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THE 1977 AMENDMENTS TO THE CORPORATE DISTRIBUTION RULES

By Blake Murray*

The rules regarding the distribution of corporate surpluses are changed again, and the rules as to what is and what is not taxable are enough to drive a Canadian lawyer to Philadelphia.1

Under Canadian tax law, it has long been the rule that if a corporation has taxable income it must pay tax at the corporate tax rate, and if that corporation distributes an amount of its after-tax income to a shareholder, the shareholder must pay tax at the appropriate rate on the amount of that distribution. Limited relief from the tax payable at the shareholder level has been given to residents on dividends received from a resident corporation, both in order to mitigate the harshness of full taxation on the same income at the shareholder and corporate level, and to encourage Canadians to invest in Canadian corporations. Notwithstanding these concessions, numerous provisions have been included in the Income Tax Act2 to ensure the imposition of tax at both the corporate and the shareholder levels.

The amendments to the corporate distribution rules contained in Bill C-11 (the “1977 Amendments”) reduce, in most cases, the income tax payable by a resident individual shareholder on taxable dividends, and both simplify and relax the corporate distribution rules intended to prevent shareholders from removing surplus from a corporation as capital.

This article is intended to provide a brief description of the background to the 1977 Amendments and to examine the apparent policies underlying the following changes:

1. the increase from one-third to one-half in the gross-up and credit respecting taxable dividends received from a taxable Canadian corporation;

2. the exclusion of certain stock dividends paid by a public corporation from dividend income;

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3 An Act to amend the statute law relating to income tax and to provide other authority for the raising of funds, Bill C-11, 1977 (30th Parliament, 3d session), enacted as S.C. 1977-78, c. 1. Bill C-11 contained the legislation to give force to the amendments to the Income Tax Act proposed in the Notice of Ways and Means Motion to Amend the Income Tax Act of October 20, 1977. Most of the amendments contained in Bill C-11 were previously included in Bill C-56, 1976-77 (30th Parliament, 2d session) which had resulted from the Budget and the Notice of Ways and Means Motion of March 31, 1977.
3. the simplification of paid-up capital;

4. the repeal of tax-paid undistributed surplus provisions and the restriction of the distribution of 1971 capital surplus on hand to distributions on a winding-up; and

5. the revision of the anti-dividend stripping rules:
   a) the repeal of the paid-up capital limit and the debt limit rules;
   b) the repeal of designated surplus; and
   c) the enactment of new anti-dividend stripping rules while retaining Ministerial discretion under subsection 247(1).

I. BACKGROUND

The following summary of the Canadian tax treatment of corporate distributions under prior legislation, though necessarily incomplete, may be useful in assessing the significance of the 1977 amendments.

This discussion is divided into three sections:

A. The Pre-1972 System: a description of the corporate distribution rules under the Income Tax Act as it read immediately before 1972 (the "Pre-1972 Act").


A. The Pre-1972 System

In general, the rules for corporate distribution under the Pre-1972 Act were as follows:

1. Corporate Tax Rate

A taxable corporation was liable to pay income tax at the rate of 21 percent on its first $35,000 of taxable income, and at the rate of approximately 50 percent on any taxable income thereafter. No distinction was made between private and corporations as is made under the present Act. Neverthe-
Corporate Distributions

less certain special status corporations were subject to special corporate distribution rules.  

2. Capital Gains Tax

Capital Gains were not taxed.

3. Order of Distribution

Until the undistributed income on hand, i.e., the after-tax income of the corporation was paid out, distributions to a shareholder were included in his income as a dividend or as ordinary income. Once the undistributed income on hand of a corporation had been cleared, tax-free distributions could be made through appropriate capital transactions between the corporation and its shareholder (such as a stock dividend of redeemable preferred shares followed by their redemption).

4. Inter-Corporate Dividends

Generally, dividends between resident corporations flowed tax-free. Such dividends were included in the income of the recipient corporation, but were deductible in computing its taxable income.

5. Dividends to Resident Individuals

A resident individual shareholder included the amount of any dividends he received in his income without an offsetting deduction in computing taxable income. However, as partial recognition for the tax paid at the corporate level, he was permitted to deduct from his tax otherwise payable 20 percent of the amount of dividend received from a resident corporation (not exempt from tax in the year the dividend was received). This “20 percent dividend tax credit” reduced the premium rate of tax payable by an individual on dividend income from a resident corporation to approximately 60 percent.

6. Dividends to Non-Residents

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For example, pursuant to s. 68 of the pre-1972 Act, income of a personal corporation was taxed directly in the hands of the owner of the corporation as if he had received that income directly. A personal corporation was defined to be a corporation that, among other things, was controlled by a resident individual alone or with one or more members of his family resident in Canada and did not carry on an active financial, commercial or industrial business.

Defined by paragraph 98(1)(a) of the pre-1972 Act, undistributed income on hand was the aggregate of the corporation's incomes for taxation years ending after 1917, minus the aggregate of a number of deductions including losses sustained, disallowed expenses, capital losses net of capital gains and dividends paid. One exception to this general rule was that a corporation could pay a special 15% tax on a specified amount of its undistributed income on hand and then distribute the remaining 85% (“tax paid undistributed income”) by way of a tax-free stock dividend. Ordinarily, the stock dividend would be satisfied with redeemable preferred shares which would later be redeemed.

R.S.C. 1952, c. 148, s. 81.

Id., paragraph 6(1)(a) and subsection 28(1).

Id., subsection 38(1).

The maximum rate of tax payable by an individual pursuant to subsection 32(1) of the pre-1972 Act was 80%.
Generally, a non-resident shareholder was liable to pay Canadian withholding tax at the rate of 15 percent on the gross amount of any dividend he received, or was deemed to have received from a corporation resident in Canada. No credit was given to that shareholder for the tax paid by such a corporation on its taxable income.

7. Dividend Stripping

Individual shareholders often attempted to avoid the high tax imposed on the distribution of earnings in the form of a dividend.

Provisions were enacted to block the more direct methods of obtaining the benefit of use of a corporation's surplus without the payment of a dividend.

Any appropriation of corporate property or benefit conferred by a corporation on a shareholder was required to be included in that shareholder's income.

Further, provision was made to require a shareholder to include in income any benefit that he had directed the corporation to confer upon another person to the extent that that benefit would have been included in the shareholder's income if he had received it directly.

The use of loans at little or no interest to a shareholder was restricted. Subject to certain exclusions, the amount of a loan to a shareholder would be included in that shareholder's income were the loan not repaid within one year.

Nonetheless, certain methods of avoiding the tax on dividends remained. In particular, by excluding capital gains from income, the pre-1972 Act left open the possibility of a shareholder using a capital transaction in order to receive the surplus of a corporation in the form of a tax-free capital gain rather than as a dividend distribution. In the simplest case, this might have involved accumulating surplus in a corporation by foregoing dividends, thus increasing the value of the shares of that corporation and ultimately selling those shares to a third party in order to realize a capital gain. Where the purchaser of those shares was an individual, he merely acquired the vendor's situation. Until the corporation's undistributed income on hand was distributed, none of its surplus could be removed without tax being paid at the shareholder level. However, where the purchaser was a resident corporation, it could have removed the undistributed income on hand of the purchased corporation as a tax-free inter-corporate dividend and used that amount to pay the purchase price of the shares it had acquired. This led, among other things, to resident individual shareholders selling the shares of one resident corporation to a second resident corporation which they controlled for the sole purpose of stripping the surplus of the first corporation. This latter type of trans-

16 Id., subsection 8(1).
17 Id., subsection 16(1).
18 Id., subsection 8(2).
action, which would effect the removal of surplus from the corporate level to the shareholder level without payment of all or part of the tax imposed at the shareholder level, was referred to as “dividend stripping” or “surplus stripping.”

8. Anti-Dividend Stripping

a) Designated Surplus

The potential for dividend stripping through a sale to a corporate purchaser prompted the enactment in 1950 of the designated surplus provisions which were essentially an anti-dividend stripping rule. Under the designated surplus provisions, where control of one corporation (the “acquired corporation”) was acquired by another corporation (the “acquiring corporation”), the undistributed income on hand of the acquired corporation at the end of its last complete taxation year before control was acquired became “designated” with respect to the acquiring corporation.

Dividends paid by the acquired corporation out of designated surplus to an acquiring corporation that was resident in Canada were not deductible by the acquiring corporation. Accordingly, those dividends were potentially taxable to the acquiring corporation at the full corporate tax rate of approximately 50 percent. Inasmuch as the highest rate of tax applicable to a shareholder on a dividend distribution was approximately 60 percent, the designated surplus provisions in theory at least, would have extracted roughly the equivalent amount of tax from the acquiring corporation as would have been paid by a resident individual shareholder had he received the underlying surplus as a dividend from the acquired corporation.

Where an acquired corporation paid dividends out of designated surplus to an acquiring corporation not resident in Canada, the acquired corporation would become liable to pay a special tax equal to 15 percent of such a dividend. This tax together with the withholding tax levied on distributions to a non-resident shareholder would have resulted in a total tax of 30 percent on a dividend out of the designated surplus of the acquired corporation.

Generally, defects in the designated surplus provisions were so abundant that taxpayers were able to avoid that tax. A fundamental drawback to the designated surplus provisions was that after-tax earnings accumulated in the control period, i.e., after control was acquired, could be distributed tax-free to an acquiring corporation resident in Canada, notwithstanding that there was designated surplus in the acquired corporation. Thus, a “future” dividend strip was possible under which the acquiring corporation in effect paid the purchase price for the acquired corporation with the after-tax income earned by the latter after control was acquired.

Other technical defects were that designated surplus was eroded by such

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19 Id., subsection 28(2).
20 Id.
21 Id., subsection 105B(1).
22 Id., subsections 28(4), (5) and (6).
items as provincial taxes, and could be eliminated through certain transactions such as statutory amalgamations.

b) Miscellaneous Rules

Even after the enactment of the designated surplus provisions, methods of dividend stripping continued to arise. In many cases, such as the purchase by a corporation of its own shares, the methods of dividend stripping fell outside the designated surplus provisions. Consequently, it became necessary to enact special provisions to the *Income Tax Act* in order to offset the potential strip.

c) Ministerial Discretion

The enactment of subsection 138A(1) in 1963 was an admission by the Canadian revenue authorities that "the proliferation of methods of moving undistributed income from a corporation into the hands of its shareholders without the payment of tax" could only be stopped by giving the Minister of National Revenue discretionary power. The Minister was given discretion to add an amount to a taxpayer's income where he considered that one of the purposes of a disposition of shares, or of a transaction by a corporation relating to its capital stock, or of some other transaction, was to "effect a substantial reduction of, or disappearance of, the assets of a corporation in such a manner that the whole or any part of any tax that might otherwise have been or become payable under this Act in consequence of any distribution of income of a corporation has been or will be avoided . . ."24

Although there is only one reported case, *Giguere v. MNR*,25 in which the Minister exercised his discretion under subsection 138A(1), an official of the Department of National Revenue stated that the discretion was used in a number of cases, and went on to say:

> I think it would be fair to say that while the provision (subsection 138A(1)) has been effective in dealing with strips that were completed, it has been even more effective as a deterrent to tax avoidance both in respect of transactions proposed but not carried out, and in respect of a series of transactions where a surplus strip potential was created but funds had not yet been removed. In those cases where the surplus strip had not been completed, it has generally been found possible for the taxpayer to avoid a direction by further transactions so altering the course that no avoidance of tax would result.26

B. 1971 Tax Reform

Effective January 1, 1972 the corporate distribution rules were amended as follows:

1. Private, Public and Other Corporations

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26 Taken from a paper delivered by Mr. C. W. Primeau, then Assistant Director, Rulings Division, Revenue Canada, Taxation, delivered at the Annual Meeting of the Canadian Bar Association at Toronto in August, 1974. This paper was reprinted in (1974), 22 Cdn. Tax J. 421 at 422.
The effective corporate tax rate payable by a corporation became dependent, among other things, upon whether the corporation was a public,\(^\text{27}\) private\(^\text{28}\) or other\(^\text{29}\) corporation for the purposes of the *Income Tax Act*.

2. Rate of Tax

A public corporation, or a corporation that was neither public nor private, became liable to pay tax at the corporate rate of approximately 50 percent\(^\text{30}\) on the amount of its taxable income for each year.

The general rule was that private corporations were liable to pay tax at the corporate rate of approximately 50 percent in respect of income derived from carrying on an active business. However, a private corporation that qualified as a “Canadian controlled private corporation”\(^\text{31}\) could, subject to specified limitations,\(^\text{32}\) reduce the level of tax on such income to 25 percent through a mechanism loosely referred to as the “small business deduction.”

The purpose of the small business deduction was to encourage small businesses by permitting resident individuals to defer income tax for an active business income earned through a Canadian controlled private corporation. When coupled with the “one-third gross-up and credit” rule respecting dividends discussed below,\(^\text{33}\) a 25 percent level of tax resulted in integration of the taxes paid by a corporation and a resident individual shareholder on corporate income distributed to a shareholder as a dividend. That is, the sum of the taxes paid by the corporation on such income and the taxes paid by a resident individual on the dividend would be equal to the tax payable by a resident individual if he had earned that income directly.

Investment income of a private corporation, such as interest and taxable capital gains, became taxable, in the first instance, at the corporate rate of approximately 50 percent. Prior to the 1977 amendments, a refund equal to

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\(^{27}\) The *Income Tax Act*, S.C. 1970-71-72, c. 63, paragraph 89(1)(g).

\(^{28}\) *Id.*, paragraph 89(1)(f).

\(^{29}\) A number of corporations, such as a resident corporation controlled by a public corporation or a non-resident corporation carrying on business in Canada, will be neither private nor public corporations.

\(^{30}\) It will be appreciated that the combined federal-provincial corporate tax rate varies from province to province. For the purposes of this paper, it is assumed that the rate is 50%. The combined federal-provincial corporate tax rate in Ontario since 1972 has been:

1972 — 52%; 1973 — 51%; 1974 — 50%; 1975 — 49% and 1976 and subsequent tax years — 48%.

\(^{31}\) S.C. 1970-71-72, c. 63, paragraph 125(6)(a) defined a “Canadian controlled private corporation” as a private corporation that was incorporated in Canada or has been resident in Canada throughout the period commencing June 18, 1971 and that is not controlled or indirectly in any manner whatever by non-residents.

\(^{32}\) *Id.* Section 125 limits the maximum amount of active business income that will be taxed at the low rate of tax and the maximum after-tax earnings that may be accumulated by a corporation entitled to this rate of tax. Initially, the annual limit was $30,000 and the total limit $400,000. Since that time, the annual limit has been increased to $100,000 and then to $150,000. The total limit was increased from $400,000 to $500,000 and then to $750,000.

\(^{33}\) See text accompanying note 65, *infra.*
25 percent of the investment income earned by a private corporation was potentially available on payment of sufficient taxable dividends to its shareholders. The potential refund was called "refundable dividend tax on hand"\textsuperscript{34} of a private corporation. As a result, the net corporate tax on investment income that flowed through a shareholder as a taxable dividend was 25 percent.

The purpose of this treatment was to remove any significant benefit to earning investment income through a private corporation by taxing accumulated investment income at full corporate rates. Provision was made for a refund of part of such tax on payment of taxable dividends to shareholders, in order to neutralize the tax consequences of earning investment income through a private corporation as compared with earning such income directly. As noted above, where income of a corporation was taxed at the level of 25 percent, in theory there was complete integration of the tax paid at the corporate and shareholder level.

3. Capital Gains Tax

The 1972 Act required a taxpayer to include in his income for each year one-half of any capital gains that had accrued after 1971 and were realized in that year, less one-half of any capital losses that had accrued after 1971 and were realized in that year.\textsuperscript{35} Special provisions were needed to avoid taxing the same gain as both a dividend and as a capital gain, and to permit a private corporation to distribute the untaxed half of a capital gain (net of one-half its capital losses) to its shareholders on a tax-free basis.\textsuperscript{36}

4. Return of Paid-Up Capital

As noted above,\textsuperscript{37} the pre-1972 Act permitted a corporation to make distributions of "capital" to a shareholder only after its entire undistributed income on hand had been distributed. Consequently, a shareholder's investment in a corporation could not be returned tax-free until the entire undistributed income on hand of that corporation had been cleared.

As part of 1971 Tax Reform, provision was made to permit a Canadian corporation to return its shareholders' original investment as capital before being required to distribute any amount of its net assets as income. The reasoning behind this change was clear: if a shareholder had used tax-paid dollars to make his investment in a corporation, then he, or any successor shareholder, should be entitled to receive those dollars as capital before being required to include any amount in income.\textsuperscript{38} Nevertheless, the 1972 Act clearly did not intend to permit the distribution to shareholders of the after-

\textsuperscript{34} S.C. 1970-71-72, c. 63, s. 129.
\textsuperscript{35} Id., paragraph 3(1)(b).
\textsuperscript{36} See discussion accompanying note 57, infra.
\textsuperscript{37} See discussion accompanying note 11, supra.
\textsuperscript{38} In effect, the 1972 Act, by permitting a return of paid-up capital prior to dividend distributions, extended neutrality between investment in a corporation by way of equity as compared with debt. It will be appreciated that prior to 1972, a shareholder who loaned money to a corporation on a demand basis could receive repayment of that loan at any time without tax cost. By comparison, any amount invested in share capital was locked in until the undistributed income on hand of the corporation had been distributed.
tax income of a corporation as capital in the guise of a return of paid-up capital.

In order to accomplish the intended result, the 1972 Act defined what was to be regarded as capital for tax purposes through the concepts of paid-up capital,\textsuperscript{39} paid-up capital deficiency\textsuperscript{40} and paid-up capital limit.\textsuperscript{41} A corporation was permitted to return as capital the lesser of its paid-up capital and its paid-up capital limit (which was the amount of its paid-up capital less its paid-up capital deficiency). In the absence of a special surplus account, the remainder of a corporation's net assets could be distributed to shareholders only as income.

For tax purposes, the paid-up capital of a corporation, as defined in the 1972 Act, was generally considered to mean the same thing as its capital for corporate law purposes.\textsuperscript{42}

Paid-up capital deficiency, generally, was a measure of the amount by which realized capital losses that accrued prior to 1972 had eroded the paid-up capital of a corporation\textsuperscript{43} and the amount by which transactions after 1972 had created "paid-up capital" for corporate law purposes without using tax-paid dollars.\textsuperscript{44}

In order to distribute an amount to its shareholders as a return of paid-up capital,\textsuperscript{45} a corporation had to carry out a transaction involving its capital stock, such as a redemption or purchase by it of its own shares, a reduction of capital pursuant to the relevant company act, or a winding-up of the corporation.

Any amount received by a shareholder as a return of paid-up capital on a share of a corporation was not regarded as an actual or deemed divi-

\textsuperscript{39} S.C. 1970-71-72, c. 63, paragraph 89(1)(c) defined paid-up capital as follows: "paid-up capital" in respect of a share of any class of the capital stock of a corporation at any particular time means an amount equal to the paid-up capital of the corporation at that time that is represented by the shares of the class to which that share belongs, divided by the number of issued shares of that class then outstanding.

\textsuperscript{40} Id., paragraph 89(1)(d).

\textsuperscript{41} Id., paragraph 89(1)(e).

\textsuperscript{42} Generally this would be the same amount shown as the issued capital or stated capital of the corporation for financial statement purposes.

\textsuperscript{43} This limitation on the right to make distributions of capital to shareholders was presumably to thwart improper avoidance through the use of the concept of paid-up capital to return post-1971 earnings as capital.

\textsuperscript{44} For example, where a shareholder elects, pursuant to subsection 85(1) of the Act, to defer a capital gain on property sold to a corporation in consideration for shares, it cannot be said that he has used "tax-paid dollars" to create paid-up capital since he has been able to defer any capital gains tax liability with respect to the transferred property. In the absence of a concept like paid-up capital deficiency, in many cases, a shareholder could convert income gains to capital gains by transferring properties to a corporation pursuant to subsection 85(1) in consideration for shares.

\textsuperscript{45} See S.C. 1970-71-72, c. 63, s. 84. Any distribution of property by a corporation to a shareholder otherwise than by a transaction contemplated by s. 84 would be either: (i) an ordinary dividend, or (ii) ordinary income pursuant to subsection 15(1) of the \textit{Income Tax Act} as being an appropriation of corporate property to a shareholder.
However, it had potential capital gains consequences since, for the purpose of computing capital gains or capital losses, that amount was treated either as proceeds of disposition of the share or a reduction of the adjusted cost base of the share to the shareholder. Any distribution on a share in excess of the lesser of the paid-up capital on the share and the paid-up capital limit of the corporation was deemed to be a dividend or ordinary income.

5. Taxable Dividends

The 1972 Act did not define the portion of a corporation’s surplus that had to be distributed as taxable dividends. Instead, it defined, by way of special surplus accounts, the portion of a corporation’s surplus that could be distributed to shareholders otherwise than as a taxable dividend. Any dividend not paid out of one of these special surplus accounts was defined to be a taxable dividend.

Three special surplus accounts were created: tax-paid undistributed surplus, 1971 capital surplus on hand, and the capital dividend account (for private corporations only). These special surplus accounts were created to provide advantageous tax treatment to the distribution of certain kinds of accumulated earnings. A corporation could, of course, postpone or entirely omit distributions to its shareholders out of special surplus accounts and instead distribute all or part of its retained earnings as taxable dividends.

6. The Special Surplus Accounts

Tax-paid undistributed surplus and 1971 capital surplus on hand were created in order to provide advantageous tax treatment to the distribution of surplus existing on (or accrued to) December 31, 1971.

a) Tax-Paid Undistributed Surplus

Under the pre-1972 Act, the undistributed income on hand account of a corporation was a calculation of its accumulated after-tax income. After the amount of that account had been reduced to nil, the remainder of a corporation’s net assets could be distributed free of tax to its shareholders.

The “1971 undistributed income on hand” of a corporation was essentially its undistributed income on hand from 1950 to December 31, 1971, with some minor adjustment. Tax-paid undistributed surplus of a corporation was created by electing to pay a 15 percent tax on all or part of its 1971 undistributed income on hand. The tax-paid undistributed surplus thus created could then be returned as capital to a shareholder by declaring a dividend and filing a prescribed election. Such a dividend was excluded from the income of the shareholder, but had to be deducted in arriving at the adjusted cost base of

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46 S.C. 1970-71-72, c. 53, s. 84.
47 Id., paragraph 54(h).
48 Id., subparagraph 53(2)(b)(ii).
49 Id., s. 84.
50 Id., paragraph 89(1)(j).
51 See discussion accompanying note 11, supra.
52 S.C. 1970-71-72, c. 63, s. 196.
his shares. Prior to the 1977 amendments, the 1971 capital surplus on hand and capital dividend account of a corporation could not be distributed without penalty until the entire amount of its 1971 undistributed income on hand had been converted to tax-paid undistributed surplus.

Nonetheless, a corporation could pay special dividends out of its tax-paid undistributed surplus, 1971 capital surplus on hand or capital dividend account prior to distributing any portion of its post-1971 after tax earnings.

b) 1971 Capital Surplus on Hand

The 1971 capital surplus on hand of a corporation was essentially its realized capital gains less realized capital losses accrued prior to 1972, plus certain other tax-free amounts relating to the years prior to 1972. The 1971 capital surplus on hand account preserved the ability that existed under the pre-1972 Act to return surplus of a corporation as at 1972 other than undistributed income on hand as a return capital. As noted above, the whole of the 1971 undistributed income on hand had to be converted to tax-paid undistributed surplus before the 1971 capital surplus on hand could be distributed to a corporation's shareholders without tax penalty. A distribution out of 1971 capital surplus on hand was made by the declaration of a dividend and the filing of the prescribed election.

c) Capital Dividend Account

The capital dividend account applied only to private corporations. This account was created to permit a private corporation to distribute tax-free to resident shareholders the untaxed half of its net capital gains, thus neutralizing the effect of interposing a corporation between a shareholder and capital property. The capital dividend account was defined to include, among other things, one-half of a private corporation's realized capital gains accrued after 1972 less one-half of its realized capital losses accrued after 1972. In order to pay a capital dividend, a corporation first declared a dividend and then elected that the dividend be paid out of its capital dividend account. No portion of a capital dividend was included in a resident individual shareholder's income or treated as an adjustment to the cost of his shares. Non-resident shareholders, however, were subject to withholding tax on such dividends.

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53 Where the shareholder owned his share from December 31, 1971 to the time the dividend was paid without interruption, his adjusted cost base of the share would ordinarily be at least equal to its value of December 31, 1971 less any post-1971 adjustments to that base. On the assumption that the undistributed income on hand of the corporation was reflected in its value on December 31, 1971, a dividend out of tax-paid undistributed surplus was tax-free in that the downward adjustment to cost base would be covered by the value of a share on December 31, 1971. It is apparent, however, that such a dividend did have capital gains consequences inasmuch as it increased the potential capital gain to the shareholder and reduced the potential capital loss to him. Nevertheless, this treatment was considerably more favourable to a taxpayer in the highest marginal tax bracket than receiving ordinary taxable dividends.

54 S.C. 1970-71-72, c. 63, s. 194.

55 Id.

56 Id., subsection 83(1).

57 Id., subsection 83(2).

58 Id., paragraph 89(1)(b).
7. Inter-Corporate Taxable Dividends

Subject to the designated surplus provisions and the refundable tax imposed under Part IV of the Act, taxable dividends, i.e., any dividend not paid out of tax-paid undistributed surplus, 1971 capital surplus on hand, or the capital dividend account of a corporation flowed tax-free between Canadian corporations. Dividends paid out of tax-paid undistributed surplus or 1971 capital surplus on hand, of a paying corporation to a shareholder corporation, reduced the adjusted cost base of the shares in the capital stock of the paying corporation and, generally, were added to the corresponding surplus account of the shareholder corporation. Capital dividends were tax-free to a resident corporation, and if that corporation was a private corporation, were added to its capital dividend account.

A special refundable tax was imposed under Part IV of the Income Tax Act on certain dividends received by a private corporation. That Part imposed a refundable tax of 33\(\frac{1}{3}\) percent on the amount of any dividends received by a private corporation from a corporation that it did not control. That tax was intended as a proxy for the tax imposed on dividends received by resident individuals in order to block the use of corporations as a means of deferring tax on portfolio dividends; the result was neutrality as between receiving such dividends directly or through a private corporation. Part IV imposed a further tax equal to the dividend refund received by the payer corporation by virtue of a taxable dividend to the recipient corporation; this tax was intended to block the use of a chain of private corporations to obtain a refund of the refundable dividend tax on hand of the payer corporation without paying taxable dividends to resident individuals.

8. Dividends to Resident Individual Shareholders

A resident individual shareholder, in computing his income for a year, was required to include in his income the amount of any taxable dividend he received in the year from a taxable Canadian corporation plus one-third of that amount (the "gross-up") and was allowed to deduct an amount approximately equal to the gross-up from any tax otherwise payable for that year. The purpose of the gross-up and credit rule was to provide integration of the taxes paid at the corporate and shareholder level without requiring that an actual record be kept of the corporate taxes paid. Where corporate income was taxed at the level of 25 percent, as noted above, there was virtually complete integration of the taxes paid by the corporation and an individual shareholder. That is, the aggregate of the taxes paid by the corporation and an individual shareholder on such income was approximately equal to the tax that would have been paid had the individual shareholder earned that income directly.

50 Id., s. 186.
60 Id., paragraph 89(1)(j).
61 Id., subsection 82(1) and subsection 112(1).
62 Id., subparagraph 53(2)(a)(i).
63 Id., paragraph 186(1)(a).
64 Id., paragraph 186(1)(b).
65 Id., paragraph 12(1)(j), subsection 82(1) and s. 121.
In other cases, the integration of taxes was less complete, as in the case of a public corporation, where the effect of a one-third gross-up and credit was to give some, but not total, recognition at the shareholder level for the taxes paid at the corporate level.

As indicated above, the maximum rate of tax payable by a resident individual was reduced from approximately 80 percent under the pre-1972 Act to approximately 61 percent under the 1972 Act. On this basis, the maximum rate of tax payable by a resident individual shareholder on dividend income under the one-third gross-up and credit system was approximately 47 percent. This compared with a maximum rate of tax on capital gains of approximately 30.5 percent, i.e., \( 61\% \times 50\% \) of the capital gain. Consequently, there remained a lesser, but still significant, incentive to remove surplus from a corporation as a capital gain rather than as an ordinary dividend.

9. Dividends to Non-Resident Shareholders

Under the 1972 Act, the general rate of withholding tax was to be increased from 15 percent to 25 percent. By virtue of a transitional rule, however, that increase did not become effective until 1976. Taxable dividends and dividends paid out of the capital dividend account of a corporation were subject to Canadian withholding tax at the applicable rate.

Dividends paid to a non-resident shareholder out of the tax-paid undistributed surplus or 1971 capital surplus on hand of a resident corporation were exempt from Canadian withholding tax, but reduced the adjusted cost base of the shares of the resident corporation to a non-resident shareholder.

10. Anti-Dividend Stripping

a) Designated Surplus

The designated surplus provisions were substantially amended, but retained. Among other changes, the tax rate was reduced to a flat rate of 25 percent on the gross amount of any taxable dividends paid by the acquired corporation out of designated surplus to an acquiring corporation resident in Canada. This reduction in the rate of tax was intended to recognize the imposition of a tax on capital gains which had reduced the benefit to an individual shareholder of realizing corporate surplus as a capital gain instead of as a taxable dividend to approximately 17 percentage points (i.e., 47% less 30.5%). Where the shareholder paid tax at the rate of approximately 30 percent on the capital gain arising from the disposition of his shares, and the corporate purchaser paid a tax at the rate of 25 percent on any dividend out of the designated surplus of the acquired corporation, the total tax burden on the surplus removed from the acquired corporation would be approximately

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60 This assumes a maximum federal tax rate of 47% and a maximum provincial tax rate of 30.5% of the federal tax as levied in Ontario.
67 S.C. 1970-71-72, c. 63, s. 212.
68 ITAR, subsection 10(2).
69 S.C. 1970-71-72, c. 63., Part VII and Part VIII.
70 Id., subsection 192(1).
55 percent. This was roughly equivalent to the amount of tax that would have been payable had the underlying surplus been removed as a dividend.

Where a dividend out of designated surplus was paid by an acquired corporation to a non-resident acquiring corporation, the acquired corporation continued to be liable to pay a special tax equal to 15 percent of the amount of the dividend.\(^7\)

b) Miscellaneous Rules

The rules covering special situations, such as the redemption or acquisition by a corporation of its own shares at a premium, were carried forward under Part II of the 1972 Act for shares (other than common shares) issued on or before June 18, 1971.\(^7\)

c) Ministerial Discretion

Subsection 138A(1) of the Pre-1972 Act was carried forward into the 1972 Act as subsection 247(1) without any substantive change. It appears that this provision was retained under the 1972 Act as an obstacle to persons attempting to remove surplus at capital gains rates through a capital transaction. A significant factor in this decision may have been the prospect of a taxpayer who owned shares of a corporation on December 31, 1971 removing the surplus of a corporation as at December 31, 1971 completely free of tax through a non-arm’s length sale (for example, to a holding company).\(^7\)

C. The 1974-75 Amendments

Under the 1974-75 Amendments, substantive changes were made to the concepts of paid-up capital, paid-up capital deficiency and 1971 capital surplus on hand. In addition, two anti-dividend stripping rules were added to the Income Tax Act.\(^7\)

1. Paid-Up Capital

The concept of paid-up capital was expanded to include contributions of property to a corporation by a shareholder, whether or not shares were issued to him in return,\(^7\) and to permit a corporation to increase its paid-up capital for corporate law purposes without adding to paid-up capital for tax purposes.\(^7\)

\(^7\) Id., subsection 194(1).
\(^7\) Id., section 182.

\(^7\) For example, a taxpayer might have used the value of his shares on December 31, 1971 as his “cost” for computing the capital gain arising from disposition of those shares to a holding company. The holding company could then have eliminated any designated surplus in the first corporation by causing it to pay the 15% tax to convert its 1971 undistributed income on hand to tax paid undistributed surplus. Retained earnings could then have been paid to the taxpayer as the purchase price for the shares of the first corporation. Dividends out of the pre-1972 surplus account of the first corporation would increase the corresponding accounts of the holding company, thus enabling the distribution of future earnings at capital gains rates while retaining ownership of the first corporation through the holding company.

\(^7\) See T. McDonnell and E. Richardson, Surplus Distribution and the 1974-75 Amendments (1975), 23 Cdn. Tax J. 276; and R. Lindsay and R. Friesen, More About the Debt Limit (1975), 23 Cdn. Tax J. 223 for an excellent review of these changes.

\(^7\) S.C. 1970-71-72 clauses 89(1)(c)(ii)(B) and (C).

\(^7\) Id., clause 89(1)(c)(ii)(F).

Special rules were introduced to provide for the non-realization of 1971 capital surplus on hand or of paid-up capital deficiency of a corporation through a transaction with a related corporation. In some cases, these provisions deemed to be nil the upward or downward adjustment to 1971 capital surplus on hand and paid-up capital deficiency that would otherwise have occurred as a result of a transaction with a related corporation. In other cases, the provisions deemed a disposition to a related corporation not to have occurred for the purpose of determining the 1971 capital surplus on hand or paid-up capital deficiency of the transferring corporation; in such cases, the provisions also deemed the property in question to have been owned by the transferfree corporation since December 31, 1971 and to have been acquired by it at an actual cost equal to the actual cost of the property to the transferring corporation. This latter rule was intended to permit the transferfree corporation to realize the 1971 capital surplus on hand or paid-up capital deficiency when it disposed of the property in an arm’s length sale.

3. 1971 Capital Surplus on Hand and Paid-Up Capital Deficiency Made Virtually Symmetrical

Although the 1971 capital surplus on hand and the paid-up capital deficiency of a corporation at December 31, 1971 would have been complementary, certain adjustments were required to be made to one account that were not required to be made to the other, making it possible for the calculations of these accounts to diverge in the period following 1971. This made it possible to distribute post-1971 earnings as capital through a combination of a return of paid-up capital and a dividend out of 1971 capital surplus on hand. The 1974-75 Amendments cured such anomalies by requiring that virtually every upward adjustment to 1971 capital surplus on hand would result in an equal downward adjustment to paid-up capital deficiency and vice versa.

4. New Anti-Dividend Stripping Rules: Section 84.1 and Subparagraph 89(1)(d)(iv.1)

Two anti-dividend stripping rules were added to neutralize the potential dividend strip that could arise through a non-arm’s length sale of the shares of one corporation to another. These rules were intended to ensure that a vendor of such shares could not receive a greater amount as capital from the purchaser corporation than he could have received as a return of capital from the corporation whose shares were sold. The method for achieving this was to attach potential dividend treatment to any shares or debt received as consideration on a sale of shares to which those rules applied.

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78 For example, one of the most significant of these one-sided adjustments was that dividends out of 1971 capital surplus on hand prior to the 1974-75 Amendments reduced the 1971 capital surplus on hand of a corporation but did not increase its paid-up capital deficiency.

II. THE 1977 AMENDMENTS

The 1977 Amendments do not enact yet another set of corporate distribution rules; rather, significant revisions are made to the system established under the 1971 tax reform.\(^8\) There appear to be two overall objectives: the first, to encourage equity investment by resident individuals in Canadian corporations, and the second, to simplify the corporate distribution rules to the extent possible without a significant sacrifice of tax revenues.

The key change in the 1977 Amendments is the enrichment of the gross-up and credit respecting taxable dividends to one-half the amount of such dividends, which results in a substantial reduction in the effective rate of tax on dividend income. This led logically to the repeal of a number of provisions originally enacted to block the extraction of corporate surplus at capital gains rates.

In other cases, such as the curtailment of the concept of 1971 capital surplus on hand, the Department of Finance has, in effect, traded existing beneficial treatment for the granting of offsetting concessions to taxpayers. The 1977 Amendments strongly suggest that the Department of Finance in a number of cases may have chosen to pursue the overall objective of simplification over technical perfection in the sense of equity and neutrality.

Finally, although the 1977 Amendments have substantially alleviated the problem, they have not entirely done away with complexity in the corporate distribution rules. Specifically, the new anti-dividend stripping rules and the retention of ministerial discretion under subsection 247(1) perpetuate the need for caution in interpreting these rules.

A. Enrichment of the Gross-up and Credit Respecting Taxable Dividends

Historically, dividend income received from a resident corporation has been taxed at lower rates than other investment income in order to provide partial relief from the double taxation that would otherwise occur at both the corporate and shareholder levels, and in order to encourage Canadians to own shares in Canadian corporations. Commencing January 1, 1978, dividends received from taxable Canadian corporations are grossed-up by one-half, as opposed to the one-third gross-up formerly required, and taxpayers will be allowed to claim a credit equal to this higher amount against their taxes otherwise payable.

Often a lower tax may be paid where income is earned through a corporation than where the income is earned directly by an individual.

The objective in increasing the gross-up and credit respecting taxable dividends was to make investment in shares of a Canadian corporation more attractive to Canadian investors in all income brackets. The result is to provide a significantly more favourable tax treatment to dividend income than

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\(^8\) For an excellent explanation of the technical changes effected by the 1977 Amendments, see Cronkwright, Dart and Lindsay, "Corporate Distributions and the 1977 Tax Changes," delivered at the 1977 Conference of the Canadian Tax Foundation. That paper will be published as part of the proceedings of the Conference or may be obtained in booklet form from the Canadian Tax Foundation.
to other investment income, except possibly capital gains. The following table illustrates the favourable treatment accorded to taxable dividends under the enriched gross-up and credit when compared with interest income and capital gains.

**COMPARISON OF AFTER TAX INCOME FROM DIVIDENDS, INTEREST AND CAPITAL GAINS**

<table>
<thead>
<tr>
<th>Taxable income</th>
<th>Marginal tax rate</th>
<th>Taxable dividends</th>
<th>Interest</th>
<th>Capital gains</th>
</tr>
</thead>
<tbody>
<tr>
<td>$17,000-$21,000</td>
<td>40%</td>
<td>94%</td>
<td>60%</td>
<td>80%</td>
</tr>
<tr>
<td>21,000- 37,000</td>
<td>46</td>
<td>85</td>
<td>54</td>
<td>77</td>
</tr>
<tr>
<td>37,000- 59,000</td>
<td>52</td>
<td>76</td>
<td>48</td>
<td>74</td>
</tr>
<tr>
<td>59,000- 91,000</td>
<td>56</td>
<td>70</td>
<td>44</td>
<td>72</td>
</tr>
<tr>
<td>over $91,260</td>
<td>62</td>
<td>61</td>
<td>38</td>
<td>69</td>
</tr>
</tbody>
</table>

For certain kinds of income, a lower tax may be paid where the income is earned through a corporation than where that income is earned directly by an individual.

There is a substantial advantage to earning active business income through a corporation where, by virtue of the small business deduction, the corporate rate of tax on that income is 25 percent or less. Except for the benefit of deferral, there will be a slight disadvantage to earning active business income taxable at full corporate rates in a corporation as compared with earning that income directly. There is a slightly greater incentive to earn investment income, other than portfolio dividends, through a corporation rather than directly. Shareholders who are liable to pay tax on portfolio dividend income at rates higher than 25 percent will enjoy deferral of tax by having such portfolio dividends paid to a corporation. This deferral can become significant at higher rates; for example, a resident individual liable to tax at 39 percent on such dividends will defer 14 percentage points of tax by accumulating those dividends in a holding company. The system remains neutral on portfolio dividends income flowed through a corporation to a resident individual.

The increase in the gross-up and credit facilitated the repeal of designated surplus by narrowing the difference between the tax treatment of capital gains and dividend income to approximately 7.9 percent at maximum rates. Similarly, the reduction of the tax burden on taxable dividends mitigates the loss to a shareholder of the right to receive dividends out of tax-paid undistributed surplus.

A number of consequential amendments were made to the *Income Tax Act* to reflect the reduced tax burden on taxable dividends as follows:

1. The amount of a private corporation's refundable dividend tax on hand was decreased by one-third, effective January 1, 1978, in order to avoid

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[^81]: This advantage arises out of the application of the gross-up and credit, which produces a credit larger than the tax paid on the gross-up included in income. The tax saving on investment income achieved by use of a holding company will vary from province to province.
conferring a windfall benefit on individual shareholders of a corporation entitled to the benefit of that account.\(^8\) Absent this reduction, accumulated and future investment income of that corporation would be taxed at a significantly lower rate than the same income earned directly by individual residents. The reduction of the refundable dividend tax on hand account from 25 percent to 16\(\frac{2}{3}\) percent of the investment income of a private corporation largely neutralizes the benefit of earning investment income through a private corporation.\(^8\)

2. The tax payable under Part II of the Act on purchases by a corporation of its own shares in the open market was repealed effective March 31, 1977;\(^8\) presumably, this reflects an acceptance by the Canadian revenue authorities that whatever capital gains tax is paid by a shareholder disposing of the shares is a sufficient level of taxation. In addition, the tax imposed under Part II on the redemption or acquisition of shares issued before June 18, 1971 at a premium has been repealed effective December 31, 1977.\(^8\) This change presumably was made because the enriched gross-up and credit respecting taxable dividends produces an equivalent result.

3. The tax imposed under Part III on excess elections on dividends paid out of tax-paid undistributed surplus or 1971 capital surplus on hand has been reduced from 100 percent to 50 percent,\(^8\) and the tax imposed on excess elections on dividends out of the capital dividend account has been reduced from 100 percent to 75 percent.\(^7\) Again, this reduction appears to reflect the reduced tax payable on dividend income because of the increased gross-up and credit.

4. The rate of tax imposed under Part IV on portfolio dividends received by a Canadian private corporation has been reduced from 33\(\frac{1}{3}\) to 25 percent of the dividend.\(^8\) It will be recalled that Part IV exists in order to prevent high income taxpayers from using private corporations to defer tax on portfolio dividend income. The refundable tax imposed under Part IV is a substitute for the tax that would otherwise be payable if the dividend income had been received directly by a resident individual shareholder. The reduction of the rate to 25 percent merely reflects the general reduction in the tax burden on dividend income received by such shareholders under the enriched gross-up and credit on taxable dividends.\(^8\)

\(^8\) S.C. 1977-78, c. 1, subsection 62(3).
\(^8\) Supra note 81.
\(^8\) S.C. 1977-78, c. 1, subsection 81(1).
\(^8\) Id., subsection 82(1).
\(^8\) Id., subsection 83(6).
\(^8\) Id., subsection 83(2).
\(^8\) Id., subsection 85(1).
\(^8\) Id. That same amendment exempted a corporation that is “connected with” the payer corporation from Part IV tax except to the extent the dividend generates a dividend refund to the payer corporation. [A corporation is “connected with” a payer corporation if it owns more than 10% of the issued share capital (having full voting rights at all times) of the payer corporation and shares having a fair market value of more than 10% of the total fair market value of all issued shares of the payer corporation.]
B. The Exclusion of Certain Stock Dividends Paid by a Public Corporation from Dividend Income

Prior to the 1977 Amendments, the issuance of a stock dividend by any corporation resulted in a taxable dividend equal to the amount of the increase in the paid-up capital of the corporation by virtue of the dividend.90

The 1977 Amendments gave additional assistance to Canadian public corporations attempting to attract and retain equity investment by amending the definition of “dividend” to exclude stock dividends paid by a public corporation, except to the extent that such dividends are received by a non-resident owned investment corporation, or a non-resident individual, who either alone or together with other related persons owns more than ten percent of the shares of the class of stock of the public corporation on which the stock dividend was paid.91

For the purpose of computing the adjusted cost base to a recipient, shares issued as a stock dividend that are excluded from the definition of a dividend are deemed to have been acquired by the recipient at no cost.92 Consequently, there is a potential future liability for capital gains tax attached to dividends paid by a public corporation.

The removal of stock dividends from the definition of a dividend will permit Canadian public corporation to use stock dividends to meet their shareholders' demand for regular dividend payments without having to distribute part of their retained earnings.93 Those shareholders who wish may convert their stock dividend into cash by selling the shares so issued. Not all shareholders of a public corporation, however, may wish to receive stock dividends. For example, the potential capital gains tax liability arising on the disposition of shares so issued will probably make stock dividends unattractive to corporations who, subject to the refundable Part IV tax, could receive a taxable
dividend tax-free, or to resident individual shareholders with moderate in-
comes who might prefer to receive a taxable dividend under the enriched
gross-up and credit.

Public corporations making distributions may want to permit their share-
holders to choose between stock dividends with potential capital gains con-
sequences and cash dividends, which as taxable dividends would receive the
enriched gross-up and credit.

The exclusion of stock dividends paid by a public corporation from
income offsets the loss to the shareholders of such corporation of the right
to receive dividends out of 1971 capital surplus on hand. At the same time,
however, this change will make it impossible for a public corporation wishing
to do so to capitalize its 1971 capital surplus on hand before 1979 by issuing
a stock dividend; such a stock dividend will not qualify for the election neces-
sary to deem a distribution to have been made out of 1971 capital surplus
on hand. Possibly this reflects a policy decision to discourage public cor-
porations from capitalizing undistributed 1971 capital surplus on hand. The
reason for this may have been a desire to end the loss in tax revenues on
cash distributions by public corporations resulting from the treatment of
distributions out of 1971 capital surplus on hand as a reduction in the ad-
justed cost base of the shares of the corporation. Allowing a public corpora-
tion to capitalize this account would perpetuate the possibility of distributing
cash to its shareholders without immediate tax consequences. By way of
contrast, a shareholder receiving a stock dividend must sell that share and
face potential capital gains tax in order to receive cash.

Stock dividends paid by a private corporation will continue to give rise
to a deemed dividend equal to the resulting increase in the paid-up capital
of the private corporation. The likely reason for continuing to include such
stock dividends in income is the concern that shareholders of a closely-held
private corporation might use stock dividends to effect a strip of the surplus
of that corporation against the Valuation Day value of their shares.

94 Stock dividends are expressly excluded from the definition of “dividend” in sub-
section 248(1). The prescribed election under subsection 83(1) to distribute 1971 capital
surplus on hand may only be made on a dividend.

95 Further evidence of this intention to prevent public corporations from distributing
1971 capital surplus on hand as capital after 1978 can be found in Bill C-56, 1978 (30th
Parliament, 3d Session), which contains the legislation giving force to the Budget of
April 10, 1978. Subsection 19(1) of the Bill would add subsection 84(4.1) to the Act.
The proposed subsection will deem any payment by a public corporation after April 10,
1978 made as a reduction of paid-up capital in respect of a share of its capital stock to
be a dividend, unless such payment is made upon redemption or cancellation of the
share, or upon the winding-up of the corporation, or upon the reorganization of the
corporation’s capital stock.

But for the proposed amendment, a public corporation might increase the paid-up
capital of its existing shares by capitalizing an amount of its surplus equal to the amount
of its 1971 capital surplus on hand, and electing in prescribed form that the resulting
deemed dividend be out of its 1971 capital surplus on hand. Thereafter, the public
corporation could make a payment on its shares as a reduction of the paid-up capital
of those shares which, like a dividend out of 1971 capital surplus on hand, would reduce
the a.c.b. of its shares but would be excluded from income. The proposed subsection
84(4.1) would deem such a distribution to be a dividend.
The denial of the special stock dividend treatment to private corporations makes the repeal of the election to pay dividends out of 1971 capital surplus on hand much more significant to their shareholders. Private corporations wishing to preserve the right to make cash payments to shareholders without triggering an immediate tax will likely wish to capitalize their 1971 capital surplus on hand before 1979. This would involve taking an appropriate corporate transaction before 1979, such as issuing a stock dividend to increase the paid-up capital of the corporation to an amount equal to its 1971 capital surplus on hand; the prescribed election pursuant to subsection 83(1) of the Act would have to be made to have the resulting deemed dividend to the shareholders of the corporation treated as a distribution of capital surplus on hand.

C. The Simplification of Paid-Up Capital

The 1977 Amendments essentially restored the definition of paid-up capital employed in the 1972 Act by removing contributed surplus as a component of paid-up capital, and by removing the right to capitalize surplus for corporate purposes without creating paid-up capital for tax purposes.\footnote{S.C. 1977-78, c. 1, subsection 44(3).} These changes almost certainly were made solely in order to simplify the corporate distribution rules, prompted, perhaps, by a realization that the problems caused by the definition of paid-up capital contained in the 1974-75 Amendments far outweighed the benefits.

Under the 1977 Amendments, the starting point for determining the paid-up capital of a corporation is the amount of its “capital” for corporate law purposes.\footnote{Generally, this is the amount shown as “issued capital” or “stated capital” for financial statement purposes.} Adjustments to this amount are then required to be made in order to deal with: (1) transactions that occurred in the period May 6, 1974 to March 31, 1977, during which the definition of paid-up capital contained in the 1974-75 Amendments applied and the anti-dividend stripping rules contained in sections 84.1 and subparagraph 89(1) (d) (iv.1) were applicable; and (2) transactions subject to the new anti-dividend stripping rules enacted by the 1977 Amendments. The adjustments are as follows:

1. A downward adjustment under subsection 84.2(1) where a subparagraph 89(1)(d)(iv.1) paid-up capital deficiency had been created prior to April 1, 1977; the downward adjustment is potentially greater if a subsection 85(1) election was made in conjunction with the sale of the shares of one Canadian corporation to another Canadian corporation.

2. A downward adjustment under subsection 84.2(2) where after March 31, 1977 and before 1979, any debt to which the former debt limit rules applied is converted to shares of a corporation.

3. A downward adjustment under subsection 87(7) where on the amalgamation or merger of two or more Canadian corporations, the paid-up capital of the amalgamated or merged corporation exceeds the aggregate of all amounts, each of which is the paid-up capital of each of the predecessor corporations; and
4. (a) A downward adjustment under paragraph 212.1(1)(d) where a non-resident person sells shares (the “subject shares”) of one Canadian corporation to another Canadian corporation (the “purchaser corporation”) for shares of the purchaser corporation having a paid-up capital of the subject shares.

(b) An upward adjustment under subsection 212.1(2) whereby, by virtue of the downward adjustment required pursuant to subsection 212.1(1)(d), deemed individual treatment is subsequently received with respect to the return of paid-up capital of the shares of the purchaser corporation; the purpose of this adjustment is to ensure that deemed dividend treatment is only received once with respect to the tainted paid-up capital.

The addition of contributed surplus to the definition of paid-up capital enacted by the 1974-75 Amendments was potentially a favourable change for shareholders since it made it possible for contributions of property made after December 31, 1977 to be returned to shareholders as capital.

As a result of the 1977 Amendments, contributions of property to a corporation, whenever made, will not form part of the paid-up capital of that corporation. Contributions of property to a corporation by a shareholder made before April 1, 1977 will be reflected in the 1971 capital surplus on hand of the corporation. Contributions of property to a corporation made on or after that date will have no special character and therefore will be distributable to shareholders of that corporation as income only and not as a return of capital.

Since a contribution of property generally increases the adjusted cost base of the shares of a corporation to the contributing shareholder,\(^7\) that shareholder may be able to recover his contribution tax-free through the sale of his shares in a capital transaction. It will be appreciated, however, that by removing the ability of the corporation to return contributions of property made after March 31, 1977 as capital, the 1977 Amendments impose a potential double taxation on those contributions. In effect, the right of a shareholder to recover his original investment in a corporation prior to receiving distributions on account of income has been eroded. This change will primarily be relevant to shareholders in private corporations since few shareholders of a public corporation are likely to make contributions of property to such a corporation.

Furthermore, the enriched gross-up and credit, and in particular the exclusion of stock dividends paid by a public corporation from income, in most cases, offsets the loss to a resident individual shareholder of a public corporation of the right to receive contributed surplus as a distribution of capital.

A non-resident shareholder derives no benefit from the enriched gross-up and credit, since he must account for withholding tax on the gross amount of any dividend from a corporation resident in Canada.\(^8\) In order to preserve

\(^7\) S.C. 1970-71-72, c. 63, paragraph 53(1)(c).

\(^8\) Id., subsection 212(2).
his right to receive his investment in a corporation as a distribution of capital, in lieu of contributing property, such a shareholder will likely want to receive shares with a paid-up capital equal to the amount of his investment or debt with a principal amount equal to his investment.

The 1977 Amendments have removed the ability of a corporation to add an amount to its capital for corporate law purposes without creating any corresponding increase in its paid-up capital for tax purposes. By issuing stock dividends, however, public corporations will be able to capitalize retained earnings without triggering a taxable dividend to their shareholders. The impact of this change on private corporations is difficult to assess, but one would suspect that the majority of such corporations will be indifferent to the removal of this right.

D. The Repeal of Tax-Paid Undistributed Surplus and the Restriction of 1971 Capital Surplus on Hand to Distributions on Winding-Up

Under the 1977 Amendments, after 1978 the election to pay dividends out of tax-paid undistributed surplus or out of 1971 capital surplus on hand will no longer be available. Nevertheless, through a new concept, "pre-1972 capital surplus on hand," any undistributed 1971 capital surplus on hand of a corporation will, after 1978, reduce the deemed dividend that would otherwise arise on the winding-up of such corporation.

The most likely reasons for these changes were the cost and difficulty of policing the rules respecting these surplus accounts and the overall objective of simplification. As well, in the case of public corporations, there may have been a desire to foreclose the ability of such a corporation to distribute cash to its shareholders without triggering any immediate liability for tax.

Although calculating these special surplus accounts could involve considerable cost to a corporation, that cost was generally acceptable in view of the beneficial tax treatment to its shareholders of distributions from these accounts as compared with taxable dividends under the former one-third gross-up and credit rule. Revenue Canada, too, would incur considerable costs in maintaining a staff competent to audit these calculations. However, the decision to grant both administrative and legislative relief from penalties to taxpayers who had erred in the calculation of these accounts or in the procedure for making a valid election meant that Revenue Canada derived little revenue to offset its costs. Furthermore, it was impracticable for Revenue Canada to police certain of the rules such as the requirement to reduce the adjusted cost base of any share on which a dividend out of tax paid undistributed surplus or 1971 capital surplus on hand had been received.

The decision to remove the right to pay dividends out of tax-paid undistributed surplus was made easy since for most shareholders the enriched

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99 S.C. 1977-78, c. 1, subsection 44(3).
100 S.C. 1977-78, c. 1, s. 43(11), which repealed and re-enacted subsection 88(2) of the Income Tax Act.
101 See text accompanying notes 51 and 55, supra.
gross-up and credit almost entirely removed the attractiveness of such dividends. That is, most shareholders will, after 1977, prefer to receive a taxable dividend subject to the one-half gross-up and credit rather than receive a dividend out of tax-paid undistributed surplus, which involves a 15 percent tax cost to the corporation and thereby reduces the assets of the corporation available for distribution.

The following steps were taken in order to relieve the anticipated pressure to retain the election to pay dividends out of the 1971 capital surplus on hand. First, as an inducement to corporations to distribute their 1971 capital surplus on hand before 1979, the 1977 Amendments permit a corporation, in most cases, to pay dividends out of 1971 capital surplus on hand without first paying the 15 percent tax to convert the entire amount of its 1971 undistributed income on hand to tax-paid undistributed surplus. Secondly, a "grandfather" clause was included in the 1977 Amendments to permit the continued payment of dividends out of 1971 capital surplus on hand in the case of outstanding public issues of preferred shares which entitled the holder of dividends out of that account. Finally, the concept of pre-1972 capital surplus on hand was introduced so that after 1978 any undistributed 1971 capital surplus on hand will reduce the deemed dividend that would otherwise arise on the winding-up of a corporation.

As noted above, since stock dividends by a public corporation are generally no longer treated as dividends for tax purposes, they cannot be used by a public corporation to capitalize 1971 capital surplus on hand.

It is unlikely that a public corporation would make a cash distribution of its 1971 capital surplus on hand to its shareholders if the amount is significant, notwithstanding the removal of the requirement to first convert 1971 undistributed income on hand to tax-paid undistributed surplus.

Most private corporations will be able to make a cash distribution of their 1971 capital surplus on hand or capitalize that account prior to 1979. There is, however, likely to be pressure to extend the time limit from private corporations that are having difficulty in carrying out the necessary steps before 1979.

E. The Revision of the Anti-Dividend Stripping Rules

Generally, the revisions to the anti-dividend stripping rules effected by the 1977 Amendments reduce the scope of these rules. As was indicated by the Honourable Donald S. MacDonald, the former Minister of Finance:

The increase in the dividend tax credit, and the maturing of the capital gains tax introduced in 1972, make it possible to abandon many of the complex rules designed to prevent surplus stripping, that is, the avoidance of tax on the distribution of corporate surplus. The present rules very often hamper constructive business reorganization and expansion. The rules will be eliminated or greatly simplified.

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103 S.C. 1977-78, c. 1, subsection 37(5) amending the application of subsection 83(1) for dividends that become payable after March 31, 1977 and before 1979.
104 Id., subsection 37(1).
105 Id., subsection 43(11). See also note 56.
106 Supra note 93.
Efficiency of business operation should be improved through the removal of artificial impediments to decision-making. It will be particularly beneficial to small business..."\(^\text{107}\)

1. The Repeal of Designated Surplus

Four factors appear to have led to the repeal of the designated surplus provisions: their complexity, their ineffectiveness, the maturing of the capital gains system, and the narrowing of the difference between capital gains and dividend treatment (resulting from the enrichment of the gross-up and credit on taxable dividends).\(^\text{108}\)

The designated surplus provisions were retained after 1971, in part, to ensure that corporate surplus could not be removed at capital gains rates.\(^\text{109}\) These provisions attempted to collect from the corporate purchaser an amount approximately equivalent to the difference between the rate of tax on capital gains and the rate of tax on taxable dividends. The complexity of these provisions became unjustifiable with the reduction of that differential to a negligible amount. Even if this differential between capital gains and taxable dividends had not been virtually eliminated, the designated surplus provisions might have been repealed in view of the difficulty of eliminating the many loopholes that existed, the fact that this tax was rarely paid, and the fact that it merely served as an impediment to corporate re-organizations.

The principal effect of the repeal of the designated surplus provisions should be to facilitate corporate reorganizations to which this tax would have applied and takeovers in an arm's length transaction, since it will permit an acquiring corporation to finance the purchase price for a target corporation through a tax-free inter-corporate dividend payable out of the retained earnings of the target corporation.

2. The Repeal of the Paid-Up Capital Limit and the Debt Limit Rules

The paid-up capital limit rules were enacted in order to block the distribution of accumulated after-tax earnings of a corporation in the guise of a return of paid-up capital. Similarly, the debt limit rules were intended to prevent dividend stripping in the form of a repayment of debt received as consideration for the sale of share of one corporation to another corporation. Essentially, these rules were an attempt by the Department of Finance to codify what would be regarded as improper dividend strips and to preclude the application of subsection 247(1) to such transactions by imposing deemed dividend treatment.

As a general comment, since the paid-up capital deficiency of a corporation was almost the inverse of its 1971 capital surplus on hand, those two calculations shared many of the same defects. The most significant of these

107 Id. at 12-13.
108 For a critical review of the former designated surplus provisions see the 1976 Recommendations on the Income Tax Act by the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants (n. pub.) ch. 7, at 49-53.
109 See text accompanying note 69, supra.
was the complexity of the calculation and the requirement for factual information which often was unobtainable, such as the value of a particular property at a particular time. Similar criticism could be made of the debt limit rules.

Retaining the concept of a paid-up capital limit would have meant maintaining an audit staff to review calculations of that account. Inasmuch as the administrative cost of policing the calculation of 1971 capital surplus on hand was a principal consideration in curtailing that concept, it is unthinkable that Revenue Canada would maintain the same staff solely to police the calculation of paid-up capital deficiencies.

Conceivably, the deficiency created by subparagraph 89(1) (d) (iv.1) and the debt limit under section 84.1 might have been retained separately as anti-dividend stripping rules in spite of the repeal of the remainder of the paid-up capital limit rules. This, however, would have detracted from the overall objective of simplification of the corporate distribution rules, since to do so would have required the retention of the concept of paid-up capital limit. In addition, there were several conceptual flaws in the deficiency created under subparagraph 89(1) (d) (iv.1) and the debt limit rules under section 84.1, including the following:

a) The 89(1) (d) (iv.1) deficiency rule and the debt limit rules applied where a corporate shareholder sold shares of one corporation to another corporation. Although the scope of those provisions might have been appropriate to block dividend stripping by non-resident corporations, they made little sense when applied to a resident corporate shareholder, since, subject to the Part IV tax, an inter-corporate dividend could have been received tax-free. Nevertheless, such a transaction created a deficiency or debt limit which might later adversely affect a resident individual shareholder.

b) The 89(1) (d) (iv.1) deficiency and the debt limit rules only applied where debt and shares in capital of the purchaser corporation were taken back by the vendor. Consequently, a sale for cash or other non-debt/non-share consideration, fell outside the scope of those provisions. Ministerial discretion under subsection 247(1) could potentially have been invoked in such a case.

c) The 89(1) (d) (iv.1) deficiency and the debt limit rules resulted in potential dividend treatment to the holder of shares or debt subject to those rules on a reduction of capital by a corporation or a repayment of the debt. The vendor of shares could, nonetheless, avoid or transfer this potential liability for dividend treatment through a sale of the tainted shares or tainted debt to a third party. A corporate purchaser of the tainted shares or tainted debt who controlled the payer corporation might be indifferent to deemed dividend treatment since inter-corporate dividends generally flowed tax-free.

Consequently, it is not surprising that with the enrichment of the gross-up and credit, these rules were repealed and new anti-dividend stripping rules were enacted to safeguard against what would be regarded as improper dividend strips.

The following provisions were enacted to prevent persons holding tainted
shares or tainted debt from realizing a windfall benefit by virtue of the repeal of those concepts:

a) Where a subparagraph 89(1)(d)(iv.1) deficiency was created with respect to the shares of a corporation prior to April 1, 1977, there will be a downward adjustment to the paid-up capital of the corporation\(^{110}\) (which adjustment is potentially greater if a subsection 85(1) election was made in conjunction with the sale of the shares of one Canadian corporation to another Canadian corporation).

b) The adjusted cost base of any debt that was subject to a debt limit as of March 31, 1971 is to be reduced by the deemed dividend that would have resulted had that debt been paid in full at that time,\(^{111}\) subject to the following option. To the extent that such tainted debt is converted to share capital of the purchaser corporation prior to 1979, the adjusted cost base of such debt will be restored to its former level and the paid-up capital of any shares received on that conversion will be reduced by an equal amount.\(^{112}\)

3. The New Anti-Dividend Stripping Rules and the Retention of Subsection 247(1)

In theory, any transaction by a taxpayer that involves the shares of a Canadian corporation and that, directly or indirectly, effects a distribution to the taxpayer of all or part of that corporation's surplus at a tax cost that is less than the tax otherwise payable on a dividend of that surplus to the taxpayer would be regarded as a dividend strip. In this regard, subsection 247(1) gives the Minister discretion to make a direction in a broad number of situations.\(^{113}\)

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\(^{111}\) Id., subsection 84.2(2) added by S.C. 1977-78, c. 1. subsection 39(1).

\(^{112}\) Id., subsection 84.3.

\(^{113}\) S.C. 1970-71-72, c. 63, subsection 247(1) reads as follows:

**DIVIDEND STRIPPING**

> Where a taxpayer has received an amount in a taxation year,
> (a) as consideration for the sale or other disposition of any shares of a corporation or of any interest in such shares,
> (b) in consequence of a corporation having
> (i) redeemed or acquired any of its shares or reduced its capital stock, or
> (ii) converted any of its shares into shares of another class or into an obligation of the corporation, or
> (c) otherwise, as a payment that would, but for this section, be exempt income, which amount was received by the taxpayer as part of a transaction effected or to be effected after June 13, 1963 or as part of a series of transactions each of which was or is to be effected after that day, one of the purposes of which, in the opinion of the Minister, was or is to effect a substantial reduction of, or disappearance of, the assets of a corporation in such a manner that the whole or any part of any tax that might otherwise have been or become payable under this Act in consequence of any distribution of income of a corporation has been or will be avoided, the amount so received by the taxpayer or such part thereof as may be specified by the Minister shall, if the Minister so directs,
> (d) be included in computing the income of the taxpayer for that taxation year, and
> (e) in the case of a taxpayer who is an individual, be deemed to have been received by him as a taxable dividend.
The stated practice of the Revenue Canada, however, was to apply subsection 247(1) only where in its view there had been an "improper" avoidance of tax. Mr. Primeau of Revenue Canada, in a paper on the application of subsection 247(1) that was delivered before the 1974-75 Amendment, said:

... it was our view that the shareholder was entitled to realize his equity in the form of a tax-free gain if he parted with his ownership, but that re-arranging his ownership so that he did not really part with ownership but merely held indirectly what he formerly held directly resulted in an improper avoidance of tax on the distribution of retained earnings.\textsuperscript{114}

The difficulty was, and is, in defining the point at which the vendor can be said to have parted with his ownership.\textsuperscript{115}

As noted above, the former debt limit rules and the subparagraph 89(1)(d)(iv.1) deficiency were enacted to neutralize the potential dividend stripping transactions to which they applied, thereby precluding the need for the Minister to make a direction under subsection 247(1).\textsuperscript{116}

The new sections 84.1 and 212.1 are also intended to obviate the need for the use of subsection 247(1). The new section 84.1 appears intended to block dividend stripping by a resident individual shareholder against the Valuation Day value of his shares\textsuperscript{117} of a Canadian corporation through a sale of such shares to another Canadian corporation with whom he does not deal with at arm's length. The new section 212.1 appears intended to block dividend stripping by a non-resident shareholder, whether against the Valuation Day value of his shares or by virtue of a treaty exemption from Canadian tax on capital gains, through the sale of such shares to a Canadian corporation with whom he is not dealing at arm's length.\textsuperscript{118}

4. The New Section 84.1

The new section 84.1 will apply where:

(a) a person resident in Canada, other than a corporation (the "vendor"), disposes of shares (the "subject shares") of a corporation (the "subject corporation") to another corporation (the "purchaser corporation");
(b) immediately after that disposition, the vendor does not deal at arm's length with the purchaser corporation (for the purpose of section 84.1 where the vendor is one of a group of ten persons or less who "act in concert" to control a corporation, the vendor is seemed for the purpose of section 84.1 to be a person not dealing at arm's length with that corporation);
(c) immediately after that disposition, the purchaser corporation, alone or together with persons with whom it does not deal at arm's length, controls (i.e., owns more than 50% of the voting shares of) the subject corporation; and

\textsuperscript{114} Supra note 26, at 422.
\textsuperscript{115} Id. at 423.
\textsuperscript{116} See text accompanying note 73, supra.
\textsuperscript{117} By virtue of ITAR subsection 26(3), a vendor who owned his shares without interruption since December 31, 1971 may use the higher of (i) the value of those shares on that date and (ii) the actual cost of those shares to him in computing the capital gain arising on the disposition of those shares.

While a vendor is free to use the Valuation Day value of his shares if sold in an arm's length transaction, Revenue Canada objects to the vendor engaging in a non-arm's length transaction in order to accelerate his right to a tax-free receipt of that amount.

\textsuperscript{118} See text, infra.
(d) the shares of the subject corporation were not shares acquired by the vendor after 1971 and owned after 1971, and before the vendor acquired such shares by a person with whom the vendor was dealing at arm's length.

The new section 84.1 is aimed at resident persons outside the corporate sector such as individuals, partnerships and trusts. A disposition of shares by a corporation resident in Canada is excluded from the new section 84.1 since, in such a case, no surplus is removed from the corporate level.

It is an underlying assumption in the new section 84.1 that if the vendor is not dealing at arm's length with the purchaser corporation, then he has not, in substance, parted with his ownership in the subject shares. It is this continuing interest in the subject corporation that makes the dividend strip improper.

It should be noted, however, that for the purposes of the Income Tax Act, a person may be “deemed” to be not dealing at arm’s length with a subject corporation notwithstanding that he is, in fact, dealing with that corporation at arm’s length and owns no shares in its capital stock. The application of the new subsection 84.1 in such cases may produce unduly harsh results. For example, assume two brothers each own 50 percent of the issues shares of an operating company; one of the brothers wishes to retire. His brother offers to buy his shares for cash if the purchase can be made through a holding company. Prior to the 1977 Amendments, if the shares of the operating company had been sold for cash, the transaction would have been outside the former paid-up capital limit and debt limit rules and, depending on all the facts, one might have expected Revenue Canada to rule that no direction would be made. Such a transaction is now clearly caught by the new section 84.1. Apparently, the Department of Finance chose not to exempt such types of transactions from section 84.1 because of the difficulty of doing so without enacting a considerably more complicated provision.

Pursuant to paragraph 84.1(2) (b), a vendor is deemed to be a person not dealing at arm’s length with the purchaser corporation if the vendor together with a group of less than ten persons “act in concert” to control that corporation. This rule is intended to catch situations where a small number of arm’s length persons act together to control a purchaser corporation, but each person alone, arguably, is at arm’s length with the purchaser corporation. But for such a rule, a small group might be tempted to effect a dividend strip against the Valuation Day value of their shares of one corporation by dispos-

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119 S.C. 1970-71-72, section 251. For the purposes of the Act, “related” persons are deemed not to deal with each other at arm’s length. It is a question of fact whether persons not related to each other were at a particular time dealing with each other at arm’s length. Specific rules are set out for determining whether persons are related.

120 After the 1974-75 Amendments had been enacted, Mr. Brian Bryson, C.A., then chief of the Corporate Reorganizations Section, Revenue Canada, delivered a paper, "Surplus Stripping: the Application of Subsection 247(1) in Light of the 1975 Amendments to the Income Tax Act" (1975), Cdn. Tax Foundation Conf. Rep. 295. At 301, his example 2 indicates that subsection 247(1) would not be invoked in a similar transaction where the vendor does not lend the purchaser money to buy the corporation. But see also his example 2, at 300, in which he states that subsection 247(1) would be invoked in a similar transaction if the purchaser corporation merely took out a “day-light” loan to side-step the paid-up capital limit and debt limit rules, which was paid with a loan from the buyer of the purchase price.
ing of those shares to a purchaser corporation in which they would take proportionate shareholdings.

The Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants aptly made the following comment respecting the “acting in concert” concept in their 1977 Recommendations on the *Income Tax Act*:

We are concerned about the legal uncertainties that may result from the introduction of the concept of “persons who act in concert”. This is particularly true because the test is whether or not ten persons act in concert “to control a corporation”. Does this mean that a shareholder who, immediately after the disposition of the subject shares votes at a shareholder’s meeting contrary to the majority will be considered to be at arm’s length with ten others, whereas a shareholder who votes on the same issue with the majority will not be at arm’s length with the others? At the very least the test should relate to the transfer of the subject shares, i.e., when a person acts in concert with others with a view to reducing corporate distribution tax by, inter alia, transferring the subject shares to the predecessor corporation.\(^1\)

Where the purchaser corporation controls the subject corporation, it will be able to receive dividends from the subject corporation free of tax and will also be able to cause the subject corporation to pay dividends on its shares.\(^1\)\(^2\)

By virtue of an amendment to Part IV of the *Income Tax Act*, enacted as part of the 1977 Amendments, a corporation that is “connected with”\(^1\)\(^2\) a second corporation, under certain circumstances, will be able to receive dividends free of tax from that second corporation. This raises the possibility of a dividend strip where the purchaser corporation does not control but is connected with the subject corporation. The unanswered question is whether the Department of National Revenue would apply subsection 247(1) to such a transaction.\(^1\)\(^2\)

The exclusion from the new section 84.1 of shares acquired after 1971 from a person with whom the vendor was dealing at arm’s length is apparently intended to restrict the application of that provision to strips against the Valuation Day value of shares. Nevertheless, it will also be applicable to shares issued out of treasury after 1971. Apparently this was intended to prevent a person who owned shares on December 31, 1971 from effecting a dividend strip through a series of sales to holding companies. Generally, the application of the new section 84.1 to shares issued out of treasury after 1971 will not be detrimental, provided the shareholder is careful to ensure that the paid-up

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\(^{121}\) 1977 Recommendations on the *Income Tax Act* by the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants. (n. pub.) ch. 7, at 5-6.

\(^{122}\) Dispositions by corporations resident in Canada are excluded from the new section 84.1, there being no surplus removed from the corporate level.

\(^{123}\) *Supra* note 89.

\(^{124}\) Sections 19 and 49 of Bill C-56, 1978 (30th Parliament, 3rd Session) contain draft legislation to enact Ways and Means Resolution 10 from the Budget of April 10, 1978. If these amendments are passed, sections 84.1 and 212.1 will be extended to situations where the purchaser corporation is connected with the subject corporation immediately after the disposition, thus removing the need to consider whether subsection 247(1) should be applied. This draft legislation also, however, clearly extends sections 84.1 and 212.1 to a dividend strip by a minority shareholder, a transaction not blocked by the former paid-up capital limit or debt limit rules.
capital of such shares is at least equal to his adjusted cost base for such shares. Since contributions of property to a corporation by a shareholder will no longer form part of paid-up capital, care should be taken to avoid such transactions in situations where the new section 84.1 could be applicable.

In the situations where the new section 84.1 does apply, resident individual shareholders, by varying the consideration received from the purchasing corporation, will be able to choose between immediate or deferred capital gain or dividend treatment on the retained earnings of the subject corporation.

Where a vendor receives consideration other than shares or debt of the purchaser corporation (such as cash or a debt obligation of a third party), the vendor will incur an immediate capital gain pursuant to paragraph 84.1(1)(a) to the extent that the lesser of:

(i) the adjusted cost base of the subject shares, and
(ii) the fair market value of any consideration received for the disposition of the subject shares other than shares or debt of the purchaser corporation exceeds
(iii) the paid-up capital of the subject shares.

Where the vendor receives shares or debt of the purchaser corporation as consideration, pursuant to paragraph 84.1(1)(b), the adjusted cost base of such debt and of such shares is to be reduced to the extent that the lesser of:

(i) the adjusted cost base of the subject shares, and
(ii) the aggregate of
(a) the fair market value of any consideration received for the disposition of the subject shares other than shares or debt of the purchaser corporation;
(b) the fair market value of any debt of the purchaser corporation received for the disposition of the subject shares; and
(c) the paid-up capital of any shares of the purchaser corporation received by the vendor as consideration for the disposition of the subject shares exceeds
(iii) the greater of
(a) the fair market value of any consideration received for the disposition of the subject shares other than shares or debt of the purchaser corporation, and
(b) the paid-up capital of the subject shares.

The reduction in the adjusted cost base of any shares or debt of the purchaser corporation received by the vendor as consideration for the disposition of the subject shares is to be applied pro rata to each share or debt based upon the relative costs to the vendor of all such shares or debt.

Example:

Assume Mr. A has owned all the shares of B Co. (the "subject shares") since 1967. On April 1, 1977, Mr. A sells the subject shares to a second wholly owned corporation, C Co., for an aggregate consideration of $1,000,000 to be satisfied by the payment by C Co. of $100,000 in cash and the issuance by C Co. of a demand promissory note in the amount of $400,000 and redeemable preferred shares in the amount of $500,000. Mr. A elects, pursuant to subsection 85(1), that the proceeds of disposition of the subject shares is to be $500,000, which is the adjusted cost basis of those shares to him (based
upon their value on December 31, 1971). The paid-up capital in respect of
the subject shares is $10,000.

Under subsection 85(1), there is neither a gain nor a loss to Mr. A on this
sale. The adjusted cost base to Mr. A of the promissory note would be
$400,000 provided that it has a fair market value equal to that amount; the
adjusted cost base to him of the shares taken back is nil.

The new section 84.1, however, applies to deem an immediate capital gain
of $90,000 to Mr. A on the cash consideration, and the adjusted cost base
to Mr. A of the promissory note will be reduced to nil, as follows:

Deemed capital gain under paragraph 84.1(1)(a) determined as:

the lesser of

1. the adjusted cost bases of the subject shares .... $500,000
   and
2. the fair market value of any consideration re-
   ceived for the disposition of the subject shares
   of debt of the purchaser corporation .......... $100,000

Lesser amount .......................................................... $100,000

Deduct:

paid-up capital of the subject shares .......... $10,000

Deemed capital gain ................................................ $90,000

Reduction in adjusted cost base of promissory note and potentially of shares
under 84.1(1) (b) as follows:

the lesser of:

1. adjusted cost bases of the subject shares
   and ................................................. $ 500,000

2. the aggregate of
   (a) the fair market value of any non-debt/
       non-share consideration ...... $ 100,000
   (b) the fair market value of the debt
       consideration ...................... $ 400,000
       and
   (c) the paid-up capital of the share
       consideration .................... $ 500,000

Sub-Total ...................................... $1,000,000

Lesser amount .......................................................... $500,000

exceeds

3. the greater of:
   (a) the fair market value of any non-debt/
       non-share consideration ......$ 100,000
       and
   (b) the paid-up capital of the subject shares
       .................................................. $ 10,000

Greater amount .......................................................... $100,000

Reduction in adjusted cost base ................................ $400,000

Inasmuch as the cost to Mr. A of the redeemable
preferred shares is already nil by virtue of his election pursuant to subsection 85(1), the entire amount of the reduction under paragraph 84.1(1)(b) will apply to reduce the adjusted base to him of the note.

Had Mr. A taken back redeemable preferred shares with a par value of $10,000 but a redemption price of $1,000,000, there would have been no immediate capital gain or reduction in the adjusted cost bases of those shares to him by virtue of the new section 84.1. By doing so, he would preserve his right to flow through the Valuation Day value of the subject shares to the shares of the purchaser corporation. Assuming that the shares of the purchaser corporation have a fair market value of $1,000,000, he would have the choice of:

1. selling those shares and realizing a capital gain of $500,000; or
2. causing C Co. to redeem those shares, which would result in a deemed dividend of $990,000 and a capital loss of $490,000 to him.

The combined effect of restricting 1971 capital surplus after 1978 to the winding-up of a corporation and the enactment of the new section 84.1 will, in many cases, block resident individuals from removing the Valuation Day value of their shares prior to disposing of their interest in those shares. While, in the case of 1971 capital surplus on hand, one could argue that this was not intended and can be avoided by capitalizing that account prior to the end of 1979, in many cases the consequence will be as described.

5. Section 212.1

Generally, the new section 212.1 will apply where:

(a) a non-resident of Canada (whether or not a corporation) disposes of shares of a corporation (the "subject corporation") to another corporation (the "purchaser corporation") that immediately after a disposition does not deal at arm's length with the non-resident; and
(b) immediately after that disposition, the purchaser corporation, alone or together with persons with whom it does not deal at arm's length, owns more than 50% of the voting shares of the subject corporation (for the purposes of section 212.1, a vendor who is a member of a group of less than 10 persons who act in concert to control a corporation is deemed not to deal at arm's length with that corporation).

The comments above concerning the requirement that the vendor and purchaser corporation be non-arm's length, and the requirement that the purchaser corporation control the vendor will also be relevant here. However, the following differences between the new section 84.1 and section 212.1 should be noted.

The exemption from section 84.1 of shares of a corporation acquired in an arm's length transaction after 1971 has not been repeated in section 212.1. Apparently, this was an intended omission. Canada could expect to receive tax at capital gains rates (as opposed to dividend income rates) from a resident individual disposing of such shares to a holding company; if a non-resident shareholder, entitled to treaty protection respecting capital gains were allowed to remove the surplus of that corporation as a capital receipt, then he might avoid completely the payment of Canadian tax. Hence section 212.1 applies to shares of a Canadian corporation, whenever acquired. As well,
although section 84.1 offers a resident individual shareholder the choice between dividend income and capital gains treatment due to the treaty protection respecting capital gains enjoyed by some non-resident shareholders, section 212.1 imposes dividend income treatment only.

Under section 84.1, debt of the purchaser corporation may be received by a resident individual shareholder without immediate tax consequences but with potential capital gains consequences in the future. Under section 212.1, there is an immediate taxable dividend to a non-resident shareholder to the extent that he receives non-share consideration from a purchaser corporation. Where a non-resident shareholder takes back shares of the purchaser corporation in a transaction to which section 212.1 applies, deferred dividend treatment is imposed to the extent that the paid-up capital of such shares exceeds the paid-up capital of the shares so disposed of through a downward adjustment in the paid-up capital of the shares of the purchaser corporation.

Where, as consideration for the disposition of the subject shares, a non-resident vendor receives any non-share consideration (which includes cash or debt) from the purchaser corporation, there will be an immediate dividend to the non-resident pursuant to paragraph 212.1(1)(a) to the extent that:

1. the fair market value of any non-share consideration received for the subject shares exceeds
2. the paid-up capital of the subject shares.

Where, as consideration for a disposition of the subject shares, shares of any class in the capital stock of the purchaser corporation are issued to the non-resident vendor, there will be a reduction in the paid-up capital of the purchaser corporation pursuant to paragraph 212.1(1)(b) equal to the amount by which:

1. the increase in the paid-up capital of the purchaser corporation by virtue of the disposition exceeds the amount by which
2. a) the paid-up capital in respect of the subject shares exceeds
   b) the fair market value of any non-share consideration received by the vendor shareholder for the disposition of the subject shares.

Where more than one class of shares of the purchaser corporation is issued to the non-resident vendor as consideration for the subject shares, that reduction is to be applied pro rata to reduce the paid-up capital of the classes of shares so issued on the basis of the increase in the paid-up capital of each such class of shares relative to the total increase in the paid-up capital of the purchaser corporation.

Example:

X Co., a non-resident of Canada, purchases all the shares of Y Co., a Canadian corporation, in 1976, in an arm’s length transaction for $2,000,000. On April 1, 1978, X Co. sells all the shares of Y Co. to a second wholly owned Canadian corporation, Z Co., for an aggregate consideration of $3,000,000, to be satisfied by the issuance by Z Co. of a demand promissory note in the amount of $1,000,000 and the issuance of common shares of Z Co. having
a fair market value of $2,000,000 (which increased the paid-up capital of Z Co. by that amount). The paid-up capital of the shares of Y Co. immediately before the sale was $500,000.

Section 212.1 applies to deem an immediate dividend of $500,000 to X Co. and the paid-up capital in respect of the common shares of Z Co. would be reduced to nil, as follows:

Deemed dividend under paragraph 212.1 (1) (b) determined as:

1. the fair market value of any non-share consideration received for the subject shares .................................. $1,000,000.00

less

2. the paid-up capital of the subject shares ................ $ 500,000.00

DEEMED DIVIDEND ............................................ $ 500,000.00

Reduction in paid-up capital of the shares of Z Co. determined as:

1. the increase in the paid-up capital of Z Co. by virtue of the disposition .................................. $ 2,000.00

less

2. the excess of:
   a) the paid-up capital of the subject shares .................................. $ 500,000
   b) the fair market value of any non-share consideration received for the subject shares .................................. $1,000,000

EXCESS ...................................................... nil

Reduction in paid-up capital of Z Co. ............................................. $2,000,000.00

Since only common shares of Z Co. were received, the entire amount of the reduction would apply to reduce the paid-up capital of those shares.

X Co. will be subject to immediate Canadian withholding tax treatment on the deemed dividend of $500,000. The proceeds of disposition to X Co. of the subject shares is reduced by an amount equal to that deemed dividend by virtue of sub-paragraph 54(h)(xi), but not by the amount of the reduction in paid-up capital. Consequently, in addition to a deemed dividend of $500,000, X Co. realizes a $500,000 capital gain by virtue of this transaction. Where treaty protection is available, that capital gain will not result in any additional Canadian income tax liability. Where no such protection exists, however, there is potentially double taxation, since a deemed dividend of $2,000,000 will result on the reduction of the paid-up capital of the common shares. Tax on that capital gain could have been avoided, of course, if X Co. had made an election pursuant to subsection 85(1) that the proceeds of disposition of the shares of Y Co. be $2,500,000.

6. Subsection 247(1)

Despite the enactment of the new anti-dividend stripping rules in sections 84.1 and 212.1, subsection 247(1) has been retained intact. Moreover,
paragraph 214(3)(h) was added to the Act to make it clear that subsection 247(1) could be invoked against non-residents.\textsuperscript{125}

Possibly, this is to safeguard against the discovery of a loophole in the new anti-dividend stripping provisions or to permit a direction to be made on potential stripping transactions that were set up prior to the enactment of the new rules. In many ways, however, the continuation of Ministerial discretion detracts from the overall objective of the 1977 Amendment to simplify the corporate distribution rules. Whether Revenue Canada will administer subsection 247(1) so as to broaden the scope of the anti-dividend stripping rules contained in sections 84.1 and 212.1 remains to be seen.\textsuperscript{126}

After the 1974-75 Amendments had been enacted, Mr. Brian Bryson, then Chief of the Corporate Reorganizations Section in Revenue Canada, delivered a paper at the 1975 conference of the Canadian Tax Foundation on the application of subsection 247(1) in light of the enactment of the paid-up capital limit and debt limit rules. It was clear from his paper that if the debt limit rules or paid-up capital limit rules applied to a transaction, Revenue Canada would not seek a direction under subsection 247(1) in respect of the same transaction.\textsuperscript{127} Mr. Bryson further suggested, however, that the debt limit and paid-up capital rules might have broadened the possible application of subsection 247(1) by specifying a broader range of circumstances where dividend treatment should apply to corporate surplus distributions.\textsuperscript{128}

\textsuperscript{125} S.C. 1977-78, c. 1, subsection 94(2).

\textsuperscript{126} Supra note 81. If the proposed changes to sections 84.1 and 212.1 are made, the sale of a minority shareholding for the purpose of a dividend strip will be blocked after April 10, 1978.

\textsuperscript{127} Bryson, supra note 120, at 299-300:

... Basically, the Department regarded situations where an individual sold shares of one company to another company which he controlled and which was either owned by himself, his wife or adult children who neither participated in the business nor contributed substantial capital, to be a divided strip except possibly in the fully mature system. This view is unchanged, except that if such transactions are completed in a manner so that the new rules in section 84.1 and/or paragraph 89(1)(d) apply, it would appear for the reasons cited earlier in this paper that there will be no need to apply subsection 247(1). This will be so because the shareholder should not be in a position, as a result of the transaction, to remove in a tax-free manner any assets from his corporation in excess of what he would otherwise have been entitled to had he not entered into the transaction. Consequently, the need to apply subsection 247(1) in cases which the Department formerly considered to be dividend strips should be lessened.

However, with the introduction of the new debt limit rules under section 84.1 and the paid-up capital deficiency rules under subparagraph 89(1)(d) (iv. 1), the Act now provides a broader range of circumstances where dividend treatment is to apply to corporate surplus distributions. The new rules cover more circumstances than this Department previously felt should receive dividend treatment in accordance with Mr. Primeau's paper. As a consequence, the base for the possible application of subsection 247(1) has been broadened, and step transactions designed to avoid these new rules could contribute a series of transactions for the purpose of avoiding tax on a distribution within the meaning of subsection 247(1).

\textsuperscript{128} Id. at 300-01. Mr. Bryson, after giving an example of such a transaction, said: This type of transaction would have been one where, according to the Department's policy prior to the introduction of the new debt limit and paid-up capital deficiency rules, subsection 247(1) would not likely have been invoked. However,
It is clear enough that where section 84.1 or section 212.1 apply to block the dividend stripping potential of a transaction, subsection 247(1) should not be invoked because it is unnecessary. Generally one might expect subsection 247(1) to be invoked in the case of a transaction intended to avoid section 84.1 or section 212.1. It is still not known whether subsection 247(1) will be applied to situations that clearly are not intended to be covered by sections 84.1 and 212.1.

The Canadian Bar Association, in its brief to the Carter Royal Commission on Taxation, criticized ministerial discretion under subsection 138A(1) of the Income Tax Act as it read, as follows:

1. Taxpayers are unable to know what rule will be applied. Uncertainty as to tax treatment will often inhibit any action being taken with respect to a transaction even though the transaction may have a perfectly legitimate objective. It is difficult for taxpayers to plan or arrange their affairs and business activity is unnecessarily inhibited.

2. A discretion may not be exercised in the same way for one taxpayer as for another. The knowledge or suspicion that this is the case results in a sense of dissatisfaction on the part of taxpayers against whom the discretion is exercised.

3. The existence of ministerial discretion confers undue power on departmental officials. Such power can be exercised against the taxpayer for reasons not related directly to the merits of the matter in respect of which the discretion is exercised. Such an indirect motive may influence departmental officials either consciously or unconsciously or may be suspected even if it does not exist. This creates a sense of grievance on the part of taxpayers.

4. The existence of ministerial discretion deprives persons of effective recourse to the courts except in extreme cases. The right of such recourse is the bulwark of our system of government.

In the opinion of this Association these objections to ministerial discretion are valid no matter how able and well-intentioned the department officials are.129

Although the enactment of specific anti-dividend stripping rules has considerably reduced the uncertainty in this area, the criticisms of the Canada Bar Association remain valid today. Pending repeal of subsection 247(1), a clear statement by the Department of National Revenue respecting the present scope of subsection 247(1) would be welcome.

III. CONCLUSION

The enriched gross-up and credit on taxable dividends was enacted to stimulate investment in the Canadian equity market. It is too soon to conclude whether that change will have the desired effect, but by extending a preferential tax treatment to dividend income equivalent to that accorded capital gains, it facilitated the repeal of a number of provisions whose function had

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been to block taxpayer attempts to remove corporate surplus at capital gains rates.

Generally, the 1977 Amendments now permit a taxpayer to choose between paying tax at either capital gains or dividend income rates on any distribution of corporate surplus he receives. Nevertheless, the use of a non-arm’s length transaction to remove all or part of the corporate surplus of a corporation at nil rates continues to be regarded as an improper dividend strip. The new section 84.1 is intended to prevent dividend stripping by resident individual shareholders against the Valuation Day value of their shares. Shares acquired in an arm’s length transaction after 1971 are excluded from the application of section 84.1 since any gain on a disposition of such shares will be subject to capital gains tax. The new section 212.1 is intended to prevent dividend stripping by non-resident shareholders whether through the use of a Valuation Day value for shares or through the benefit of a treaty exemption from Canadian capital gains tax. Consequently, section 212.1 applies to shares of a Canadian corporation whenever acquired.

Finally, the problem of determining what portion of a corporation’s net assets can be distributed as capital has been greatly simplified. This has been done by the revision of the concept of paid-up capital, the curtailment of 1971 capital surplus on hand, and the repeal of the paid-up capital limit rules.

For most corporations incorporated after 1978, the only special tax accounts will be the capital dividend account and paid-up capital. In the usual case, the sum of these two will be the amount such a corporation can distribute to its shareholders as capital for corporations incorporated before 1979. The potential adjustments to paid-up capital for transactions that occurred under the former rules and the new concept of “pre-1972 capital surpuls on hand” will require a more detailed investigation. Even for these corporations, however, the new corporate distribution rules seem less complicated than those existing before the 1977 Amendments.