CAPITAL GAINS AND SURPLUS STRIPPING

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ABSTRACT

This thesis examines recent legislative developments in tax avoidance law, dealing specifically with surplus stripping and capital gains bailouts. Surplus stripping consists in the avoidance of the second level of tax on corporate source income normally exigible when dividends are paid to shareholders. Surplus, or dividend-stripping, is the taxpayer's response to the double taxation of corporate earnings and has accordingly been practiced in Canada since the 1926 revision of the Income War Tax Act, 1917, first introduced this scheme for the taxation of corporations and their shareholders. As a result of changes to the Income Tax Act in 1977, the scope of surplus stripping operations was greatly limited and subsequent legislation moved to block the few remaining perceived abuses.

Capital gains strips or bailouts represent a much less long-standing problem for the fiscal authorities, being established upon the imaginative combination of statutory rules and results, some of which were passed into law as recently as 1977. Capital gains strips import the abolition of capital gains tax at the corporate level and can effectively provide individuals with unlimited deferral of tax upon the realization of appreciated capital property. Thus, capital gains strips, while perhaps not precipitating a serious loss of revenue to the fisc, undermine the
principle of equity, a cornerstone of tax reform. Whereas surplus stripping operations have been curtailed (principally by the elimination of the incentive to engage in them) the government has only very recently moved to eradicate capital gains avoidance with complicated and as yet untested legislation.

The present study deals with each of the two types of avoidance activities mentioned in the preceding paragraphs. The first chapter traces the evolution of dividend-stripping in Canada from its beginnings to the time of the enactment of the most recent legislative provisions designed to combat it. These are analysed and commented in the second and third chapters of the thesis. The fourth and fifth chapters present an interjurisdictional comparison, investigating surplus stripping activities and the corresponding efforts of the fiscal authorities to combat them in Great Britain and in the United States respectively.

The sixth through to the eighth chapters deal in a similar fashion with capital gains stripping. The new Canadian rules are deployed and critically evaluated. Capital gains stripping practices in the United States and Great Britain respectively are then studied along with the related anti-avoidance legislation.
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I. SURPLUS STRIPPING

Introduction

Dividend-stripping involves the avoidance of the second level of tax applicable when assets of the corporation are taken out of corporate solution and distributed to the shareholders. As justifications for dividend-stripping have occasionally been advanced, it would, before deploying the historical background to the subject, be advisable to briefly investigate these claims.

Dividend-stripping is perhaps justified by notions of horizontal equity. The benefits of avoidance of the tax normally incidental to surplus distributions was, prior to the introduction of capital gains tax, available to the shareholders of public companies. By acquiring the shares of companies retaining and not distributing their earnings, investors see the market value of their securities rise. Upon the sale of all or a part of their shareholding, the proceeds of disposition were, before 1972, received as a tax free capital gain. The argument may be made that the government's policy of discouraging dividend-stripping is by comparison unfair to the shareholders of private corporations. To the contrary, it may be questioned whether the interests of shareholders in public and closely held private companies can usefully be compared. Shareholders of public corporations generally have no control over management and dividend policies, a situation which is reversed in the case of most private corporations.
In addition, the shareholders of public companies really own only their shares, and as they dispose of these they decrease their interest in the corporation and its undertaking. In some dividend-stripping transactions, the real source of economic returns, the business of the corporation, continues indirectly to be the property of the selling shareholders following the strip of assets.

The economic justifications of dividend-stripping would likely be that it increases the amount of capital available to small, closely held companies and opposes the export of capital to tax haven jurisdictions. The first claim may be answered by pointing out that the accumulation of earnings in a corporation for the purpose of effecting tax free distributions of surplus is not a productive use of capital. The effects of the second alleged benefit are perhaps economically negligible.

A self-evident argument against dividend stripping would simply point to the government's loss of tax revenues. Although the amount of this loss was perhaps not significant in the overall scheme of things, the transfer of a tax burden from the persons upon whom liability was meant to be imposed to other tax payers, to the extent that this might have occurred, was an unfair result. Of perhaps greater importance is the contempt into which the tax system was brought by the spectacle of successful tax avoidance practiced by a relatively small and affluent segment of the population. The deleterious consequences of this public attitude are difficult
to assess with precision, but its possible impact upon a levy relying upon the self-assessment system must be regarded as considerable.

A number of solutions to the problem of dividend-stripping can and at various times have been considered. Some of these called for the elimination of the two-tier system of taxation of corporate source income. Others recommended the narrowing of the gap between the tax treatment of capital and income receipts. Others still involved less far reaching overhauls of the system, coming to grips with particular stripping techniques with particular legislative provisions. Briefly, the basic types of solutions that were from time to time brought forward are as follows:

1) Inducing distributions of corporate earnings by imposing penalty taxes on undistributed surplus. The amounts taken into income under this proposal would be taxed at the shareholder's personal rate.

2) Imposing a flat rate of corporate tax followed by tax free distributions to shareholders. As this method does not integrate the corporate tax with the tax imposed on individuals, it would tend to defeat the objectives of the progressive personal tax rate structure.

3) Taxing current income of the corporation in the hands of the shareholders based upon their proportionate share of earnings. This may or may not be coupled with the abolition of corporation tax as such.

4) Taxing gains realized upon the disposition of
capital property, including shares in a corporation, by bringing the full amount of such gains into income.

5) Conferring discretionary authority upon administrative officials to restructure a taxpayer's transactions.

6) Enacting specific or 'sniper' anti-avoidance provisions directed against particular abuses.

The long struggle between the taxpayer and the fisc for the tax dollars to be levied on surplus distributions reveals the predominating preference of the government for the sixth alternative above delineated. As we shall see, this has historically not provided a satisfactory solution to the problem of dividend-stripping, and the eradication of the stripping practices is more a consequence of legislative developments serving unrelated objectives of fiscal policy than of the efficacy of the government's efforts to eliminate them.

It should be mentioned that some of the other suggested methods of combatting dividend-stripping have, in more or less modified form, at various times constituted the law of the land. Under the Income War Tax Act, 1917, for example, it was provided, in section 3 (1)(d), that "for the purpose of the normal tax, the income embraced in a personal return shall be credited with the amount received as dividends upon the stock or from the net earnings of any company or other person which is taxable upon its income under this Act." Thus, corporation tax was paid at the 'normal', flat rate of 4% and the dividends paid to individuals were not included
in personal income. The concept of integration applied to this case because individuals paid tax at the same basic rate as corporations and both taxpaying groups benefited from the $3,000 personal exemption. The same Act also adhered to the philosophy of forcing corporate distributions. Individuals, unlike corporations, were also liable to assessment for surtax on income exceeding $6,000. Thus, under section 3(4) corporate retentions were permitted only in circumstances where the Minister was "of the opinion that the accumulation of such undistributed gains and profits (was) not made for the purpose of evading the tax, and (was) not in excess of what (was) reasonably required for the purposes of the business." Thus, the undistributed income of the corporation was, absent a ministerial direction to the contrary, attributed to the shareholder for surtax purposes.

The 1917 policy of not treating the corporation as a separate tax paying entity was abandoned as part of an extensive revision of the Act in 1926. The change was introduced in response to a perception of policy that earned income should be taxed at a lower rate than unearned income. This objective was seen as partly realized by including dividends in income and taxing them as ordinary earnings. Combined with the amendment, in 1919, to subsection 3(4) permitting the accumulation of income in corporations except as the Minister might otherwise direct, the double taxation of corporate source income set the stage for the
long conflict surrounding the avoidance of this second level of tax.

The first shot was actually fired in 1924 when the Income War Tax Act was amended by the addition of subsection 3(9), which provided that on a winding up, discontinuance, or reorganization of a company's business, the distribution of its property to its shareholders was to be treated as a dividend to the extent of the undistributed income on hand. This section was in response to the English Court of Appeal decision in *R v Burrell* which held such receipts to be on account of capital and hence non-taxable. The provision was aimed at the avoidance of surtax which might be payable by the dividend recipient. As if in anticipation of the avoidance efforts of taxpayers, the 1926 Act also endeavoured to prevent the capitalization of surplus by the issuance of stock dividends, and the distribution of capital surplus in advance of undistributed income upon the redemption of shares or pursuant to a legal reduction of capital. A provision also deemed a dividend to have been paid when shares were redeemed at a premium and when a loan was made to a shareholder.

Probably the most important changes introduced in the 1926 Act from an anti-avoidance point of view had to do with the deductibility of intercorporate dividends from income of the recipient. It was apparent that in order
to avoid the multiple taxation of corporate source income, some allowance would have to be made for dividends received by corporate shareholders. Accordingly, subsection 3(12) exempted intercorporate dividends from tax. A problem was seen to arise however in connection with incestuous share sales in which the shareholder sold his shares in a surplus-laden operating company to a holding company also owned by him in exchange for debt which was subsequently discharged with surplus of the operating company paid out as tax exempt dividends to its parent holding company. In order to nullify such schemes, subsection 4(11) was enacted to deem the intercorporate dividend to have been received by the vendor of the shares.

Subsection 4(11) turned upon the receipt of a dividend by a corporation paid out of the retained earnings of another. A means of by-passing the provision was seen in having the acquiring corporation wind up its subsidiary i.e. the subsidiary's assets were received tax free, but not as a dividend. Furthermore, the receipt of the subsidiary's assets did not create undistributed income in the parent holding company so that upon its liquidation its properties, including of course the surplus of its former subsidiary, might themselves be distributed tax free. By amendment to the Act in 1936, subsection 19(2) aimed at plugging this loophole by deeming a distribution in the described circumstances to be an exempt dividend to the recipient.
This created undistributed income in the parent which would be subject to tax upon liquidation of that corporation.

Another problem arose in that the terms of subsection 4(11) required that the acquiring corporation be controlled by the vendor or act as the vendor's agent, trustee, or attorney. Thus, so-called 'bootstrap' transactions, in which an acquiring company dealing at arm's length with the vendor received a dividend out of the acquired company's surplus in order to replace its own funds used in the acquisition, were not covered by the subsection. Accordingly, a discretion in broad terms was conferred on the Treasury Board in 1938 to direct that an intercorporate dividend be taxed at ordinary rates where it found that the main purpose of a transaction involving the acquisition of shares in a company by another company was "to reduce or avoid the tax which would have been paid to the shareholders of (the acquired corporation)...on the distribution to them of (its) undistributed income." 7

An important development in the history of dividend stripping was the introduction in 1938 of section 32(A), which, as we have seen 8, conferred discretionary powers upon the Treasury Board to modify or direct the tax consequences of transactions tainted by tax avoidance motives. These provisions are good illustrations of the high water mark of official discretion in fiscal matters. In addition to subsection 32(A)(3), already discussed, the new legislation introduced the predecessor of subsection 246(1) 9, which was
intended to bolster the previously enacted anti-avoidance provisions by conferring the broadest discretion upon the Treasury Board to give such directions as it considered appropriate where it found that one of the main purposes of a transaction was improper tax avoidance. Subsection 32(A)(2) was also of a general nature, permitting the Treasury Board to deem any payments or benefits received directly or indirectly from a corporation possessing undistributed income on hand to be income of the recipient insofar as the main purpose of his transactions was found to be the reduction or avoidance of tax.

The above described anti-avoidance measures would seem to have operated reasonably efficiently because in 1930 it was necessary to enact subsection 19(1) which permitted the tax-free distribution of pre-1930 retained profits. This surplus had 'bunched' in large accumulations and resulted in a very large tax liability to the estate of a deceased shareholder. The payment of tax free dividends out of pre-1930 surplus was available until 1934, when the right was discontinued. Again in 1945, however, in response to the recommendation of the Ives Commission, a scheme for the tax-reduced distribution of retained earnings was adopted pursuant to which private corporations were permitted to elect to pay a tax ranging from 15%-33% on pre-1940 earnings. Following the election and payment of the tax, the surplus might be distributed at no further tax cost.
With the advent of the Income Tax Act, 1948, the provisions already discussed in connection with the use of tax exempt or tax reduced dividends paid to corporations were not carried forward. Instead, the concept of designated surplus was brought into being in 1950. Designated surplus arose in circumstances where control of a corporation possessing undistributed income on hand was acquired by another corporation. The balance of the UI on hand of the controlled corporation at its last fiscal year end preceding the date of the change in control, minus any dividends that were paid in the year control was acquired, was 'designated' so that tax free dividends could not be paid out of this fund. Unlike the provisions of subsection 4(11) of the Income War Tax Act, designated surplus rules sought to tax the dividend recipient rather than the vendor of the shares.

It soon became obvious that the designated surplus concept possessed a number of flaws. For example, income of the acquired corporation after the change in control, known as 'control period earnings', might be paid out as tax free dividends to the controlling corporation. This, of course, is because only the income on hand in the acquired corporation at the time of the change in control was designated. The definition of control period earnings in subsection 28(5) of the Act made no provision for a reduction in this account for business losses or provincial
income taxes paid. Thus, the control period earnings might exceed the balance of post-control undistributed earnings on hand in the acquired company. To the extent that dividends were paid out in excess of the dollars actually on hand attributable to post-control earnings, the designated surplus was effectively reduced.

Another problem arose because under the designated surplus rules it was necessary for the controlled corporation to possess undistributed income on hand at the time of the change in control. If the shares of an operating company were transferred to a holding company before it began business operations, the surplus later accumulated in the subsidiary would not then be designated. It was also possible to skirt the provisions governing the concept of control by appropriately structuring the share capital of the acquired corporation prior to the take-over or by selling to two arm's length purchasers. In addition tax reduction or avoidance might successfully be practiced by other means. Trader's in securities, for example, might acquire the shares (ensuring the tax free receipt of the proceeds to the vendors), cause the company to pay out a dividend equal to the undistributed surplus on hand (to replace all or a portion of the purchase price paid), and resell the shares to the original owners at a loss, which, in view of the trader's business, might be deducted from his income. It was also possible to sell the shares to a non-resident
corporation controlled by the vendors and pay out the surplus at the reduced tax cost of 15%, or to sell the shares to a tax exempt person.

As a result of these avoidance possibilities, section 105 B was enacted in 1955 to provide that a 15% tax was exigible on dividends paid to tax exempt persons and to non-resident corporations, and that a 20% tax was to be levied on dividends paid to share dealers. These amendments were however themselves vulnerable to tax reduction measures lawfully available to taxpayers. For example, sales to a share dealer continued to be attractive because the 20% tax under section 105 B was imposed on the amount distributed as a dividend and not on the surplus available for distribution. By paying less than the surplus on hand in the company and electing to pay tax on a dividend equivalent to the purchase price, the 20% tax might be reduced to 16 2/3%, the share dealer would participate in the transaction at no economic cost, and the vendor would effectively receive the distributable income at a very favourable rate even after compensating the share dealer for his services.

Other stripping practices also flourished. These involved e.g. the conversion of a resident operating company into a non-resident owned investment corporation, the payment of dividends subject to designated surplus tax to a company which might offset the tax with business losses, the acquisition by a subsidiary of the shares of its
parent, and the revaluation of a parent company's assets to fair market value, that is, of the shares of its subsidiary companies, followed by the payment of a stock dividend out of the resultant capital surplus which might indirectly be redeemed tax free with funds subsequently paid by the subsidiary to the parent.

These and other abuses led to the enactment in 1963 of section 138(A), now subsection 247(1) which confers a discretion on the Minister of National Revenue, in circumstances where he is of the opinion that one of the purposes of the impugned transaction(s) is the avoidance of tax on surplus distributions, to direct that all or a portion of the amounts received by a taxpayer as, inter alia, consideration for the disposition of any shares of a corporation, be included in computing the taxpayer's income for that year, or, where the taxpayer is an individual, be deemed to have been received by him as a taxable dividend. In spite, or perhaps because of the outcry surrounding the reintroduction of ministerial discretion in fiscal matters, section 138(A), and its successor, have rarely been invoked by the government. Indeed, it would appear that broad as its terms may be, the wording of this provision continued to offer opportunities for avoidance. For example, in the case of stripping through a non-resident owned investment corporation \(^{13}\), the fact that debt is taken by the vendor from the NRO in return for the shares of the operating company is significant because section 138(A) taxes 'amounts
received'. It may be argued that although the debt constitutes an amount, it is not received.

The next important development bearing on the issue of dividend-stripping is the work of the Carter Commission, particularly those portions of the report dealing with corporation tax and the taxation of property gains. With regard to corporation tax, the Carter Commission proposed a scheme of full integration of personal and corporate income taxes. Because the flat corporation tax rate of 50% was equivalent to the recommended highest personal rate, the Carter proposal neither encouraged nor discouraged the retention of earnings. Thus, in the words of the Commission, "(T)he advantages of, and facility for, tax avoidance by means of "surplus stripping" that are inherent in the present tax structure would be removed." The opposition of the Canadian business community to the Carter proposals led eventually to the adoption of the compromise solution of partial integration, an approach which initially in most cases moderated but did not eliminate the incidence of double taxation (as well as the resulting incentive to strip surplus). A similar fate befell the Commission's proposal that all realized gains from property be taken into income as parts of a comprehensive tax base. Had this recommendation been implemented, all strips of surplus based upon the transformation of an income into a capital receipt would have been abolished. Partly as a result of the recommendations of the Commons Committee Report
on the White Paper 17, the tax reform legislation adopted a 'middle-of-the-road' solution by bringing only one-half of capital gains into income, thus preserving the distinction between gains on property and ordinary income and perpetuating the rationale underlying strips of corporate surplus.

The tax reform amendments of 1971 radically altered the rules governing the taxation of surplus distributions. Whereas under the 'old' Act all distributions were taxable to the extent of the corporation's undistributed income on hand, the new legislation reversed the order of distributions so that shareholders might be permitted a tax-free return of capital in advance of further distributions, which were to be taxable as dividends. This change was implemented in connection with the capitalization of corporations and was intended to harmonize the tax treatment of a return of capital to shareholders with the repayment by the corporation of loans made by shareholders. In view of the new rules, it was necessary to guard against the possibility that surplus might be converted into capital as a result of procedures available under the corporate law and then returned to the shareholders on a tax-free basis. The danger was the more menacing in that paragraph 89(1)(c) of the 1972 Act defined paid up capital as paid in capital for corporate law purposes. The concepts of paid up capital deficiency and paid up capital limit were therefore introduced in paragraphs 89(1)(d) and (e) respectively to indirectly arrive at a computation of paid up capital for tax purposes.
Briefly, the paid up capital deficiency was deducted from the corporate paid up capital to establish the paid up capital limit of the corporation, or the amount that might be returned to shareholders tax free in advance of taxable distributions. Amounts paid in excess of the PUCL were treated as dividends.

In 1974-75, extensive amendments to the Act were effected including a redefinition of paid up capital to comprise any premiums paid upon the issuance of shares and contributions to the capital of the corporation, certain minor modifications to the PUCD and PUCL computations, and the introduction of the new concept of debt limit in section 84.1. The debt limit provision was similar in principle and in purpose to the PUCD and PUCL rules but was directed at a situation where corporate surplus was translated into debt instead of into paid up capital in incestuous share sales. The debt limit equalled the paid up capital of the shares transferred to the purchasing company, minus the paid up capital of any shares taken back in addition to the debt. Any amount distributed in excess of that figure was treated as a dividend to the shareholder.

These provisions continued in effect until their repeal in 1977, when the increase in the dividend tax credit to 50% narrowed the gap between the effective rate of tax on realizations of corporate surplus in the form of dividends and returns of capital. Indeed, the preference for capital gains treatment remained only for shareholders exposed to the
highest marginal rates, who benefited to the extent of 8%, while for most taxpayers dividend treatment actually imported a more tax beneficial result. In consequence, the government at last decided to call a halt to hostilities over the conversion of corporate surplus available for payment as dividends into capital gains. This change in policy also naturally dictated the repeal of the designated surplus provisions. From March 31, 1977, it may be said that the government is indifferent to the manner in which corporate surplus is realized, subject to the exceptions to be discussed in the following chapter.
FOOTNOTES

1. S.C. 1917, c.28.

2. (1924) 2 K.B. 52.

3. IWTA, s. 4(12).

4. Ibid., s. 4(9).

5. Ibid., s. 4(10).

6. Ibid., s. 4(8).

7. IWTA, s. 32(A)(3).

8. Supra, at pp. 7-8.

9. IWTA, s. 32(A)(1).

10. IWTA, ss. 14, 19(2), 32(A)(2) and (3).

11. ITA, 1948, s.28.

12. The taxpayer would first incorporate a company in a tax haven jurisdiction. This company would incorporate a subsidiary in Canada and apply pursuant to former section 70 to qualify as a NRO. The taxpayer would then sell his shares of the operating company to the NRO in return for debt. The surplus company would itself then apply to be converted into an NRO pursuant to the same provision. This status would enable it to pay a tax free dividend to its parent NRO (a Canadian resident corporation not subject to with-
holding tax). The parent NRO could then pay a tax free dividend to its tax haven parent NRO pursuant to former section 106(1)(a).


II. Section 84.1

(a) Introduction

One of the strips of corporate earnings examined in the first chapter of this thesis was that involving the incestuous sale by a taxpayer of shares of an operating company to a holding company owned by him in return for proceeds of disposition attracting capital gains treatment. Part VII tax was the government's response, but in spite of the designated surplus rules it was still possible to make tax free payments out of post-control earnings. Strips of this type were particularly objectionable to the government prior to 1972 because under the former Act capital gains were not taxable. They continued to be looked upon with disfavour however, even after the introduction of capital gains tax, presumable because only one-half of a capital gain, as opposed to the full amount of a taxable dividend, was included in income. But the progressive narrowing of the difference between the tax treatment of dividend income and capital gains, particularly the increase to 50% in the dividend tax credit in 1977, brought about a change in attitude. It became a matter of indifference to the government whether corporate surplus was withdrawn in the form of dividends or capital gains.

Thus the shareholder won the right to choose for himself the form in which corporate surplus might be dis-
tributed. In this regard the government demonstrated commendable adherence to a consistent policy. The objection had hitherto never been that the strip permitted a premature realization of the shareholder's equity. The emphasis all along seems rather to have been on the alleged wrongful conversion of surplus from a scheme of less to a scheme of more favourable tax treatment. Absent this element of improper conversion, it followed that the taxpayer might be permitted a return of capital (an amount not taxable in any case) and a payment in respect of the remainder of his interest provided it was subject to some form of tax at the very latest upon receipt of funds.

Generally, the taxpayer would now roll his shares of the operating company into the holding company pursuant to subsection 85(1), taking back at least shares of the holding company and possibly also cash and debt in an amount not exceeding the adjusted cost base of the shares transferred. The rollover became necessary when the taxation of capital gains was introduced, exposing an ordinary sale to tax. Subsection 85(1) provides a means whereby capital assets, including shares of the capital stock of a Canadian corporation, may be transferred to a company on a tax free basis by a taxpayer in circumstances where the true economic interests of the parties have not changed. In order to accomplish this tax free result, the figure selected as the deemed proceeds of disposition to the taxpayer will be the adjusted cost base of the shares rolled over, and
the same amount will correspondingly be treated as the cost thereof to the transferee corporation.

If after March 1977 dividend treatment of the corporate surplus to be distributed is desired, the taxpayer takes back shares of the holding company with a low paid up capital. Amounts paid upon redemption of these shares in excess of the paid up capital attributable thereto would result in a deemed dividend under subsection 84(3) and probably also a capital loss. If instead the taxpayer's preference is for capital gains treatment, he takes back shares of the holding company with a paid up capital equal to the fair market value of the shares of the operating company rolled over. Upon redemption of his shares at an amount not in excess of their paid up capital the taxpayer will incur a capital gain equal to the excess of the amount received over the adjusted cost base of the shares taken back (the elected amount). In either case the taxpayer may control the flow of his receipts and the corresponding incidence of taxation by redeeming his shareholding in a piecemeal fashion.

A problem was seen to arise however where the shares being rolled into the holding company were held prior to 1972 by the transferor. The adjusted cost base of such shares, that is, the amount that might be returned tax free to the shareholder, might greatly exceed the amount actually invested. The discrepancy is of course explained by the fact that the increment in the value of the shares is,
in an arm's length transaction, non-taxable to the extent of the V-day value. In other words, the adjusted cost base of such shares is normally established at a figure exceeding historic cost. As in the case of the pre-reform strips turning on the incestuous sale of shares, funds normally taxable to the shareholder as dividend income might be converted into a non-taxable capital receipt. The similarity was of course not lost upon the government and section 84.1 was the result. Generally, depending upon whether hard consideration, debt, or shares of the purchaser corporation are taken back, section 84.1 will provide either for an immediate or deferred capital gain of the V-day value inherent in the shares transferred to the extent that the aggregate consideration taken back exceeds the paid up capital of those shares.

(b) Conditions of Applicability

In order for section 84.1 to apply, it is necessary that the acquiring corporation and the corporation the shares of which are acquired (the subject corporation) be 'connected'. What this means is that where the acquiring company owns less than what is necessary to exempt it from Part IV tax (10% votes and values), section 84.1 will not apply and the transferor may strip out the V-day value inherent in the shares transferred to the extent that the amount of intercorporate dividends paid permits. This scheme should however be regarded as a tradeoff in that Part IV tax will be payable.
by the company receiving the dividend and will be refunded only when taxable dividends are in turn paid to the shareholder. It would otherwise be very difficult to see on what principle the exception should be made. The V-day value of a 10% interest will vary considerably from one company to another, and if stripping is improper, there seems little reason to countenance it at all. There is, moreover, nothing in the section to prevent a taxpayer owning more than 10% from using the connected corporations concept to strip out the V-day value of his entire shareholding by transferring no more than 10% to as many holding companies as are necessary to account for his interest. Were it not for the tradeoff involving Part IV tax such a procedure would probably result in a direction pursuant to subsection 247(1).

Subparagraphs 84.1(2)(a) and (b) contain an extended definition of non-arm's length applicable to section 84.1 transactions. The taxpayer will be deemed not to deal with the acquiring corporation at arm's length if he was one of the same group of less than six people who before the disposition controlled the subject corporation and after the disposition controlled the acquiring corporation. The shareholdings of the taxpayer's spouse, of an inter vivos trust of which the taxpayer, his spouse, or a corporation controlled by either of them is a beneficiary, and of a corporation controlled by the taxpayer, his spouse, or an inter vivos trust such as is above described,
will be attributed to the taxpayer for the purpose of determining whether he is one of the group of less than six persons that controls a company. It is easy to understand the purpose behind this broadening of the non-arm's length rule. In any company with ownership divided between unrelated business associates it might otherwise be possible for the shareholders, assuming none of them owned more than 50% of the operating company, to strip out the V-day value of their shares by rolling them into the same holding company. Following the rollover each shareholder would be at arm's length with the holding company, at least insofar as may be determined under the related persons rules contained in subsections 251(1) and (2). The government would then be forced to rely upon the difficult factual non-arm's length concept in order to bring the matter within the purview of section 84.1. The extended definition of non-arm's length provided in section 84.1 is therefore for greater certainty.  

(c) Operation of Section 84.1

The purpose of section 84.1 is to prevent the stripping of the V-day value inherent in shares held since before 1972. When an individual or a trust resident in Canada transfers pre-72 shares which are held as capital property to a holding company with which the taxpayer is not at arm's length, and the acquiring company is connected with the subject company, section 84.1 will apply to trigger
an immediate capital gain where hard consideration or cash is taken back or a reduction of the adjusted cost base of any shares or debt received by the taxpayer to the extent that the V-day value might otherwise be prematurely realized. The calculations are done according to the following formulas:

**The Immediate Capital Gain is**

The amount by which the lesser of
1) The ACB of the shares transferred and
2) Cash and/or the FMV of tangible asset(s) taken back

Exceeds
3) The PUC of the transferred shares

**The ACB Reduction is**

The amount by which the lesser of
1) The ACB of the shares transferred and

The aggregate of
1) Cash and/or FMV of tangible assets taken back
2) Debt taken back
3) The PUC of shares taken back

Exceeds the greater of
1) Cash and/or the FMV of tangible assets taken back
2) The PUC of shares transferred

Assume that a taxpayer (other than a corporation) in circumstances such as are contemplated by section 84.1 transfers shares with the following characteristics into a holding company

<table>
<thead>
<tr>
<th>PUC</th>
<th>ACB</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>100</td>
<td>500</td>
<td>1000</td>
</tr>
</tbody>
</table>

and takes back shares of the acquiring company with the following attributes

<table>
<thead>
<tr>
<th>PUC</th>
<th>ACB</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>100</td>
<td>500</td>
<td>1000</td>
</tr>
</tbody>
</table>
together with cash of $400 and a note with a face value of $100. The deemed proceeds of disposition are, pursuant to the subsection 85(1) rollover, the adjusted cost base of the shares transferred or 500. The immediate gain is

\[
\text{The lesser of} \\
\begin{align*}
1) \text{The ACB of shares transferred} & \quad 500 \\
2) \text{The hard consideration} & \quad 400 \\
\end{align*}
\]

Exceeds

\[
\begin{align*}
1) \text{The PUC of shares transferred} & \quad 100 \\
& \quad 300 \\
\end{align*}
\]

and the adjusted cost base reduction of the shares and debt is

\[
\text{The lesser of} \\
\begin{align*}
1) \text{The ACB of the transferred shares} & \quad 500 \\
& \quad 500 \\
\end{align*}
\]

And aggregate of

\[
\begin{align*}
1) \text{Hard consideration} & \quad 400 \\
2) \text{Debt} & \quad 100 \\
3) \text{PUC of shares taken back} & \quad 100 \\
& \quad 500 \\
\end{align*}
\]

Exceeds greater of

\[
\begin{align*}
1) \text{Hard consideration} & \quad 400 \\
2) \text{PUC of shares transferred} & \quad 100 \\
& \quad 400 \\
& \quad 100 \\
\end{align*}
\]

The adjusted cost base reduction of 100 will be prorated amongst the particular shares and debt according to their relative cost to the taxpayer. The cost of the non-share consideration received by the taxpayer will normally be its fair market value. The cost of the shares taken back, assuming that they are preference shares of one class, will be

\[
\text{The lesser of} \\
\begin{align*}
\text{Their FMV} & \quad 1000 \\
\text{And} & \quad 1000 \\
\text{The amount by which} & \quad 1000 \\
\text{Proceeds \text{(s.85(1))}} & \quad 500 \\
\text{Exceeds} & \quad 500 \\
\text{FMV of other consid.} & \quad 500 \\
\text{(cash 400, debt 100)} & \quad 500 \\
& \quad 0 \\
& \quad 0 \\
\end{align*}
\]
The adjusted cost base reduction of 100 will thus be entirely allocated to the debt consideration taken back, decreasing the cost of the note from 100 down to nil. In the final analysis, the taxpayer will have received $100 free of tax, a figure equivalent to the paid up capital of the shares transferred to the acquiring corporation, and any amounts paid to retire the debt will give rise to a further capital gain of 100. It is therefore apparent that section 84.1 has stripped the taxpayer of the $400 protection previously afforded his pre-72 shareholding by the V-day value.

As the foregoing example indicates, the penalty cannot be avoided by taking back shares of the acquiring company with a paid up capital equal to that of the shares transferred if additional consideration is received as well. Although there will be no immediate capital gain where only shares of the purchaser are taken back, the taxpayer will fare no better whenever the door is opened to a premature realization of the pre-72 capital gains following the rollover. Assume a rollover situation involving shares with the following characteristics:

<table>
<thead>
<tr>
<th>Shares Transferred</th>
<th>Shares Taken Back</th>
</tr>
</thead>
<tbody>
<tr>
<td>PUC 100</td>
<td>PUC 1000</td>
</tr>
<tr>
<td>ACB 500 (V-Day)</td>
<td>ACB 500</td>
</tr>
<tr>
<td>FMV 1000</td>
<td>FMV 1000</td>
</tr>
</tbody>
</table>

But for the operation of section 84.1, redemption of the taxpayer's shares at their fair market value would result in recognition of a 500 capital gain and the tax free receipt
of the pre-72 capital increment. Section 84.1 however reduces the adjusted cost base of the shares taken back as follows:

Lesser of
1) ACB of shares transferred 500
And aggregate of
1) Hard consideration 0
2) Debt 0
3) PUC of shares taken 1000 1000

Exceeds greater of
1) Cash taken back 0
2) PUC of transferred shares 100 100 400

Thus the adjusted cost base of the shares taken back will equal the paid up capital of the shares transferred, and any redemption of these shares in an amount exceeding the reduced cost base of 100 effectively exposes the pre-72 increment to capital gains tax. The situation is not improved by having the purchaser corporation sell the transferred shares. This would result in a $500 capital gain to the purchaser which, by virtue of the capital gains dividend account and refundable tax provisions, would attract the same treatment as if the gain had been realized by the shareholder directly. A distribution of the remaining $500 would result in an ordinary taxable dividend. Using the $500 to partially redeem the taxpayer's shares would precipitate a further $400 capital gain. The taxpayer would in either case be in the unenviable position of having forfeited the V-Day value protection inherent in the shares transferred.
(d) The Subsection 84.1(3) Exemption

Section 84.1 is obviously meant only to apply where there exists a V-Day value in shares which may be stripped. Subsection 84.1(3) attempts to exempt certain fact situations from the operation of the governing subsection. Thus, where a share was acquired by a taxpayer after 1971 and it was owned after 1971 and before the taxpayer acquired it by a person with whom the taxpayer was dealing at arm's length, s. 84.1 will not apply to a subsequent rollover of that share into a holding company.

One might have thought that all rollovers of shares of companies formed after 1971 would lie beyond the scope of section 84.1 because presumably no V-Day value inheres in them. The simple wording necessary to give effect to an exemption on this basis is however not found in subsection 84.1(3). One commentator gives, in substance, the following explanation. A taxpayer might roll the shares of an operating company into a holding company and take back shares with a paid up capital equal to that of the transferred shares, thereby avoiding the adjusted cost base reduction provided for in subsection 84.1(1). This would be followed by a transfer of his newly acquired shares of the holding company to a second holding company in return for shares with a paid up capital equal to the adjusted cost base of the shares of the first holding company. These shares might then be redeemed by the second holding company. The first holding company would serve merely as a buffer to insulate the taxpayer from the deleterious conse-
quences of section 84.1 and as a conduit for dividends effectively paid by the operating company to the second holding company.

This transaction presumably explains why the share transferred should have been owned "after 1971 and before the taxpayer acquired it by a person with whom the taxpayer was dealing at arm's length." The shares of the first holding company taken back would apparently not satisfy this condition and accordingly section 84.1 would apply to the subsequent transfer of these shares to the second holding company with the same consequences as would have obtained had the taxpayer rolled them directly into the first holding company in contravention of section 84.1. However, unimpeachable may be this result in the contemplated circumstances, if we accept that shares taken after 1971 by a taxpayer from the treasury of a company will bring into play section 84.1 on a subsequent rollover of these shares into a holding company, by parity of reasoning shares acquired after 1971 as e.g. a stock dividend or as an original allotment should be treated in a like manner. In neither case would the shares be owned "after 1971 and before the taxpayer acquired (them) by a person with whom the taxpayer was dealing at arm's length." This may appear not to be a significant problem because usually the cost base will in such circumstances be on a par with the paid up capital. However this need not necessarily be the case. Where the adjusted cost base has been 'bumped', for example
as a result of a subparagraph 85(4)(b) transaction (loss on disposition of capital property to a controlled corporation) or a section 7 benefit, the adjusted cost base reduction would permanently deny recognition of a loss otherwise only deferred or tax the same amount twice.

Whereafter 1971 a taxpayer acquires pre-72 shares in an arm's length transaction and later disposes of them to a non-arm's length party, will section 84.1 apply on a subsequent rollover by the new owner of his shares into a holding company? In principle of course it should not because the pre-72 value no longer inheres in the shares. It will have been properly realized by the first owner in the post-71 arm's length sale. But the wording in subsection 3 leaves the matter open to doubt. Can it be said of the shares rolled into the holding company that they were owned after 1971 by a person with whom the transferor taxpayer was dealing at arm's length? The only dealings of the transferor in respect of the shares were with a non-arm's length party. It is therefore possible that paragraph 84.1(2)(a) would apply to reduce the new owner's adjusted cost base to his immediate transferor's cost. Such a result could not have been intended by the legislator.

Subsection 3 gives rise to further questionable results, but these will be examined in the section dealing with estate planning.
Section 84.1 and Estate Planning

Section 84.1 can be most troublesome to the estate planner who is seeking to 'freeze' the shares of the owner of an operating company. The estate freeze is a procedure whereby the beneficial ownership of growth assets may be transferred to the intended beneficiaries in circumstances where the transferor may continue, should he so desire, to exercise control over the asset. In the result, taxes exigible upon the death of the transferor will in some measure normally be reduced. In the typical case, the freezor will roll his shares of the operating company into the holding company taking back cash or debt in an amount equal to the adjusted cost base of the shares transferred, and redeemable preference shares with a paid up capital equal to the excess of the fair market value of the shares transferred over the adjusted cost base thereof.

Although this procedure effectively defers the tax otherwise payable by the transferor on the disposition of his shares, a possible element of double taxation arises in that the deferred gain may be taxed twice, once when the transferor's shares of the holding company are redeemed (or upon his death) and again when the holding company disposes of the shares of the operating company. The double gain can apparently be avoided however if the holding company is wound up and its assets are distributed to the beneficiaries, if the shares are paid off with new
debt of the holding company, or if there is a step-up in the basis of capital property available under paragraph 88(1)(c). The transferor will want to ensure that the fair market value of the consideration taken back will equal the fair market value of the shares transferred. Subparagraph 85(1)(e.2) provides that any deficiency which may reasonably be regarded as a gift to the other shareholders of the holding company may be added to the elected proceeds resulting in an immediate capital gain to the transferor without, be it noticed, a corresponding adjustment to the cost bases in either the holding company's shareholding in the operating company or the shareholdings of the benefited shareholders in the holding company.

The departmental view is that estate freezing is in itself a legitimate tax planning procedure. Difficulty arises however where the means employed to effect it provide a shareholder with an opportunity to withdraw free of further tax corporate surplus normally taxable as dividend income in his hands. That which an estate freeze and a dividend strip have in common is the incestuous sale element which permits a shareholder to go through a form of sale and to receive proceeds while maintaining control of the asset rolled over. An important point of difference however is that estate freezing limits the transferor's economic interest in the property, excluding future growth, whereas following a strip it will continue to be absolute. However, where control is relinquished, the division and apportionment of
the incidents of ownership in estate freezing will not exempt the transaction from the operation of the new section 84.1 rules. Formerly, although old section 84.1 and subparagraph 89(1)(d)(iv.1) applied where debt or shares were taken back, the government would not invoke subsection 247(1) where the transfer to the holding company constituted a buy out of the transferor on a cash basis. As section 84.1 applies indifferently to cash transactions as well as to rollovers financed with debt or share capital, there is no scope for the favourable exercise of discretion and accordingly there are circumstances, which will now be examined, where the new provisions may interfere with the legitimate goals of tax planners.

In estate freezing situations, the transferor of pre-72 shares will normally be loath to take back shares with a low paid up capital because a redemption would expose the V-Day value to dividend treatment. Assume that father has pre-72 shares with the following tax attributes:

- PUC 50
- ACB 100 (V-Day value)
- FMV 150

If the father sells the shares to the son's holding company at fair market value, the transfer will be caught by section 84.1 and father will incur an increased capital gain of 100 (ACB reduction is excess of ACB of 100 over PUC of transferred, or 50=50 plus 50 gain determined under normal rules). Father therefore determines to sell
the shares directly to his son. In so doing, father realizes a capital gain of 50 and the shares will have the following characteristics in the son's hands:

- PUC: 50
- ACB: 150
- FMV: 150

The transfer would take place at fair market value because subparagraph 69(1)(b) would otherwise in any event deem the father to have received fair market value, while the son would apparently not benefit from an increase in his cost. Were it not for subparagraph 84.1(2)(a) this state of facts would lead to a serious problem on a subsequent rollover of the shares into a holding company by the son, because the amount otherwise subject to reduction would reflect not only the pre-72 capital gains section 84.1 was designed to protect, but post-71 capital gains as well. Assuming the son immediately rolled his newly acquired shares into a holding company, taking back shares with a paid up capital and adjusted cost base of 150, section 84.1 would apply to reduce the adjusted cost base of the son's shares by 100 (amount by which the lesser of ACB of transferred shares, or 150, and PUC of shares taken back, or 150, exceeds PUC of shares transferred or 50=100), fixing it at 50. On any subsequent redemption or sale of the shares the son would realize a capital gain of 100. This would obviously result in an element of double taxation because a capital gain of 50 would already have been taxed to the father. Subparagraph 84.1(2)(a) therefore provides that for the
purpose of the section 84.1 calculations is the cost of the
shares to the son will be deemed to be the cost thereof
to the father. When the son rolls the shares into the
holding company, the adjusted cost base of the shares
taken back will be reduced from 150 to 100 (ACB of shares
rolled over, or 100 less the PUC thereof, or 50=100).
Thus on any subsequent sale or redemption the son will
realize a capital gain of 50. As can be readily seen,
although the son in fact has no pre-72 capital gains in
respect of the shares acquired from father, section 84.1
will effectively impute them to his shareholding to the
extent that they existed while the shares were the
father's property. Of course this can only be justified
on the theory that the son and the father are to be treated
as the same person for tax purposes. Even where the parties
are, under Act, non-arm's length, this may not always be
the appropriate hypothesis, as the government has itself on
occasion come to realize.11 Basically, in situations
where the transferor and transferee transact at fair market
values and the transferor relinquishes control of the operating
comp any, the pre-72 capital appreciation of his shares
should not be imputed to the transferee's shareholding.

In addition to the freeze involving the transfer
of shares into a holding company, growth assets may be
frozen in either of two other ways. The 'reverse freeze'
is accomplished when an operating company sells its assets
and undertaking to another operating company, the common
shares of which are owned by the beneficiaries. The old operating company takes back shares and/or debt of the new operating company with a fair market value and adjusted cost base equal to that of the assets transferred. This fact situation is not contemplated by section 84.1 because no strip can result. The adjusted cost base and paid up capital of the father's shares of the old operating company are unaffected by the transaction so that the tax consequences of a redemption of those shares, of a sale of the shares in an arm's length or non-arm's length transaction, or of a winding up of the old operating company would be the same as would have occurred has the freeze never taken place.

The 'internal freeze' involves the use of the capital reorganization provisions of the Act contained in sections 51 and 86. The freeze is effected by having the freezor convert his shares of the operating company into non-growth shares thereof. This fact situation too is distinguishable from that against which section 84.1 is directed because, when proceeding under either of sections 51 or 86, the paid up capital of the corporation cannot be increased without triggering a section 84(1) dividend. This effectively obliges the freezor to receive dividend treatment on the redemption of his shares, and accordingly will not be an attractive alternative for all taxpayers.¹²

The estate freezing technique employing the holding company is itself divisible into two general categories: that in which portfolio securities are rolled over and that in
which the shares of an operating company are transferred to the holding company. It is worthy of note that section 84.1 will not apply to the freezing of investment securities. Thus a strip of the V-Day value inherent in such shareholdings may be effected either upon their transfer to a holding company capable of receiving tax free intercorporate dividends from an operating company, or directly to the operating company itself. The feeling of the government may be that this case cannot be properly regulated because the owner may sell and immediately reacquire his shareholding on the market, incurring only incidental expenses such as brokerage costs. However if the owner wishes to enjoy a tax free receipt of his shares up to the V-Day value thereof and also defer the capital gain on the difference between their adjusted cost base and fair market value, the rollover will continue to be attractive. The ever present danger of a direction pursuant to subsection 247(1) must however be considered and a ruling should perhaps be obtained before proceeding.

(f): Avoiding the Penalty and Anomalies

The penalty imposed by section 84.1 may be avoided by taking back shares of the purchaser corporation with a paid up capital equal to that of the pre-72 subject shares (or combined cash, debt, and paid up capital of shares taken back not in excess of the paid up capital of the shares
transferred). The V-Day value of the shares transferred remains intact because there is no reduction of the adjusted cost base of the shares of the purchaser corporation taken back, which, pursuant to subsection 85(1), is established at the adjusted cost base of the shares transferred. On a subsequent disposition of the shares taken back, the taxpayer realizes a gain only on the excess of proceeds over the elected amount, enjoying full V-Day value protection of pre-72 gains. The subsection 85(1) rollover would accomplish the estate freeze, if one is intended, and accordingly it might appear that matters are satisfactorily resolved both from the government's and the taxpayer's point of view. Unfortunately, this conclusion could not be justified.

Quite apart from the question whether it is necessary or desirable to implement section 84.1 by structuring the threat of a permanent penalty into the provision, it is surely inconsistent to disadvantage a taxpayer who does all that he can to comply with obvious policy underlying the section. The purpose of section 84.1 is theoretically limited to preventing the premature realization of the V-Day value in shares. Ideally, once this objective has been secured, the particular taxpayer should be in no worse position than a taxpayer rolling shares into a holding company in circumstances where section 84.1 is inapplicable. This, however, is not the case. The transferor of post-71 shares may redeem the shares of the purchaser corporation taken back. This enables him to obtain a return of capital
and to choose between dividend or capital gains treatment on the excess of the fair market value over the adjusted cost base of the shares taken back (the elected amount) while continuing to own the shares. This flexibility is denied the transferor of pre-72 shares.

The transferor of pre-72 shares may or may not be able to recoup his original cost depending upon whether his outlay represents an amount paid for shares taken from the treasury or acquired from a shareholder. Section 84.1 evidently does not take into account the possibility that the shareholder who acquires shares before 1972 may have done so for an amount exceeding their paid up capital. Consider a fact situation involving shares with the following attributes:

<table>
<thead>
<tr>
<th>PUC 100</th>
</tr>
</thead>
<tbody>
<tr>
<td>PRE-72 COST 1000</td>
</tr>
<tr>
<td>ACB 1200</td>
</tr>
<tr>
<td>FMV 1500</td>
</tr>
</tbody>
</table>

If after 1972 the taxpayer rolls his shares into a holding company in return for shares with a paid up capital of 1000, the adjusted cost base of the shares taken back will be reduced from 1200 to 300 (PUC of shares taken back, or 1000 less PUC of shares transferred, or 100=900 reduction). In addition to paving the way for an unwarranted capital gain, section 84.1 will effectively deny the taxpayer a return of his investment. The latter result is of course also brought about where he rolls the shares into the holding company in return for shares thereof with the same paid up
capital in order to avoid the penalty. The pre-72 shareholder who acquires his shares from another shareholder is accordingly singularly disadvantaged.

The pre-72 shareholder who acquires his shares from the treasury or from another shareholder is effectively denied a choice between capital gains and dividend treatment on the excess of the fair market value over the adjusted cost base of the shares taken back. Their low paid up capital will ensure that capital gains treatment is selected in most cases. Otherwise, on a redemption of the shares by the holding company the V-Day value would be exposed to tax as a dividend. It is true that the redemption might create a capital loss, but the loss might also vanish under the neutral zone rules unless an election has been made under Itar 26(7) by the taxpayer in respect of all of the capital property held by him on V-Day. Even where the election has been made and the loss is accordingly available, the tax consequences of exposing the V-Day value to dividend treatment are only marginally better than the clearly unsatisfactory results of subjecting it to capital gains tax.  

Where non-arm's length transferees of pre-72 shares who take after 1971 wish to establish a schedule for payment of the price, section 84.1 may throw obstacles into the path of ordinary financing procedures. If the taxpayer cannot enjoy a return of capital on a redemption of his shares of the holding company taken back he will incur
additional and unnecessary expense in retiring any debt
given to finance the acquisition. Instead of making payments
as they fall due with amounts withdrawn from the operating
company through the holding company on a tax free basis, the
necessary funds will take the form of taxable dividends.\textsuperscript{14}

The government has made it quite clear that any
colourable attempts to avoid section 84.1 will likely
result in a direction pursuant to section 247.\textsuperscript{15} Having
alerted the reader to this warning, a few techniques may
briefly be examined, however they are neither numerous
nor attractive.

At the outset, it should be mentioned that winding
up a Canadian corporation provides a lawful means of
realizing the V-Day value in pre-72 shares on a tax free
basis. The V-Day value will in such a case take the form
of pre-72 capital surplus. This will of course not always
be an inviting possibility, especially since it will
normally result in a taxable dividend on the excess of the
amounts distributed by the corporation to the shareholder
over the paid in capital, the pre-72 capital surplus and,
where the company is a private corporation, the capital
dividend account.

In cases of equally divided ownership of the operating
company, there are two other possibilities. The first of
these requires a reorganization of the capital of the
operating company so that the shares are divided into classes
with greater paid up capital attributable to the prospective
transferor's shares. This might be accomplished under section 51 of the Act. In order to avoid a section 84(1) dividend, this procedure would involve a reduction of the paid up capital of the shares held by other shareholders in an amount equal to the increase in that of the shares of the transferor. If the increased paid up capital of the transferor's shares were sufficient to account for the difference between the paid up capital and adjusted cost base of his original shares, he might prematurely realize the V-Day value of his pre-72 shares indirectly following a rollover of his new shares into a holding company.16 The fact that the paid up capital of shares taken from the treasury of an operating company is normally very low of course limits the utility of this procedure.

Section 84.1 applies only to transfers by a taxpayer to a corporation with which he does not deal at arm's length. Where ownership of the operating company is equally divided, section 84.1 might be avoided by having each shareholder transfer his shares to a shell company formed by another shareholder in return for cash and/or debt in the amount of the adjusted cost base of the shares transferred, and redeemable preference shares with a high or low paid up capital so that the desired tax treatment might be obtained on the excess of the fair market value over the adjusted cost base of the shares sold. In this way the V-Day value might be stripped out while the shareholder continued to own the same proportionate shareholding as before.
Of course the efficacy of this technique rests upon the assumption that the transferring shareholders and the acquiring companies are at arm's length. This transaction could not be impugned on the basis of the related persons provisions contained in section 251, however it is likely that the government would regard this as a case of factual non-arm's length. Interpretation bulletin IT-419 gives, in this writer's opinion, a broader reference to the factual non-arm's length concept than the decided cases would seem to justify. Although there is no doubt that unrelated business associates transacting at fair market values may be non-arm's length, 'acting in concert' would seem to have been applied to date in circumstances where one party was the 'guiding hand' or where business dealings connoted a single enterprise as opposed to separate business entities. However, the courts have, historically, given increasingly broader scope to the factual non-arm's length concept and, in view of the Minister's certain challenge, this device is hardly to be recommended.

As noted, section 84.1 applies to taxpayers other than corporations. This may perhaps be regarded as a technical
deficiency insofar as it enables certain taxpayers to realize the V-Day value inherent in their shares without disposing of them in an arm's length transaction. Where the taxpayer rolled his shares into a holding company before 1972, and the corporate shareholder does not control the operating company, a dissolution of the holding company will result in the recognition of pre-72 capital surplus (which includes 1971 capital surplus on hand at December 31, 1978). The value in this account when crystallized and paid out to the shareholder will be deemed not to be a dividend and will not be included in income. This constitutes, of course, an anomaly rather than an avoidance of evasion technique.

As we have seen, subparagraph 84.1(2)(b) provides that the taxpayer will be deemed not to deal with the acquiring company at arm's length if he was one of the same group of less than six persons who before the disposition controlled the subject corporation and after the disposition controlled the acquiring corporation. Assume that the ownership of Opco is divided amongst three individuals as follows:

\[
\begin{align*}
X & \ 25 \\
Y & \ 25 \\
Z & \ 25
\end{align*}
\]

X and Y roll their pre-72 shares into a holding company, taking back shares corresponding to their equal interests in the Holdco. X and Y together do not control Opco, and neither X nor Y controls Holdco. Although a group of less than six persons controls both companies, it is not the
same group. But for the likelihood of a Ministerial direction or a claim that X and Y are factually non-arm's length, this fact situation could result in the stripping of the V-Day value of the shares rolled over.

Section 84.1 figures most prominently in estate freezing situations, however it will apply whenever a shareholder sells pre-72 to a company with which he is not at arm's length and the acquiring company owns more than 10% of the issued share capital of the subject corporation. Cronkright, Dart, and Lindsay suggest a situation where the shares of one of two brothers who have competed in business for many years are bought by the other brother's company for cash. The V-Day value of the selling brother's shareholding would in such a case be exposed to capital gains tax. Other scenarios come to mind. Once an investment reaches maturity, a venture capitalist will seek to divest himself of his shares. An increasingly important method of accomplishing this involves the repurchase by the company of the investor's shares. If the jurisdiction in which the company is incorporated does not permit buy-backs, the shares will be rolled into a holding company formed in a jurisdiction which does. The individual owner of the shares transferred and the venture capitalist (if he is unincorporated) will in such circumstances be subject to an unwarranted reduction in the cost base of the shares taken back.
(g) Conclusion

To conclude, section 84.1 is fraught with many difficulties, inequities, and anomalies. Briefly, it may apply in circumstances where it was never intended that it should. This will be the case if subsection 84.1(3) fails to exempt shares taken by the taxpayer from the treasury of a corporation formed after 1971 or from a non-arm's length party who has himself acquired the shares in an arm's length transaction after 1971.

Section 84.1, contrary to principle, discriminates between individuals who own shares to which it does not apply and individuals who own shares to which it does apply but who have taken all necessary steps to comply with the underlying policy. Thus persons rolling their shares into a holding company in return for shares thereof with the same paid up capital as the shares transferred are effectively bound to realize their interests as capital gains and are denied a choice of tax treatment on the post-71 earnings of the operating company. This also means that they must transfer their interests in the operating company with the disposition of their shares in the holding company (for which there would otherwise be no market). Shareholders enjoying the possibility of a share redemption do not necessarily have this consequence imposed upon them.

Shareholders who have acquired their interests from other shareholders (and not the treasury) before 1972 and
non-arm's length transferees for values of pre-72 shares taking after 1971, are, upon a rollover, denied a return of capital upon their investment. This follows from the fact that redemption of the low paid up capital shares taken back by the pre-72 acquiror would expose part of his capital cost to dividend treatment, and the non-arm's length transferee for value would have his cost reduced to that of his transferor, paving the way for an uncalled-for capital gain upon redemption of the shares. If the purchase cannot be funded with the tax free surplus of the operating company, any debt financing schemes might be seriously compromised. Purchase through a holding company might have solved the problem for the non-arm's length transferee except for the fact that it would expose his transferor to capital gains treatment of the V-Day value protection of his shares.

Section 84.1 unnecessarily throws obstacles into the path of estate freezes using a holding company. The low paid up capital of the shares taken back imports both the unsatisfactoriness of a share redemption (exposing the V-Day value to tax as a dividend) and the non-marketability of the shares for ordinary sale (they will not transfer ownership of the operating company). The owner of pre-72 shares may therefore shun the holding company mechanism and, accordingly, be fortuitously denied the benefits of this planning technique.

Perhaps a section which permitted the premature
realization of the V-Day value but at some reasonable tax cost would have been preferable. Admittedly such a scheme would be difficult to put in place, because the length of time the shareholder continued indirectly to own the shares of the operating company would have to be factored in. This period would differ from shareholder to shareholder and would be indeterminate when the rollover and strip took place. Some form of refundable tax provision might overcome this problem. In any case, there can be little doubt that the tenor and thrust of section 84.1 are misconceived. Presumably, the abuses it is imperfectly designed to prevent would otherwise be governed by subsection 247(1). In principle, therefore, section 84.1 should be provided for the greater certainty of tax advisers who might then pursue their legitimate objectives free of the menace of a ministerial direction. Unfortunately, section 84.1 itself threatens a permanent penalty which may be difficult to avoid because of the verbal ambiguities of the provision and which in any case fortuitously disadvantages certain taxpayers.
FOOTNOTES


2. Subparagraph 54(h)(x) will, for the purpose of determining any capital gain or loss, reduce the proceeds of disposition by the amount of the deemed dividend.

3. Subsection 186(4)

4. Reliance upon factual non-arm's length may continue to be necessary where the transaction is governed neither by the related persons provisions nor the extended definition of non-arm's length: see, infra, at p. 26.

5. See subparagraph 85(1)(f). For the cost of preferred shares taken back see subparagraph 85(1)(g).

6. For individuals taxed at the highest marginal rate, the consequences of exposing the V-Day value to dividend or capital gains treatment, even where a capital loss is available, are similar with perhaps a slight preference for dividend treatment.

<table>
<thead>
<tr>
<th>Opco Shares Transferred</th>
<th>Holdco Shares Taken Back</th>
</tr>
</thead>
<tbody>
<tr>
<td>PUC 100</td>
<td>PUC 1000</td>
</tr>
<tr>
<td>ACB 500 (V-Day value)</td>
<td>ACB 500</td>
</tr>
<tr>
<td>FMV 1000</td>
<td>FMV 1000</td>
</tr>
</tbody>
</table>

Case I
Section 84.1 will reduce the ACB of the shares taken back by 400, fixing it at the PUC of the shares transferred, or 100. On a section 84(3) redemption (or on a section 84(4) reduction of the paid up capital down to nil) of the Holdco shares the taxpayer would therefore incur a capital gain of 900, 1/2 of which, or 450, would be included in income. Taxed at a marginal rate of 61 this would result in total tax payable of 450 x 61 = 274.50.
Case II
If the Opco shares were sold by the Holdco for their fair market value of 1000, the taxpayer would indirectly attract capital gains treatment on the excess of the FMV of 1000 over the ACB of 500, at a tax cost of 500 x 1/2 x .61 = 152.50. If the remaining 500 were used up in a partial redemption of the taxpayer's shares of Holdco, there would be a further capital gain of 500 (proceeds) - 100 (reduced ACB) = 400 at a further tax cost of 400 x 1/2 x .61 = 122.00 for a total tax cost of 274.50.

As between Case I and Case II, the latter provides more favourable overall results for the particular taxpayer, because the next 500 paid to fully redeem the shares will attract capital gains treatment, whereas any additional amount paid on the shares in Case II (assuming the shareholder continues to own them) will be taxable as a dividend.

Case III
If in case II the additional 500 in the Holdco were paid out to the shareholder as a taxable dividend the tax cost would be 152.50 plus (500 + 250 x .61 - 250) or 207.50 = 360.

Case IV
If, in order to avoid the penalty, the taxpayer takes back shares of the Holdco with a PUC of 100, ACB of 500, and FMV of 1000, a redemption of the Holdco shares would precipitate a deemed dividend of 900 and a section 54(h)(x) capital loss of 1000 (proceeds) less 900 (deemed dividend) 100 less ACB 500 = 400. The tax cost of the dividend would be 900 plus 450 = 1350 x .61 - 823.50 less 450 = 373.50. Assuming the availability of capital gains for immediate setoff, the total tax cost would then be 373.50 less (400 x 1/2 x .61) or 122 = 251.50.

Case V
Sale of the shares taken back in Case IV would result in a capital gain of 500 and a total tax cost of 500 x 1/2 x .61 = 152.50.


11. Primeau, at p.423 and see Bryson, footnote 10.

12. The reverse freeze requires, in addition, that the shareholder forego the considerable advantages of isolating the investment portfolio from the active business.


14. Non-arm's length taxpayers would not be able to avoid this difficulty by acquiring the shares through a holding company.


16. The low paid up capital need not inconvenience a shareholder who is planning to sell his shares: see Sheldon Silver, "Section 55 and Subsection 247(1)," in 1978 Conference Reports, 626 at p. 635.

17. Pender Enterprises Limited v MNR, (1965) CTC 91.


20. Subsection 88(2.1)

21. Subparagraph 88(2)(b)(ii)

23. Even if their Holdco shares taken back on the rollover are redeemed, they may continue to own shares taken from the treasury of Holdco. In such a case they would continue to own Opco indirectly and their shares of Holdco would reflect the post-rollover increments in Opco. These shares might therefore themselves be rolled over into a second Holdco at some future time, again permitting the shareholder a choice as to the tax treatment of the Opco surplus.
III. Section 212.1

(a) Introduction

Section 84.1 is aimed against a strip accomplished, following an incestuous share sale, by disguising a portion of an operating company's earned surplus as the capital cost of shares which may be returned to the investor free of tax. The strip is made possible because where pre-72 shares are involved the adjusted cost base does not correspond to the amount invested by the taxpayer. Section 212.1 is likewise directed against a strip which turns upon the conversion, through the magic of the incestuous share sale, of tax retained earnings into capital. In this case the strip is set up by the fact that non-residents are by treaty frequently exempted from capital gains tax to which they would otherwise be exposed.¹

In the typical case, the non-resident Usco wishes to avoid withholding tax exigible upon dividends paid to it by its wholly owned Canadian Opco, a company plump with retained earnings and ripe for the picking. Usco therefore sells the shares of Canadian Opco to Canadian Holdco, a company created by Usco to make the purchase, taking back cash, debt, and/or shares of Holdco with an aggregate value equivalent to the fair market value of the Opco shares transferred. Usco will therefore incur a capital gain equal to the excess of the fair market value of the Opco shares over their adjusted cost base. The purchase price is of
course paid with the surplus of Opco which is moved through to Holdco in the form of deductible section 112 dividends, an arrangement facilitated since the repeal of Part VII tax. As one might expect, government officials regard this procedure as a colourable attempt to avoid Part XIII tax, specifically the 25% tax imposed by paragraph 212(2)(a) on non-residents receiving amounts from corporations resident in Canada on account, in lieu, or in satisfaction of taxable dividends.  

(b) Conditions of Applicability

Section 212.1 will apply whenever, after April 10, 1978,

1) a non-resident person
2) disposes of shares of a Canadian company
3) to another Canadian company
4) with which he is not at arm's length, and
5) the two Canadian companies are 'connected'.

The non-resident may be an individual, a trust or a corporation.  

For greater certainty, an expanded definition of non-arm's length is provided in subsection 212.1(3). This corresponds to the definition in subsection 84.1(2)(b) according to which the taxpayer is not at arm's length with the purchaser corporation if he is one of the same group of less than six persons who control the subject corporation before the disposition and the purchaser corporation after the disposition. There are also rules in paragraph 212.1(3)(b) corresponding exactly to the rules in paragraph 84.1(2)(c) which provide that shares owned by the taxpayer's spouse, and certain non-arm's length companies and inter vivos
trusts will be attributed to the taxpayer for the purpose of determining whether he was one of a group of less than six persons that controlled a company. 4

Like section 84.1, section 212.1 requires that the purchasing company and the company the shares of which are acquired be connected. This requirement was introduced by resolutions 25 and 56 respectively of the December 19, 1978 expanded Notice of Ways and Means Motion. In both cases the Act formerly required that the purchasing corporation control the subject corporation. The changes were of course necessary if sections 84.1 and 212.1 were to continue to mesh with the Part IV tax provisions. In 1978 criterion for the exemption from Part IV tax went from 'controlled' (over 50% votes and value) to 'connected' (over 10% votes and value). 5

As first enacted 6, section 212.1 applied where the non-resident and the purchasing corporation were non-arm's length "immediately after the disposition". This led to an unfair result in certain arm's length transactions. For example, in a takeover by a Usco and its Canadian Subco of a target Usco and its Canadian Subco in circumstances where the U.S. and Canadian purchasers acquired the shares of the targets in the same transaction, the purchasing Subco and the target Usco would not, "immediately after the disposition", be at arm's length because the purchasing Subco's parent would then own the target Usco. The consideration taken by the target Usco would therefore receive
dividend treatment to the extent that it exceeded the paid up capital of its Canadian Subco. This would, effectively, subject the capital gain to withholding tax. Resolution 49 of Bill C-56 changed the wording of section 212.1 so that the section applies where the non-resident person and the purchaser corporation are non-arm's length before the disposition.

(c) Operation and Tax Consequences of Section 212.1

The consequences of section 212.1 will depend upon the nature of the consideration taken back from the purchaser corporation by the non-resident. Where cash or debt only are taken back, the excess of the fair market value of this consideration over the paid up capital of the shares acquired by the purchaser corporation will be treated as an immediate taxable dividend subject to withholding tax. Where shares of the purchaser only are issued in payment, the paid up capital of these shares will be reduced by the amount of the excess of their paid up capital over the paid up capital of the shares transferred. This of course paves the way for a deemed dividend on any subsection 84(3) redemption or subsection 84(4) reduction of capital of the non-resident's shares where the amount received exceeds their reduced paid up capital.

In all cases, an immediate deemed dividend will arise only to the extent that the actual amount of cash or debt exceeds the paid up capital of the subject shares.
This means that where a combination of cash, debt, and shares of the purchaser are taken back, the excess of the fair market value of the aggregate consideration received over the paid up capital of the subject shares will be applied first to the reduction of the paid up capital of the shares taken back by the non-resident (which defers the deemed dividend until redemption of the shares). Where shares of different classes of the purchaser are issued in payment, the paid up capital reduction is prorated amongst these classes on the basis of the relative increase in paid up capital of each class.

(e) **Comparison of Sections 84.1 and 212.1**

In spite of the many technical similarities between sections 84.1 and 212.1, there are important differences as well. Section 84.1 applies to resident taxpayers other than corporations whereas section 212.1 applies to all non-resident persons, including corporations. As the object of the strip regulated by section 84.1 is the premature realization of a capital gain, the penalty takes the form of a reduction in the adjusted cost base of the shares taken back, resulting in exposure to capital gains tax: as the object of the strip thwarted by section 212.1 is the transformation of retained earnings normally distributable as taxable dividends into non-taxable capital gains, the adjustment calls either for the recognition of an immediate or deferred deemed dividend (depending,
as we have seen, upon the nature of the consideration received by the non-resident). The penalty in section 84.1 is limited to the excess of the V-Day value of the subject shares over their paid up capital; the provisions of section 212.1 will deem all surplus removed from the subject corporation in excess of its paid up capital to be a dividend. Another important point of difference lies in the fact that where debt is taken back by the non-resident it will give rise to an immediate tax liability, to the extent that it exceeds in value the paid up capital of the subject shares; under section 84.1 the adjusted cost base of any debt consideration is reduced and accordingly the tax liability thereon is deferred.

Another significant difference, pointing to a possible deficiency in the drafting of section 212.1, has to do with the characteristics of the shares modified by the two sections. Section 84.1 applies only to reduce the adjusted cost base of the particular shares taken back by the taxpayer from the purchaser corporation. Section 212.1, on the other hand, applies to reduce the paid up capital of the class to which the shares taken back by the non-resident belong. Thus, if additional shares of the class(es) taken by the non-resident are held by other shareholders of the purchaser corporation, the reduction in paid up capital will apply to and float with those other shares. This will of course result in a benefit to the non-resident in that the reduction will be distributed amongst all of
the shares of the relevant class(es). Conversely the other shareholders may be disadvantaged by a corresponding reduction in the paid up capital of their shares. This does, however, present certain planning possibilities. If, for example, the other shareholders are themselves corporations owned by the non-resident, the reduction in the paid up capital of their shares does not constitute a detriment because surplus may be moved between corporations on a tax free basis. Care would have to be taken to avoid any Part IV tax by ensuring that the shareholder corporation(s) and the purchaser corporation were connected. Alternatively, even where a new class of shares are issued to the non-resident, another Canadian company wholly owned by the non-resident might purchase shares of the same class, in effect decreasing the reduction in the paid up capital of the non-resident's shares.

(d) Subsection 212.1(2) Adjustment

The adjustment in the computation of the paid up capital of the shares taken back provided for in subsection 212.1(2) is made necessary by the excessive reductions effected by subsection 212.1(1)(b) where the shares are redeemed in successive stages and not all at once.

Assume that subject shares having a paid up capital of 100,000 are sold by the non-resident in return for shares of the purchaser possessing a paid up capital of 500,000. Subsection 212.1(1)(b) will reduce the paid up
capital of the shares taken back by 400,000, leaving a paid up capital of 100,000. Let us further assume a subsequent subsection 84(3) 300,000 redemption of the non-resident's shares in the purchaser corporation. The subsection 84(3) redemption would trigger a deemed dividend of 240,000 (300,000 - 3/5 of PUC of 100,000 attributable to shares redeemed). Pursuant to subsection 212.1(1)(b) the revised paid up capital of the shares would be determined as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>PUC remaining (corporate law)</td>
<td>200,000</td>
</tr>
<tr>
<td>212.1(1)(b) reduction</td>
<td>400,000</td>
</tr>
<tr>
<td>PUC of shares</td>
<td>NIL</td>
</tr>
</tbody>
</table>

Thus, the full amount of the remaining 200,000 paid up capital would be brought into income on a subsequent redemption of the remaining shares, for a total deemed dividend of 440,000, a figure 40,000 above the original reduction in paid up capital. Subsection 212.1(2) therefore makes the following addition in the computation of the paid up capital:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>PUC remaining (corporate law)</td>
<td>200,000</td>
</tr>
<tr>
<td>Less 212.1(1)(b) reduction</td>
<td>400,000</td>
</tr>
<tr>
<td>Plus 212.1(2) addition</td>
<td></td>
</tr>
<tr>
<td>(lesser of 212.1(1)(b) reduction</td>
<td>240,000</td>
</tr>
<tr>
<td>and the deemed dividend paid on redemption of 3/5 of shares</td>
<td></td>
</tr>
<tr>
<td>Paid up capital</td>
<td>40,000</td>
</tr>
</tbody>
</table>

Accordingly, on a redemption of the remaining shares there would be a deemed dividend of 200,000 - 40,000 = 160,000, for a total deemed dividend of 400,000.

Subsection 212.1(2) is necessary because subsection
212.1(1)(b) applies in computing the paid up capital of the shares taken back "at any particular time after March 31, 1977." If subsection 212.1(1)(b) were amended to compute the paid up capital "immediately after the disposition", a partial redemption of shares as in the above example would result in a paid up capital of 40,000 for tax purposes remaining after the reduction and partial redemption (3/5 of the paid up capital of 100,000, or 60,000 is recouped on the redemption of 300,000 of the outstanding 500,000 shares, leaving a paid up capital of 40,000). The suggested change would appreciably simplify the operation of section 212.1 and eliminate some of its rather dense and tortuous wording. The draftsman probably felt that because subsection 89(1)(c) appears to determine paid up capital by reference to the applicable provisions of the corporate, and not the tax law, an "immediately after the disposition" test would imply that at any other time paid up capital means corporate paid up capital i.e. 200,000 and not 40,000 after the initial redemption in the above example. There is, however, no compelling reason why this should be the case. The "paid up capital...in respect of the class of shares" referred to in subsection 89(1)(c) can just as easily (and more conveniently) be taken as referring to the reduced paid up capital of 40,000 for tax purposes.
(f) **Conclusion**

It may be argued that section 212.1 is ineffective where the relevant tax treaty (which over-rides the domestic tax law) prohibits the taxation of the non-resident's capital gains. However, the deemed dividend under section 212.1 is determined with reference to the paid up capital concept and not according to the usual capital gains criteria. Thus a tax liability may arise under section 212.1 even where no capital gain, or perhaps even a loss, is triggered by the sale. This will occur when the adjusted cost base of the subject shares equals or exceeds their fair market value and the paid up capital is a lower figure. Moreover, where shares only are taken back by the non-resident, the capital gain and section 212.1 tax liability will arise at different times and in respect of different transactions on different shares. Even where cash only is taken back and the amount of the deemed dividend closely approximates the amount of the capital gain, it is still arguable that section 212.1 traces and taxes a distribution of surplus, especially in view of the fact that the non-resident continues to own the shares (albeit indirectly). The non-resident might perhaps argue that one tax is in effect substituted for the other, and that the government is attempting to do indirectly what it cannot do directly (this maxim might also be levelled against him). It might also be argued in his behalf that the subject
shares, being after the disposition the property of a Canadian resident corporation, will be subject to capital gains tax in a subsequent arm's length sale. This tax liability would of course ultimately be borne by the non-resident himself, and would arise only because he ceased to own the shares directly. It is unlikely that this tradeoff reasoning would curry favour with the government or the courts, especially since the stripping of the subject corporation's surplus would permanently reduce the gain on any sale of the shares and might, indeed, contribute to a loss (the purchaser corporation's cost will be the fair market value of the shares before the strip). If the purchaser were, moreover, a mere shell, the capital gains tax on the sale of the shares of the operating company could easily be avoided by selling instead the shares of the holding company owned by the non-resident.

Section 212.1 contains at least two traps for the unwary. As previously noted, the paid up capital reduction will apply to the class(es) of the shares taken back by the non-resident. Purchasers acquiring shares of the relevant class(es) from the non-resident or from other shareholders may find that the paid up capital of their newly acquired shares is less than they might otherwise conclude following an examination of the share certificates and balance sheet. For this reason, the purchaser would do well to exact a warranty concerning the paid up capital of the shares.
A non-resident purchaser of the shares of a Canadian company can in principle recoup the purchase price in either of two ways. He may form a holding company to make the acquisition or acquire the shares directly and subsequently roll them into a holding company. The enactment of section 212.1 makes that the second method is to be avoided, because the purchase price will be treated as a dividend to the extent that it exceeds the paid up capital of the shares. This will, of course, subject it to withholding tax.
FOOTNOTES

1. Under subparagraphs 115(1)(a)(iii) and (b). And see Art. VII, Canada - U.S. Convention.

2. Normally reduced by treaty to 15%.

3. See definition of 'person' in subsection 248(1).

4. Section 212.1 and section 84.1 share the same legislative history. Originally, as resolutions 93 and 39 respectively of Bill C-11, the non-arm's length criterion was the nebulous 'act in concert' principle. This was discarded as too vague in resolutions 49 and 19 of Bill C-56 wherein the 'less than six' test is adopted. The attribution rules therein were too broad however, referring to 'related persons' (mothers-in-law, siblings, sons-in-law, etc.) and were accordingly eliminated by resolutions 56 and 25 of the expanded Notice of Ways and Means Motion tabled Dec. 19, 1978 wherein the present rules were put forward.

5. Subsection 186(4).

6. Bill C-11, res. 93.


8. Subparagraph 84(3)(a)

9. See Canada - U.S. Tax Convention, Art. VII.
IV. Surplus Stripping in Great Britain.

In comparing the dividend stripping provisions of the British tax law, found in sections 460 et. seq. of the Income and Corporations Tax Act, 1970, with those of the Canadian Act, both differences and similarities are noticeable. A basic similarity with subsection 247(1) is found in the fact that previous legislative efforts had proven ineffectual against the taxpayer's ingenuity with the result that a broadly framed discretionary power to reassess offending taxpayers was conferred by the government upon the fiscal authority. Both provisions are aimed against the taking of corporate surplus otherwise available for distribution as dividends subject to tax in a form involving no tax liability or a less onerous tax burden than would be associated with a dividend.

Leaving these important basic similarities to one side, one discovers that the differences are perhaps more numerous. Section 84.1, for example, is meant to apply to a very specific factual situation and accordingly contains minutely articulated conditions of applicability; the corresponding provisions of the British tax law are general and framed in the widest terms so as to cover the broadest spectrum of avoidance practices. Unlike subsection 247(1) of the Canadian Act, sections 460 et. seq. are exhaustive and comprehensive. An interesting consequence of the thoroughness with which the British system has attempted to block surplus stripping is the fact that the
authority to restructure transactions and reassess the taxpayer has been viewed by the courts as enjoining the counter-action of tax advantages whenever circumstances such as are contemplated in the law are uncovered by the fisc. Thus, sections 460 et. seq. have, unlike subsection 247(1), been litigated on a number of occasions.

While subsection 247(1) extends to the disappearance or reduction of corporate assets and to their tax free receipt as exempt income or as proceeds of disposition, conversion, or redemption of a company's shares, the ambit of subsection 247(1) is necessarily circumscribed by more particular anti-avoidance provisions relating e.g. to capital reorganizations, benefits to shareholders, and the winding up of Canadian companies. Sections 460 et. seq., on the other hand, are truly an anti-avoidance code dealing with avoidance through capitalization of reserves followed by a legal reduction of capital, transfers of assets from one company to another followed by the liquidation of the first company, the claiming of refunds of tax paid on dividends received through the artificial creation of losses (a form of stop-loss provision), surplus stripping through incestuous share sales, and shareholder benefits, to mention the most important aspects only.

The person subject to reassessment pursuant to subsection 247(1) is he who disposes of the shares and receives tax free proceeds whereas in Britain the rules in sections 460 and following envision the reassessment for tax
of both parties to a transaction. This is because a tax advantage may be enjoyed by either or both parties to a share-dealing operation. Moreover, the section 460 fact situations contemplate the improper reduction of taxable income through share-dealing and therefore the section does not apply exclusively to cases involving tax free and tax reduced receipts. Perhaps the single most noteworthy distinction to be drawn between the Canadian and British systems is that although surplus stripping has virtually been eliminated in both countries, this development is in the former case a result of changes in other areas of the tax law and not a consequence of the anti-avoidance legislation itself.7

Section 460 will apply whenever a) any of the circumstances mentioned in section 461 are present and

b) in consequence of a transaction in securities or the combined effect of two or more such transactions, a person is in a position to obtain, or has obtained, a tax advantage, unless he shows that the transaction or transactions were carried out for bona fide commercial reasons or in the ordinary course of making or managing investments, and that none of them had as their main object, or one of their main objects, to enable tax advantages to be obtained.

The important expressions contained in the quoted paragraph are defined in other sections of Chapter I of Part XVII (Tax Avoidance) or have been judicially considered. Thus, the expression 'transactions in securities' is defined in subsection 467(1) as including 'transactions of whatever description relating to securities, and in particular -
(i) the purchase, sale, or exchange of securities,
(ii) the issuing or securing the issue of, or applying or subscribing for, new securities, (iii) the altering, or securing the alteration of, the rights attached to securities". In the important case of IRC v Parker 8, the argument was made that the specificity of this provision excluded other share dealing transactions, in the particular case a redemption of shares. The House of Lords rejected this contention and favoured the broadest interpretation of the expression based upon the phrase "transactions of whatever description relating to securities". 9

As is evident from the wording of the provision, transactions otherwise within the legislation are excepted if they are undertaken for bone fide commercial reasons and do not have as one of their main objects the obtaining of tax advantages. It would appear that incidental tax advantages enjoyed because a predominating business or commercial purpose committed the taxpayer to a particular course of action do not prevent his transaction from being carried out for bone fide commercial reasons. Decisions taken by the directors of companies to implement schemes involving tax benefits but initiated in order to ward off takeover bids 10 or to secure the control of a company to the founding family members 11 have been judicially interpreted as reflecting the necessary business purpose. It should be noted however that the presence of an acceptable business purpose is not enough to avoid the section if one
of the main purposes of the transaction is conceived to be the obtaining of a tax advantage. Another exemption is provided in cases where the transaction is "in the ordinary course of making or managing investments". This phrase would seem to represent legislative recognition of certain judicial conclusions arrived at in dividend-stripping cases and will be commented on when those decisions are considered. The statutory definition of 'tax advantage' and the judicial gloss on "assets available for distribution" will also be discussed in connection with the sets of circumstances deployed in section 461.

As noted, section 460(1)(a) incorporates as conditions of applicability the presence of fact situations separately described in section 461. Section 461 is accordingly broken down into five groups of circumstances. Section 461A is directed against 'dividend-stripping', as that expression is used in Britain. In that jurisdiction, the income tax chargeable to the dividend recipient is deducted by the corporation at a standard rate. Adjustments may follow at the shareholder level e.g. surtax may be exacted from a high bracket taxpayer or a taxpayer disposing of a loss claim available for set-off against tax paid by the company may have all or a portion of the amount refunded to him. Thus, 'stripping' generally involves the receipt by the taxpayer of a refund by reason of a loss claim, subvention payment, or his tax exempt status, of tax notionally deducted from the dividend received. The types of arrange-
ments subsumed under this heading are numerous and varied, some of them resembling the schemes formerly employed by Canadian taxpayers. For example, shares of a company possessing a large credit balance in its profit and loss account and liquid assets available for distribution might be sold. The vendors would realize a tax free capital gain in respect of the surplus on hand. The tax exempt purchaser would then cause the company to pay him a large dividend from which he would recoup most of the purchase price. The shares would then be resold to the original owners at a cost reflecting their depreciated value. This operation would effectively permit the owners to realize the distributable surplus tax free, as noted, and a premium on the repurchase might be paid to purchaser for his services. This type of strip bears close comparison with the schemes which were employed in the famous Smythe and Craddock cases in Canada where as a result of a number of factual non-arm's length transactions, the taxpayers hoped to realize corporate surplus in the form of capital gains, to continue their ownership of the corporate assets, and to remunerate the professional 'strippers' who participated in their machinations with a premium arising upon the reacquisition of their interests.

The majority of the decided cases on dividend-stripping do not, however, conform to the above pattern. If the shares to be resold to the original owners, or, indeed, to a third party, were held by a trader in securities, he
would incur a loss on the resale which might form the basis of a claim for refund of tax deducted by the company from the gross dividend.\textsuperscript{14} Thus, tax on the dividend would effectively be eliminated. This was the fact pattern in \textit{Griffiths v J.P.Hamilton} \textsuperscript{15}, the first case of this type to be considered in the House of Lords, where it was held that the taxpayer's activities were demonstrably of a share dealing nature.\textsuperscript{16} Due to the strong dissenting reasons of Lords Denning and Reid, however, the taxpayer's luck began to run out in subsequent cases of this type. The facts, too, it should be acknowledged, were less favourable to the taxpayer. In some cases \textsuperscript{17} the loss shares were transferred to an associated company, or were sold below fair market value even after the payment of dividends. In other cases \textsuperscript{18} the original owners of the shares maintained an interest in them in the form of a contractual right to share in the refund of tax upon resale of the shares, or the purchase price was to be determined in part with regard to the refund of tax.

It should be noted that in order for section 461A to apply, the transaction must be "in connection with the distribution of profits of a company, or in connection with the sale or purchase of securities being a sale or purchase followed by the purchase or sale of the same or other securities". In addition it is necessary that the shareholder should receive "an abnormal amount by way of dividend". By 'abnormal' is meant the circumstance that the dividend
should far exceed in amount what might be regarded as a normal return on investment. 19

Section 461B also is predicated on the basic assumptions mentioned in connection with "A", that is, the distribution of corporate profits on the sale or purchase of securities. The difference is that section 461B operates to deny the dividend recipient "a deduction in the computation of profits or gains by reason of a fall in the value of securities resulting from the payment of a dividend thereon", and does not deal with the repayment of tax deducted from the dividend. Presumably the set-off by the sharedealer of business losses against business income upon a disposition of shares depreciated in value is here intended, as well as the set-off which arises when such shares are carried on the books of the company at fair market value rather than at cost.

Section 461C deals with the receipt by the taxpayer of consideration for the sale of his shares of proceeds which do not bear tax as income. The purchaser must subsequently receive an abnormal amount by way of dividend or become entitled to a deduction from the profit and gains account upon which the income tax is levied. In addition, the consideration must either be or represent the value of assets available for distribution, be received in respect of future earnings of the company, or be or represent the value of its trading stock (inventory). In this case, the 'person in question' is not the dividend recipient but the
vendor of the shares. Thus, section 461C deals with the possibility, first encountered in the Harrison case, that the purchaser's activities, otherwise within sections 461 A or B, are undertaken "in the ordinary course of making or managing investments". The concept of 'assets available for distribution' will be discussed in connection with 461D. Suffice it here to say that a limitation upon 461C is imposed by the fact that 'assets available for distribution' does not include the paid in capital of shares disposed of or otherwise dealt with. An example of consideration "received in respect of future receipts of the company" would be a case in which a taxpayer, anticipating large profits in the near future, had his company create and issue to him a class of shares carrying rights to very high dividends which he subsequently sold to a third party, converting a taxable surplus distribution into a receipt not assessable to tax as income.

The circumstances envisioned by section 461D have to do with the receipt by the owner (or former owner) of shares of consideration as in 461C i.e. primarily of assets otherwise available for distribution as a dividend. The circumstances contemplated in section 461D have to do with the 'distribution of profits' of a company and the argument might therefore be made that a purchase and sale, in which the purchaser corporation receives an asset in return for disbursement of the purchase price, cannot be regarded as a 'distribution'. The point is of interest because section
461D has been invoked in situations involving the incestuous sale of shares preceding the tax free (or tax reduced) extraction of surplus in the form of the purchase price. In IRC v Cleary, the taxpayer sold shares of her wholly owned company to another wholly owned company, taking the surplus of the latter company as a tax-free capital gain. In response to the taxpayer's claim that there was no reduction in the assets of the company available for distribution, and that therefore there was no 'distribution', Viscount Dilhorne drew attention to the particular words employed to define these expressions. As 'distribution' included a "transfer or realization (including application in discharge of liabilities)" and as 'profits' meant "references to income, reserves, or other assets", his Lordship had little difficulty in finding that the transfer of corporate assets in satisfaction of a contractual liability to make payment constituted a 'distribution of profits'.

Another important issue in the case had to do with whether or not the taxpayer had secured a 'tax advantage' by withdrawing the surplus in the form of a capital receipt. "Tax advantage" is defined in subsection 466(1) as "a relief or increased relief from, or repayment or increased repayment of, tax, or the avoidance or reduction of a charge to tax or an assessment to tax or the avoidance of a possible assessment thereto, whether the avoidance or reduction is effected by receipts accruing in such a way that the recipient
does not pay or bear tax on them, or by a deduction in computing profits and gains." Pennycuick J. at trial said that in deciding whether 'avoidance or reduction (has been) effected by receipts accruing in such a way that the recipient does not pay or bear tax on them':

it is necessary to compare like with like, that is to say, one must look at the actual transaction which comprises the receipt and see whether, upon another form of transaction producing the same result, the receipt would have been taxable. One cannot for this purpose look at the actual transaction by way of sale under which, although containing a common element, produces a different result. So, it seems to me, one cannot look to the actual transaction by way of sale, under which a member of a company transfers property to the company equivalent to the amount paid by the company to the member, and compare that transaction with a simple receipt by the member from the company without consideration. 26

Thus, Pennycuick J. was of the opinion that only if proceeds of disposition (rather than a dividend) might have been received at greater tax cost should one tax result be substituted for another. Following Pennycuick J.'s judgement, but before the Cleary appeal was heard in the House of Lords, the same issue was considered by the Court in Parker where Lord Wilberforce concluded that the definition turned simply upon the difference between taking a receipt in a non-taxable way in preference to a possible taxable way. 27 In the Cleary appeal, therefore, Viscount Dilhorne
merely reiterated the position previously taken by Lord Wilberforce, reversing Pennycuick J. 28

As we have seen, in order for 461D to apply, the 'person in question' must receive consideration as in 461C, comprising "assets available for distribution by way of dividend". In IRC v Brown 29 the taxpayer sold the shares of five companies owned by himself to another company owned by him in return for 30,000 £ in debentures, 25,000 £ in cash, 100,000 £ on loan. Because the purchaser corporation was unprofitable, it borrowed the 25,000 £ cash consideration from the bank. When the taxpayer was reassessed under section 460 and 461D, the defence was raised that the 25,000 £ did not represent "assets available for distribution by way of dividend" because it was not consistent with sound commercial practice for the directors of a company to pay dividends with borrowed money. However, although the company was unprofitable i.e. its current liabilities exceeded its current assets, it maintained a healthy balance in its profit and loss account so that payment of a dividend would not have been contrary to law. Megarry J., refusing to apply a standard of prudence or reasonableness, accepted the revenue's contention that amounts legally available for distribution are within the section. 30 It must be remembered that section 461D applies only in the case of companies under the control of not more than five persons and to corporations not listed on a prescribed stock exchange (close corporations).
Thus, it would seem that the stripping of surplus through the incestuous sale of shares of an operating company to a holding company is effectively barred by the above discussed provisions of the British tax law. As if sensible to the arguments of the taxpayer in the Cleary case to the effect that a sale did not involve a 'distribution of profits'. paragraph 461E was enacted to provide, in more explicit terms, that a transfer, directly or indirectly, of assets of a close company to another close company, or a transaction in securities in which two or more close companies are involved, is a circumstance upon which a section 460 assessment may be made. Any possibility of stripping on the Canadian model is therefore precluded by the comprehensiveness of the British tax avoidance legislation. By way of conclusion, it is necessary to point out that pursuant to subsection 460(3) "the tax advantages obtained or obtainable by (the taxpayer) in consequence (of any transaction or transactions) shall be counteracted by such of the following adjustments, that is to say an assessment, the nullifying of a right to repayment, or the requiring of the return of a repayment already made...or the computation or recomputation of profits or gains, or liability to tax on such basis as the Board may specify." The 'Board' referred to is a special tribunal of the Chairman of the Board of Referees and two or more other persons appointed by the Lord Chancellor.
FOOTNOTES

1. As amended by the Finance Act 1973 (c.51) sch. 11, para.1, originally FA 1960, s. 28.


3. ITA s. 84.

4. ITA s. 15

5. ITA s. 88(2)(b)(iii).

6. They do not, however, cover the full gamut of avoidance practices prohibited under the law. Bondwashing and transfers of income and of assets abroad are dealt with in other chapters of Part XVIII.

7. Namely, the increase in 1977 of the dividend tax credit which largely negative the benefits of realizing upon an investment with a capital receipt rather than with a dividend.

8. Supra, footnote 2, at p.2.

9. Ibid., per Lord Guest, at pp. 172-173.


15. (1962) 1 All E.R. 909.

16. This was so in spite of the fact that the taxpayer's objects had been expanded in order for it to carry on a share trading business, a target company 'pregnant with dividend' had been located, the money to purchase the target's shares was borrowed, it was the only transaction of its kind undertaken in the year, and it was made with the intention of obtaining a refund of tax and not for the ordinary trading purpose of earning commercial profits.

17. Petrotim Securities Limited v Ayres (1964) 1 All E.R. 269; Ridge Securities Limited v IRC (1964) 1 All ER 276

18. Inland Revenue Commissioners v FS Securities Ltd., (1964) 2 All ER 691; FA and AB Lupton (1971) 3 All ER 948 (HL); Bishop v Finsbury Securities Ltd., (1966) 3 All ER 105.

19. ICTA, 1970, s. 467(3).

20. It should be noted in this connection that 'consideration' is defined as including "the receipt of any money or money's worth": 476(2)(c).

21. Cases such as Hague v IRC, (1968) 44TC 619; IRC v Horrocks, (1968) 44TC 645, and notably IRC v Parker, supra, footnote 2, at p.2, involving the legal reduction of capital following the capitalization of surplus otherwise available for distribution as a dividend are indisputably within the provision.

22. (1968) AC 766.


25. ICTA (1970) s. 460(1).

27. Supra, footnote 2, at p. 178.

28. Supra, footnote 22, at p. 782.


30. Ibid., at p. 235.
V. Surplus Stripping in the United States

As we have seen, in Canada the increase in the dividend tax credit to 50% in 1977 resulted in the government's indifference to the manner in which taxpayers decided to realize the distributable surplus of corporations. The discrepancy between capital gains and dividend treatment of corporate earnings thus came officially to be regarded as unimportant. In the United States, a progressive rate schedule taxes income received by individuals at a maximum rate of 70%, whereas long-term capital gains are taxable only at a rate of 28%, being 40% of the rate applicable to income receipts of the highest bracket taxpayer. As might be anticipated, this discrepancy in tax burdens has occasioned a number of schemes aimed at transforming the corporate surplus available for distribution as a dividend into capital gains. These mostly turn on the use of the US provisions governing liquidations, preferred stock bailouts, so-called 'collapsible corporations', and what is of special interest in the context of the present study, 'incestuous' share sales involving affiliated corporations. The writer proposes to deal with the last of the noted avoidance practices, and to discuss also the countermeasures adopted by the fiscal authority in response to this planning device.

Incestuous Share Sales to Affiliated Corporations

The avoidance device aimed at procuring the receipt
of corporate surplus at capital gains rates which bears closest resemblance with the types of dividend stripping schemes formerly popular amongst Canadian taxpayers involves the sale of shares of one corporation to its affiliate by the controlling shareholder. Schemes of this nature are reflected in two basic fact situations. Shares of a parent corporation might be bought by its subsidiary and shares in a "brother-sister" controlled group might be acquired by corporations in the group. Where shares in a parent corporation are acquired by a subsidiary, or shares in a company are acquired by a related company, the net economic effect of the transaction is similar to a redemption of shares. The fact that another corporation owns the shares transferred by the taxpayer is generally of no economic consequence. Accordingly, the problem of surplus stripping through incestuous share sales has in the United States been assimilated to the law relating to redemptions and partial liquidations, which in turn provides rules for determining the tax consequences i.e. capital gains or dividend treatment, of various buy-back transactions. This characterization of the incestuous share sale is set out in section 304.

Section 304 provides, firstly, that in the case of shares acquired by a related corporation from the controlling shareholders, the sale proceeds are to be treated as a distribution in redemption of the stock of the acquiring corporation, and the shares are received by it as a contribution to capital. However, in applying the rules contained in Code
section 302 applicable to redemptions and their tax consequences, the relevant determinations are made with respect to the shares transferred to the purchaser corporation.\(^6\) In the event that application of the section 302 rules results in a distribution rather than in a sale or exchange, the amount of the dividend is determined with regard to the post 1913 surplus of the acquiring corporation.

In a case where shares of a parent corporation are acquired by a subsidiary, the redemption is treated as being of the shares of the issuing, parent corporation.\(^7\) The transaction is essentially regarded as a distribution of the proceeds to the parent, followed by a distribution to the vendor by the parent in exchange for its own shares.\(^8\) This of course means that the section 302 principles are applied in respect of the shares of the issuing parent, but also imports the consequence that the proceeds are added to the post 1913 earnings and profits account of the parent corporation, increasing the amount that will be treated as surplus available for distribution of a dividend (should a dividend be found) and making it unlikely that any sums will be received free of tax in reduction of basis or as a capital gain where the basis is eliminated entirely. Indeed, the probable result in any case in which market value is paid for the shares is a loss of basis protection to the transferor.
In either of the above discussed hypothetical redemption situations, it is necessary that the transferor(s) control each of the two corporations. Control is defined for this purpose as "ownership of stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote, or at least 50% of the total value of shares of all classes of stock". Control exercised indirectly through a corporation is included within the definition. The attribution rules contained in IRC section 318(a) are also incorporated by reference into section 304.

Since section 304 treats incestuous share sales as tantamount to stock redemptions, albeit hypothetical redemptions, it is necessary to consult section 302 in determining the tax consequences of the redemption. Redemptions can take various forms and their net economic effect to the shareholder vary with the circumstances. The redemption of stock in a one man corporation is really closely analogous to a dividend payment because the shareholder's economic interest and control over the corporation and its assets remain undisturbed. For the same reasons, a pro-rata redemption of widely held stock is also equivalent to a dividend payment. At the other extreme, a redemption which totally eliminates a shareholder's ownership, actual and constructive, in a corporation is comparable to a sale of the stock to a third party purchaser. Section 302 sets out the criteria which characterize the particular redemption as belonging to one or the other of these two categories. This
operation will in turn determine whether the shareholder's receipts will attract capital gains or dividend treatment.

Section 302 must be read against the backdrop of section 301, which provides that "except as otherwise provided in this chapter, a distribution of property... made by a corporation to a shareholder made with respect to its stock shall be treated (as a dividend distribution)." The exceptions to this rule are contained in subsection 302(1),(2),(3), and(4) and provide for sale or exchange i.e. capital gains treatment whenever the redemption is not substantially disproportionate, the redemption is in complete termination of the shareholder's interest, or the redemption is that of stock of certain railway companies pursuant to reorganizations of capital.

Redemptions "not essentially equivalent to a dividend" might at first glance seem to be the broadest of the exceptions. However, the specificity of the other criteria have tended to confine its operation within a very narrow compass. Accordingly, in United States v Davis the Supreme Court held that the test was whether there had been a significant change in the relative economic interest of the shareholder in the company. The presence or absence of a tax saving motive or business purpose is, it would appear, immaterial. This position is also reflected in the regulations, where it is said that a pro-rata redemption will be treated as a dividend where the corporation has but one class of shares outstanding.
Presumably, a pro-rata redemption in cases where the corporation had several classes of shares might qualify as not "essentially equivalent to a dividend" insofar as the rights to participate in present or future profits, to share in the assets upon a liquidation of the company, or to exercise voting control of the class of shares redeemed might be altered relative to the rights inhering in shares of other classes.

Subsection 302(b)(2) provides for the case of redemptions which are "substantially disproportionate". In order for a redemption to qualify under this provision three conditions must be satisfied. The shareholder must, immediately after the redemption, own less than 50% of the total combined voting power of all classes of shares. The redemption must also result in at least a 20% reduction in the shareholder's pre-redemption stock ownership. A similar requirement is that the redemption must eliminate at least 20% of the shareholder's percentage of ownership of common stock, both voting and non-voting. The attribution rules in section 318 will apply, however, in circumstances where shares are held beneficially for the taxpayer by an entity or where there is share ownership by family members.

The last exception of practical importance is for redemptions in termination of the shareholder's interest. It should be noted that the attribution rules of section 318 apply to such redemptions so that 'sale or exchange'
treatment is virtually precluded for close, family corporations. However, constructive ownership rules can be waived if the shareholder divests himself of any interest in the company (including employment as a director, officer, or employee), refrains from acquiring such an interest in the ten years following the redemption, and he did not acquire, in the ten years preceding the redemption, stock from any person whose ownership would be attributed to him by virtue of section 318.
FOOTNOTES

1. Gains resulting from the disposition of capital property held for a period of more than one year: IRC s.1201.

2. IRC ss. 331-337. In this case a company is liquidated, securing to the shareholder capital gains treatment of the surplus available for distribution as a dividend, and the corporate assets are then rolled into a new corporation at the 'bumped' cost base (equal to their fair market value). No special statutory provision is directed at this particular problem. One of the two major plans of attack is usually employed, one having to do with the characterization of the transaction as being equivalent in net economic effect with the payment of a dividend to shareholders, and the other stressing the close analogy of the steps taken with a statutory reorganization involving the receipt by the shareholder of 'boot' taxable as ordinary income.

3. IRC s. 306. Preferred stock bailouts involve the non-taxable distribution of stock dividends followed by their sale to third parties, a procedure which secures to the vendor tax on the proceeds at capital gains rates. Subsequent redemptions in termination of the third party's interest also result in tax at capital gains rates, which, since the cost base of the shares approximates their fair market value, normally gives rise to no tax liability. IRC sections 305 and 306 effectively provide for dividend treatment of such stock distributions and redemptions.

4. IRC s. 341. The general rule with regard to corporate liquidations in the United States is that there has been a sale or exchange of the stock in return for the assets distributed by the company (IRC s.331). This results in tax at capital gains rates on the excess of the distributed amount over the adjusted cost base of the interest surrendered. The collapsible corporation device turns on the liquidation of a company before the expected returns from the sale of the corporate asset have been realized. The difference between the shareholder's original capital contribution and the fair market value of the property distributed attracts tax at capital gains rates. The cost base of the asset is in the shareholder's hands 'bumped' to fair market value so
that no tax is payable upon a subsequent sale of the asset by the shareholder. IRC section 341 translates the gain realized upon liquidation into ordinary income.

5. IRC s. 304.

6. IRC s. 304(b)(1).

7. IRC s. 304(a)(2)(A) and (B).

8. IRC s. 304(b)(2)(B).

9. IRC s. 304(c)(1).

10. IRC s. 318, entitled "constructive ownership of stock", attributes to the taxpayer stock owned by members of his family (parents, children, grandchildren, and spouses), by partnerships, trusts, and corporations, where he or a family member is the beneficial owner of the stock, and stock in respect of which he enjoys an option to acquire.

11. IRC s. 301(a).


VI. CAPITAL GAINS STRIPPING

a) Introduction

It is sometimes said that the tax law relating to corporations has come full circle. Where once the efforts of tax planners were aimed at transforming taxable dividends into exempt capital gains, the new game has to do with the conversion of capital gains into exempt dividends. To the disinterested bystander, there might well appear to be some irony in this reversal, however in the light of developments in the federal income tax over the course of the last ten years the situation is perfectly comprehensible. What is more, the two types of avoidance practices are only superficially similar. The classic dividend strip was essentially a non-arm's length transaction in which the taxpayer went through a form of share sale in order to receive corporate surplus free of tax on dividend distributions. Where the source of wealth was a business possessing inherent value, the taxpayer's ownership was occasionally indirectly continued. The benefits of dividend stripping schemes were conferred upon individuals controlling companies and accordingly these activities were essentially confined to dealings in the shares of closely held, private corporations. By comparison, capital gains strips, as the phrase would suggest, are not aimed at
avoiding the second level of tax on corporate source income. Moreover, they involve bone fide arm's length dispositions (not incestuous sales) of any capital property (not just shares). Furthermore, though the nature of the benefits differ according to whether the taxpayer is an individual or a corporation, the advantages of capital gains strips are not available to individuals only, but accrue to any taxable person disposing of appreciated capital property.

The incentive to avoid capital gains tax was of course contemporaneous with the introduction of a capital gains tax in Canada as part of the 1972 reform package. Section 2 of the Income Tax Act brings 'taxable income' into charge and section 3 includes in the computation of income formula one half of all capital gains net of capital losses for the year. The Carter Commission had advocated the inclusion in income of all receipts, including capital gains, affecting an increase in the taxpayer's command over limited resources. This recommendation was based upon the four major policy considerations of vertical and horizontal equity, neutrality, and certainty. Horizontal equity imports the same tax treatment of taxpayers in similar circumstances i.e. enjoying receipts in the same amount. Vertical equity ensures that taxpayers who are in unequal economic circumstances are treated unequally e.g. increases in economic power through appreciation of capital assets is generally the preserve of upper income groups. If their
gains from property escaped taxation, these groups would effectively benefit from a lower average rate of tax than wage-earners who are unable to acquire investment properties. This disparity between upper and lower income groups would increase exponentially where a progressive rate schedule, such as Canada has adopted, is in place. The full inclusion of capital gains in income would have eliminated all avoidance techniques aimed at changing the tax character of a receipt from income to capital and vice-versa. As we have seen, a good deal of effort and expense has gone into combatting the more obnoxious avoidance practices. Even where there is no attempt at tax avoidance, the inclusion of all receipts in a comprehensive tax base would do away with the difficult and sometimes artificial distinctions that judges are constantly called upon to make with respect to the tax character of a receipt. Although the government of the day generally shared the same perceptions of policy, the Carter Commission proposals were not accepted. Perhaps partly as a result of submissions made by the Finance, Trade, and Economic Affairs committee of the House \(^2\), the hybrid system adopting the preferential treatment of capital gains was introduced.

It is beyond the scope of the present analysis to treat exhaustively of the economic arguments for and against capital gains tax. To but briefly mention the most important, it has been claimed that capital gains represent less tax-paying capacity than ordinary income receipts because they
are less regular, are frequently unforeseen, and may be soon followed by capital losses. As a prudent man therefore does not raise his level of consumption in response to these increments they do not constitute suitable objects of taxation. The point is also sometimes made that the tax furnishes an example of double taxation. Since capital appreciation is frequently a measure of the increased income an asset is expected to yield in future, capital gains taxes effectively tax that which will be taken into income at a later date. Further arguments point to the illusory nature of capital gains as merely reflecting changes in interest rates or shifts in the general price level, and to the deleterious consequences of the tax on individual and corporate saving, capital investment, mobility of capital, and risk taking.

The opposing philosophy argues that windfall gains increase the taxpayer's capacity to pay taxes precisely because they are not included in consumption expenditures. Moreover, on the generally accepted definition of income as consisting of consumption plus saving, no double taxation occurs where gains are taxed on the realization of an asset because the taxpayer can increase his consumption in an amount equal to the gain. Assuming he chooses to reinvest the proceeds of disposition, he should, arguably, be in no better position than a taxpayer investing solely with after tax dollars derived from savings. Gains on bondholdings due to downward fluctuations in interest rates are only illusory
if the asset is not sold and the proceeds not used for consumption purposes or for new investment operations (these being the modus operandi of the speculator).

As for the claim that a large component of any gain can be discounted for inflation, the answer can be made that inflationary pressures are brought to bear upon other sources of economic return. The Carter Commission considered the possible negative implications of the tax for personal and corporate savings, finding that these would be reduced by a negligible amount. \(^3\) There is, furthermore, no evidence to show that capital gains in fact diminish business initiative and risk taking. To the extent that the return on investment is expected to take the form of ordinary income, capital gains tax is irrelevant. Where capital gains are taxed in full, they are exposed to no greater tax burden than ordinary income. Where gains on property receive preferential tax treatment, the incentive to transform business income into capital gains is present. Though the mobility of capital is certainly impaired by the tax, it can be argued that this is a beneficial result, encouraging stability and responsibility in investment decisions and correspondingly discouraging less productive, transitory ownership. \(^4\)

b) History

The lynch-pin in capital gains stripping schemes is the intercorporate dividend which may be deducted from income pursuant to subsections 112(1) and 113(1).
It is perhaps ironic that a provision introduced for the relief of the taxpayer should over many decades have shown itself to be the tax avoiders most serviceable tool. Under the Income War Tax Act, all shareholders, including corporations, received dividends from taxable corporations free of tax. The rates did not discriminate between individual and corporate taxpayers, so that the corporation was essentially regarded as a conduit and a convenient point in the income flow at which to impose the tax. Not long afterwards, the rates of tax applicable to individuals and corporations began to differ and the double taxation of corporate source income was introduced. A perceived evil resulting from this change was the possible pyramiding of tax where dividends were paid to corporate shareholders. Accordingly, the Income War Tax Act was amended in 1926 to permit the tax free receipt of intercorporate dividends. This development therefore moderated the then recent tendency to regard corporations and their shareholders as distinct tax paying entities. As we have seen, the rule was immediately put to use in various types of dividend stripping transactions which lead to the imposition, in the form of designated surplus, of restrictions on the ability of corporations to transfer surplus without tax costs through dividend payments.

A further limitation on the tax free movement of surplus at the corporate level is found in the tax imposed upon the dividend income derived from portfolio investments
of private corporations. The obvious policy of the Part IV tax provisions is to prevent the undue deferral of investment income through the use of personal holding companies. And exception to the Part IV tax rules was provided for dividends received from controlled corporations on the hypothesis that such amounts were not properly the investment income of the recipient and did not involve a control of income flows greater than already existed. In an effort to encourage equity participation in small business enterprise, the 'control' test was in 1977 reduced to a 'connected', or 10% votes and value requirement where the payor of the dividend was a Canadian-controlled private corporation. This has of course facilitated avoidance schemes turning on the use of tax free intercorporate dividends, particularly in connection with the redemption of shares possessing a low paid up capital. It is important to note that the 10% ownership requirement must be present only prior to the redemption, and not after payment of the dividend when the shareholder may no longer own any shares of the payor.

Another important 1977 development was the increase in the dividend tax credit. This narrowed the gap between capital receipts and payments taken into income as dividends. This gap had previously been the battleground for taxpayers and revenue officials but a difference of 8% in favour of capital gains treatment benefiting only the highest income group evidently did not justify the expense and administrative complexity of prolonging the war. This led directly to
the repeal of designated surplus. As we shall see, one variety of strip requires a preliminary rollover of the shares of an operating company into a holding company, followed by the removal of the operating company's surplus to the holding company by means of dividend payments. Under the former designated surplus provisions, the operating company's pre-acquisition surplus would be locked in by a 25% tax payable by the dividend recipient and only post-acquisition surplus might be moved up to the parent holding company. This would however not present a problem where the shares of the operating company had been transferred to the holding company early on. In such a case, the 'control period earnings' i.e. post-acquisition surplus, would likely approximate the surplus on hand. Also, even in circumstances where designated surplus would have presented a problem, alternative means of accomplishing the strip, asset sales for example, might have offered a solution. There can be no doubt, however, that the repeal of designated surplus has provided the tax planner with greater flexibility. In addition, it is worth mentioning in a general way that the government's decision to abandon the tax probably encouraged capital gains strips for no other reason than it created a favourable climate for acquisitions, facilitating them by permitting the earnings of the target to be used in the financing of takeovers.

Prior to tax reform in 1972, corporate surplus distributions were treated as dividends to the extent of
any undistributed income on hand. Amounts distributed in excess of "undistributed income on hand" (UIOH) upon a liquidation of the corporation or a redemption of shares were regarded as a return of capital. The tax reform legislation reversed this order of distributions, permitting a non-taxable return of paid up capital, a concept originally defined so as to correspond with corporate paid up capital, in advance of further distributions, which were to be treated as dividends. The paid up capital concept was then seen as only partially fulfilling its promise of permitting the shareholder a recovery of his investment because where shares were issued at a premium or where property was contributed to a corporation large amounts of paid in capital were not reflected in the paid up capital of the shares. In order to bring contributed surplus and share premium accounts into paid up capital, the latter expression was redefined in 1974. The determination of paid up capital was greatly complicated however, because it now required the computation of contributed surplus from the inception of the company (as well as the paid up capital deficiency of the corporation which when deducted from the paid up capital fixed the amount that might be distributed tax free, known as the paid up capital limit). As part of the movement towards simplification of the tax system which came to fruition in 1977, the definition of paid up capital was once more made to agree with corporate paid up capital.

When corporate surplus was distributed as a dividend
to the extent of income on hand, the shareholder could clearly not control the nature of his receipts. If the payor corporation possessed little in the way of earnings, a large payment would naturally take the form of capital. Under a definition of paid up capital such as was introduced in 1974, choice is also lacking because paid up capital is statutorily determined. When in 1977 paid up capital was once more brought into line with paid up capital for corporate law purposes, the taxpayer acquired a measure of control over the tax consequences attaching to his receipts. This freedom was the more useful as the above noted increase in the dividend tax credit made the choice of dividend or capital receipts upon the realization of their investment of interest to individual shareholders who would decide in favour of one or the other in accordance with their marginal rates. In a subsection 85(1) rollover situation, for example, a taxpayer desiring capital gains treatment on the excess of his receipts over the elected amount might take back redeemable\textsuperscript{1} no par value preference shares with a redemption amount equal to the fair market value of the property rolled into the corporation. The paid up capital of no par value shares is the amount paid for them or the fair market value of property in consideration of which they are issued. Thus, upon a subsequent redemption of the shares, no deemed dividend would arise and the amounts received in excess of the elected amount (and ACB) would be treated for tax purposes as a capital gain. Dividend
treatment could now also easily be secured upon a buy-back of shares. This was especially attractive to corporate shareholders because dividends would be deducted from income pursuant to subsection 112(1). Assuming that the taxpayer had a preference for dividend treatment, he might take back redeemable preference shares with a low par value. Thus, upon a share redemption, the difference between the paid up capital (par value) and the redemption amount (FMV) would come into income as a dividend and to the extent of the dividend there would be no capital gain.

A 1974 development that is largely responsible for opening the door to capital gains strips was the repeal of the requirement in subsection 85(1) that the transferor own 80% of all classes of the transferee corporation. The new rule stipulated only that the transferor should take back shares of the transferee. Prior to 1974 taxpayers frequently engaged in step transactions in order to avoid the 80% rule. For example, owners of unincorporated businesses wishing to combine their operations and to conduct them in corporate form would first roll assets into separate companies and then amalgamate. Apart from the added expense of duplicating the initial step, there was considerable doubt as to the propriety of this procedure. Feelings that the 80% requirement was too restrictive thus led to the change in the rule. An important consequence of the new development, however, was that the subsection 85(1) rollover might be employed as a method of disposing of eligible
property to a Canadian corporation in an arm's length transaction.

As time passed and enabled tax planners to adopt a critical perspective on the above described developments, it became clear that a number of schemes might be devised to virtually eliminate the incidence of capital gains tax at the corporate level and to provide individuals disposing of capital assets to corporations with unlimited deferral of tax. The following are the types of arrangements employed by tax planners to achieve these results.

c) **Share sales**

Consider the following corporate structure:

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 X
 / \
HOLDCO
 / \
OPCO
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The capital gains tax normally applicable to a sale by Holdco of its appreciated Opco shares might be eliminated by having Opco pay a cash dividend to Holdco sufficient in amount to reduce the fair market value of the Opco shares to their adjusted cost base. Needless to say, the surplus of Opco could be removed on a tax free basis by means of a subsection 112(1) intercorporate dividend. A minor variation on this fact situation which perhaps involves a step transaction
problem occurs where X rolls his shares of Opco into Holdco prior to payment of the dividend and the sale of the Opco shares. It may happen that the earned surplus in Opco available for distribution as a dividend to Holdco will be insufficient to bring the fair market value of the shares in line with their adjusted cost base. In such a case, thought might be given to reappraising the capital assets of the operating company and creating an appraisal surplus out of which a dividend can be paid under the corporate law (assuming, of course, that Opco has sufficient cash on hand).

As an alternative to the payment of a cash dividend, Opco might increase its paid up capital by capitalizing earned, contributed, or appraisal surplus. Subsection 84(1) provides that a deemed dividend to Holdco will result from this transaction. This procedure will also 'bump' the adjusted cost base of the Opco shares to Holdco by operation of paragraph 53(1)(b), so that it might equal the fair market value of the shares and permit their disposition without tax cost. This scheme would however not appear to be universally available, as not all corporation statutes permit an increase in paid up capital without a corresponding increase in issued capital.

Where this is a problem, the payment by Opco of a stock dividend could lead to the same result. It should be noted that this alternative is available only if Opco is a private corporation. Only taxable dividends received by
a corporation may be deducted from income, and, by virtue of the definition of 'dividend' in subsection 248(1), stock dividends paid by public corporations after March 31, 1977 are not 'dividends'. The amount of a stock dividend is the amount of the surplus capitalized in respect of it, and this figure also constitutes its cost to the shareholder under paragraph 52(3)(a). The amount of the stock dividend should be sufficient to raise the average adjusted cost base of all shares of Opco held by Holdco to the fair market value of the Opco shares. This upward averaging is provided for by the 'identical properties' rule contained in section 47 of the Act. Where the shares of Opco were issued prior to 1971, Itar 26(8) provides that the adjusted cost base of the new post-71 shares will not be averaged in with that of the pre-72 shares. This does not present any special difficulty however because the stock dividend will also reduce the fair market value of previously issued shares so that the proceeds of disposition may yet not exceed the adjusted cost base of the shares.

As a further alternative to the above described measures, Opco might purchase all of its shares but one for cancellation from Holdco. Subsection 84(3) provides that in such circumstances Holdco will be deemed to have received a dividend equal to the excess of the amount paid over the paid up capital of the shares. The only apparent tax cost would be the small gain from the disposition of the outstanding share. This procedure would seem to involve certain risks however. Holdco and Opco are not at arm's length. Accordingly the
Opco shares must either be bought back at their fair market value or, by virtue of section 69, Holdco will be deemed to have received proceeds of disposition equal to the fair market value. In the former case, it is difficult to see what would be left in the corporation of any value, as the share values presumably represent paid up capital, earned surplus and other surplus accounts, and the appreciated value of goodwill and other assets. In the latter case, assuming the shares of Opco had been redeemed at less than their fair market value, the deemed proceeds of disposition (together with the actual proceeds) might so far exceed the deemed dividend that a capital gain might arise. Needless to say, this would constitute a counterproductive result. Probably the best course would be to have Opco repurchase but a portion of Holdco's shareholding, reducing the fair market value of the remaining Opco shares so that it approximated their adjusted cost base. The remaining shares would then be disposed of by Holdco to the purchaser.

In a case where the liquid assets of the operating company were insufficient to pay a cash dividend to the holding company, or where an appraisal surplus or other surplus account failed to supply a fund for capitalization and the forcing out of a deemed dividend, the buyer might inject the necessary cash (effectively the purchase price) by subscribing for shares of the operating company. These assets might then be used to pay a dividend to the holding company or to repurchase the Holdco's shares for cancellation.
It would, of course, be necessary for the purchaser to take back shares of a different class than are owned by the holding company (as well as to take at least one common share if the Holdco shares are to be cancelled). As the purchaser's shares would not be redeemed, it would also be advisable to give them a high paid up capital (where the purchaser is an individual) to avoid the locking in of the investment capital.

Capital gains stripping manoeuvres were also available where a shareholder wished to be cashed out. This situation would of course frequently arise in connection with private corporations the constitutional documents of which imposed share transfer restrictions prohibiting sales to outsiders. It would be necessary as a preliminary step to reorganize the capital of the corporation to give the vendor a different class of shares than were held by the remaining shareholders. The change would normally involve the conversion of common into redeemable preference shares possessing a low paid up capital and might be effected pursuant to sections 51 or 86. The selling shareholder would of course have to roll his shareholding into a holding company either prior to or following the reorganization. A portion of the cash dividend received by the Holdco would in effect represent earned or other surplus attributable to other shares. Alternatively, any of the measures previously discussed having to do with the payment of a deemed dividend by the capitalization of surplus prior to a
tax free sale of the Opco shares to the remaining shareholders might be implemented. It should be remembered in all cases however that a dividend is payable out of earnings or surplus, and that if the goodwill value of the Opco attributable to the vendor's shares exceeds the balance in these accounts, payment of the dividend would probably offend the relevant corporate law. Where this is a concern, thought should be given to having the remaining shareholders contribute capital or make loans to the corporation in the necessary amount.

Another useful device of special interest in acquisition transactions involving public companies is the share for share exchange set out in section 85.1. Where the section 85.1. rollover is employed, a choice of capital gains or dividend treatment on the realization of his investment may be offered the shareholder of the target if the plan of arrangement, amalgamation, or other governing document permits him to elect either for a class of redeemable shares possessing a paid up capital equal to the redemption amount (for a capital gain) or for shares with a paid up capital equal only to the adjusted cost base of the shares given up (for a deemed dividend). In the latter case, if the shareholder of the target is a corporation, the dividend will pass tax free and the vendor will have avoided capital gains tax on the disposition of the shares. The same share exchange mechanism is available under subsection 85(1) where the shares of a private or public company with little
dispersal of share ownership are rolled into the purchaser corporation.

d) Asset Sales

The foregoing procedures all involve the sale, exchange, redemption, or repurchase for cancellation of the vendor's shares. Capital gains strips may also be implemented where assets are disposed of by a corporation resident in Canada to a taxable Canadian corporation. These transactions differ somewhat from ordinary asset sales however, in that the rollover provision in subsection 85(1) is necessarily employed as part of the avoidance scheme. Thus the purchaser will not benefit from a higher cost for opening inventory, an increased basis for capital cost allowance purposes or for the write-off of eligible capital expenditures, etc. The tax attributes of these properties will flow through to the purchaser. Accordingly the price paid in 'asset' acquisitions of this type would likely be discounted in a manner normally encountered in share sales.

In 'asset' sales it is unnecessary for the shareholders of Opco to first roll their shares into a holding company as the operating company, denuded of its assets and undertaking, would itself be transformed into an investment holding company. The assets are of course exchanged for 'high-low' redeemable preference shares which are immediately bought back by the purchaser corporation. The intercorporate
dividend is of course paid without tax cost and the vendor corporation is left with tax free dollars realized from the sale of its business and properties. Again, Part IV tax will be a concern, especially where a small business is being acquired by a larger enterprise, and use of a 'clean', wholly owned subsidiary of the purchaser corporation formed in order to make the acquisition may be necessary to guarantee that the vendor takes back at least a 10% or, if the buyer is a public company, a 51% interest in the payor corporation.

The planning techniques that have been described imported the virtual abolition of capital gains tax at the corporate level together with unlimited deferral of tax for individuals disposing of capital property held by corporations they control. Following a capital gains strip, the vendor corporation would normally be left with liquid assets available for all manner of investment operations. Thus the rollover and intercorporate dividend provisions were employed not merely to accomplish a tax free exchange of assets, but the tax sheltered realization of appreciated capital assets. It is of course true that individual shareholders benefited only to the extent that corporate distributions were deferred, but Revenue Canada has always properly regarded the unlimited deferral of tax as equivalent to the non-payment of tax. Considering the effects of inflation and the income earning capacity of the tax dollars withheld, the government's position is entirely
comprehensible. Moreover, the individual shareholder might further benefit from the anomalies of the dividend tax credit where e.g. a spouse with no other source of income were paid dividends on shares acquired in the holding company. In addition, the possibility of taking receipts in excess of the cost of the shares as dividends or capital gains, depending upon the most tax beneficial result, remained open to the shareholder.

e) Subsections 55(2)-(5)

i) Introduction

For some time the government's policy position on capital gains strips was expressed in the so-called 'Robertson rules', according to which the capital gain was artificially reduced if it was less than the post-71 increase in the value of goodwill and other capital assets of the corporation.  

The government's response to capital gains strips had to be carefully considered because the avoidance techniques employed by the taxpayer depended upon statutory rules and results that served important policy objectives. Restrictions on the use of rollovers, for example, might seriously impair genuine corporate reorganizations and limitations on the ability of corporations to pay tax free intercorporate dividends might lead to the pyramiding of tax on corporate source income. Instead of amending the rules already in place, the government eventually decided
to launch its attack upon capital gains strips through a new anti-avoidance provision. The result is a somewhat loosely drafted miniature code designed to catch and deal with the many various capital gains avoidance schemes. The following features stand out in boldest relief.

1) The payment of a deductible intercorporate dividend to a corporation resident in Canada is identified as the lynchpin of all capital gains strips and accordingly constitutes the most basic condition of applicability of the new rules.

2) A 'purpose' and, in the case of intercorporate dividends arising under subsection 84(3) (essentially redemptions and other buy-backs) a 'results' test. It is perhaps not entirely clear from the wording of subsection 55(2) whether the 'purpose' or 'result' is that of the dividend or of "a transaction or event or a series of transactions or events". There is no doubt, however, that the specific purpose or result must be "a significant reduction in the portion of the capital gain that, but for the dividend, would have been realized on a disposition at fair market value of any share of capital stock immediately before the dividend". An important question with far reaching implications bearing upon the interpretation and administration of the new provisions, is the nature of the subsection 55(2) purpose test. This matter will be later taken up in detail.

3) The limitation to be imposed upon the payment of tax free intercorporate dividends is itself circumscribed
by the principal exemption for "income earned or realized by any corporation after 1971 and before the dividend was received". What this means is that to the extent that the distributing corporation possesses post-1971 tax retained earnings, it may pay pre-sale tax free intercorporate dividends without regard for the new rules. This is a clear expression of the underlying policy. Post-71 income has already borne tax at the corporate level and will (in the case of public corporations especially) be taxed again when received by the shareholder. As for pre-72 income and other pre-reform asset values of the corporation, these will be reflected in the adjusted cost base of the shares. Thus, all that is left as a target for the new rules is an intercorporate dividend partly or wholly representing the increase after 1971 in the value of goodwill and other capital assets, effectively the values which would be recognized as gains upon a sale of those assets. In addition to the important exemption for post-71 income, subsection 55(2) is also inapplicable in circumstances where the dividend, though deductible, is subject to part IV tax.

4) The tax consequences of paying a dividend in excess of post-71 income are delineated in paragraphs 55(2)(a), (b), and (c). Paragraph 55(2)(a) provides that, except for the purpose of computing the dividend recipient's cumulative deduction account, the dividend shall be deemed not to be a dividend. The main consequences of paying a
dividend in contravention of the new rules are set out in paragraphs 55(2)(b) and (c). Paragraph 55(2)(b) provides that where a corporation has disposed of the share the gain from the disposal of which was unduly reduced by the dividend, the dividend shall be deemed to be proceeds of disposition. Where a corporation has not disposed of the share, paragraph 55(2)(c) provides that the dividend will be deemed to be a gain of the corporation for the year in which the dividend is received. Paragraph 55(2)(c) is tied to the fact pattern in subparagraph 55(3)(a)(ii), in which a purchaser injects funds into the target corporation pursuant to a subscription for shares and these funds are then diverted to the corporate vendor whose interest in the target company is not completely terminated.

A consequence of the capital gain/proceeds of disposition dichotomy is that the sale by a parent of its shares in a subsidiary may give rise to large proceeds of disposition for the year of sale. In circumstances where the subsidiary has paid dividends in excess of post-71 income over a period of years, paragraph 55(2)(b) will deem the full amount of the dividends to be proceeds of disposition and, as such, will treat the amount as having been received following the disposition. This result is perhaps particularly harsh in view of the fact that paragraph 55(2)(f) will permit the taxpayer an election to reduce the amount of the dividend which is 'offside' i.e. in excess of post-71 income, only where there has been a repurchase by the
corporation of its own shares, and not an arm's length sale to a third party. Indeed, the need would seem to be greater in circumstances where the dividend is received otherwise than as a subsection 84(3) dividend.

(ii) Non-Arm's Length Exception

A further limitation on the scope of subsection 55(2) is found in the requirement (in subparagraphs 55(3) (a)(i) and (ii)) that the property be disposed of to an arm's length purchaser, or that the increase in interest in the target be that of an arm's length party. As a result of this self-evident condition, it was also necessary to guard against the possibility that the parties might structure their transactions so as to bring themselves within the statutory concept of relatedness set out in subsections 251(2) or (3) of the Act. Consider the following example:

<table>
<thead>
<tr>
<th>BUYCO</th>
<th>49%</th>
</tr>
</thead>
<tbody>
<tr>
<td>X</td>
<td></td>
</tr>
<tr>
<td>OPCO</td>
<td>assets</td>
</tr>
<tr>
<td>shares</td>
<td>51%</td>
</tr>
<tr>
<td>SUBCO</td>
<td></td>
</tr>
</tbody>
</table>

Buyco, wishing to acquire the assets of Opco, incorporates Subco to make the acquisition. Opco then rolls its assets into Subco in return for 'high-low' redeemable preference shares carrying with them voting control of the Subco. The subsequent redemption of the Subco shares held by Opco would then not be "a disposition of property to a person with whom (Opco) was dealing at arm's length" within subparagraph 55(3)(a)(i). The dividend upon the redemption would however
nevertheless be caught because there would result a significant voting and proprietary increase in the interest in 'any' corporation i.e. the Subco of a corporation, the Buyco, which is at arm's length with the Opco within subparagraph 55(3)(a)(ii).

Let us now assume that instead of having the Opco acquire voting control of Subco, Subco subscribes for shares of Opco carrying with them voting control of Opco with the result that Opco and Subco are non-arm's length pursuant to subparagraph 251(2)(b)(i). The shares of Opco taken by Subco have a paid up capital equal to their cost and fair market value. Opco then rolls its assets into Subco in return for preference shares as before, and these are subsequently redeemed, resulting in a deemed dividend to Opco. Later the Opco shares held by Subco are repurchased for cancellation at no tax cost to either party. Upon the redemption of the Subco shares held by Opco, there is neither a disposition of property to a person at arm's length with Opco (55(3)(a)(i)), nor an increase in the interest of any person at arm's length with Opco in any corporation (55(3)(a)(ii)), because Buyco and Opco are non-arm's length. On a buy-back of the Opco shares held by Subco, there is, by reason of X reacquiring control of Opco, an increase in the interest in Opco of a person at arm's length with Subco, however there is no dividend on the buy-back because the shares repurchased have a high paid up capital and were issued solely in order to bring Subco and Opco into a non-arm's
length relationship. In order to discourage such schemes, subsection 55(4) provides as follows:

Where it may reasonably be considered that the principal purpose of one or more transactions or events was to cause two or more persons to not deal with each other at arm's length so as to make subsection 2 inapplicable, for the purposes of that subsection, those persons shall be deemed to deal with each other at arm's length.

Thus, in the second example considered above, the 'principal purpose' of the issuance of voting shares of Opco to Subco is to bring them into a non-arm's length relationship so as to make subsection 55(2) inapplicable. Accordingly, the parties will be deemed to be at arm's length.

The 'principal purpose' requirement is an important feature of subsection 55(4) which can, in unusual circumstances, come into special prominence. Consider the following example:

The ownership of S1 is divided between Buyco and S2 on the basis of 49% and 51% interests respectively. S2 is originally the wholly owned subsidiary of S1, however the redeemable preference shares taken by Opco as part of the subsection 85(1) rollover of its assets into the S2 carry with them voting control. Upon the redemption of the S2 shares held
by Opco, subparagraph 55(3)(a)(i) provides that the dividend avoids the consequences of paragraph 55(2)(b) because Opco and Subco 2 are non-arm's length (pursuant to subparagraph 251(2)(b)(i)). In addition, there is no increase in the interest of a person at arm's length with Opco in S2 because subparagraph 251(2)(b)(i) and subsection 251(3) provide that Opco and S1 are also non-arm's length. It might be argued that although Buyco has neither a proprietary nor a voting interest in S2 its indirect economic interest in S2 is increased by virtue of S1's reacquisition of a 100% interest in S2. The writer submits that this does not present a problem because neither S1's direct nor Buyco's indirect economic interest in S2 is increased following the redemption of the shares held by Opco. S2 has eliminated its liability on the shares but has also commensurately decreased its asset value.

Assuming that the incestuous intercorporate shareholding pre-exists the transfer of the Opco assets and is unconnected with the rollover, a strong case can be made for saying that the 'principal purpose' of the issuance of voting shares of S2 to Opco was not to bring the parties into a non-arm's length relationship. The phrase 'principal purpose' clearly suggests the specified purpose must predominate over other purposes while the issuance of S2 shares to Opco is done as much to accomplish the rollover of assets (a common feature of the types of transactions under discussion) as to create a non-arm's length relationship.
The exemption for non-arm's length transactions is perhaps explained in part by a desire to preserve the tax free consequences of estate freezing operations. The result is that estate freezing will permit the freezor to realize his investment in the operating company free of tax (and subsection 55(2)) by means of the rollover and intercorporate dividend rules and the exemption in subsection 55(3) for non-arm's length transactions. In order to accomplish this, it will of course be necessary for the freezor to roll his preference shares into a personal holding company prior to their redemption.

The fairness of permitting non-arm's length parties engaged in estate freezing transactions to enjoy the benefits of capital gains strips is perhaps questionable. Once the future growth and, perhaps, voting control has been transferred to the next generation, it is arguable that the objects of the freezing procedure have been achieved. The notion that the tax consequences to the freezor ought to be deferred should, it would seem, be premised upon the assumption that the receipt and use of the proceeds are also deferred. Taking a tax free intercorporate dividend in satisfaction of his interest in the operating company permits the freezor to transform the proceeds into new and different investment forms as he desires. This feature of the transaction strongly suggests that a disposition has occurred in an economic sense. There would seem to be no compelling reason to extend the deferral advantage available
to the freezer beyond that effected by the tax free transformation of his interest from a participatory to a non-participatory one.

(iii) Significant Reduction

It is further required that the reduction in the capital gain be 'significant'. No indication is given regarding meaning of this expression. Is a $5,000 reduction in what would otherwise be a $15,000 gain 'significant'? Probably it is. But what of a $5,000 reduction of a $500,000 or $5,000,000 gain? Certainly the reductions in the gain in the two latter mentioned cases are less significant than in the former case. In the first example the gain is reduced by 1/3, while in the remaining two it is reduced by 1/100 and 1/1000 respectively. It is likely that the government would tend to regard the measure of what is significant strictly in terms of dollars rather than in terms of fractions of the total gain. Any loss of tax revenues on $5,000 is 'significant' to the government regardless of the amount of the gain which is recognized as a result of the transaction. It should be noted, however, that the reduction which must be 'significant' is in the portion of the gain otherwise realizable. The word 'portion' would clearly suggest a part or fraction of the gain rather than a specific amount. Moreover, if what is 'significant' does not vary from case to case by comparison with the recognized gain, but is a constant amount in dollars for all transactions, why would the legislator not simply
stipulate in precise terms the amount intended?

(iv) **Butterflies Are Free**

Paragraph 55(3)(b) contains an exception to the normal rules in subsection 55(2) in order to preserve the tax free consequences of certain corporate divisions or break-ups commonly referred to in tax jargon as 'butterflies'.

A fairly typical situation would arise in circumstances where equal owners of an operating company wished to part company and divide the corporate assets between them. For convenience, suppose that the assets consist of two separate businesses and it is agreed that each of the shareholders is to be left with one of the businesses following the reorganization.

The above diagram, known as the 'two-winged butterfly', illustrates the following steps: 1) The individual shareholders of Opco, X and Y, roll their Opco shares into personal holding companies XCO and YCO, taking back shares of the holding companies with the same paid up capital as the transferred shares of Opco: 2) new OXCO and OYCO are formed as subsidiaries of Opco; 3) Opco rolls the assets to be divided according to the intended ownership into OXCO
and OYCO in return for redeemable shares possessing a low paid up capital and a redemption amount equal to the fair market values of the transferred businesses; 4) XCO subscribes for common shares of OXCO, and YCO follows suit in respect of OYCO common shares; 5) OXCO and OYCO purchase all of their shares for cancellation from Opco; 6) Opco purchases its shares owned by XCO and YCO, or is wound up; 7) the wholly owned subsidiaries OXCO and OYCO are wound up into XCO and YCO respectively. In the final analysis, it is apparent that each of shareholders X and Y is left with his own operating company. Where it was desirable, the operating and investment incomes might be kept separate simply by dispensing with the last step.

A more frequently encountered variation of the above transaction involving less complexity and expense is the so-called 'single-winged butterfly'. Assume the same basic fact situation as in the previous example.

In the above diagram, Y has transferred his shares in Opco to YCO in exchange for common shares of YCO possessing the same paid up capital as the transferred shares of Opco. The assets of the business to be carried on by YCO are transferred by OPCO, again pursuant to subsection 85(1), in return for preference shares with a redemption amount equal to the fair market value of the business and with
a low paid up capital. The YCO preference shares held by OPCO should amount to at least a 10% voting and value interest in order that, upon their redemption, the taxable dividend may pass free of Part IV tax. OPCO purchases for cancellation its shares held by YCO and YCO redeems its preference shares held by OPCO. It will be noted that the movement of cash in this operation is circular, with the net result again being that each individual is left with his own operating company.

Such then are the types of transactions excluded by paragraph 55(3)(b) from the ambit of subsection 55(2). A major limitation of this exception is that the fair market value of each type of property distributed must approximate that proportion of the fair market value of property of that type owned by the distributing company before the division that the fair market value of the receiving company's shareholding (or the shareholding of a person who owns the receiving company's shares) in the distributing company is of the fair market value of the distributing company's shares. The obvious objective of this rather tortuous wording is to ensure that a corporate division is not employed for the purpose of cashing a selling shareholder out on a tax free basis. If, for example, the law merely required that the assets be divided in proportion to the respective equity interests of the shareholders in the distributing company, only liquid assets might be allocated to the selling shareholder.

The 'each type of property' stipulation would appear to be inflexible and arbitrary. Interpreted conservatively,
the provision would deny the exemption for corporate divisions where the corporation owned but one type of property. The government has let it be known that favourable rulings will be given so long as the distribution apportions 'hard' and 'liquid' assets in proportion to the relative equity interests such that each shareholder gets his pro-rata share of each type of asset. Although this is helpful in giving the paragraph some scope in which reasonably to operate, difficulties may continue to arise. Before dealing with these, it might be well to mention that paragraph 55(3)(b) perhaps itself creates an opportunity for capital gains avoidance. This loophole would be the more useful to taxpayers because of the specificity of the new rules. Cases strictly within the exemption of paragraph 55(3)(b) might be unassailable under subsection 55(1).

X and Y each own assets (or groups of assets) used in business. The assets are of the same type and possess the same fair market value. Each would like to exchange his assets for those of the other on a tax free basis. They each roll their assets into a shell corporation and take back common shares equal in value and in number. A single or two-winged butterfly is then used to divide the corporate assets among the shareholders with each taking the properties formerly belonging to the other.

As noted, the government has let it be known that 'types of assets' will be taken to mean 'hard' and 'liquid' assets. This interpretation does not lend sufficient flexibility to the section. For example, where two businesses
of equal value are being conducted by a single company and two equal owners wish to be left each with one business following the reorganization, a problem will arise where the hard and liquid assets of the two businesses are not of the same type. Even if the values of the two businesses are roughly the same, the fair market values of the hard and liquid assets may not be equal. Consider two businesses with the following assets and values breakdown:

<table>
<thead>
<tr>
<th>Business 1</th>
<th>Business 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goodwill</td>
<td>Goodwill</td>
</tr>
<tr>
<td>200</td>
<td>1000</td>
</tr>
<tr>
<td>Hard</td>
<td>Hard</td>
</tr>
<tr>
<td>700</td>
<td>100</td>
</tr>
<tr>
<td>Liquid</td>
<td>liquid</td>
</tr>
<tr>
<td>600</td>
<td>400</td>
</tr>
<tr>
<td>Total</td>
<td>Total</td>
</tr>
<tr>
<td>1500</td>
<td>1500</td>
</tr>
</tbody>
</table>

It can be argued from a policy point of view that the rollover ought to be preserved in a transfer of these businesses into separate companies. Neither shareholder, however, continues to own a 50% interest in the hard and liquid assets of the distributing company.

In certain circumstances, compliance with paragraph 55(3)(b) may demand additional, expensive, and unnecessary tax planning. Consider the following corporate structure:

A and B are equal shareholders of XCO, an operating company. YCO, also an operating company, is the wholly owned subsidiary of XCO. A and B would like to part company with B taking
over the business of YCO and X continuing to own the XCO business. The businesses are of equal value. B would like to continue operating the YCO as a subsidiary in order to keep the investment and active business incomes separate, and he is the sole shareholder of ZCO, an investments holding company.

A handy method for reorganizing the corporate structures according to the client's desires would be for XCO to roll the YCO shares into ZCO in exchange for redeemable preference shares. B also rolls his XCO shares into ZCO. This is followed by a repurchase for cancellation of the XCO shares held by ZCO and a redemption of the ZCO shares held by XCO. In the result, B diviest himself of his XCO shares, and YCO is the wholly owned subsidiary of ZCO. Unfortunately, paragraph 55(3)(b) would not appear to permit this result. A security representing an investment in a subsidiary may be classified as a hard asset. Even though the shares in effect represent a combination of hard and liquid assets vested in the subsidiary, the distribution to ZCO will constitute a transfer of more than 50% of the fair market values of the hard and liquid assets of XCO. In order to accommodate paragraph 55(3)(b) it is necessary first to wind up YCO into XCO, transfer the YCO business into ZCO and roll the investment properties of ZCO (including the YCO shares) into a new corporation. Alternatively, the YCO business could be transferred into a new corporation. This involves the unnecessary formation and dissolution of
companies.

It is important to note that the 'principal purpose' test in 55(3)(b) is extended by including in the series of transactions or events "any related transactions or events completed in contemplation of the series." Interestingly, the extension to the purpose test would seem to contemplate transactions or events completed following the reorganization. Consider the situation where V owns all of the shares of OPCO, which carries on two businesses. The assets of the business which V wishes to sell account for 1/4 of the fair market value of OPCO and the assets of the business to be retained represent the balance of OPCO's net worth. The relevant values are $25,000 and $75,000 respectively and the fair market values of the assets of both businesses are equally divisible into hard and liquid assets. V makes a contribution of $50,000 to the capital of OPCO. P subscribes for shares of OPCO, injecting $50,000 into the company and taking back shares with a fair market value equal to 1/4 of V's shareholding. After a short period of time, the company is split into two separate parts with P taking the smaller business as well as his 1/4 share of OPCO's hard and liquid assets.15

In the circumstances, the transaction complies with the provisions of paragraph 55(3)(b). P will take approximately 1/4 of the hard and liquid assets of OPCO, a fraction on all fours with his shareholding in that company. Whether or not it is caught by the proviso respecting additional planning depends upon the view taken of the expression "related
transactions or events completed in contemplation of the series".

(v) The Concept of Post-71 Income: Computational Rules and Comment.

Subsection 55(5) contains a number of rules applicable to the computation of post-71 income. Paragraph 55(5)(a) provides that where the sale price of shares is based upon an earn-out, that is, where the price is tied to the future profitability of the company, the taxpayer cannot claim that the avoided gain is attributable to post-71 income earned following the sale. This is a good indication of the official policy view that restricts post-71 income to tax retained income on hand. Although this restriction may be appropriate in the case of earn-outs, there are circumstances in which its validity is questionable. These will be examined later.

Paragraph 55(5)(b) contains provisions designed to make adjustments to the post-71 income of public corporations, and to take account of certain deductions from Division B income which do not involve actual disbursements. According to subparagraph 55(5)(b)(i) and paragraph 55(5)(c) the inventory and scientific research allowances are added back to post-71 income. These deductions do not involve the reduction of post-71 tax retained earnings and accordingly will continue to be reflected in the share values and the gains from the disposition of shares. The decision was therefore taken to permit the removal of these amounts by means of dividend payments prior to the sale of the shares.
Subparagraph 55(5)(b)(i) brings into post-71 income "½ the amount, if any, by which the aggregate of the capital gains of the corporation for the period exceeds the aggregate of its capital losses for the period." This represents the non-taxable ½ of capital gains which is not brought into income by subsection 3(b). These funds will increase the fair market value of a public corporation's shares and increase the gain upon their disposition. If a public corporation could not pay out these sums as a pre-sale dividend, the full amount of its capital gains would effectively be subject to tax because ½ of the gain would come into income when realized and the remaining ½ would itself be taxed as a gain upon a sale of the corporation's shares.

Private corporations of course have available the option of paying out the non-taxable ½ of capital gains by eliminating the balance in the capital dividend account. Such dividends are not taxable dividends and accordingly are not caught by subsection 55(2).

Subparagraph 55(5)(b)(iii) includes in the post-71 income concept the untaxed portion of receipts from the disposition of eligible capital property to the extent that subsection 14(1) brings these amounts into income. This provision is thus in the same spirit as that dealing with the untaxed ½ of realized capital gains. The untaxed portion of such receipts are not added to the post-71 income of public corporations where none of the proceeds are brought
into income but serve instead to reduce the corporation's cumulative eligible capital. Presumably, this is because amounts merely reducing the amortized amount are not subject to tax.

Paragraph 55(5)(b) takes into account the possibility that part of the fair market value of a corporation's shares may be attributable to an investment in a foreign affiliate. A foreign affiliate is defined in paragraph 95(1)(d) as a non-resident corporation at least 10% of the equity of which is owned by a Canadian resident corporation. It is also recognized that the Canadian corporation's shares might reflect values attributable to income earned or realized by the foreign affiliate after 1971 and which might normally be received as a tax free dividend pursuant to subsection 113(1). The income of a foreign affiliate is accordingly deemed to be the amount that would have been deductible pursuant to subsections 113(1)(a) and (b) on the assumptions that 1) the Canadian corporation owned all of the foreign affiliate's stock, 2) that all of the shares had been disposed of for their fair market value, and 3) that the Canadian corporation had made a 93(1) election in respect of the full proceeds of disposition. Subsection 93(1) permits a corporation resident in Canada to elect to treat the proceeds of disposition of the shares of a foreign affiliate as a dividend. The dividend will be deductible however only to the extent permitted by subsection 113(1). This provision applies to dividends paid out of exempt, taxable, and pre-
acquisition surplus of the foreign affiliate. It should be noted, however, that paragraph 55(5)(a) refers only to the portion of the dividend attributable to exempt and taxable surplus. Indeed, a portion of the taxable surplus itself may be excluded since paragraph 55(5)(d) makes no reference to paragraph 113(1)(c), which adds to the deductible dividend amounts paid in respect of non-business income tax. This omission may be explained by the fact that there will be no such tax i.e. withholding tax paid in the foreign jurisdiction because the subsection 93(1) election gives rise to a deemed, not an actual dividend. As for the pre-acquisition surplus of the foreign affiliate, presumably it would be reflected in the adjusted cost base of its shares held by the Canadian corporation and accordingly could not contribute to a capital gain upon a disposition of those shares. A possible problem in this regard is the case of a Canadian corporation acquiring the shares of a foreign affiliate with post-71 income. The adjusted cost base of the foreign affiliate's shares would then, it is submitted, be properly included in the post-71 income of the Canadian corporation. Another possible area of difficulty lies in the fact that the subsection 93(1) election can be made only in respect of exempt and taxable surplus as computed at the last year end. The amount of the deemed dividend which may be deducted pursuant to paragraphs 113(1)(a) and (b) i.e. the post-71 income of the foreign affiliate, will therefore not take
into account current exempt and taxable surplus. These amounts may therefore unduly increase the gain from the disposition of the shares by limiting the amount of the pre-sale dividend that the Canadian corporation may pay out to its parent.

Once the deductible portion of the subsection 93(1) dividend is determined, the post-71 income of the foreign affiliate may be computed by taking that fraction of the dividend that is the Canadian corporation's percentage ownership of the foreign affiliate. This follows from the use of the words "reasonably attributable to anything other than (post-71 income)" in subsection 55(2). As noted, the Canadian corporation's interest may vary from 10% to 100%.

Having examined the rules relating to the computation of post-71 income, the concept itself may be evaluated from a policy point of view. It should be noted at the outset that an 'onside' dividend may be paid out of the post-71 income of 'any' corporation. This provision accounts for the possibility that part of the value of the company's shares may derive from the post-71 income of a subsidiary.

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A
100%
B
100%
C
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In the above example, B has no post-71 income, however company C, in which B owns a 40% interest, has post-71
income of $100,000. In the circumstances, it would be reasonable to conclude that C's post-71 income contributes $40,000 (40% x $100,000) to the value of B's shares. Accordingly, it would be permissible and advisable for B to pay an exempt dividend to A prior to a sale of the B shares by A.

As is clear from the above example, only that portion of the gain realizable on a sale of the B shares that is 'reasonably attributable' to C's post-71 income may be removed prior to the sale. Thus, dividends in excess of $40,000 would be caught by subsection 55(2). The 'reasonably attributable' requirement is clearly envisioned as accomplishing a number of objectives. For example, it is clear that post-71 income means income computed for the purposes of division B. Losses and amounts paid for taxes and as dividends do not reduce Division B income, and yet, by reason of the 'reasonably attributable' test, it would appear that post-71 income does not include such amounts. The government's position, insofar as it might be determined, would seem to be that post-71 income is reflected in a corporation's shares on a dollar for dollar basis. However, the extent to which a gain realized upon the disposition of shares is reduced by losses and dividends may not even roughly approximate the arithmetic total of these amounts. For example, a price might be arrived at with regard to a corporation's income earning performance as measured by its
profits over a specified post-71 period of years. The impact of a loss incurred in one year might be discounted as an uncharacteristic error in judgement made by management or as a result of circumstances entirely beyond the corporation's control. The gain 'reasonably attributable' to post-71 income might therefore not be reduced by the loss on a dollar for dollar basis. The argument is perhaps better made in the case of dividends paid to shareholders. Dividend policies might reasonably be regarded as having no bearing whatsoever upon a price tied to post-71 earnings. The same might be said of taxes paid by the corporation.16

Further along these lines, what of post-71 income which has been transformed into increased plant capacity? Though not in liquid form, the post-71 income continues to have a bearing on the fair market value of the corporation's shares and upon the gain realized upon a disposition of them. What of the case of a subsidiary which acquires the shares of another corporation out of post-71 income and shortly thereafter disposes of the newly acquired shares at cost? The proceeds of disposition are not income for the purposes of Division B, being instead a return of capital. Thus the money cannot be recharacterized as post-71 income and would (unduly) increase the gain on a disposition of the acquiring company's shares by its parent.

Capital cost allowance enters into the computation of Division B income by reason of paragraph 20(1)(a). Consider
the case of a wholly owned subsidiary possessing no post-71 income but having $300 available for distribution to its parent. The $300 represents the difference between accelerated capital cost allowance taken and the actual depreciation booked in an accounting sense. The discrepancy is significant only from the point of view of timing because capital cost allowance claimed in future years will fall below the depreciation shown in the financial statements. Assuming that no pre-sale dividend is paid to the parent, a disposition of the subsidiary's shares would effectively expose a portion of the capital cost allowance claimed to capital gains tax. The purchaser would not obtain the benefit of an increase in the cost base of the depreciable property, being limited to taking depreciation on the balance of the seller's undepreciated capital cost. The objectives of the capital cost allowance system would thus seem to be defeated. The government would presumably argue that the $300 does not represent tax retained earnings i.e. earnings which have borne tax, however it will in fact be taken into income at a later date when the capital cost allowance falls below the actual depreciation booked for the year.  

It is not unlikely that slippage in the concept of post-71 income will occasion challenges to the government's interpretation of the new rules. This possibility is naturally enhanced to the extent that the taxpayer's circumstances evidence a genuine hardship case. It may be that some sacrifice of equity is justified by expedience,
however the justification of fiscal convenience varies in inverse proportion with the frequency of hardship cases and with their gravity.

The 1977 tax changes serving to stimulate corporate acquisitions have been noted. The years since 1977 have indeed seen an increase in takeovers, both friendly and hostile. An important and controversial facet of corporate acquisitions is the minority squeeze-out which involves the elimination of minority shareholders who resist the take-over. A tax planning technique often employed to help appease the minority involves offering these shareholders the choice of realizing upon their investment with a capital gain or a deemed dividend. Corporate minority shareholders (including investments holding companies) will naturally prefer dividend to capital gains treatment upon giving up their shares. Subsections 55(2)-(5) will now apply to these transactions so that dividends paid in excess of post-71 income of the target will be treated as proceeds of disposition to the recipient. The argument can be made that where the take-out is essentially compulsory and contrary to the desires of the vendors they should be offered the opportunity of transforming the proceeds into new and independent investment forms at no tax cost.

Even if this position is rejected, ambiguities in the post-71 income concept might easily lead to confusion in typical takeover situations. Consider the following
corporate structure:

Privco, a private holding company, owns all of the Opco shares and 80% of the target's shares. Privco wishes to combine the operations of Opco and Tarco. 10% of the minority shares are held by Minco, a Canadian corporation, and 10% are owned by individuals. The necessary shareholder's resolutions are passed and Tarco and Opco amalgamate. Pursuant to the terms of the amalgamation agreement the shares of the amalgamated company taken back by the minority may be redeemed by it or bought by Privco. The first option would secure to the shareholder deemed dividend treatment while the second would result in a capital gain to the shareholder. Prior to the amalgamation, Opco had $100,000 of post-71 income, while Tarco had only $1,000 of post-71 income, most of its value being due to goodwill appreciation. There is, of course, the question to consider whether the use of the word 'reasonably' in subsection 55(2) would require that the post-71 income be allocated amongst all the shareholders in accordance with their proportionate shareholding interests, or whether a greater amount might be allocated
to the selling shareholder's stock. Assuming that the post-71 income were apportioned rateably amongst the shareholders in accordance with their relative interests in Amalco, would the amount of post-71 income available for distribution to the minority shareholders represent their proportionate share of $101,000 (the post-71 income of Amalco) or $1,000 (that of the predecessor corporation Tarco)? It would appear that "the capital gain that, but for the dividend, would have been realized on a disposition at fair market value of any share of capital stock immediately before the dividend" means the capital gain that would have arisen on a disposition of the preference shares of Amalco. Unless subsection 55(2) intends that the attributes of non-existent corporations be taken into account, Amalco represents the only company to which it might apply in the circumstances. In other words, Minco would appear to enjoy a benefit in the increase of post-71 income available for distribution upon redemption of the Amalco shares held. This might permit the receipt of the proceeds tax free or, assuming a paragraph 55 (f) election, at a reduced tax cost.

(vi) Subjective or Objective Purpose?

In order for subsection 55(2) to apply, one of the purposes of the transaction or series of transactions must be the reduction of the capital gain that would have been realized on the disposition of any share. A difficult and
and important question centers upon whether this purpose test creates a condition of applicability of an objective or a subjective nature. In other words, the question is whether a particular motivation or objective i.e. the reduction of a capital gain, must be ascribed to the taxpayer or whether all that is necessary is that a reduction in the gain should in fact result from the payment of the dividend. For example, a parent corporation adopts over many years, and in connection with some business purpose, the practice of having its wholly owned subsidiary pay dividends which commonly exceed the post-71 income of the subsidiary. At the time the dividends are paid, the parent has no intention of disposing of the subsidiary's shares. An attractive offer for these shares is made by a prospective buyer. The shares are sold and the gain is reduced by reason of the prior years' dividend policies. If the subsection 55(2) purpose test requires some positive element of intention to reap a fiscal benefit, it would be open to the parent to argue that none of the purposes of the dividend payments was the reduction of the capital gain. It must be remembered however that any 'secondary' intention of the parent to reduce the gain in the event of a future sale of the shares would suffice to bring subsection 55(2) into play, because the reduction of gain need be but one of the taxpayer's purposes. On the other hand, if the actual reduction in the amount of the gain suffices to establish the requisite purpose, then the dividend would be regarded
as taxable proceeds of disposition pursuant to paragraph 55(2)(b).

It is at least arguable that the better view is that 'purpose' refers to the actual consequences of a transaction or series of transactions rather than to any tax-saving motivation of the taxpayer. The plain words of the statute speak of the purposes of transactions, not of taxpayers. In addition, the subsection 55(2) purpose test is effectively qualified and circumscribed by the 'results' test in subsection 55(3). The latter subsection can be regarded as imposing necessary restraints on a subsection 55(2) objective purpose test that would otherwise operate where there had been no disposition of property or increase in interest of an arm's length purchaser in any corporation. Presumably, a subjective purpose to reduce a gain would always result either in a disposition or increase such as are contemplated in subparagraphs 55(3)(a)(i) and (ii). The discrepancy between a 'purpose' and 'results' test in subsection 55(2) would then be explained by the fact that since subsection 84(3) transactions always involve a disposition, the stipulation in express terms of a 'results' test was in the particular case both possible and appropriate.

Neither an objective nor a subjective purpose test serves the policy and equity objectives of the new rules in all circumstances. Consider the following corporate structure:
Vendco owns all of the Holdco shares and Holdco in turn owns the Subco shares. Vendco would like to dispose of the Holdco shares to Buyco for $1,000. Neither Holdco nor Subco possess any post-71 income however Subco has surplus of $300 available for distribution under the relevant corporate law. Subco pays this amount out as a dividend to Holdco. This transaction creates post-71 income in the Holdco because dividends received are included in the computation of income for the purposes of Division B. Therefore, prior to the sale of the Holdco shares to Buyco, a dividend of $300 may be paid to Vendco out of Holdco’s post-71 income that reduces the market value of the Holdco shares and the gain realizable upon their disposition. It would appear that this operation effectively permits the reduction of the gain in excess of the post-71 income on hand in the chain prior to the series of transactions.

In the above illustration, the dividend from Holdco to Vendco could not be impugned because it is paid out of post-71 income. Assuming that subsection 55(2) contains
a subjective purpose test, it would be difficult for the
government to argue that the taxpayer's purpose was to
reduce the gain that would have arisen on a sale of the
Subco shares held by Holdco because the taxpayer (Vendco)
manifestly had no intention of disposing of the Subco
shares. If, however, the objective purpose test is applied,
it is possible to say that one of the purposes i.e.
consequences or results, of the Subco-Holdco dividend is
the reduction of the capital gain that, but for the dividend,
would have been realized on a disposition of the Subco
shares.

Support for a subjective purpose test can, however,
be found in the following example. Consider a genuine,
bone fide estate freeze in which the freezor does not roll
his preference shares into a personal holding company
but redeems them instead in a piecemeal fashion in gradual,
taxable dispositions. The funds used to redeem his shares
are funnelled through to the holding company (owned and
controlled by the next generation) by Opco but exceed the
post-71 income of Opco. The children then decide to sell
the Opco shares to a purchaser in a cash transaction. Assuming
that the subsection 55(2) purpose test is really more in
the nature of a results test, it follows that one of the
'purposes' of the dividend paid by Opco to Holdco is to
reduce the gain that would have been realized (and, indeed,
that was realized) upon the disposition of the Opco shares.
This result is clearly unsatisfactory and results in a measure
of double taxation (equal to the amount of the offending dividend) in that amounts upon which capital gains tax has been paid by the freezor will subsequently be treated as proceeds of disposition to the next generation. In such circumstances, the taxpayer's claim that it was manifestly not the purpose of any transaction to eliminate or reduce the gain from the disposition of any share is most persuasive. Alternatively, the argument might be made that the dividend was not received as part of a series of transactions or events that resulted in a disposition of any property, in accordance with subparagraph 55(3)(a)(i). In order to be a 'part' of a transaction or series of transactions presumably more is required than that the dividend should precede the disposition or increase in interest. On the other hand, a causal connection between the dividend and the reduced gain is all that is called for to make of the dividend a 'part' under a straightforward results test.

In the final analysis, the purpose of the series of transactions will be dealt with as any question of fact. The subjective motivations of the taxpayer will be relevant only to the extent that the evidence otherwise adduced is ambiguous. The 'purpose' then is indeed that of the 'series of transactions' rather than of the taxpayer, as the statutory language would suggest, however it is submitted that subsection 55(2) clearly contemplates the possible co-existence of a gain-reducing dividend with a predominating business purpose, just as subsection 247(2) envisions the fiscal propriety of
family members owning non-associated Canadian-controlled private corporations. In the case of the latter subsection, none of the main purposes of the taxpayer's transactions may be tax avoidance; in the case of subsection 55(2) tax avoidance may not be 'one of the purposes'. In either situation, the heavy onus will be on the taxpayer to extricate himself from the provisions of the law, but imprecisions in the statutory language will likely facilitate his task.

Occasionally, it may be possible for a situation in principle within the intendment of subsections 55(2)-(5) to avoid the consequences of the provisions because their wording cannot, on a natural and plain reading, cover the particular case. Consider the simple situation where the Opco rolls its assets into the Buyco in return for redeemable preference shares structured such as to give rise to a deemed dividend upon redemption. A tax free subsection 112(1) dividend is received by Opco. The 'taxable dividend' to which subsection 55(2) refers can only be the subsection 112(1) dividend. The shares referred to can only be the shares of Opco or the redeemable Buyco shares.

Opco shares: Can it be said that one of the results of the series of transactions is to reduce the capital gain that, but for the dividend, would have been realized on a disposition of the Opco shares immediately before the dividend? It is apparently necessary that the reduction in the capital gain on the hypothetical sale of the Opco shares should have
arisen 'but for the dividend'. This is, it would seem, why the imagined gain is computed on the basis of a disposition 'immediately before the dividend'. But the gain on the sale of the Opco shares would not be reduced by the dividend arising from the redemption of the Buyco shares because the same values would be reflected in the Opco shares before as well as after the payment of the dividend. No reduction occurs, then, 'but for the dividend'. In order to read the provision in a manner favourable to the government, it would be necessary to understand 'but for the dividend' to mean 'but for the series of transactions' or, more precisely, 'assuming the taxpayer had not received a dividend but had disposed of the Opco shares instead'. A plain reading of the present wording would however suggest that the payment of the dividend itself has some impact on the quantum of the unrealized gain from a disposition of the Opco shares.

It is submitted that the awkwardness of applying the statutory language to the suggested fact pattern derives from the fact that the wording contemplates and is better adapted to the following situation.
pre-sale dividend is paid to the Holdco prior to a disposition of the shares of Opco. Here the dividend either decreases the fair market value of the Opco shares (assuming it is a cash dividend) so that it approximates their adjusted cost base, or (assuming it is a deemed dividend arising from e.g. a capitalization of surplus) increases the adjusted cost base of the Opco shares so that it equals their fair market value. On a sale of the Opco shares by Holdco, it can perhaps more conveniently be said that there has been a reduction in the capital gain that, but for the dividend, would have been realized upon their disposition immediately before the dividend.

Buyco shares: Can it be said that the result of the dividend is to reduce the gain that would have been realized, but for the dividend, on a disposition at fair market value of the redeemable Buyco shares immediately before the dividend? It would appear that it cannot. The circumstances clearly point to the conclusion that the only likely disposition of the Buyco shares is the anticipated redemption of them by Buyco, a transaction that would give rise to a deemed dividend, not a capital gain. Are we then to assume an improbable disposition to a third party where none is contemplated? Suppose that the redeemable Buyco shares are in terms not transferable. Are we to imagine a disposition of shares having different attributes than the Buyco shares in fact possess? The 'any share' referred to in the subsection can only mean a real and
existing share, and not an imagined one. Therefore it would appear that the subsection cannot apply to the shares of Buyco. It is accordingly submitted that the normal 'asset' type of subsection 55(2) transaction is not easily included within the wording of the provision.
FOOTNOTES


3. Carter Commission, supra, footnote 1, at pp. 139-140.


5. S.C. 1917, c.28.

6. This scheme was made necessary by the decision in the English case Inland Revenue Commissioners v Burrell (1924) 2 K. B. 52, which laid down the rule that amounts paid to shareholders upon a corporate liquidation were capital distributions. In the days when capital gains were not taxable, this provided an easy expedient for taxpayers seeking to convert a corporation's accumulated earnings into tax free receipts.

7. ITA s. 54(h)(x).

8. This would appear to be the case in British Columbia and Alberta. Section 32(2) of the OBCA defines 'issued capital' attributable to no par value shares to include "such amounts as from time to time by by-law of the corporation may be transferred thereto". Pursuant to subsection 21(1) the
directors may pass by-laws...to regulate...(g) the conduct
in all other particulars of the affairs of the corporation". Under the CBCA there can be only no par value shares (subsec­
tion 24(1)). Subsection 26(1)(1.4) says "Where a corporation
proposes to add any amount to a stated capital account it
maintains in respect of a class or series of shares, if/(a)
the amount to be added was not received by the corporation
as consideration for the issue of shares, and/(b) the cor­
poration has issued any outstanding shares of more than
one class or series, the addition to the stated capital
account must be approved by special resolution... Subsections
26(1) and (1.1) require a 'stated capital account' to be
maintained for each class and series of issued shares
and to add to the appropriate account the consideration
it receives for any shares it issues. Under subsection
54(1) of the Quebec Company Act "The directors of a company
may make a by-law to increase the capital stock to any
amount which they consider requisite for the due carrying
out of its objects". The by-law may provide for the increase
of the paid up capital of a company with par value or no
par value shares through the capitalization of its surplus
accounts. The by-law must be confirmed by supplementary
letters patent.

9. J.R. Robertson, "Recent Developments in Federal Taxation,"

10. The kinds of fact situation here envisioned comprise asset
sales where preferred shares are redeemed following a roll­
over of assets or shares, or following a capital reorga­
nization, and share sales where e.g. the shares of a sub­
sidiary are disposed of following the payment of a dividend
to the parent. That the full amount of the dividend will
be treated as proceeds of disposition will not present a
problem from a policy point of view in the case of a
subsection 84(3) redemption of preferred shares. The amount
received will equal the fair market value of the capital
asset sold and the amount of the dividend should in such
cases be the difference between the adjusted cost base of
the assets (and shares taken back) and their fair market
value. In other words, the dividend should equal the gain
avoided. If, however, the paid up capital of the preference
shares were unduly low (below the ACB of the shares) a portion
of the ACB protection would be lost. In the case of dividends
paid by a subsidiary to its parent prior to a disposition
of the subsidiary's shares, on the other hand, any 'tainting'
of the dividends will cause them to be treated in their full
amount as proceeds of disposition. Where offending dividends
are paid out over a period of years their amount might
greatly exceed the post-71 increment in the value of capital assets of the corporation.

11. It appears from subparagraphs 55(3)(a)(i) and (ii) that the new rules will apply only if there has been 1) a disposition of property or 2) an increase in the interest of a purchaser in the target. The payment of annual dividends by a subsidiary to its parent does not meet the requirement in 2 above, however a sale by a parent of its shares in a subsidiary is a disposition of property within condition 1. Where there has been a disposition of property (a share), paragraph 55(2)(b) treats the receipt as proceeds of disposition. It is only where the share has not been disposed of that the receipt may be treated as "a gain of the corporation for the year in which the dividend was received" (paragraph 55(2)(c)). In other words, paragraph 55(2)(c) and subparagraph 55(3)(a)(ii) are directed at the situation where funds are injected into an operating company by a purchaser and are subsequently used to pay a dividend to the corporate vendor without a disposition taking place. This might be done following a reorganization of the target's capital structure and would involve paying dividends upon a legal reduction of capital in respect of fixed-value, preference shares.

12. Since their paid up capital equals their fair market value and redemption amount, as well as their ACB, no deemed dividend or taxable gain arises as a result of this operation.

13. ITA 251(2)(b)(i) and (3).


15. It is necessary for V to make the contribution to capital and for P to inject twice the purchase price in order to guarantee that the necessary 1/4 fraction of the hard and liquid assets of Opco be reflected in P's proportionate shareholding.

16. Insofar as the 'reasonably attributable' test is viewed by the government as restricting the concept of post-71 income to the algebraic sum of tax retained earnings on hand in the company, a problem perhaps arises in connection with
purchase and sale transactions employing a multiple of earnings formula in respect of income earned after 1971. Might the taxpayer argue that a dividend equal to the total gain can be paid as 'reasonably attributable' to post-71 income?

17. It should be noted that the new rules can perhaps work to the taxpayer's advantage with regard to capital cost allowance. Where, instead of selling assets in a cash transaction, the corporate taxpayer rolls them into the purchaser corporation in return for redeemable preference shares, subsection 55(2) will apply to the dividend received upon the redemption to treat as a capital gain that which would have been taken completely into income as recaptured depreciation had the assets been sold. This benefit may, however, be relatively unimportant. The vendor may have to compensate the purchaser with a lower price because there is no increase in the cost base of the assets transferred pursuant to the rollover. This could account in full for the tax saving. In fact, the vendor finds himself in much the same position as a party to a share as opposed to an asset sale.

18. Supra, at pp. 5-12. To these might be added the relaxed rules concerning the flow through of losses upon amalgamations and windings-up.

19. The amount added to the cost base cannot exceed the fair market value of the property as at the date the parent last acquired control of the subsidiary, see ITA 88(1)(d)(ii). This would be the fair market value of the preference shares at the time of their acquisition by Opco. A further limitation on the step-up in cost base is that it cannot exceed the difference between the net asset value of the subsidiary and the adjusted cost base of the subsidiary's shares, ITA 88(1)(d)(iii).
VII. Capital Gains Stripping in the United States

(a) Introduction

Capital gains stripping through the use of tax free intercorporate dividends is perhaps a less troublesome problem for the fiscal authorities in the United States than it is in Canada. Indeed, the subject of capital gains strips has received quite limited judicial attention, with only one case formulating the issues in the same manner that discussion has evolved on the topic in Canada.\(^1\)

It is moreover important to note at the outset that of the two major varieties of capital gains strips, involving the transfer of assets or shares, only the latter warrants extensive analysis because the former is effectively precluded by differences in the Canadian and U.S. rules relating to corporate reorganizations, share redemptions, and surplus distributions.

(b) Asset Sales

As we have seen, capital gains strips of assets in Canada typically involve the exchange pursuant to subsection 85(1) of assets of the vendor for redeemable preference shares of the purchaser conditioned so as to give rise to a tax free deemed dividend upon their redemption. This effectively avoids the capital gains normally realized by the vendor corporation upon an arm's length disposition of appreciated capital property. In addition, the tax benefit secured to individuals engaged in such transactions
is the deferral of tax on dollars received pursuant to the share redemption and held by the corporation for investment, savings, or business purposes.

The American rollover provision that bears closest comparison with subsection 85(1) transfers is type C, defined in section 368(a)(1)(C) of the Internal Revenue Code to consist in the acquisition by one corporation of substantially all of the assets of another corporation in exchange for voting shares of the acquiring corporation. The type C reorganization would seem a serviceable tool with which to initiate a capital gains strip on the Canadian model, however the American rollovers are circumscribed by judicial doctrines and limitations which render them unsuitable for the purpose of stripping gains on property. Of particular interest in connection with type C reorganizations is the continuity of interest doctrine which requires that there be a continuity of interest of the transferor in the assets rolled over. The case on point is Cortland Specialty Co. v CIR in which the court made it very clear that the provision could not be employed as part of a sale transaction. Generally, it may be said of all American reorganization provisions that they cannot be motivated by tax minimization considerations and must constitute bone fide reconstructions undertaken for predominating business purposes.

The redemption of preferred shares evokes in the U.S. strong tax avoidance connotations. Preferred stock bailouts were for many years a means of withdrawing the earned surplus
of corporations at capital gains rates. Accordingly, IRC section 306 deems preference shares issued under specified conditions to be 'section 306 stock', and treats the amounts received as dividends instead of as a return of capital to the extent of the distributing corporation's earnings and profits. One of the specified circumstances involves stock received in a corporate division or reorganization. All other factors being equal, this tax treatment would seem to encourage avoidance using tax free or tax reduced dividends. However, strips based on subsection 84(3) of the Canadian Act normally involve the realization of the shareholder's entire interest in the redeeming corporation. This is what brings about the tax-free receipt of liquid assets that is so offensive to the government. In the United States, an exception from the 306 dividend treatment is provided in subsection 306(b)(1) for dispositions that terminate the shareholder's interest in the corporation. In such circumstances the shareholder is given capital gains treatment of his receipts over his basis in the shares. Needless to say, this is precisely the result that the taxpayer is seeking to avoid in capital gains stripping situations. Similar considerations govern the redemption of a shareholder's interest represented by common shares. As noted, the benefits secured to individuals in capital gains strips (particularly to sellers of small businesses) is the deferral of tax on what will normally be taken in due course into income as a dividend. The accumu-
lation of earnings in American corporations for other than business purposes is proscribed by the accumulated earnings tax of IRC section 531 and the penalty taxes on personal holding companies in sections 541-547. The deferral advantages secured to individuals in Canada would accordingly be impossible in the United States.

(c) **Share Sales**

The Code provisions dealing with dividends received by corporations is section 243. The Code policy in essence affirms the principle that corporate source income should not bear tax when distributed as dividends to corporate shareholders. In general, the scheme of section 243 is to allow at least an 85% deduction from income of dividends received by a domestic corporation from another domestic corporation, a 100% deduction for dividends received by an affiliated corporation out of earnings and profits of the payer accumulated while the corporations were affiliated, and a 100% deduction from income of a dividend received by an affiliated corporation where both corporations belong to a group filing a consolidated return.

In *Waterman Steamship Company v Commissioner*, the Federal Court of Appeal held that the pre-sale payment of a gain reducing dividend from a subsidiary to its parent corporation improperly avoided capital gains tax. The *Waterman* case was decided in 1966 for the 1955 taxation year. In 1966 amendments to the IRC regulations provided that a
parent corporation filing a consolidated return with its subsidiary could increase the basis of its shares in its subsidiary by the amount of earnings and profits of the subsidiary for the year. This is accomplished by deeming a dividend to be paid by the subsidiary to its parent, followed by a deemed contribution to the capital of the subsidiary by the parent. As the earnings and profits account of one of the subsidiaries was adequate to pay a pre-sale dividend sufficient in amount to reduce the capital gain to nil, the Waterman fact situation would today, by operation of law, give rise to no gain. The Waterman case continues to be of interest, however, because the 'deemed dividend' election cannot be exercised unless there are no minority shareholders and affiliated corporations have elected to file consolidated returns (an election which may be declined for good business reasons). The question then becomes whether gain reducing pre-sale dividends may be deducted from income pursuant to IRC 243(a)(3), or whether the Waterman principles over-ride the statutory provision.

In Waterman Steamship, a parent corporation, Waterman, was offered $3,500,000 for its two subsidiary companies. This figure also represented the adjusted cost base of the subsidiaries' assets, so that a sale of those assets at the price offered would not give rise to a capital gain. The purchaser was, however, unwilling to acquire the assets of the subsidiaries because certain valuable non-transferable rights were vested in them. The alternative of
a share transaction was not attractive to Waterman because its basis in the shares amounted to only 700,000. Upon a share sale Waterman would therefore realize a capital gain of $3,500,000 - $700,000 = $2,800,000. A scheme was embarked upon in order to satisfy the demands of both parties. One of the Waterman subsidiaries, possessing a sufficient balance in its post-1913 earnings and profits account, paid a dividend of $2,800,000 to its parent, effectively reducing the total purchase price of the shares of both subsidiaries to $700,000, the amount of Waterman's basis in the stock of the subsidiaries. Since Waterman filed a consolidated return with its affiliates, the dividend would in the ordinary course be received free of tax.

An important factual detail of the case was that the dividend was paid in the form of a promissory note, with the purchaser corporation not only undertaking to guarantee payment by the subsidiary but in fact supplying it with the necessary funds by way of loan. The subsidiary then discharged its note to Waterman. Accordingly, the Commissioner asked the Tax Court to disregard the dividend payment as a sham and to recast the transaction in the mould of a receipt by Waterman's of the purchase price with the subsidiary acting as a conduit for the movement of cash. Thus, the Waterman fact pattern may be compared with the capital gains strips practiced in Canada involving the injection by the purchaser of liquid assets into the target company coupled with the subsequent payment of a
dividend to the selling corporation. The majority decision of the Tax Court found in favour of the taxpayer, firstly on the basis of his right to arrange his own affairs in such a way as to minimize his tax burden and, secondly, because at the time the dividend was paid the vendor maintained its beneficial interest in the shares. The dissenting Judges, led by Judge Tannenwald, held that no dividend whatsoever had been paid by the subsidiary and that the purported dividend in fact constituted payment by the purchaser of the price.

On appeal to the Fifth Circuit Court of Appeals, the decision of the Tax Court was reversed and replaced with a ruling that the dividend was in 'substance' the payment of the purchase price. In view of the unusual financing arrangements of the parties, the case might have been limited to its particular facts so that the payment of a cash pre-sale dividend out of post-1913 earnings and profits with the liquid assets of the subsidiary (not of the purchaser loaned or otherwise made available to the subsidiary) would not fall within its holding. The generality of the language employed by the Court however makes it clear that all gain reducing dividends are suspect. Judge Wisdom, for example, speculated that "a new horizon of tax avoidance possibilities would be opened by allowing...corporations with wholly owned subsidiaries...to circumvent capital gains treatment through a pre-sale extraction of earnings and profits". 
The American provision permitting the adjustment of the parent's basis in its shares of its subsidiary to take account of the subsidiary's earnings perhaps suggests that the new capital gains stripping rules in subsections 55(2) - (5) of the Canadian Act represent a comparatively awkward solution. Why not simply introduce a similar adjustment to the cost base of shares held by Canadian corporations? This simple expedient would unfortunately not be of use in Canada because the increase in the cost base would only reduce the size of the pre-sale dividend to be paid in order to reduce the fair market value of the shares to be sold to their adjusted cost base. In Canada, a dividend is for tax purposes, subject to the limited exception for stock dividends paid by a public corporation after March 31, 1977, essentially the same as dividends paid under the relevant corporation law. Thus, a dividend may, under normal circumstances, be paid out of contributed or appraisal surplus. Moreover, under the present scheme of distributions all amounts received upon a buy-back of shares in excess of their paid up capital may be determined by agreement of the corporation and its (prospective) shareholder. By contrast, in the United States a dividend is defined for tax purposes in section 316(a) as "any distribution of property made by a corporation to its shareholders - (1) out of its earnings and profits for the taxable year..." Thus, a dividend for tax purposes need not correspond in all cases with the dividends permitted under
the state laws, and is strictly limited to the balance available for distribution in the post-1913 earnings and profits account. In addition, subsection 316(a) also provides, by cross-referencing with section 301, that all amounts received in excess of post-1913 earnings and profits will be received in reduction of the basis in the shares and additional amounts will be treated as a capital gain of the shareholder. Bearing in mind the American tax law of dividend distributions, Judge Wisdom's anxiety concerning the possible use of tax-free intercorporate dividends in capital gains stripping transactions therefore is perhaps not justified. As the American dividend can only be paid out of profits, it would appear that avoidance is really a non-issue and that the upward adjustment to the cost base of the subsidiary's shares constitutes legislation introduced to relieve the corporate shareholder from the burden of double taxation. In circumstances where the adjustment to basis cannot be made i.e. there are minority shareholders or the affiliated corporations have not elected to file a consolidated return, subsection 243(a)(3), allowing the 100% deduction for dividends received by an affiliated company, should apply to a pre-sale dividend paid by a subsidiary to its parent and the Waterman decision should be disregarded or limited to its particular facts. The Internal Revenue Service would seem to have decided in favour of restricting the scope of Waterman. Revenue Ruling 75-493, which in part distinguishes Waterman from a subsequently
decided case 15, emphasizes that "...the funds to pay the dividend were actually furnished by the buyer; that amount was considered as part of the purchase price paid by the buyer of the stock of the subsidiary. Thus, the form of the transaction was a sham designed to disguise the substance of the transaction."

The above quoted passage also points to another element of the Waterman decision which perhaps serves to separate it from the basic policy issues surrounding capital gains avoidance through inter-corporate dividend payments. It is clear that both the revenue authorities and the appeals court considered that the parties to the sale transaction in fact themselves regarded the dividend to be part of the purchase price. In Court Holding Co. v Commissioner 16, a corporation engaged in protracted negotiations concerning the sale of its sole asset, an apartment building. An oral agreement, which was not binding by reason of state Statute of Frauds legislation, marked the culmination of the parties' discussions. Prior to the execution of an agreement however, the corporation's solicitor advised against its consummation because of the unfavourable tax consequences of an asset sale. A new arrangement was struck upon whereby the shareholders would sell the asset to the purchaser following the liquidation of the company. In looking at the substance of the matter, the Supreme Court decided that the negotiations indicated conclusively that the intention of the parties had throughout
been that the company should sell the building and that
the last-minute interposition of the shareholder as
vendor and the liquidation of the company were acts
inconsistent with the negotiating positions which had been
adopted. From this case is derived the American doctrine
that the form of a transaction must reflect the substance
of the preceding negotiations, and it would appear that
this concept influenced the decision in *Waterman Steamship*.
Parenthetically, it is of course also necessary in Canada
to construe a document with due regard to surrounding
circumstances in cases of ambiguity. Upon such a legal
construction, however, it would be surprising to find a
Canadian court disregarding an unequivocal document brought
forward by the parties as representing their agreement on
the basis that the 'substance of negotiations' indicated
a contrary intention.

The doctrine of the 'substance' (as in substance
versus form) which in the United States effectively permits
the judicial reconstruction of transactions in accordance
with their perceived true natures, was perhaps the principal
ground of decision in *Waterman Steamship*. The view that the
payment of the dividend was merely a subterfuge masking
the real transaction would appear to be tied to a situation
where a dividend is paid with funds injected into the cor-
poration by the purchaser. Presumably, payment of a dividend
with liquid assets on hand in the corporation would not be
subject to the *Waterman* principle.
To conclude, it would seem that despite the decision in Waterman Steamship, a pre-sale extraction of earned surplus through intercorporate dividends will not constitute proceeds of disposition to the dividend recipient, unless the funds used to pay the dividend were supplied by the purchaser. The fact that dividends can in the United States be paid out of earnings and profits would seem to put the pre-sale removal of earned surplus beyond reproach from a policy point of view because the funds distributed will accordingly not represent the appreciation of goodwill and other capital assets of the corporation the shares of which are to be sold. 'Asset' type strips cannot be practiced in the United States because of fundamental differences in the reorganization and surplus distribution rules.
FOOTNOTES

1. Waterman Steamship Company v Commissioner, 430 F.2nd 1185.

2. 60 F.2d. 937.

3. These schemes involved the issuance of non-taxable preferred stock dividends which were subsequently redeemed.

4. IRC s.306(c)(1)(B).

5. IRC s.302(b)(3)

6. IRC s.243(a)(1)

7. IRC s.243(a)(3). Affiliated corporations are, essentially, corporations under common control.

8. The 15% inclusion in income of intercorporate dividends received from non-affiliated domestic corporations does not represent a partial withdrawal from the notion that intercorporate dividends should pass tax free. Historically, the provision is connected with the introduction in 1935 of a graduated corporate income tax. One of the dangers perceived as flowing from this development was the possibility that taxpayers might employ multiple corporations in order to expose the income earned by a single enterprise to a lower effective rate of tax. The 15% inclusion of intercorporate dividends was regarded as discouraging this result. At the time this rule was in effect, no distinction was made between affiliated and non-affiliated corporations. With the drawing of this distinction in 1964, the full deductibility of intercorporate dividends paid within an affiliated group was permitted.

10.  
   Regs. 1.1502-32(b)(1)(i), (b)(2)(iii), (e), 1.105-1(e).

11.  
   Regs. 1.1502-32(f)(2).

12.  
   Supra, at p. 4.

13.  
   430 F.2nd. 1191.

14.  
   Ibid., at p. 1195.

15.  

16.  
   450 F.2d. 379.
VIII. Capital Gains Stripping in Great Britain

One type of capital gains tax avoidance would seem to be possible in Britain, however such activities would appear also to be confined within a narrower compass than was the case in Canada prior to the recent legislative changes. The writer will provide a brief background on the British capital gains tax before comparing the relevant corresponding provisions of the British and Canadian tax systems. For convenience, strips are roughly classified as those involving parent-subsidiary relations and those featuring tax free rollovers.

Capital gains tax was first introduced in Britain in 1962 in the form of a charge on short-term capital gains. The relevant time periods were three years in the case of land and, for all other assets, six months. The short-term capital gains tax was continued, with modifications, even after the introduction, with the coming of the Finance Act, 1965, of a capital gains tax on gains not previously taxable. In 1970, however, Case VII (the short-term gains provision) was abolished, making the subsisting tax on capital gains of general applicability.

Capital gains tax may be exacted following the disposal by a person of certain assets. A tax liability, or loss allowance, has always been in effect in respect of the disposition of 'revenue', as opposed to capital, assets of a trade, profession, or vocation. The capital gains rules exclude from their operation such gains and losses as are
within the general Income and Capital Gains Tax Act ambit. All of the factors relevant in Canada to a determination of whether a receipt is of an income or capital nature are taken into account in Britain for the purpose of characterizing the proceeds of disposition of assets. The basic rate for the taxation of capital gains is 30% for individuals and corporations. As the corporation tax liability exceeds the tax on chargeable gains, there is clearly an advantage in a corporation taking a capital receipt in preference to an income receipt. Chargeable gains are measured as the difference between the consideration received for the disposal and the 'allowable expenditure', which includes cost, maintenance, and the expenses of the disposal. Allowable losses may be set-off against chargeable gains for the period and any unused losses may be carried forward indefinitely (but not back). Individuals receive an exemption for the first £3,000 gain, however this relief is not available to corporations.

Certain limitations on the use by British tax planners of the types of schemes employed by Canadian taxpayers to avoid capital gains tax are imposed by differences in the British laws governing dividend distributions. The trading and investment income of a UK company is not subject to income tax, bearing corporation tax instead. Although only one corporation tax is actually levied, it is effectively paid in two installments. When a dividend distribution is made to shareholders a fraction equal to 3/7 ths of the
dividend is forwarded to the Inland Revenue. Corporation tax is again payable at the end of the company's accounting period, but tax paid concurrently with dividends may be matched against the tax payable upon profits. A tax credit equal to the ACT (advance corporation tax) paid is accorded the shareholder and the dividend is grossed up by the amount of the credit. For shareholders whose total income is less than £10,000 after personal deductions, the application for the 30% basic rate will result in no tax payable.

UK resident corporations are not subject to corporation tax or amounts received pursuant to "qualifying distributions" which includes all distributions with two minor exceptions. A 'distribution' is defined in section 233 of the Income and Corporation Tax Act, 1970, as including any dividend paid by the company. Thus, intercorporate dividends may be received tax free, however the payor corporation will nevertheless be required to pay advance corporation tax of 3/7ths of the distributed amount. This tax may of course be set-off against the 'mainstream' corporation tax liability at the termination of the payor's accounting period, however in circumstance where the ACT exceeds the tax payable on profits i.e. distributions exceed earnings for the period, the relief will be delayed to a further period.

An important exception to the tax costs incidental to intercorporate dividend payments in Britain applies in
the case of "group income", which is effectively the income resulting from intercorporate transfers within a related group or consortium, for present purposes from a parent to its wholly or partially owned subsidiary. Thus, an opportunity is created for at least one variety of capital gains strip, that turning on the payment by the subsidiary to the parent of a dividend prior to the sale by the parent of the subsidiary's shares. In this connection, a relevant anti-avoidance provision would appear to be section 26 of the Capital Gains Tax Act, 1979, which provides, inter alia,

26(1) This section has effect as respects the disposal of an asset if a scheme has been effected or arrangements have been made (whether before or after the disposal) whereby -
   (a) the value of the asset has been materially reduced and
   (b) a tax-free benefit has been or will be conferred -
      (i) on the person making the disposal or a person with whom he is connected, or
      (ii) subject to subsection (3) below, on any other person

Subsection 2 further provides, inter alia, that "a benefit is conferred on a person if he becomes entitled to any money or money's worth." A dividend would thus seem to be within the definition of 'benefit' contained in the section.

Subsection 7, however, provides, inter alia, that:

In relation to the disposal by a company of an asset consisting of shares in another company the reference in section (1)(a) above to a reduction in the value of the asset does not include a reference to any reduction attributable to -
(a) the payment of a dividend by the second company at a time when it and the first company are members of the same group of companies...
'Group of companies' is a technical expression defined in section 272 of the Income and Corporations Taxes Act, 1970, to include, _inter alia_, "a principal company, and all its 75% subsidiaries..." Thus, dividend payments made by a wholly owned operating subsidiary to its parent holding company would not only be received free of tax but would seem also to by-pass the relevant anti-avoidance provisions of the Capital Gains Tax Act. In the writer's submission, this opens the door to capital gains strips in Britain because it is there well established that a reserve fund resulting from the revaluation of unrealized fixed assets (an appraisal surplus) constitutes a legitimate fund from which to pay dividends. On the other hand, contributed surplus, or share premium accounts, are regarded as capital in nature and accordingly are unavailable as a source of funds for the payment of dividends. Such reserves can, however, be capitalized by e.g. a 'bonus issue' (stock dividend) and subsequently paid out pursuant to a legal and selective reduction of capital.

As we have seen, Canadian capital gains strips frequently turn upon the buy-back by a corporation of its own shares either by way of repurchase for cancellation of common shares or the redemption of preferred shares. In Britain, the common law rule prohibiting the repurchase by a company of its own shares continues to be rigorously applied and is mitigated only by exceptions for buy-backs pursuant to court order and for the redemption of preference
shares which are redeemable either unconditionally or at the option of the company. A disposal of redeemable shares would, however, involve a capital gains tax liability because British corporations do not enjoy the luxury of controlling the tax character of receipts to the shareholders in respect of their shares. A 'capital distribution' i.e. giving rise to capital gains tax liability, is defined as any distribution "except a distribution which in the hands of the recipient constitutes income for the purpose of Income Tax". Under paragraph 233(2)(b) of the ICTA a 'distribution' means "any ...distribution out of assets of the company, except so much of the distribution, if any, as represents a repayment of capital on the shares". It would appear, therefore, that capital gains strips based upon the repurchase by a corporation of the common or preferred stock are effectively precluded by differences in the British tax law relating to surplus distributions.

Even assuming that the same tax consequences followed from the buyback of shares in Britain as in Canada, differences in their rollover provisions would not permit the establishment of similar gains avoidance devices. Take the example of an internal reorganization of capital involving the conversion of common to preferred shares preliminary to the redemption of those shares for deemed dividend treatment. The British counterpart to sections 51 and 86 of the Canadian Act is sections 77 et.seq. of the CGTA, 1979, providing for the new shareholding.
Paragraph 77(2)(B), which reads as follows, is particularly relevant:

77(2) ...reorganizations of a company's share capital includes
(b) any case where there are more than one class of shares and the rights attached to shares of any class are altered.

However, section 77 reorganizations must be scrutinized in the light of section 25 CGTA, an anti-avoidance provision aimed against 'value shifting'. Value shifting involves the transfer of value from shares held by a person having control of the corporation to shares held by another person. Thus, to the extent that value passes out of the shares owned by the person having control of the company, there is a part disposal of his shareholding which may result in a capital gain. The obvious example is that of an indirect gift, but a situation where the vendor took back a fixed value security in return for his common shares would probably also be within the provision. Shares conditioned so as not to participate in future growth of the company might be regarded as less valuable than proprietary shares. Any modification importing in any way the depreciation of the interest formerly held would result in the recognition for capital gains purposes of the monetary value of the eliminated rights.

The definitions provided in section 77 and the basic rollover contained in section 78 with respect to internal reorganizations of share capital apply mutatis mutandis to the section 85 'amalgamation' provisions (in fact, a share for share exchange rollover). and the more complex section
86 'scheme of reconstruction or amalgamation' (comprising actual mergers and corporate reorganizations featuring the tax free exchange of assets for shares and involving several companies).

Like its Canadian counterpart, the section 85 share for share exchange has been used in Britain in connection with gains avoidance schemes, though these did not feature the use of tax-free intercorporate dividends. The essential facts in *Floor v Davis* are that the taxpayer exchanged his shares of an operating company for shares of a holding company owned by him. The shares taken back by the taxpayer of course possessed the same adjusted cost base as the shares given up, however the shares of the target enjoyed a step-up in basis to the acquiring corporation. The acquiring corporation promptly disposed of the target's shares to a UK subsidiary of an American parent, realizing no capital gain on the sale because of the increase in cost base of the acquired shares (as in Canada, the cost base is 'bumped' because, in spite of the rollover, the acquiring corporation has in effect paid the fair market value). The problem of securing the newly received liquid assets of the holding company (the purchase price) to the shareholder on a tax-free basis was accomplished by having a Caymen Islands corporation subscribe for preference shares of the holding company, which was promptly liquidated. Thus, the British strip was even more effective than Canadian strips in that the tax was not only deferred, but absolutely avoided at the shareholder
level. In the Court of Appeal, the Crown argued that the sale by the holding company of the target's shares to the purchaser was 'in substance' simply a direct disposal by the taxpayer of his shares in the operating company, and that the transaction accordingly gave rise to a capital gains tax liability. On this point, Sir John Pennycuick had the following to say:

It seems to me that this contention disregards the legal effect of what were admittedly genuine transactions and really seeks to resurrect the conception of substance which was buried in the House of Lords in IRC v Duke of Westminster. 14

The legislative response to this state of affairs was the anti-avoidance provisions of sections 87 and 88 of the Capital Gains Tax Act, 1979. Section 87(1) in essence provides that the capital gains rollovers in sections 85 and 86 will not apply "unless the exchange, reconstruction, or amalgamation in question is effected for bone fide commercial reasons and does not form part of a scheme or arrangement of which the main purpose, or one of the main purposes, is avoidance of liability to capital gains tax or corporation tax." 15 It should be noted that it is not enough that the transactions be implemented for bone fide commercial reasons. None of the main purposes of the 'scheme or arrangement' may be avoidance of tax. This precludes use by the taxpayer of the argument that arrangements incidental to an arm's length disposition of capital property are undertaken for bone fide commercial reasons.
A plan of avoidance such as that effected in *Floor v Davis* would now presumably be caught by the terms of section 87. It should be observed, however, that the scheme in that case was especially offensive to the fisc because the proceeds of disposition received by the holding company were immediately distributed to the shareholders tax-free by reason of additional planning manoeuvres. It must also be remembered that sections 85 and 86 are rollover provisions designed to serve the purpose of avoiding tax. Possibly, a mere rollover of the shares of an operating company into a holding company in return for the shares of the holding company could not, in itself, be impugned. In this connection, the period of time elapsing between the rollover and the sale by the holding company, might determine the legitimacy of the transaction. The situation suggests comparison with reorganization rollovers in the United States, where the question of the permanence of the changes brought about can determine the legitimacy of the plan. The fundamental distinction is perhaps between systems which permit the use of rollovers in connection with sales (as in Canada) and systems which do not (the United States). In Britain, it would appear that reorganizations must be such in the true sense of the word and not mere devices employed to bring about different results. This aspect is particularly evident with respect to 'schemes of reconstruction or amalgamation' qualifying for rollover treatment under section 86. As noted, these include fact situations in which
assets of one company are transferred to another in return for shares of the second corporation. The 'continuity of interest' doctrine would seem to be firmly implanted in England with respect to such transactions. In Re South Africa Supply and Cold Storage Co. Ltd., Buckley J. suggested that this arrangement "involves, I think, that substantially the same business shall be carried on and substantially the same persons shall carry it on."¹⁶ A 'statement' i.e. ruling relating to the section 86 provisions now clearly reiterates the same philosophy, as follows:

A scheme of reconstruction entails the second company carrying on substantially the same business and having substantially the same members as the first. ¹⁷
FOOTNOTES

1. FA 1980, s. 20.

2. The 3/7th of the dividend that is paid as ACT, and which may be claimed as a credit, is a fraction of the net amount, or 30% of the gross amount of the dividend.

3. FA 1972. s.84(4).

4. s. 233(2)(a) Distributions received by UK resident corporations are called 'Franked Investment Income' (FA 1972, s.88(1) et. seq. and see also Income and Corporation Taxes Act, 1970 (c.10) s. 254 et seq.) Together with the credits for ACT paid by the payer corporation, 'Franked Investment Income' may be set off against the dividend.

5. s. 272(1)(b).

6. Dimbula Valley (Ceylon) Tea Co. Ltd. v Laurie (1961) Ch. 353.

7. Companies Act, 1948, s. 66(1)

8. Ibid., s. 58(1).

9. CGTA 1979, s. 72(5)(b).

10. CGTA, 1979, subsection 25(2) provides that "if a person having control of a company exercises his control so that value passes out of shares in the company owned by him or a person with whom he is connected, or out of rights in the company exerciseable by him or by a person with whom he is connected, and passes into other shares in or rights over the company, that shall be a disposal of the shares or rights out of which the value passes by the person by whom they were owned or exerciseable."
11. ITA, s. 85.1


13. CGTA, 1979, s. 78.


15. Section 88, in effect, sets out an advance rulings procedure.

16. (1904) 2 Ch., 268 at p. 286.

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