Canadian corporations that receive dividends from other Canadian corporations now have more guidance from the CRA about the potential application of an expanded anti-avoidance rule. Many corporations may be adversely affected by this rule, which recharacterizes certain otherwise tax-free inter-corporate dividends as capital gains that are subject to tax. This expanded rule will apply to dividends received after April 20, 2015.

The changes to the anti-avoidance rule in subsection 55(2) were introduced more than a year ago in the 2015 federal budget, and the proposed legislation is expected to become law soon. Despite the CRA’s latest guidance, it is still unclear how the expanded rule may apply to dividends received by corporations in many common circumstances, including where cash or other assets are moved within a corporate group. As a result, taxpayers should consider calculating safe income before paying a dividend to determine whether it qualifies for the safe income exception to the anti-avoidance rule for dividends paid out of a corporation’s safe income.

This TaxNewsFlash-Canada discusses key issues that may arise from the changes to the anti-avoidance rule. We also highlight our current understanding about the application of the new rule to many common transactions involving the payment of inter-corporate dividends, based on comments and interpretations made by the CRA on the proposed new rules.

What types of transactions may be caught?
The amendments could have a significant impact on standard transactions, including the movement of cash or other assets through a corporate chain and reorganizations of corporate structures.
You will need to consider whether the expanded anti-avoidance rule in subsection 55(2) will apply if your corporation is paying a dividend to another corporation in the following circumstances, among others:

- **Distribution of cash from Opco** — Paying a cash dividend from an operating company (Opco) to a related or unrelated corporation
- **Asset protection** — Paying a dividend from Opco to a holding company (Holdco) to potentially protect Opco’s assets from its creditors
- **Asset value extraction** — Paying a dividend using borrowed funds to extract the appreciated value of Opco’s underlying assets
- **Purification for capital gains exemption** — Paying a dividend to remove non-active business assets from Opco to make Opco’s shares eligible for the capital gains exemption
- **Change of asset ownership** — Paying a dividend as part of a reorganization to move an asset within a related group of companies
- **In-house loss utilization** — Paying a dividend as part of a loss utilization transaction to enable the corporate group to utilize tax losses
- **Share ownership change** — Paying a dividend as part of the division of a corporation between related shareholders.

These examples do not cover every situation; the new rule may apply to dividends in other situations as well. All types of dividends should be considered, including cash dividends, stock dividends (including high-low stock dividends), dividends-in-kind, deemed dividends on stated capital increases, deemed dividends on share redemptions and deemed dividends on taxable wind-ups.

For details on the key changes to the subsection 55(2) anti-avoidance rule and their potential impact on Canadian corporations, see KPMG’s *TaxNewsFlash-Canada* 2015-23, “Are Your Tax-Free Inter-Corporate Dividends in Jeopardy?”.

I. Background — When did the “old” anti-avoidance rule apply?

The “old rule” under subsection 55(2) (before the proposed 2015 changes) could apply when one of the purposes of a dividend was to significantly reduce a capital gain that would be realized on a disposition at fair market value (FMV) of any share immediately before the dividend was paid (known as the “purpose test”). For deemed dividends arising on share redemptions, acquisitions or cancellations under subsection 84(3), the old rule could apply if one of the results of the deemed dividend was to significantly reduce a capital gain.

The old rule did not apply if any of the following exceptions were met:

- **Safe income exception** — Applied to a dividend that did not exceed after-tax retained earnings (i.e., “safe income on hand”)
- **Related party exception** — Applied to a dividend received in related-party transactions that involved no unrelated persons
• **Part IV tax exception** — Applied to a dividend that was subject to the refundable Part IV tax on dividends, provided that the Part IV tax was not refunded as a consequence of the dividend recipient paying a dividend to another corporation (i.e., if the Part IV tax was refunded by paying dividends to individuals, this Part IV tax exception was available), or
• **Butterfly reorganization exception** — Applied to a dividend received in a “butterfly reorganization” using paragraph 55(3)(b) of the *Income Tax Act*.

**II. Key issues arising from changes to the anti-avoidance rule**

Proposed changes to the subsection 55(2) anti-avoidance rule include two new purpose tests added to the existing purpose test, new limitations to the application of some of the exceptions to the rule and expanded application of the rule to stock dividends. These changes raise some key issues for corporations.

**New purpose tests — Broader application of subsection 55(2)**

The proposed changes add two new purpose tests to the existing subsection 55(2) anti-avoidance rule.

Under the old rule, subsection 55(2) did not apply to a dividend that reduced the fair market value (FMV) of a share that had an adjusted cost base (ACB) equal to or greater than its FMV. In such a case, a dividend might reduce the FMV of the share, creating or increasing an accrued loss that could shelter an accrued capital gain on another property from tax.

The new rule applies to this type of transaction by adding two new purpose tests in new subsection 55(2.1). The new rule can apply to treat a tax-free dividend (other than a deemed dividend on a redemption, acquisition or cancellation of shares under subsections 84(2) or 84(3)) as a capital gain when one of the purposes of the payment or receipt of the dividend is to effect:

• a significant reduction in the FMV of any share, or
• a significant increase in the total cost of properties of the recipient of the dividend.

The previous purpose test under subsection 55(2) remains part of the new rule. As such, the anti-avoidance rule can also apply when one of the purposes of a dividend (or one of the results in the case of a deemed dividend under subsection 84(3)) is to significantly reduce a capital gain that would be realized on a disposition at FMV of any share immediately before the dividend was paid.

**Key issue for corporations**

The two new purpose tests place the onus on the corporation to demonstrate that none of the purposes in paying or receiving the dividend was to reduce the FMV of any share or increase the cost of property. While the tests are intended to only look at the purpose of the dividend, it may be difficult to ignore that the result of a dividend in most cases is a reduction in the FMV of a share or an increase in the cost of property.
Subsection 55(2) may now apply to dividends paid in some common circumstances if the purpose of the dividend is to reduce the FMV of a share or increase the cost of property, even though the objective was not to reduce a capital gain or increase a capital loss. For example, the purpose of a dividend paid as part of an asset protection transaction may be to reduce the FMV of the company's shares, as discussed further below.

**Related-party exception — Narrowed scope**

Under the new rule, corporations will not be able to rely on the related-party exception, unless the dividend is deemed to arise on a redemption, acquisition or cancellation of a share of the corporation under subsections 84(2) or 84(3) of the *Income Tax Act*.

**Key issue for corporations**

This change is significant because corporations will no longer be able to easily conclude that the anti-avoidance rule does not apply when the transactions only involve related parties.

**Narrowing of Part IV tax exception**

A further change narrows the Part IV tax exception from subsection 55(2) so that it no longer is available when the dividend recipient is subject to Part IV tax on the dividend but receives a dividend refund by paying a dividend to an individual.

**Key issue for corporations**

The Part IV tax exception is now only available if there is no dividend refund to the dividend recipient.

**Stock dividends**

The new subsection 55(2) anti-avoidance rule also affects high-low stock dividends (i.e., issuance of shares with high value and low paid-up capital (PUC)) that shift value to the shares issued as a stock dividend. Previously, only the PUC amount of a high-low stock dividend was subject to scrutiny under subsection 55(2). Under the new rules, the amount of a stock dividend for purposes of the subsection 55(2) anti-avoidance rule will no longer equal the PUC of the stock dividend shares but will now equal the greater of their PUC and their FMV.

While it seems that the intent of the amendment relates to the payment of a stock dividend of one class of shares (e.g., preferred shares) on another class (e.g., common shares), the rule can apply to stock dividends paid on the same class of shares (e.g., common share stock dividend paid on common shares).

Complex amendments to the stock dividend cost basis rules were also introduced in conjunction with the new changes to the subsection 55(2) anti-avoidance rule.
Key issues for corporations

All types of stock dividends will be subject to the potential application of the anti-avoidance rule.

Corporations receiving same-class stock dividends paid by public corporations to achieve stock splits now face the possible application of subsection 55(2) to those dividends.

III. Mitigating risk using the safe income exception

As a result of the new purpose tests and the uncertainty they create, as well as the narrowing of the related party and Part IV tax exceptions, corporations face having to maintain current safe income calculations to mitigate the risk that the anti-avoidance rule will apply even in circumstances where no disposition of shares is expected to occur.

However, the safe income exception may not be available even if the corporation has safe income. Under the new rule, the safe income exception is not available if there is no capital gain on the share on which the dividend was paid (i.e., there is an accrued loss on the share or its FMV is equal to the ACB).

As such, when there is no capital gain on the share on which the dividend was paid and the purpose tests apply, the safe income exception would not be available.

KPMG observation — Safe income determination time

As more corporations face having to rely on the safe income exception it will become increasingly important to consider the rules related to the calculation of safe income, including the determination of their “safe income determination time”.

Under the safe income exception, a dividend can only be protected by income earned or realized before the “safe income determination time” for the transaction, event or series of transactions. Under its definition, the “safe income determination time” can be triggered by the payment of a dividend as part of a series of transactions. The determination time is immediately before the first dividend is paid as part of a series of transactions. This definition, which remains unchanged under the new rule, may lead to inappropriate results.

When relying on the safe income exception to subsection 55(2), it will be necessary to conclude whether there has been a safe income determination time.

For corporations that pay regular periodic dividends, it is unknown whether the CRA will consider the periodic dividends to be part of a series of transactions resulting in a safe income determination time immediately before the first dividend is paid. If the CRA takes this position, the corporation’s safe income amount would therefore not include its income earned after that first dividend in the series, possibly limiting the corporation’s ability to rely on the safe income exception for future dividends in the series. The CRA
Dividends that exceed safe income

In some situations, corporations may pay dividends that exceed their safe income. Under the section 55 rules, if a dividend received by a corporation exceeds the dividend payor corporation’s safe income, the entire dividend would be subject to subsection 55(2) and would be treated as a capital gain.

However, paragraph 55(5)(f) provides relief to corporations receiving dividends in such a situation by giving them the discretion to designate any portion of the dividend to be a separate taxable dividend. By making a designation, corporations can ensure that the portion of the dividend equal to safe income is not recharacterized as a capital gain under subsection 55(2).

The new rules make the designation under paragraph 55(5)(f) apply automatically so that a dividend that is paid out of safe income will now automatically be treated as a separate dividend and no designation is required.

IV. CRA clarifies some issues at CTF Conference

The tax community’s response to the proposed new rule has included expressing concerns to Finance about the new rule’s implications and the uncertainty created by the new purpose tests. Some of the concerns about the new rule were included in questions addressed to the CRA at the Round Table at the Canadian Tax Foundation’s (CTF) Annual Conference in November 2015.

This section includes the following issues raised in this Round Table session, the CRA’s responses and the implications for Canadian corporations:

- Purpose tests and distributing cash from Opco
- Asset protection
- In-house loss utilization
- Internal reorganizations
- Dividends on non-participating discretionary shares.

Purpose tests and distributing cash from Opco

One of the concerns with the new rule is that dividends paid to distribute cash from an operating company (Opco) to another company in the normal course of business could be caught by the new purpose tests because such a dividend will typically reduce the value of the shares of the corporation or increase the cost of the dividend recipient corporation’s property.
Factors the CRA will consider

The CRA was asked to describe the factors or tests it would consider in deciding whether the new purpose tests would apply where the consequence of a dividend is a reduction in the FMV of a share.

The CRA stated that new subsection 55(2.1) is a purpose test and not a results test. The CRA stated that the determination of purpose will be based on the facts including, but not limited to, the actions taken by the parties and their motivation.

The CRA said that a dividend will normally result in a reduction in the FMV of a share or increase in cost of property, but it is not the result that drives subsection 55(2); rather, it is the purpose and motivation behind the purpose. The CRA said that it is also necessary to ascertain that the purpose of the dividend is not to increase the cost of property.

In its response, the CRA said that taxpayers should be prepared to answer the following three questions:

- What does the taxpayer intend to accomplish with the reduction in value or increase in cost of property?
- How would the reduction in FMV or increase in cost of property be beneficial to the taxpayer?
- What actions did the taxpayer take in connection with the reduction in FMV or increase in cost of property?

In the CRA’s view, there is an indication that the FMV reduction purpose test would be met where the dividend is instrumental in creating an accrued loss on a share that could be used to shelter a gain on another property. The CRA said that the use or possibility of using increased cost amounts to shelter a gain is an indication that the purpose is to increase the cost of property.

KPMG observation

It is unclear whether the CRA will only consider whether the accrued loss or increased cost amount could be used immediately or in the near term to shelter a gain or whether it will also consider the possibility of sheltering a gain in the distant future.

The CRA said it is prepared to issue a favourable opinion on the proposed rule if all of the facts and indications of the purpose support the position that the purpose tests are not met and provided two conditions are met:

- The taxpayer represents that none of the purposes are described in the anti-avoidance rule’s purpose tests in paragraph 55(2.1)(b)
- The taxpayer provides a complete description of the facts and circumstances.
The CRA acknowledged that it doesn’t usually provide opinions or rulings where the issue is a question of fact but by issuing opinions or rulings it will build up a database of parameters around the purpose tests.

**Well-established dividend policies**

The CRA added that where a dividend is paid pursuant to a well-established policy of paying regular dividends and the amount of the dividend does not exceed a reasonable dividend income return on a comparable listed share issued by a corporation in the same industry, the purpose of the dividend would not be described in the two new purpose tests.

In response to a panel question as to whether the CRA would consider the payment of an annual dividend to distribute cash flow to fall under a well-established dividend policy, the CRA said that from a tax policy perspective, a normal course dividend should not be subject to the anti-avoidance rule in subsection 55(2). However, the CRA acknowledged that there is no definition of what constitutes a “normal course” dividend.

**KPMG observation**

While it is helpful that the CRA has indicated that “normal course dividends” should not be subject to the anti-avoidance rule in subsection 55(2), the meaning of this term remains unclear.

**Asset protection**

A common transaction used to creditor-proof an operating company (Opco) (i.e., an asset protection plan) involves the declaration of a large cash dividend by the operating company (Opco) to its holding company (Holdco). Holdco then lends the cash back to Opco and takes security against Opco’s assets. These dividends typically exceed Opco’s safe income on hand.
Assuming that there are no current plans to sell Opco, the CRA was asked to confirm that this type of planning would not run afoul of the new purpose test even though there has been a significant reduction of the value of Opco’s shares.

The CRA responded that, where a “lumpy dividend” is paid in a creditor-proofing transaction to significantly reduce the FMV of the Opco shares, the apparent purpose is to reduce the value of the Opco shares. If so, the purpose test is met and the anti-avoidance rule in subsection 55(2) will apply.

The CRA noted that the purpose of the deduction for inter-corporate dividends (under subsection 112(1)) is to avoid double tax at the corporate level and that the anti-avoidance rule in subsection 55(2) establishes limits to such a deduction. The scheme of the Act is not to exempt all payments between corporations that are dividends for corporate law purposes.

The CRA added that the scheme of the Act limits the extent to which tax-free amounts can be derived by shareholders from corporations.

As a result, the payment of a dividend in excess of the after-tax income of the corporation to significantly decrease the value of the corporation by converting the accrued value into full ACB debt that can be repaid or sold without tax would be subject to tax under the scheme of the Act as supported by proposed subsection 55(2). The CRA said that the dividend’s effect of achieving creditor proofing does not alter this conclusion.

In response to a panelist’s comment that most corporations do not do safe income calculations and a question as to whether companies should start doing them, the CRA said that it would be a “healthy practice” for corporations to do safe income calculations.

**KPMG observation**

The CRA’s intention to apply the subsection 55(2) anti-avoidance rule to asset protection transactions may cause concern for taxpayers. Since the CTF Conference, the CRA has issued a technical interpretation confirming that it will apply the anti-avoidance rule to a dividend paid as part of an asset protection plan.

**In-house loss utilization**

Another concern about the new rules is whether they will affect standard in-house loss utilization transactions.
Background

In a standard in-house loss utilization, a company in a corporate group (Lossco) has unutilized losses which it wants the corporate group to be able to use. To use these losses, Lossco sets up a new corporation (Newco), then borrows funds from a third party and lends them to a profitable member of the corporate group (Profitco) as an interest-bearing loan.

Profitco uses the borrowed funds to buy preferred shares in Newco. Newco then lends the funds interest-free to Lossco so it can repay the loan from the third party. Newco pays dividends on its preferred shares to Profitco to enable Profitco to pay interest to Lossco on its loan. Profitco deducts the interest it pays to Lossco. Lossco is able to use its losses to offset its interest income.

This type of standard in-house loss consolidation arrangement has been sanctioned by the CRA in several rulings.

Effect of new anti-avoidance rule on loss consolidations

The CRA was asked to confirm that standard in-house loss consolidation arrangements would not be considered to meet the new purpose tests.

The CRA confirmed that loss consolidations that were only designed to move losses between related or affiliated corporations, and on which the CRA has ruled favourably in the past, would not be considered to meet the purpose tests. Thus, the anti-avoidance rule would not apply. The CRA stressed that any ACB that is created in a standard in-house loss consolidation must be eliminated on the unwind of the structure.

KPMG observation

The CRA’s confirmation that in-house loss utilizations will generally not be subject to the new anti-avoidance rule is welcome news. The CRA has confirmed this opinion in recently issued rulings. Before implementing a loss utilization plan, requesting an advance tax
ruling may be an appropriate course of action, particularly if the facts or steps differ from the rulings published to date.

Internal reorganizations

The CRA was also asked about the potential effect of the new anti-avoidance rule on dividends paid as part of reorganizations by related companies. Since the two new purpose tests do not apply to a deemed dividend on a redemption, acquisition or cancellation of shares under subsections 84(2) or 84(3), the CRA was asked whether share redemptions could be used as an alternative to regular dividends in order to avoid the application of the anti-avoidance rule in subsection 55(2).

In its response, the CRA explained that the scheme of proposed subsection 55(2) was to prevent capital gains strips, counter the artificial increase or manipulation of ACB and prevent the reduction in FMV of a share to fabricate a loss on the share. This scheme is supported by proposed changes to the rules which prevent high-low stock dividends from being used to reduce the FMV of a share, and the narrowing of the related-party exception to cover only deemed dividends under subsection 84(2) and 84(3) arising on the redemption, acquisition or cancellation of shares. The CRA explained that when a share is redeemed or canceled, the basis in the share is eliminated and therefore would normally not be helpful in achieving an ACB creation or FMV reduction objective.

The CRA referred to the Explanatory Notes that Finance released with the draft legislation, which say that the related-party exception is intended to facilitate bona fide reorganizations by related companies and that the exception is not intended to be used to facilitate the increase, streaming, manipulation or manufacturing of ACB. The CRA said that it would apply the general anti-avoidance rule (GAAR) if the purpose or object of the anti-avoidance rule in subsection 55(2) is frustrated by attempts to artificially create or unduly preserve ACB in a reorganization that would be exempt under the related party or butterfly reorganization exceptions.

KPMG observation

In the response above, the CRA did not directly respond to the question on using subsection 84(3) deemed dividends in lieu of “regular” cash dividends.

The CRA added that it considers certain situations to be offensive, such as where ACB is streamed prior to a reorganization using the related-party exception or a butterfly reorganization where shares with low ACB are redeemed and shares with high ACB are preserved. In addition, the CRA’s view is that it would not accept situations where shares are redeemed for a note in a reorganization using the related party exception and the note is used to generate ACB greater than the ACB of the redeemed shares.
KPMG observation

The CRA expands on its comments about creating deemed dividends to qualify for the related party exception for internal reorganizations in a recent technical interpretation. In particular, the CRA looks at a corporation that intends to spin-off business assets to a related corporation. To accomplish the spin-off, the corporation will undertake a series of transactions, including using a note to pay the redemption amount on the redemption of intercompany shares.

The CRA looks at two possible ways to implement the reorganization, and explains that, where the note generates an increase to the aggregate ACB of a corporation’s properties, the CRA would seek to apply GAAR or subsection 55(2). However, the CRA’s view is that it would be acceptable to use different reorganization steps that would eliminate the ACB created by the note. Because the ACB is eliminated, the CRA says that the related party exemption under paragraph 55(3)(a) may be available (i.e., subsection 55(2) and GAAR should not apply).

Internal reorganizations can be accomplished in many different ways. Companies that intend to rely on the amended related party exception to the subsection 55(2) anti-avoidance rule by using share redemptions (instead of regular dividends) will have to carefully consider how they implement an internal reorganization. Specifically, these corporations should ensure that ACB is not created or used in a way that causes the anti-avoidance rule or GAAR to apply.

Dividends on non-participating discretionary shares

Under the new rule, it is unclear whether dividends on non-participating, discretionary dividend shares would be subject to the purpose test in a situation such as the following hypothetical example.
In this example, assume that Opco has outstanding common shares, estate freeze shares and non-participating, discretionary dividend shares. Assuming that the non-participating shares have nominal value and no accrued gain, no safe income would be attributable to those shares.

The CRA was asked to confirm:

i. Whether the anti-avoidance rule in subsection 55(2) would apply to dividends received on the non-participating shares

ii. Whether the dividend would result in a loss of safe income on hand otherwise available for dividends on the common shares.

In the CRA’s response to the first question, it noted that whether a discretionary dividend share has a value immediately before a dividend is paid is a valuation issue. If there is no accrued gain on the non-participating shares, the CRA said that no safe income could be considered to contribute to the capital gain that could be realized immediately before the dividend as required under the safe income exception. As a result, the dividend paid on such shares would be subject to the purpose tests.

In response to the second question, the CRA said that the dividend paid on the non-participating shares would reduce the safe income attributable to the participating (common) shares since it reduces the value of, and therefore the capital gain on, the participating shares. However, if the dividend on the non-participating share is subject to the anti-avoidance rule in subsection 55(2), the CRA will accept that the safe income attributable to the participating shares will not be affected.

**KPMG observation**

The CRA recently released a technical interpretation addressing the allocation of safe income to discretionary dividend shares which expands on its response to this Round Table question.

Based on the technical interpretation, it appears that the CRA is prepared to take a “global approach” to the allocation of a corporation’s safe income where all of the issued shares are participating, discretionary dividend shares. In certain situations, the CRA appears to allow the streaming of the corporation’s “global” safe income to one class of participating discretionary dividend shares to the exclusion of others.

The technical interpretation further suggests that the global safe income may be allocated to shares that are non-participating discretionary dividend shares only if the shares have value. The CRA says that whether such shares have value is a question of fact.
V. Consider making safe income calculations before paying dividends

Corporations will have to consider the potential application of the amended anti-avoidance rule in subsection 55(2) in more situations. It may be prudent to calculate safe income before paying dividends to help ensure they will not be subject to the anti-avoidance rule.

The CRA’s comments at the Canadian Tax Foundation’s Annual Conference and in subsequent rulings and technical interpretations included some welcome news for corporations in some situations such as in-house loss utilization transactions. However, whether the anti-avoidance rule will apply in many common circumstances remains unclear. As more information on the CRA’s administrative position becomes available, we hope the application of the new rule will become clearer.

Next steps for corporations

✓ Check with your tax adviser if you are undertaking transactions or reorganizations involving inter-corporate dividends
✓ Consider alternative transactions if it appears that the new subsection 55(2) rule may apply
✓ Keep safe income calculations up-to-date.

We can help

Your KPMG adviser can help you assess the effect of the changes to the subsection 55(2) anti-avoidance rule on your business and point out ways to help mitigate their impact.

To further explain the broadened anti-avoidance rule, Rick McLean, Partner, KPMG in Canada’s M&A Tax Services and Greg Bell, Partner, KPMG’s Canadian Corporate Tax group, will host a one-hour webcast on May 26, 2016. This webcast will help you understand the circumstances in which an inter-corporate dividend may be caught by the new rule and why corporations face having to maintain safe income calculations to mitigate the risk that the anti-avoidance rule will apply. You can now register for this webcast.

For details, contact your KPMG adviser.