuneration paid to a partner will qualify as an expense only if it is paid in circumstances described in the response to Question 4. In our view, the amount paid in *Archbold* is not this type of payment and, accordingly, we do not intend to apply *Archbold* as a precedent in other cases.

Question 6

What is the CCRA's position on preference units, that is, units of a partnership that entitle the holder to a preferential share of the profits or losses of the partnership. For example, consider an arrangement where a partnership issues two types of partnership interests. In consideration for the transfer of property to the partnership or in recognition of its specialized expertise, Taxpayer A acquires a "preferred" partnership interest that entitles it to receive, in priority to some, or all, of the other partners a predetermined amount of partnership income, loss, resource pools or other partnership amounts relevant in the computation of a partner's income for purposes of the Act and a fixed entitlement to partnership capital in the event of liquidation or redemption of such partnership interest. Taxpayers B and C could acquire units that entitle them to a *pro rata* share of the remaining income, loss, resource pools or other amounts and capital of the partnership after satisfaction of Taxpayer A's interest.

Response 6

In our view, there is no impediment to the creation of partnership interests that carry different entitlements to share in the income, loss or other attributes of the partnership. However, the sharing of these tax attributes is subject to section 103 of the Act. In considering the application of section 103, we would examine whether one of the principal reasons for the separate interests was the reduction or postponement of tax, or in the case where two or more members of the partnership are not dealing with each other at arm's length, whether the amount of income or loss allocated to Taxpayer A was reasonable having regard to the circumstances, including capital invested and work performed.

Partnership Act (AB)

Business dealings by partner with partnership

60 A limited partner may loan money to and transact other business with the limited partnership and, unless the limited partner is also a general partner, may receive on account of resulting claims against the limited partnership, with general creditors, a prorated share of the assets, but no limited partner shall in respect of any such claim

(a) receive or hold as collateral security any of the limited partnership property, or

(b) receive from a general partner or the limited partnership any payment, conveyance or release from liability if at the time the assets of the partnership are not sufficient to discharge partnership liabilities to persons not claiming as general or limited partners.

RSA 1980 cP-2 s59

ELIGIBLE CAPITAL PROPERTY – HANDOUT #15

Summary

An eligible capital expenditure in respect of a business is, in the simplest terms, a capital expenditure (i.e., an expenditure that results in an enduring benefit) that does not come within any of the capital cost allowance classes but rather goes into an eligible capital property pool. A percentage of the balance of the pool at the end of the year may be claimed as a deduction for the year.

An "eligible capital expenditure" is a defined term in the *Income Tax Act*. The major part of the definition lists exclusions, i.e., expenditures that do not qualify as an eligible capital expenditure. One of the most fundamental of these exclusions is the cost of any tangible property. However, not every intangible property qualifies as an eligible capital expenditure.

This bulletin covers the details of the definition of an "eligible capital expenditure" and then discusses a number of specific types of expenditures for purposes of determining whether or not they fall within that definition. For the most part, this discussion contains general positions with respect to this question, and does not deal with exceptional cases.

Discussion and Interpretation

Introduction

¶ 1. Many expenditures commonly called "nothings", of which the cost of goodwill is the most notable, were not deductible from income under the provisions of the pre-1972 Act either as an expense or by way of capital cost allowances. Certain "nothings" are given special treatment in the current Act as "eligible capital expenditures". A discussion of this special treatment is contained in the current version of IT-123, *Transactions Involving Eligible Capital Property*.

¶ 2. An "eligible capital expenditure", which is defined in subsection 14(5), may be broadly described as an outlay or expense made or incurred by a taxpayer:

(a) in respect of a business;

(b) as a result of a transaction occurring after 1971;

(c) on account of capital; and

(d) for the purpose of gaining or producing income from the business (whether or not income from the business was actually produced by such outlay or expense).

Where a taxpayer carries on more than one business, the eligible capital expenditure arising from an outlay or expense will form part of the "cumulative eligible capital", as defined in subsection 14(5), only of that business to which it relates.