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THE CAPITAL GAINS TAXATION OF CORPORATIONS AND SHAREHOLDERS IN THE UNITED KINGDOM AND CANADA

by

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LL.B., University of London, 1969

A THESIS SUBMITTED IN PARTIAL FULFILMENT OF

THE REQUIREMENTS FOR THE DEGREE OF

MASTER OF LAWS

in the Department

of

LAW

We accept this thesis as conforming

to the required standard.

THE UNIVERSITY OF BRITISH COLUMBIA

October 1973

Department of LAW

The University of British Columbia
Vancouver 8, Canada

Date 30th SEPTEMBER 1973

THE CAPITAL GAINS TAXATION OF CORPORATIONS AND SHAREHOLDERS IN THE UNITED KINGDOM AND CANADA

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The subject of this thesis is a comparison of the tax consequences in the UK and Canada of capital gains and losses realised by corporations, and by shareholders on their shares. The comparison is made with reference to certain principles derived from the recent report in Canada of the Royal Commission on Taxation. One of the basic axioms underlying the Commission's reccommendations was that the form in which a business is carried on or property is held should be neutral in its tax consequences. Two principles are extracted from this axiom, upon which the discussions in this thesis are based.

The first principle requires that the taxation of corporations and their shareholders be integrated, so that no more taxes are paid on capital gains or other income accruing to a corporation than would have been paid had they accrued directly to an individual. In fact, discussion of the dividend tax credit given to individual shareholders and the right given to corporations to deduct certain dividends received from their income reveals a general position in both systems of partial integration only, with a fuller degree of

integration being given by virtue of special provisions to private corporations in Canada and to certain investment companies in both systems.

However, both systems are distorted by certain factors. On the one hand, the flat rate of tax paid by corporations induces individual shareholders paying higher personal rates of Income Tax to cause the corporation to accumulate, rather than to distribute, its earnings. On the other hand, the lower rate of tax paid by all taxpayers on capital gains as opposed to other income causes the same shareholders to obtain their share of such accumulations in a manner which results in a capital gain in their hands and not ordinary income. This may be done either by virtue of a sale of the members' shares or by obtaining a distribution from the corporation in capital form. Both systems have numerous provisions to discourage corporations from accumulating income and to convert what would otherwise be capital receipts in shareholders' hands into income receipts. The result is to severely curtail the opportunities for tax avoidance through manipulating the form in which corporate surpluses are distributed.

The second principle holds that there should be no tax payable on a capital gain when it results from a disposal which has only made a change in the legal form in which an asset is held and has made no change in its underlying beneficial ownership. This principle is recognised in both systems by many provisions which grant a deferral of tax on capital gains where an individual transfers assets to a corporation in return for shares, where a corporation transfers assets to another corporation which is controlled by it or directly or indirectly by another corporation which also controls the transferor (whether the transfer accompanies a corporate amalgamation or reconstruction or not) or where a shareholder's holding in a company is converted into another holding as the result of a corporate reconstruction or amalgamation or a conversion right attached to the shares. However, some equally obvious situations are not recognized in the same way, e.g. transfer of assets by a corporation to its controlling individual shareholder, so that it must be concluded that the statutes are somewhat selective in their application of this principle.

Although this thesis is primarily concerned with corporations and their shareholders, it also deals with mutual fund trusts and unit trusts and their unit holders in the same fashion. The justification for this is the similarity of the function and tax treatment of these trusts to certain investment companies found in both systems.

TABLE OF CONTENTS

PAGE

INTRODUCTION

Briefly, the subject of this thesis is a comparison of the tax consequences in the U.K. and Canada arising from capital gains and losses realised by corporations, and by shareholders on their shares. The comparison is made by reference to certain principles of taxation which have been much discussed recently in both countries.

The question of integrating the taxation of corporations and shareholders became an issue for public debate in Canada not long ago as a result of the publication of the Report of the Royal Commission on Taxation, otherwise known as the Carter Report. The report recommended strongly that integration be extended to all corporations, on the basis of the general principle underlying many of its recommendations that the form in which a business is carried on or property is held should be neutral in its tax consequences. Thus the integration of personal and corporate taxation requires that a capital gain or other income realised by a corporation, taking account of both the taxes paid by the corporation and by its shareholders when they receive a distribution of these amounts, should bear no more tax than if it had been earned directly by shareholders.

Another aspect of the principle of neutrality requires that no tax be paid on a capital gain and no recognition be made of a capital loss, when they result from a disposition of property which causes only a change in the legal form in which the property is held and no underlying change in its beneficial ownership.

It is in the light of these two aspects of the principle of neutrality that the statutory provisions of the two legal systems are explained and compared. However, the order in which the various topics are dealt with is roughly the order in time in which they would arise for consideration in practice.

Thus, in chapter one, the thesis begins with an account of the transfer of assets by an individual to a corporation. Where the transfer is for money, then no special problems arise, but if the transferor receives shares in consideration for his assets, then it could be said that he is only changing the legal form in which he holds these assets. On the hand, he may have no voice in the running of the corporation. This chapter discusses the situations in which the statutes recognize the principle of neutrality and allow the deferral of taxes on capital gains accrued to assets transferred to a corporation in return for shares.

In recognizing that a transfer of assets to a corporation involves a change in the legal form of ownership only, the Law accepts the essential identity of the corporation and the transferor. However, this essential identity of two personalities which are legally separate may be exploited for tax avoidance reasons. The provisions which recognize this aspect are also discussed in this chapter.

The taxation of capital gains realised on assets, once they are in the hands of a corporation, is considered in chapter two. By comparing this tax treatment with that accorded to capital gains realised by individuals personally, many of the disadvantages or advantages of the corporate form are revealed. Further, by using this form, the taxpayer becomes a shareholder as opposed to the direct owner of the assets which he has transferred to the corporation or which the corporation has purchased with his money. Thus the taxation of capital gains realised on such shares, as compared with the taxation of capital gains realised on the corporation's assets, is also significant and is considered in this chapter.

When the corporation's gains are derived from disposals of assets to its shareholders or to other corporations which are directly or indirectly controlled by the same shareholders as control it, the disposal may result in a change in the legal form in which the assets are held only and the same questions and problems arise as in chapter one.

The integration of personal and corporate taxation is dealt with in chapter three, which discusses the tax consequences to both corporations and shareholders of corporate distributions. The important issues here are the degree of tax credit given to individual shareholders for corporate taxes, the possibility of passing distributions through intermediary corporations without additional tax liability and the extent to which a shareholder can reduce his tax liability on a distribution by obtaining it in a form which results in its being treated as a capital gain in his hands and not ordinary income.

Further, there are special provisions applicable to certain types of corporations, i.e. private corporations in Canada and various investment companies in both systems, which permit a much greater degree of integration.

Tax avoidance opportunities occur for individuals by virtue of the differing rates of tax payable by individuals and corporations and by virtue of the lower rates of tax payable by all taxpayers on capital gains, which involve a corporation accumulating, rather than distributing, its income and capital gains. Both systems have provisions to discourage this sort of avoidance, which are considered in chapter four. These provisions discourage the accumulation of corporate earnings and attack schemes whereby the shareholder sells his shares, in order to realise his aliquot portion of a corporation's accumulated surplus as a capital gain, the purchaser being in a position to receive a corporate distribution without grave tax consequences.

From the discussions in chapters three and four of the extent to which a shareholder can obtain his share of a corporation's surplus as capital gain in his hands, there are revealed situations in which the form in which the shareholder obtains these amounts has a significant effect on the amount of tax he pays.

In the course of its operations, a corporation may wish to amalgamate with another corporation or reorganize itself. This may involve technical disposals by shareholders of their shares or by corporations of their assets, when there is no change in the underlying economic ownership of those assets and only a change in the legal form in which they are held. The extent to which the principle of neutrality is recognised in relation to corporate reorganizations and amalgamations is discussed in chapter five. The discussion will revolve around similar ideas to those found in the first chapter on transfers of assets to a corporation.

Although this thesis is primarily concerned with the corporation and its shareholders, it will also deal with the capital gains taxation of unit and mutuall funds trusts and their unit holders in a similar fashion. The justification for this lies in the similarity in function of these trusts to certain investment companies which are also discussed. Further, such trusts are to a large extent treated in a similar fashion to companies and, in the U.K., will usually be deemed to be companies for tax purposes.

CHAPTER I

TRANSFER OF ASSETS BY INDIVIDUALS TO CORPORATIONS

A corporation is a separate legal person, so that any transfer of assets by an individual to it (whether the individual is a shareholder or not) will constitute a chargeable event, in consequence of which a capital gain or loss will be calculated according to the ordinary rules of computation. This is the case, whether the transaction consists of a sale to the company by an individual who has no connection with the corporation for cash or of a transfer of business assets or investments to a corporation by an individual proprietor in return for shares.

On the other hand, it is not possible to ignore entirely the close relation which may exist between a corporation and its shareholders and the effect this may have on bargains between them. In the first place, there are avoidance problems, because the two parties can get together to fix an artificially high or low price or time disposals to best advantage, so that gains are minimized and losses maximized. In the second place, there is the opposite, but related, problem that if a person transfers assets to a corporation which he then controls, so that, in reality, there is no significant alteration in the control of or beneficial interests in those assets, it will be regarded as very unfair to impose a tax penalty on such a transfer.

The problem for a tax law is to draw the line between situations where no tax should be imposed, situations where provisions should be imposed to prevent tax avoidance and situations where no special interference is necessary. The lines drawn will be discussed in this chapter in relation to the Canadian and U.K. tax laws.

There will now be considered the particular rules enacted in both countries, by examining in Part 1 the general rules applicable in all cases, by examining in Part 2 the anti-avoidance provisions designed to counteract collusive transactions and in Part 3 the provisions which defer a capital gain when the transfer of assets to corporations leads to no more than a change in the legal form of holding the assets.

Part 1 - <u>General Rules</u>

These are the rules which apply whenever one taxpayer transfers assets to another taxpayer and the parties deal at arms length.[1] In the U.K., the Finance Act 1965 imposes a charge to Capital Gains Tax on capital gains resulting from a "disposal of assets",[2] whereas the Canadian Act includes in a taxpayer's income "taxable capital gains"[3] arising from a "disposition of property".[3] It is thus clearthat a transfer of assets by an individual to a company will be a disposal or disposition of these assets, within the normal meaning of these terms.

In order to compute the actual gain or loss, it is necessary to know the proceeds of disposition of the transferor. Generally these will be the amount of money received or the value of any non-monetary consideration, the only possible problem being the value to be assigned to any consideration received in the form of shares. It could be argued that the value of such consideration was its par value, but it has been held that the value to be taken is the market value of the shares.[4] This may, of course, equal the par value, particularly where the corporation is set up for the purpose of receiving a transfer of the assets. Where the transferee receives no consideration for the transfer, there will be a deemed disposal of the assets for proceeds equal to market value by virtue of the transfer being a gift.[5] It should be noted that where the transaction takes place at arms length and the transferor*s proceeds of disposition equal the value of property received, it is possible for him to avoid any liability to tax on any capital gain which has accrued to the property being transferred, by transferring it for consideration equal in value to what the asset cost him.[6]

The acquisition cost to the corporation of the property transferred to it will equal the amount of any money and the value of any property given by it in return,[7] unless the transfer amounts to a gift, when the acquisition cost will equal the market value of the property.[8] As to the cost of the property to the corporation which has been acquired in return for an issue of shares, the question is more difficult. It has been held in several English and Canadian cases,[9] that, prima facie, the cost of such property will equal the par value of the shares issued, in spite of the fact that the actual value of the shares is different. It is not clear how far these cases, which, in fact, dealt with the acquisition of inventory, are applicable for the purpose of computing capital gains,[10] but it would clearly be unfair to have the transferor's proceeds of disposition equalling the actual value of the shares and the company's cost equalling only their par value. Moreover, if the corporation attempts to avoid this problem by issuing shares of par value equal to the value of the property, but the market value of which exceeds that value, the difference in value may be included in the transferor's income under the provisions discussed below.

The acquisition cost to the transferor of any property, including shares, received from the corporation in consideration for the transfer will equal the value of the property transferred, as being the actual cost of the property.[11]

The realisation by the corporation of a capital gain, as the result of the issue of shares or the transfer of other property to the shareholder, will be discussed in the following chapter.[12]

Both systems have provisions which include in a taxpayer's income the amount by which the value of consideration given by a corporation exceeds the value of consideration given by a shareholder, transferring assets to it. In Canada, there are two relevant provisions. By section 84(I) there is deemed to be a dividend paid by the corporation to the extent that an increase in its paid up capital exceeds any increase in the value of its assets.[13] This will apply where the value of property transferred to a corporation is exceeded by the paid up capital of the shares issued in return for it.[14] The dividend is deemed to be paid to all the holders of the classes of shares in question, so that not only the transferor, but other shareholders, will be liable for their proportion of the dividend. To the extent that there is no deemed dividend, section 15 may apply, which includes in a shareholder's income the amount of any benefit conferred on him by a corporation. The amount of the benefit in the case of a transfer of assets to a corporation would be the amount by which the market value of the assets transferred is exceeded by the value of the consideration received from the corporation. Although it is clear that the section does not apply where the transferor receiving the benefit is not a shareholder, it is not so clear what is the position where the corporation issues shares in return for the property transferred and the transferor only becomes a shareholder of the company by virtue of that issue. It could plausibly be argued that the recipient of the benefit is not a shareholder when he receives the benefit, but only becomes a shareholder by virtue of the benefit.[15] However, there is no authority to support this argument. Where an issue of shares at a reduced consideration, i.e. at a discount, results in the shares being only partly paid up, there will be no deemed dividend under section 84(I), since the increase in paid up capital will be equalled by an increase in the corporation's assets, and there will be no benefit conferred on the shareholder, since he will remain liable to pay the balance.[16]

As will be seen later,[17] the U.K. Act includes in a shareholder's income any "distribution out of the assets of the company"[18] and the amount by which a benefit received by a member from a company exceeds the value of consideration given by the member, on a "transfer of assets" by the company to the member or by the member to the company.[19] These provisions will clearly include in a member's income the amount by which the value of the assets transferred by him to the company is exceeded by the value of the consideration given by the company. This, however, is subject to the same provisos as attach to section 15 of the Canadian Act, where the shareholder only becomes a shareholder by virtue of the benefit conferred and where the shares are partly paid.

The inclusion of part of the property given by the corporation in the shareholder's income means that any capital gain to this extent will not also be taxed as such.[20] Furthermore, in Canada, the adjusted cost base of any share issued is increased to the extent of any deemed dividend under section 84(I)[21] and, by section 52(I), that part of the value of any property received that is included in income is added to the cost to the recipient of that property. The result is that, once excess consideration received by a shareholder from a corporation has been taxed as part of his income, it will not be taxed again as a capital gain, when he finally comes to dispose of the shares or other property comprised in that consideration. There is no equivalent provision in the U.K. which increases the acquisition cost of property received in respect of amounts included in income.

Property held at the beginning of the capital gains systems[22] in both countries will not retain that characteristic in the hands of the transferee corporation, although the transitional provisions[23] will be utilized to compute any capital gain or loss of the transferor. There are two exceptions to this general rule in Canada, which are found in section 26(5) (dealing with non-depreciable property other than partnership interests) and section 20(I) (dealing with depreciable property) of the I.T.A.R. They are general rules which apply whenever property held on the 31st December 1971 is transferred by its owner to a person with whom he does not deal at arms length and their effect is generally to put the transferee in the same position as the transferor as regards the property, allowance being made for the actual consideration given by him. These provisions will apply where the transferor of assets to a corporation does not deal with the corporation at arms length.[24]

Part 2 - Anti-avoidance provisions

The general effect of these provisions is to deem the proceeds of disposition resulting from certain transfers between closely related persons to be equal to the market value of the property transferred and to deem any loss resulting to be nil.

Section 69(I)(b) of the Canadian Act deems a taxpayer to have received proceeds equal to fair market value, where he disposes of property to a person, with whom he was not dealing at arms length, for no proceeds or for proceeds less than fair market value or to any person by way of gift inter vivos. Whether persons deal with each other at arms length is primarily a question of fact,[25] but the Act deems persons termed "related persons" not to deal with each other at arms length.[26] The Act sets out a lengthy definition of "related persons"[27], but, for our purposes, a corporation is related to a person who controls it, to a person who is a member of a related group[28] which controls it or to any person related to those persons. Control is not defined in the Act, but the courts have upheld a general rule that control requires a 50% shareholding plus one share.[29] Where the transferor of property to the corporation receives no consideration from it, the transfer will amount to a gift and fall within section 69(I)(b).

In the U.K., the provisions are very similar. Section 22(4)(a) of the F.A. 1965 deems a person's acquisition of an asset and the disposal of it to him to be for consideration equal to the market value of the asset, where he acquires it otherwise than by way of a bargain made at arms length and, in particular, where he acquires it by way of gift. The question whether a bargain is at arms length is determined much as in Canada, with the difference that the term "connected person" is used instead of "related person" and the connected person relationship is extended to persons who are not relatives or corporations, for example, trustees, partners, and beneficiaries under trusts.[30] The word "control" is extensively defined by statute.[31]

These anti-avoidance provisions will apply in all cases where an individual incorporates a company and transfers assets to it. They will also apply in the U.K., where a partnership incorporates a company and transfers its business to it, as the company will be controlled by persons connected with each other. In Canada, the transaction would probably fall under the general meaning of a bargain not at arms length. In situations where the shareholders or the shareholder and persons to whom he is connected or related do not control the corporation, these rules will not apply, unless it is proved that the parties are not in fact dealing at arms length. The concept of arms length is not defined, but it "would appear to refer to some element of connection or relationship between the parties which would lead to any bargain they might make being governed by other than market considerations".[32] It appears that it would be difficult to justify any transaction at an undervalue, unless there were some bona fide commercial reason for it.

Whereas section 22(4) of the U.K. Act deals with the acquisition cost to the recipient of an asset from a person with whom he does not deal at arms length, it is apparent that section 69(I)(b) does not. This is partially remedied by section 69(I)(a) of the Act, which deems a taxpayer to acquire property at a cost equal to its market value where it is acquired from a person, with whom he does not deal at arms length, at an amount in excess of its market value, and by section 69(I)(c) of the Act, which deems the acquisition cost of property received in a gift to equal its market value. Thus the situation is covered where the recipient gives excess consideration and where he gives no consideration for the acquired property, but not where he gives consideration which is worth less than the property received. In the latter case, it would appear that although the proceeds of disposition of the disposer will equal market value,[33] the acquisition cost of the recipient will equal the actual cost to him of the property, which will be less than the value of that property. In this way the acquirer could, on a subsequent disposal, be taxed again on a gain in respect of which the disposer has already been taxed. On the other hand, it was decided in Allfine Bowlerama v. M.N.R., a decision which has been criticised for apparently contradicting the express terms of the Act [34], that in such a case the acquirer in fact takes an acquisition cost equal to the amount deemed to be the proceeds of disposition to the disposer.[35] This decision would appear to produce a fairer result. These considerations would be relevant to the transferor of assets to a company where the value of assets given by one party to the transaction was greater in value than the consideration given by the other party. In addition, where the company gives the larger amount of consideration, the excess could also be taxed as part of the transferor's income.[36]

EXAMPLE

X transfers assets worth $1000 to company Y which transfers in return assets worth $2000. X controls Y.

Proceeds of X	= 1000	(Section 69(I)(b))
Cost to Y	= 1000	(Section 69(I)(a))
Proceeds of Y	= 2000	(Section 69(I)(b))
Cost to X	= 1000	(actual cost under section 54(a) on a strict statutory interpretation)
	OR	
	2000	(if the Allfine case is correct)
Amount included in x's income	= 1000	(Section 15)

The position will not be so serious if the consideration given by the company comprises an issue of shares, as there is no disposition of those shares by the company for capital gains purposes.[37]

A difficulty arises in connection with section 22(4)(a) of the U.K. Act, where the consideration given to the transferor by the company consists of an issue of shares. It seems that in order for this section to operate, there must be both an acquisition of an asset and a disposal of an asset, so that as an issue of shares does not amount to a disposal,[38] the section will not be applicable to determine the acquisition cost to the transferor of shares issued to him by a company.[39] The cost would then equal the value of the property transferred to the company in return for which the shares were issued, as being the actual cost of those shares.

Finally, both systems have anti-avoidance provisions restricting or denying capital losses resulting from a transfer of assets to a corporation. Section 85(4) of the Canadian Act provides that where a capital loss is incurred on a disposition of property to a corporation, which, immediately after the disposition, is controlled[40] directly or indirectly in any manner whatever by the transferor, it is deemed to be nil, but the transferor can increase the cost base of the common shares (or, if none, preference shares) held by him in the company, to the extent of the loss, whether those shares are acquired as a result of the transfer or were held previously. A somewhat wider rule is found in paragraph 17 schedule 7 of the F.A. 1965, which enacts that all capital losses arising out of disposals between connected persons[41] are not allowable against other capital gains, except in the case of gains realised on a disposal between the same parties while they are still connected. The U.K. provisions are both wider in the range of persons to which they apply and the relief they allow would appear more uncertain than the relief given in Canada. A person may not make a second disposal to another person, but he must dispose of his shares one day, even if on death.

Finally, reference should be made to section 55 of the Canadian Act, which applies when, as the result of one or more transactions of any kind, a taxpayer has disposed of property under circumstances such that he may reasonably be considered to have artificially or unduly reduced the amount of a gain, created a loss or increased a loss. In this case, the taxpayer's gain or loss, as the case may be, is the amount that it would otherwise have been. This very wide provision could apply to any attempt to transfer an asset to a corporation without realising any accrued gain, when the transfer was not covered by the tax relieving provisions to be discussed in the next part of this chapter.

Part 3 - Provisions relieving from tax

Both systems provide a procedure for individuals to transfer assets to a corporation in return for shares in that corporation, without incurring any liability for tax on any capital gains which would otherwise arise. The aim and justification of these provisions is well summarised in the Canadian Government's white paper "Proposals For Tax Reform" at page 42, where it states, "If a taxpayer transfers some of his assets to a corporation in which he owns all of the shares, there is a sale within the legal definition of that word, but there has been no change in the underlying beneficial ownership of the assets. The Government proposes that this fact be recognised by treating the transaction as though it had been a sale at the cost to the taxpayer of the property transferred." As will be seen, the U.K. provision goes even further than this.

Thus section 85 of the Canadian Act applies where a taxpayer disposes of capital or eligible capital property[42] of his to a Canadian Corporation and, immediately after the disposition, owns not less than 80% of the issued shares of each class of the corporation. The section allows the taxpayer and the corporation jointly to elect the amount of the proceeds of disposition, so that if the amount elected equals the adjusted cost base of the assets to the taxpayer, no capital gain will be realised. Moreover, the elected amount will form the corporation's acquisition cost.

However, the Act contains restrictions on the amount that can be elected and, in addition, there may be practical considerations which will affect the amount elected, other than the amount of tax which may be presently avoided. In the first place, there are three statutory provisions which place an upper and a lower limit on the amount that can be elected. It must not exceed the market value of the property transferred[43] and it must not be less than the market value of any consideration (other than shares) received from the corporation[44] (the first alternative taking precedence over the latter). There are minimum amounts set by the section for depreciable property and eligible capital property.[45]

In the second place, there are several practical considerations which have to be borne in mind when making an election. The amount elected will form the cost to the corporation of the assets transferred. Two consequences flow from this. On the one hand, a reduced cost base to the corporation means reduced depreciation deductions and eligible capital deductions from income. In particular, where the capital cost to the transferor of depreciable property is greater than the amount elected, the corporation is deemed to have a capital cost equal to that of the transferor and to have received capital cost allowances equal to the difference in the two amounts.[46] Thus the corporation faces a potential liability for recapture of capital cost allowances, of which the trans feror had the benefit. Moreover, where the amount elected equals the cost base of the property transferred, the capital gain is only deferred by the transferor and it still may have to be realised at some future date by the company. It may be preferred to pay the tax now, especially where there are minority shareholders in the company, who might object to the company taking over the majority shareholder's liability in respect of the gain.

Furthermore, to the extent that that the elected amount is less than the value of the asset transferred and less than the paid up capital of the shares issued by the corporation in return for the transfer, there is an increase in the paid up capital deficiency[47] of the corporation[48]. The probable result of this is to diminish the amount that can be distributed by the corporation to its shareholders by way of a return of capital as opposed to a taxable dividend.[49]

On the other hand, while there may be inducements for the parties to elect an amount which will result in a capital gain, there will usually be little point in electing an amount which will result in a capital loss, as the loss will simply be disallowed and added to the adjusted cost base of the transferor's shares.[50]

Care should be taken in determining the consideration to be given by the corporation in return for the transfer. The provision which will result in a reduction of the corporation's paid up capital deficiency, if the paid up capital of the shares issued exceeds the elected amount, have just been considered. In addition, there will be a capital gain to the transferor if the fair market value of any consideration other than shares received from the company exceeds the adjusted cost base of the property transferred[51] and sections 84(I) and 15 may apply to include amounts received in the transferor's income to the same extent as discussed in the first part of this chapter.[52] Thus, although the transferor may avoid realising a capital gain, he may still be taxed on amounts received as part of his ordinary income.

Any consideration (other than shares) acquired from the corporation is deemed to be acquired at a cost equal to its fair market value, unless this exceeds the proportion of the fair market value of the property transferred to the corporation which this amount bears to the fair market value of all the consideration received from the corporation.[53] Any shares received from the corporation are deemed to have a cost equal to the elected amount less the deemed cost of any non-share consideration received.[54] Where two types of share are received, this cost is split between them, by allocating to any preferred shares an amount equal to the lesser of their market value and the whole amount and[55] to common shares any balance remaining after deducting the deemed cost of the preferred shares.[56] If there are several classes of common or preferred shares, the cost amount is allocated to each class according to their fair market values immediately after the disposition.[57] There is now revealed another reason for considering carefully before electing a low amount as the proceeds of sale of property disposed of to a corporation. Any shares received will have an acquisition cost equal to the amount elected, less the value of any other consideration. Coupled with the fact that the corporation is receiving the assets at a low cost base, this leads to the possibility of capital gains, which have accrued to the asset prior to the transfer, being taxed once in the hands of the corporation and once again when the shares are disposed of.

As regards assets held by the transferor on the 31st December 1971, the position is basically unchanged from that described in the first part of this chapter.[58] However, it is expressly provided in section 20(I.2) of the I.T.A.R. that where depreciable property is acquired under section 85 by a corporation, the corporation is deemed to have acquired it before 1972 and to have owned it without interruption from December 31st 1971 until it was disposed of.

Having discussed the effect of the section, it is now necessary to discuss the scope of its operation.

In the first place, it only applies to Canadian Corporations, which are defined in section 89(I)(a) as resident corporations which were either incorporated in Canada or were resident in Canada throughout the period commencing June 18th 1971 and ending at the date when the transfer is made. The reason for restricting the scope of the provisions to Canadian Corporations was that otherwise, if relief were given in respect of transfers to foreign corporations, "gains might slide right through the Canadian tax net untouched."[59] However, this definition excludes certain resident corporations.

Relief is only given under this section where the property being transferred consists of capital property[60] and eligible capital property. Therefore, a transfer of other assets, e.g. accounts receivable and inventory, will be subject to the ordinary rules which apply when such assets are disposed of on the sale of a business.[61]

The transferor must immediately after the transfer own 80% of the shares of each class of the corporation. This effectively limits the benefit of the section to a transfer by a single proprietor, unless section 85(2) of the Act applies. This permits a partnership transferring capital or eligible capital property to a corporation to obtain the benefit of the section if the partnership immediately after the disposition owns 80% of the issued shares of each class of the corporation and if all the partners and the corporation jointly make the required election. Section 85(3) goes further and allows the partners to wind up the partnership within 60 days of the transfer and distribute the property received from the corporation without tax conseqqueces.

The equivalent U.K. provisions are found in paragraph 15 of schedule 19 of the F.A. 1969. These apply where a person, who is not a company, transfers to a company a business as a going concern, together with the whole of the assets of the business or the whole of those assets other than cash, and the transfer is wholly or partly in exchange for shares issued by the company. The capital gain or loss realised is actually calculated according to the rules set out in the first two parts of this chapter, whichever may be applicable, and the relief given takes the form of a deduction from aggregate net capital gains[62] of the proportion of those gains which the cost to the disposer of the shares received from the corporation bears to the value of the whole consideration received.[63] The obvious intention of this provision is that there be no capital gain to the extent that the consideration given by the company consists of an issue of shares. This is, in fact, the result if the cost to the transferor of those shares is equal to their value, but if that cost exceeds or is less than that value, the relief will be correspondingly greater or lesser.[64] The reduction of the gain is not, however, a permanent exemption, as the cost base of the shares received from the company is reduced by the same amount. Thus the result is, as in Canada, a deferral of the gain,[65] but also, generally apply on the sale of a as in Canada, this deferral does not prevent the difference between the value of the consideration given by the company and that given by the transferor shareholder being included in the latter's income.

The fact that the capital gain is actually calculated and there is a full disposal of the assets transferred under the normal rules means that even though the gain accruing to the transferor is deferred, the corporation receives the asset at a cost equal to what was actually paid for it or its market value. This removes two difficulties found in the Canadian system. First, the corporation is not prevented from receiving full depreciation allowances or potentially liable to recapture depreciation allowed to the transferor and, second, there is no possibility of double taxation of any gain accruing prior to the transfer because of the low cost base given to the assets in the hands of the corporation and the shares in the hands of the members. Although the section is not, as in Canada, elective, it appears that most of the problems which might cause a Canadian taxpayer not to defer his gain cannot arise in the U.K. In any case, the provision could easily be avoided by selling property to the corporation for cash and then issuing shares in return for that cash.

Any assets which were held by the transferor at the beginning of Capital Gains Tax system lose that characteristic in the hands of the corporation.

As there is no express requirement in the U.K. Act that the company be resident in the U.K., it must be assumed that a transfer of assets to a non-resident company will fall within the terms of the provision. This compares favourably with the position under section 85 of the Canadian Act, which only applies to Canadian Corporations.

Turning now to the type of assets which are covered, the restriction in the paragraph which limits its operation to "assets of a business" would appear to rule out one use which is available for section 85 of the Canadian Act. It seems clear that the latter provision will apply to a simple transfer of investments to a company for estate planning purposes.[66] The business requirement in the U.K. would appear to rule this out, as far as paragraph 15 is concerned. On the other hand, it may be wondered how justifiable it is to extend tax relief to transfers of investments to companies, when the usual motive of such transfers is to avoid or reduce taxes. The same motives may exist for transferring a business to company, but, in practical terms, it is difficult to distinguish situations where there are genuine business reasons for a transfer from those where tax avoidance motives are predominant. It may be that some sort of business purpose test would be justifiable here. Again, the U.K. provisions do not apply to non-capital assets, so that the rules dealing with the transfer of such assets as inventory and accounts receivable are those which business.[67]

The U.K. provision is generally less limiting to the range of persons to which it applies, in that there is no requirement that the transferor obtain a particular percentage of the shares issued by the corporation. In particular, it extends protection to a transferor of a business who receives in return from the corporation a minority holding of shares. It may be doubted whether this is justifiable, in view of the fact that such a transfer may be more akin to a sale of the business and a reinvestment of the proceeds,[68] rather than a transfer which only changes the form in which the business is held and not the underlying beneficial ownership. In this respect the limitation in section 85 of the Canadian Act may be justifiable. On the other hand, the 80% shareholding requirement means that Section 85 will be of no use in the case of a transfer to a company of businesses by a number of persons who are not partners, whereas paragraph 15 of the U.K. Act would give relief to each transferor in so far as he received shares from the company. These aforementioned restrictions in the Canadian Act could be avoided by a combination of section 85 and section 87 of the Act, but this would make the operation more complex and difficult and consequently more expensive.[69]

In two respects the Canadian provision would appear to have the advantage over the U.K. provision. Although paragraph 15 of the U.K. Act covers joint transfers by a number of independent persons, there is no express reference to a transfer by a partnership, so that the position is in some doubt. On the one hand, the Interpretation Act 1889 lays down general rules[70] to the effect that, unless the contrary is shown, in all Acts of Parliament the word "person" shall include its plural and any body of persons whether incorporated or not. There is obviously a contrary intention in respect of companies in paragraph 15, but the statutory definition of companies expressly excludes partnerships.[71] On the other hand, by virtue of section 45(7) of the F.A. 1965, any partnership dealings are to be treated as dealings of the partners and not of the firm as such and any tax on capital gains realised on a disposal of partnership assets is to be assessed on the partners separately. It would thus appear that a transfer by a partnership is within the terms of the section, although any actual tax liability arising from it would fall on the individual partners. The shares issued would become partnership assets and as there is no provision, like section 85(3) of the Canadian Act, which permits the partnership to distribute those shares without tax consequences, it appears that any gain deferred by virtue of paragraph 15 would be taxed if the partnership was wound up.

In the second place, the Canadian provision applies in any situation where the transferor holds the requisite shareholding immediately after the transfer. There is no requirement, as there clearly is in the U.K., that the shares be issued as consideration for the property transferred, so that once a taxpayer has a qualifying shareholding he can transfer as many assets as he wishes to the corporation under the umbrella of section 85, subject to the proviso that if he receives in exchange from the corporation property other than shares with a market value in excess of the adjusted cost base of the assets transferred, there will be a capital gain. On the other hand, the provisions of section 85 which attribute the elected proceeds to shares received as their acquisition cost do not apply to shares held before the transfer is made, so that there will be no increase in the adjusted cost base of existing shares in respect of assets later transferred to the corporation under section 85, unless the provisions of section 53(I)(c) apply. This section provides for the increase in the adjusted cost base of shares held by a member who makes a capital contribution to the company. It would generally require that the adjusted cost base of the shares be increased by the increase in their market value brought about by the contribution, but this would be inconsistent with the obvious aim of section 85 to transfer to the transferor's shares the adjusted cost base of the assets which he transfers to the corporation. The position is thus somewhat doubtful and the safe course would be for the transferor to take shares from the corporation.

Finally, two omissions from both systems must be considered. Tax relief is given when share capital is issued by a company in return for property, but not when debt capital is issued. In both systems, debt capital is deemed to be consideration other than shares and so liable to cause a capital gain. This should be kept in mind when the financing of a transfer of assets to a corporation is being considered. Further, there is no express provision for liabilities taken over by the company, so that these also will strictly constitute non-share consideration received. In practice, in the U.K., the Revenue Authorities, as a concession, do not treat such as consideration given by the company[72] and it may be that the Canadian Authorities will do the same.

NOTES

1 For the meaning of the term "dealing at arms length" and the provisions governing transactions between parties not dealing at arms length see Part 2 of this chapter.

2 S. 19(1) F.A. 1965

3 S. 38 and s. 3

4 Murphy v Australian Machinery and Investment Co. Ltd. [1948] A.C. 459 and two Canadian cases Claude Belle-Isle v M.N.R. [1964] C.T.C. 40 and Piercy v M.N.R. (1956) 15 Tax A.B.C. 217

5 S. 69(1)(b) in Canada and s. 22(4)(a) F.A. 1965 in the U.K.

6 On the other hand such transactions might be stopped by s. 55 in Canada - see Part 2 of this chapter (last paragraph)

7 S. 54(a) in Canada and para. 4 sch. 6 F.A. 1965 in the U.K.

8 S. 69(1)(c)

9 In the U.K., Craddock v Zevo Finance Ltd. (1943) 27 T.C. 267, in particular Lord Green M.R. at 278, and Osborne v Steel Barrel Co. Ltd. (1942) 24 T.C. 297. In Canada, Tuxedo Holding Co. Ltd. v M.N.R. 59 D.T.C. 1102.

10 D. Ward Tax Considerations Relating to the Purchase of Assets of a Business Corporate Management Tax Conference 1972 22 at 47.

11 See n. 7 supra

12 See Part 4 of Chapter Two.

13 See Part 1 of Chapter Three Section C (text at nn. 53-6)

14 R. Brown Capital Reorganizations Corporate Management Tax Conference 1972 114 at 124.

15 This argument would not hold in the case of 84(1), which expressly covers shareholders immediately after the increase in paid-up capital.

16 R.K. Fraser v M.N.R. 1964 C.T.C. 1

17 See Part 1 of Chapter Three Section C

18 S. 233(2)(b) I.C.T.A. 1970 - see Part 1 of Chapter Three Section C (text at n. 67).

19 S. 233(3) I.C.T.A. 1970 - see Part 1 of Chapter Three Section C (text at n. 67).

20 S. 39 in Canada and para. 2(1) sch. 6 F.A. 1965 in the U.K.

21 S. 53(1)(b)

22 31st December in Canada and 6th April 1965 in the U.K.

23 See Part 2 of Chapter Two Section B

24 Mention of these provisions dealing with non-arms length transactions strictly belongs to Part 2 of this chapter but is made here for the convenience.

25 S. 251(1)(b)

26 S. 251(1)(a)

27 S. 251(2) - (6). These sections define the various persons who are related to each other.

28 S. 251(4)(a) defines a "related group" as a group of persons, each member of which is related to every other member.

29 British American Tobacco Co. Ltd. v C.I.R. 1943 1 A.E. 13 in the U.K. and Buckerfields Ltd. v M.N.R. 1965 1 Ex. C.R. 299 in Canada. See also for discussions of the courts' approach to interpreting "control" W. Latimer Corporate Control - Some Recent Decisions 14 Canadian Tax Journal 120 (1966), J. Decore Associated Corporations - Further Considerations 10 Canadian Tax Journal 452 (1962) and D. Matheson Corporate Control Concepts and Tax Reform 20 Canadian Tax Journal 45 (1972)

30 Para. 17 and 21 Sch. 7 F.A. 1965.

31 S. 45(1) F.A. 1965 and s. 302 I.C.T.A. 1970 - see Part 1 of Chapter Four Section A (text at nn. 15-6)

32 G. Wheatcroft and A. Park Capital Gains Taxes para. 7-02

33 S. 69(1)(b)

34 Case comment on case cited in text at n. 35 infra 21 Canadian Tax Journal 23 (1973)

35 26 D.T.C. 1502

36 S. 15 and s. 84(1) - see text at nn. 13-6 supra. The cost base of the asset to the shareholder would be increased to the extent of any amount so included in his income - s. 52(1) and s. 53(1)(b).

37 S. 54(c)(vii) - see Part 4 of Chapter Two section A (text at nn. 191-3)

38 Id.

39 G. Wheatcrof and A. Park supra n. 32 at para. 11-11.

40 For the meaning of "control" see n. 29 supra and text.

41 For the definition of "connected persons" see para. 21 sch. 7 F.A. 1965 and text at n. 30 supra.

42 Eligible capital property includes goodwill and other intangibles - s. 54(d) and s. 14.

43 S. 85(1)(c)

44 S. 85(1)(b)

45 S. 85(1)(d)-(e)

46 S. 85(5)

47 Defined in s. 89(1)(d).

48 S. 89(1)(d)(iv)

49 See Part 1 of Chapter Three Section C (text at nn. 58-60)

50 S. 85(4)

51 S. 85(1)(b)

52 See text at nn. 13-6 supra

53 S. 85(1)(f)

54 S. 85(1)(g)-(h)

55 S. 85(1)(g)

56 S. 85(1)(h)

57 See n. 54 supra

58 See text at nn. 22-4 supra

59 Honourable E. Benson, Minister of Finance Proposals for Tax Reform para. 3-47.

60 Defined in s. 54(b) as depreciable and other property the disposition of which results in a capital gain or loss.

61 For an account of the tax consequences of the purchase and sale of inventory and accounts receivable see M. O'Brien Sale of Assets: The Vendor's Position Corporate Management Tax Conference 1972 1 at 5-8 and D. Ward, supra n. 10 at 26-6.

62 This is the aggregate of all the capital gains from all the assets, less any losses - para. 15(2) and (7)

63 Para. 15(2) and (4)

64 The cost of these shares will be determined by the rules discussed in Parts 1 and 2 of this chapter. In particular, theproblem as to whether s. 22(4)(a) F.A. 1965 applies to determine the cost of issued shares is important here - see text at nn. 38-9 supra.

65 Para. 15(3)

66 For an account of the use of s. 85 for estate planning purposes see S. Silver and S. Taube Estate Planning in Canada 21 Canadian Tax Journal 35 (1973)

67 S. 137 and s. 485 I.C.T.A. 1970 and see P. Whiteman and G. Wheatcroft Income Tax and Surtax Chatper 9.

68 Of course, this would depend on the size of the interest received in the company and the amount of control obtained.

69 S. 87 allows Canadian Corporations to amalgamate without tax consequences - see Part 1 of Chapter five. Thus an individual could transfer assets to a corporation in which he held 80% of the issued shares of each class and this company could amalgamate with an existing larger company or other similar companies set up in the same way by other individuals - Canadian Bar Association - Brief on Tax Reform Bill C-259 Submitted to the Minister of Finance 26.

70 S. 1 and s. 19

71 S. 61(3) F.A. 1969 and s. 45(1) F.A. 1965.

72 Simon's Taxes - Vol. E Para. E4.210.

TAXATION OF CAPITAL GAINS ACCRUING TO CORPORATIONS AND SHAREHOLDERS

Capital gains and losses realised by an individual on a transfer of assets to a corporation were dealt with in the preceding chapter, which also discussed the rules for determining the acquisition cost to the corporation of those assets and the acquisition cost to the transferor of any shares or other property received by him in consideration for the transfer.

The result of such a transfer is the substitution for one taxpaying owner of the transferred assets of two separate taxpayers, both having interests in this property - the company which owns the assets and the shareholder who obtains an indirect interest[1] by virtue of his shares.[2] The purpose of this chapter is to consider the taxation of capital gains and losses realised by companies on their assets and by shareholders on their shares.[3]

The taxation of companies can not be considered in isolation from the taxation of individuals. Rather they must be compared, since the intending investor in or transferor of assets to a corporation is not so much interested in the absolute level of corporate taxation as the increase or decrease in his tax liability resulting from his action. This is particularly the case where the corporation is no more than a convenient form for an individual or partnership to use in the conduct of their business or the holding of their investments. In such a case the legal separateness of the personalities of the corporation and its members breaks down. It will be seen that there are in general no special relieving provisions in the case of such corporations as to the imposition of tax on income or capital gains,[4] although the situation is quite different when it comes to corporate distributions and accumulations which are covered in the following two chapters.

The individual who transfers assets to or invests in a corporation is changing his position from that of individual proprietor or direct property owner to that of a shareholder of a corporation. He is thus concerned not merely with the differing amounts of taxes paid by corporations and individuals, but also with the tax consequences to him of holding shares. In fact, shares are for the most part treated exactly like any other type of property - that is they are capable of being disposed of to realise capital gains or losses. However, the fact that a corporation may hold numerous types of property, e.g. depreciable property, goodwill, capital property, inventory, each of which may be subject to different rules of taxation and which are all represented by one type of asset in the shareholders' hands, may lead to tax advantages or disadvantages for the taxpayer. Thus there are special provisions governing capital gains and losses realised on shares, which in some areas attempt to equalise the position of shares and the assets they represent. The most important provisions of this type are those which prevent corporations distributing their earnings in the form of capital distributions and those which prevent shareholders realising accumulated corporate earnings as a capital gain on a sale of their shares. Although these will be discussed in the following two chapters, other provisions of a similar type will be referred to throughout this chapter.[5] In addition, there are various special rules governing the computation of capital gains and losses realised on shares. The provisions discussed in this chapter apply to gains and losses arising from shares as much as they apply to other assets, unless some statement to the contrary is made.

This chapter will also deal with the distinction drawn in both systems between capital gains and other income and the beneficial treatment accorded to the latter. This distinction is significant both for this chapter and the problem of distributing and accumulating corporate surpluses discussed in the following two chapters.

Immediately following this introduction in Part 1, there will be a discussion of the general liability of corporations and individual taxpayers to pay tax on capital gains and, in particular, the extent to which resident taxpayers are liable for capital gains abroad and non-resident taxpayers are liable for gains realised in the U.K. or Canada.

In Part 2, there is examined the computation of capital gains realised by corporations and individuals.

In Part 3, the tax treatment of capital gains and losses is dealt with. In particular this involves discussion of the availability for set-off of capital and non-capital losses, exemptions granted from tax payable on capital gains and the rates of tax payable by the different taxpayers.

In Part 4, there is discussed the rules affecting certain corporate dispositions. This covers the tax treatment of share issues and reacquisitions by corporations and dispositions made by one company to another company, which involve a change in the legal ownership of the asset transferred, but, in substance, no change in the underlying beneficial ownership, e.g. transfers between members of the same group of companies.

Lastly, in Part 5, there is a description of certain special types of company found in both systems and the way in which the rules discussed in the rest of the chapter are modified in relation to them. Most of these companies are institutions which serve as a medium through which members of the general public are enabled to invest small sums without "putting all their eggs in one basket."[6] The general policy of both Governments towards such institutions is to treat them simply as conduits between the investor and the investment. In fact, most of the provisions which do this involve corporate distributions and are discussed more fully in the next chapter, so that in some cases a reference to a company in this chapter will simply introduce it for more full discussion then. Also included in this category are unit trusts and mutual fund trusts, which serve a similar function and are to a large extent treated as or in a similar fashion to companies.

Part 1 - Liability to Tax

This part raises the question of the extent of the liability of a corporation to pay tax on capital gains, as compared with the liability of individuals. In answering this question a clear distinction must be drawn between gains made by taxpayers resident in the U.K. or Canada and those made by taxpayers not so resident. In the former case, there must be considered the separate situations of gains realised in the country of residence and gains realised outside it. Lastly, there is considered to what extent the shareholder is identified with the corporation, so as to be made liable for unsatisfied corporate tax assessments

However, these distinctions are not relevant for the purposes of determining the period with reference to which assessments to tax on capital gains are made. The period for individuals is, in Canada, the taxation year (i.e. January 1st - December 31st)[7] and, in the U.K., the year of assessment (i.e. 6th April - 5th April).[8] This is not changed for income other than capital gains, although the income which is taxed in that period may have actually arisen in the prior year[9] or partially in the year and partially outside it.[10] As for corporations, the position is similar in both systems. The assessment to tax both on capital gains and other income is made in respect of the periods for which the corporation makes up its accounts,[11] which, in Canada, is termed the fiscal period[12] and, in the U.K., the accounting period [13] and which generally lasts for 12 months.

A. Liability of Residents

(I) Gains arising in the U.K. or Canada

Although both countries make individuals and corporations fully liable for capital gains realised by them either in the U.K. or Canada (as the case may be), there is some disparity in the methods used to achieve this. Whereas, in Canada, there is one tax = Income Tax - payable by individuals and corporations alike on"taxable income",[14] which is defined in section 3 of the Act to include the amount by which the "taxable capital gains" for the year of the taxpayer exceed his "allowable capital losses" for the year, in the U.K., individuals pay Capital Gains Tax on capital gains[15] and Income Tax on other income and corporations pay Corporation Tax on "profits",[16] which are defined to mean "income and chargeable gains".[17] However, the various forms of taxation found in the U.K. are not so different as they might at first sight seem, in light of the fact that the chargeable gains portion of a corporation's profits is computed in accordance with Capital Gains Tax rules,[18] and the balance according to Income Tax Rules.[19]

(II) Capital gains arising abroad

The position just described in relation to capital gains arising in the U.K. or Canada applies equally to capital gains arising abroad, in that none of the charging sections in either of the two systems limit the liability of taxpayers to gains arising in their country of residence. In one case only is there an exception to this rule. This is found in the U.K. in section 20(7) of the F.A. 1965, which applies to individuals[20] who are resident or ordinarily resident, but not domiciled, in the U.K. at the time that assets situated outside the U.K. are disposed of. In such a case the individual is not charged to Capital Gains Tax in respect of any gain arising, but tax "is charged on the amounts (if any) received in the U.K. in respect of those chargeable gains, any such amounts being treated as gains accruing when they are received in the U.K.". There are various anti-avoidance provisions designed to ensure that the proceeds of disposition are not remitted in non-taxable form.[21]

This provision is obviously intended as a relieving provision for taxpayers whose permanent home is situated in a foreign country, but who are temporarily resident in the U.K., in regard to their foreign assets, and as such is not really appropriate for corporations. It has both advantages and disadvantages. On the one hand, losses arising from a disposal of assets situate outside the U.K. are not allowable to a person within the section, although presumably such losses can in practice be set off against gains arising from a disposal of such assets. On the other hand, it is difficult to see how the deemed disposal rules can operate on foreign assets, seeing as there are no proceeds to remit to the U.K.[22] One possible way of avoiding tax on foreign gains would be to incorporate a foreign company and transfer foreign assets to it.[23] However, the opportunities for avoidance in this area are limited in the two systems by provisions which attribute capital gains accruing to certain foreign companies to resident shareholders.[24]

Both systems provide a foreign tax credit to resident taxpayers who are liable to pay tax on a gain arising from the disposal of an asset situated abroad, when the gain is also taxable in the foreign jurisdiction.[25] There is some doubt as to the scope of the Canadian credit. Section 126(I) of the Act gives credit for "non-business-income tax" paid to a foreign góvernment and this is defined[26] as any "income or profits tax" paid by the taxpayer. The question which arises is whether this definition would cover the Capital Gains Tax found in the U.K., although it would undoubtedly cover Corporation Tax levied on capital gains, as this is expressly described as a tax on profits. This inconsistency, if correct, would clearly be unjustifiable.[27]

B. <u>Liability of Non-residents</u>

Except where otherwise provided, the general rule is that non-residents are not liable for capital gains realised by them, even where the asset disposed of is situated in the U.K. or Canada.

In Canada, there are several exceptions to this. A non-resident is liable for taxable capital gains arising as the result of a disposition of taxable Canadian property. The latter term is defined to include[28] real property situated in Canada and any other capital property used in carrying on a business in Canada, together with the following items which are of particular relevance to this thesis:

(a) shares in a resident non-public corporation[29]

(b) shares in any public corporation, if at any time during such of the five year period preceding the disposition as is after 1971 not less than 25% of the issued shares belonged to the non-resident person or to persons with whom he did not deal at arms length or to both categories of persons.

The inclusion of shares within this definition means that a non-resident may often be taxed on a gain arising on a disposition of a share which is attributable to gains realised by the corporation on a disposition of property which is not taxable Canadian property. To avoid this unnecessary additional tax liability, the non-resident should, if practical, hold property other than taxable Canadian property personally and not through a resident corporation.

As has frequently been pointed out,[30] the obvious way to avoid this liability in respect of taxable Canadian property is to transfer such assets to a non-resident corporation and to dispose of the shares in that corporation instead of the assets themselves.

There is a procedure set down in section 116 of the Act for a non-resident vendor of taxable Canadian property to notify the Revenue Authorities in respect of his disposition and to pay over 25% of his capital gain as a prepayment of tax, as a result of which a certificate will be issued to the vendor. This is of importance to a purchaser of such property from a non-resident vendor, as he can be made liable for 15% of the amount by which the actual price paid by him exceeds the amount set out in the certificate or, in the absence of such a certificate, for 15%, of the whole purchase price.[31] He can escape this liability only if, after reasonable enquiry, he had no reason to believe that the vendor was not resident in Canada.[32] Thus a purchaser should take care when making a purchase of taxable Canadian property from a vendor who could be a non-resident, either by making sure that he is not in fact a non-resident or by withholding from the purchase price the amount for which he could be personally liable. If a purchaser is made liable under these provisions, he is given a right to recover his loss from the vendor, but this may not be a satisfactory remedy if the vendor is a non-resident. None of the provisions found in section 116 of the Act are applicable where the taxable Canadian property constitutes "excluded property",[33] which is defined to include shares in a public corporation and bonds and debentures.[34]

A much narrower liability is imposed on non-residents by U.K. Law. By section 20(2) of the F.A. 1965, an individual who is neither resident nor ordinarily resident in the U.K., but who carries on a trade in the U.K. through a branch or agency situated there, is liable to Capital Gains Tax on gains arising from a disposal of assets used for the purposes of that branch or agency. Non-resident companies are similarly charged,[35] the only possible difference being that the assets must be situated in the U.K., whereas it appears to be enough for the purposes of section 20(2) if the assets are acquired for the purposes of the trade, although never actually brought to the U.K.[36] It should be noted in particular, with reference to the above Canadian provisions, that no liability is imposed on non-residents in respect of gains realised on shares of a resident corporation.

The rules just described governing the liability of non-residents are subject to the terms of any tax treaties entered into with other countries. For example, the terms of the Canada - U.K. Income Tax Agreement provide, as a general rule, that only the country of a taxpayer's residence is entitled to tax him on capital gains.[37] Exceptions are made in the case of immovable property and movable property[38] forming part of the business property of a permanent establishment in one country or pertaining to a fixed base in one country from which a profession is carried on, gains on which may be taxed in the country in which they are situated. There is no conflict between this agreement and the U.K. provisions, but an obvious one between it and the Canadian provisions. It would seem that until the agreement is renegotiated, U.K. residents will continue to escape liability for Canadian tax on capital gains realised on shares in companies resident in Canada. Moreover, this pattern is repeated in many of the international tax agreements entered into by Canada.[39]

In the tax liability of non-residents for capital gains is found the first example of a different treatment of shares and the underlying corporate assets which they represent. While the non-resident shareholder in a company resident in the U.K. is not liable on his shareholdings, the company will be liable in respect of all its capital assets. The shareholder suffers no disadvantage as long as those assets are used in a trade carried on in the U.K.,[40] but it would be unwise for him to hold investments or other business assets through a U.K. resident company. On the other hand, the corporation will not have to pay any tax, if, instead of realising its assets, the non-resident shareholder disposes of his shares. In Canada a similar problem may arise, but the same solution is not always possible when the non-residents' shares constitute taxable Canadian property.[41]

C. <u>Liability of shareholders for corporate taxes</u>

As a general rule, of course, a shareholder is not liable in respect of any of his corporation's liabilities, including tax liabilities, except perhaps when the corporation is wound up, when he may be liable to the extent of any amounts not paid up in respect of his shares. However, there are several U.K. provisions which make shareholders liable for what is primarily a tax liability of a corporation. They are designed to prevent shareholders stripping corporations of assets and leaving them nothing with which to satisfy outstanding tax liabilities.

Section 266 of the I.C.T.A. 1970 provides that where a shareholder receives a capital distribution[42] from a company otherwise than on a reduction of capital[43] and the capital so distributed derives from a disposal of assets in respect of which a capital gain was realised or the distribution itself constitutes such a disposal of assets, he is liable to pay a proportion of any Corporation Tax liability incurred by the corporation in respect of that disposal and not paid by it within 6 months of its becoming payable. This section does not affect any personal liability attaching to the shareholder as a result of a disposal of his shares caused by the distribution.[44] Further, the section gives the shareholder the right to recover the tax from the company.[45]

The above provision is obviously directed at distributions made in the course of winding up a company. However, a more general provision is found in paragraph 19 of the 7th schedule of the F.A. 1965. This operates where a chargeable gain is realised by any person as the result of a disposal of an asset by way of gift[46] and the tax assessed on the donor in respect of the gain is not paid within 12 months. In this case the donee is liable for the tax, but can recover the amount from the donor. This could cover distributions of capital assets in specie made by a corporation, for which the shareholder gives no consideration or consideration less than market value, whether made in course of winding up or at any other time.[47]

Just as the U.K. Acts recognize the group of companies as one entity for the purposes of giving tax relief on inter-group transfers[48] and the like, it also recognises it as one entity for tax collection purposes. Thus by section 277 of the I.C.T.A. 1970, where a member of a group of companies[49] is assessed to Corporation Tax on a capital gain and fails to pay within 6 months of the date when it was due for payment, then the tax can be recovered from the principal member of the group or any other member of the group who owned the asset in question in the two year period before the gain was realised. This prevents the group members transferring an asset, just before it is sold outside the group, to a group member which has no assets with which to pay any tax assessed to it. Any company incurring liability under this section is given a right of recovery from the company which incurred the gain, and, in certain circumstances, certain members of the group.[50]

Group members are also liable to be assessed to tax for which other members or ex-members are primarily liable under similar provisions, where tax is imposed through a member leaving the group with an asset which it acquired from another group member under the group transfer provisions[51] and where tax is charged on a group member in respect of shares in a company which has left the group.[52]

None of the above provisions have their Canadian equivalent, so that there remains the basic position that a shareholder is not liable for a company's tax assessments, except to the extent of unpaid capital on his shares, which may be payable if the company goes into liquidation.

Part 2 - Computation of Capital Gains and Losses

There is in substance little difference between the rules for computing capital gains and losses, as between the U.K. and the Canadian systems and as between individuals and corporations within each system. On the other hand, there is some variation of treatment within both systems, but particularly in the U.K., as between shares and securities on the one hand and other assets on the other and, within the former category, between shares and securities which are publicly traded and those which are not.

The rules first discussed in section A of this part of this chapter are those which apply to determine the amount of gains or losses resulting from disposals of all types of assets (shares and securities included) and made by all types of taxpayers. These are very strait-forward and require little comment.

However, these general rules are wholly or partly excluded, where the assets disposed of were held by the taxpayer when the tax on capital gains was first introduced into the two countries, i.e. 1st January 1972 in Canada and the 6th April 1965 in the U.K. For such assets there are special computation provisions discussed in section B, which are primarily designed to ensure that the amount of any gain or loss is the lesser of the amount computed under the normal rules and the amount accruing after the date of commencement of the system. Furthermore, both systems provide differing rules when the assets involved are publicly traded shares or securities. The distinction seems to rest on the easy availability of a fair market value of the latter at the commencement of the system.

The identical nature of shares and securities of one class of any corporation leads to a requirement for provisions to determine the acquisition cost of part of a holding of such property, when a part only is disposed of and different parts of it were acquired at different times at different prices. Not only do such provisions remove any difficulties in determining the acquisition cost of the particular shares disposed of, but they eliminate the possibility of a taxpayer artificially reducing gains or increasing losses by carefully selecting the shares disposed of, so that the acquisition cost is the one which is most beneficial to him. These identification rules, which are discussed in section C, also apply to any other type of assets which are identical with each other.

Finally, the application of many of the above provisions, together with many other provisions of the Acts, requires the determination of the market value (in the U.K.) or fair market value (in Canada) of an asset. As a rule, the Acts leave this to be determined, according to the facts of each case, by agreement between the Revenue Authorities and the taxpayer or in the last resort by the courts. However, the easy availability of valuations for quoted shares and securities leads to special rules to determine their value according to their quoted price. The valuation rules are dealt with in Section D.

A. The General Rules of Computation

Section 40 of the Canadian Act provides that "a taxpayer's gain for a taxation year from the disposition of any property is the amount by which ... his proceeds of disposition exceed the aggregate of the adjusted cost base to him of the property immediately before the disposition and any outlays or expenses to the extent they were made or incurred by him for the purpose of making the disposition".[53] The "adjusted cost base" means the cost to the taxpayer adjusted as provided in the Act.[54]

The U.K. Act refers to gains arising on a "disposal of assets".[55] The gain is computed by deducting from "the consideration ... accruing to a person on the disposal of an asset... the amount or value of the consideration, in money or moneys worth, given by him or on his behalf wholly and exclusively for the acquisition of the asset, together with the incidental cost to him of the acquisition or, if the asset was not acquired by him, any expenditure wholly and exclusively incurred by him in providing the asset. "The taxpayer is also allowed to deduct" incidental costs of making the disposal" and other expenditure incurred wholly and exclusively to enhance the value of the asset or to defend title to it.[56] The U.K. statute is much more specific on the allowable deductions, but most (if not all) of the deductions allowed in the U.K. should also be allowed in Canada under the ordinary meaning of the term "cost".[57] Losses are calculated in both systems in the same manner that gains are calculated.[58]

Once a capital gain or loss has been computed, the question arises as to how much is to be taxed. Under Canadian Law only "taxable capital gains" are included in income and only "allowable capital losses" are deductible from income.[59] The latter are defined to mean half of any capital loss and the former half of any capital gain.[60] On the other hand, in the U.K., the whole of any gain or loss is taken into account except in one case. As from the 1st April 1973 in the case of companies, the amount of chargeable gains and allowable losses will be reduced by an amount to be determined by parliament.[61] The effect of this in reducing the tax payable by corporations is obvious and will be discussed more fully in connection with the rates of tax payable by companies on capital gains.[62] In the U.K. corporations are given one specific statutory advantage, although a limited one. Section 269 I.C.T.A. permits a corporation to add to any expenditure, which it incurs on the construction of any building, structure or works and which will be deductible from the proceeds when they are disposed of, any interest on any money which it borrows to carry out such expenditure, butthe interest must be chargeable to capital. On the other hand, it may be that such interest is in any case deductible as part of the cost of the asset.

B. <u>The transitional provisions</u>

The basic transitional provision in the Canadian system, which applies to all assets, save for depreciable property and interests in partnerships, is found in section 26(3) I.T.A.R. This enacts that the adjusted cost base of an asset held on the 31st December 1971 is to be the middle amount of its actual cost, its fair market value on valuation day[63] and its proceeds of disposition.[64]. This rule is excluded if the taxpayer elects that the cost of his assets equal their fair market value on valuation day.[65] However, the election must be made in respect of all the taxpayer's assets and is not available where the taxpayer is a corporation. There are further provisions which apply to depreciable property and exclude from computation capital gains accruing before the commencement of the system[66] and others designed to prevent tax avoidance by means of transfers between persons not dealing at arms length.[67]

Only in two minor respects are there modifications of these Canadian rules as they affect shares and securities. In the first place, in operating section 26(3) in relation to obligations,[68] the amortized[69] cost of the obligation is used instead of the actual cost. In the second place, the valuation day prescribed for publicly traded securities is different from that prescribed for other property.[70]

In the U.K., different rules are applied according to the types of asset involved and the Act provides for three types of asset - land with development value, shares and securities quoted on a recognized stock exchange in the U.K. and other assets (including all other shares and securities).

The rules which apply to land with development value will not be discussed in this thesis, as not being immediately relevant to its subject, but they are substantially similar to the rules next described which govern dispositions of quoted shares and securities, without the benefit of an election like the one given in the F.A. 1968.[71]

In regard to shares and securities which are quoted on a recognised stock exchange in the U.K., the general rule is laid down[72] that such shares and securities are deemed to have been disposed of and reacquired at their market value on the 6th of April 1965. On the other hand, where the operation of this rule would cause a greater gain or loss than would result if the ordinary computation rules were followed, i.e., the acquisition cost of the asset were deducted from the proceeds of sale, then the gain or loss derived from following the latter rules is taken as the taxable amount[73] and where these transitional rules would substitute a gain for a loss or a loss for a gain, the disposition in question is deemed to be for such proceeds as would cause neither a gain nor a loss.[74] In fact, these provisions are simply a more complicated way of achieving the same result achieved by section 26(3) of the Canadian I.T.A.R. Further, the equivalent of section 26(7) of the Canadian I.T.A.R. is found in schedule 11 of the F.A. 1968, which gives the taxpayer the right to elect that the acquisition cost of quoted shares and securities equal their market value on the 6th April 1965.[75] However, it is more beneficial than section 26(7) in allowing a separate election to be made in respect of fixed interest securities and preference shares on the one hand and all other shares and securities on the other hand[76] and in applying to all taxpayers.[77]

Where, following a company reorganization under paragraphs 4-7 of schedule 7 of the F.A. 1965,[78] a share or debenture holder has received a new holding of shares or securities in return for his old holding, any election made prior to the reorganization under the F.A. 1968 in respect of one of the two types of shares and securities will only operate in respect of the new holding, if it comprises shares or securities of that type, regardless of whether the old holding was covered by the election.[79] Moreover, such an election made by the principal member of a group of companies[80] also binds the other members of the same group, unless, prior to entering the group, the member personally made an election or failed to make it within the requisite time.[81]

The rules applying to shares and securities not covered by the above provisions are those which apply to all other types of asset and are found in paragraph 24 of schedule 6 of the F.A. 1965. Any capital gain or loss is calculated according to the ordinary rules, by deducting from the proceeds of disposition the acquisition cost, and the resulting gain or loss is then evenly apportioned over the period in which it accrued. That part which accrued after the 6th April 1965 is the amount which is taxed as a capital gain or allowed as a capital loss. As an alternative, paragraph 25 of the same schedule allows the taxpayer to elect that there be a deemed disposal and reacquisition of the assets for proceeds equal to their market value on the 6th April 1965 and this election may be made or not made in respect of each separate disposal. However the election is not available if it would result in a loss or greater loss being produced and if the election would substitute a gain for a loss, the asset is deemed to have been disposed of for such proceeds as would produce neither a gain nor a loss.[82] The time apportionment rule described above is significantly different from any of the transitional rules found in the Canadian system. The alternative election follows the more general pattern set by the Canadian provisions and the other U.K. provisions, but this election right is not, as is apparently the case with the election right given by section 26(7) of the Canadian I.T.A.R., permitted where its use would increase a loss or turn a gain into a loss.[83]

One provision of the F.A. 1965, which prevents use being made of the corporate form and the above time apportionment rule to avoid taxes, should now be referred to.[84] The device in question is a transfer of assets to a closely controlled company by one of the controllers or persons connected with him, where the shares in that company were held on the 6th April 1965 by such controller and are subject to the time apportionment rule when disposed of. But for this provision, capital gains realised on such a disposal would be spread over the whole period of ownership of the shares under the time apportionment rule, even though a part of this gain was attributable to capital gains accrued to assets transferred to the company since the shares were acquired. This is prevented by spreading so much of the gain as is attributable to gains on such assets over a period beginning with the transfer of the asset to the corporation. Such provisions are unnecessary in Canada, as there is no time apportionment rule for computing gains and losses. In effect, this U.K. provision equalises the tax position of the shares and the underlying assets of the corporation, to prevent the shareholder gaining an unwarranted advantage from their difference.

C. Identification rules

The basic Canadian rule is set out in section 47 of the Act which concerns, not just the properties now being discussed, but all identical properties. It provides that where a person acquires one or more properties which are identical[85] to property already owned by him, then he is deemed to have disposed of his formerly acquired properties for proceeds equal to their adjusted cost base and to have acquired those properties, together with the new property, at a combined cost equalling the adjusted cost base of the old property plus the actual cost of the new property. The cost of each individual property is obtained by dividing the total cost by the number of properties involved or, in the case of obligations,[86] by dividing the total cost by a fraction equal to the fraction which the principal amount of each obligation is of the total principal amounts of all such obligations.[87]

The equivalent U.K. rule is similar in effect, although quite different in form, and is found in paragraph 2 of schedule 7 of the F.A. 1965. This provides that "all shares[88] of the same class held by one person in one capacity shall ... be regarded as indistinguishable parts of a single asset ... growing or diminishing on the occasions on which additional shares of the class in question are acquired or some of the shares of the class in question are disposed of."[89] A disposal of some of the shares in that holding is treated as a part disposal of a whole asset.[90] Where the shares are held by a person to whom they were issued as an employee of a company or of any other person on terms which restrict the right to dispose of them, they form a separate pool as long as the restriction is in force[91] and where a shareholder also has shares of the same class which are not within this latter provision, it is a question of fact whether a subsequent disposal comprises shares of the latter type or the former type.[92]

Both systems have special provisions concerning identical assets held at the beginning of the capital gains system. In Canada, by virtue of section 26(8) of the I.T.A.R., for the purpose of applying the transitional provisions which determine the adjusted cost base of all assets held at this time,[93] the actual cost and market value on valuation day of each identical asset is calculated by dividing the total acquisition cost and market value on valuation day of all the identical assets by the number of such assets and, in the case of obligations, by the fraction which the principal amount of each asset bears to the total principal amounts of all the assets. To distinguish such assets from assets acquired after the beginning of the system and assets acquired and sold before the beginning of the system, the rule is that the assets are deemed to be disposed of in the same order in which they were acquired. Thus, if the taxpayer has identical assets, some of which were acquired before and some after 1971, the former will be deemed to be disposed of before the latter.[94]

As for the U.K. and shares[95] held on the 6th April 1965, the rule is quite simple. Both for the purpose of distinguishing such shares from shares acquired after that date and from shares disposed of prior to that date, shares are deemed to be disposed of first which were acquired first.[96] There are no pooling provisions for such shares.

In the absence of statutory provisions to the contrary, a new holding of shares or debentures received by virtue of a reorganization under the provisions discussed in chapter five in exchange for an old holding in the same or a different company will not be subject to the transitional provisions just described, even if the holding for which they were exchanged was subject to those provisions. In fact, the U.K. provisions, i.e. paragraphs 4-7 of schedule 7 of the F.A. 1965,[97] do provide that the new holding is to be treated as acquired at the same time and for the same price as the old holding, but, in Canada, this is not generally the case, except where section 87 of the Act applies on an amalgamation.[98]

D. Valuation of shares and debentures

The only definition of market value or full market value[99] found in either system is contained in section 44 of the F.A. 1965. This defines the expression "market value" in relation to any assets as meaning the price which that asset might reasonably be expected to fetch on a sale in the open market and further provides that, in estimating the market value of any assets, no reduction shall be made in the estimate on account of its being made on the assumption that the whole of the assets are to be placed on the market at one and the same time.

This definition is amplified by the same section[100] in the case of quoted shares and securities. It is provided that shares and securities quoted on the London Stock

Exchange are to be valued according to their quoted prices, unless the quoted price does not represent a proper measure of their market value[101] or some other stock exchange in the U.K. affords a more active market. This rule is modified slightly when applied to the valuation of shares and securities on the 6th April 1965 for the purpose of the transitional provisions for computing gains and losses realised from disposals of assets held on that date.[102]

In Canada, the only statutory provisions concerning the valuation of shares and securities are found in the transitional rules. As already mentioned, the valuation day prescribed for publicly traded shares and securities is different from that prescribed for other assets.[103] In addition, it is laid down in section 26(11) of the I.T.A.R. that "the fair market value on valuation day of any property prescribed to be a publicly traded share or security shall be deemed to be the greater of the amount, if any, prescribed in respect of that property and the fair market value of that property otherwise determined" on that day. This to some extent leaves the question of fair market value open, but the Government has indicated that the prescribed values will be accepted by the Revenue Authorities, unless the taxpayer can establish some other value.[104] This will mean that it will be up to the taxpayer to show that the ordinary market price is not the correct value, because of some factor peculiar to him, e.g. he holds a controlling block of shares.

Where the above provisions do not apply or are excluded because (in the U.K.) another market than the London Stock Exchange forms a more active market for the property in question or the quoted price is not a proper valuation or (in Canada) because the taxpayers can prove a fair market value differing from the prescribed figure or no value is prescribed, then it is necessary to look to the general meaning of the terms "fair market value" and "market value". There have been many decisions on the meaning of such terms as these, of which one of the most noted is <u>Gold Coast Selection Trust v Humphrey</u>.[105] In this case, Viscount Simon[106] defined fair market value "as the highest price obtainable in an open and unrestricted market between parties acting at arms length". The U.K. definition of market value as the amount which an asset might be expected to fetch on the open market appears to be no more than a reformulation of the definitions adopted by the courts, so that the old principles laid down by the courts for ascertaining market or fair market value will apply to the capital gains provisions found in both the U.K. and Canada.[107] On the other hand, it is not so clear that the U.K. provision which excludes a reduction in a valuation through the valuation being based on the assumption that the whole asset involved is put on the market at the same time is also a mere reformulation of common law principles. Although there is authority supporting such a principle,[108] it is submitted that it would probably depend on the facts of each case as to whether such a principle should operate. It is not intended to describe in detail the principles developed by the courts to be followed in making valuations,[109] but merely to describe in a general way how they apply to shares and like assets.

The valuation of shares and securities which have their prices quoted, but yet are not covered by or are excluded from the provisions described above,[110] will prima facie be determined by that figure which is quoted.[111] However, this will clearly not be the case where the reason for the assets in question being excluded from those provisions is precisely because this price is not a proper valuation or, in any other case, where other factors make the quoted price an incorrect valuation. In particular, this will be the case where the shares in question carry with them the right to control the company,[112] but even in these situations, the quoted price will be a starting figure which can be raised or reduced accordingly.[113]

The most difficult valuation problem arises in connection with shares and securities the prices of which are not quoted. It is in this situation that rules of law or practice concerning the estimation of the value of an asset are the most unhelpful. Little more can be done than to list the numerous factors which might be relevant in assessing the value of such assets, leaving the valuer to assess their importance in the individual case in front of him and to make his valuation accordingly.[114] However, the most important of these factors are, perhaps, the earning potential of the company in which the share is held, the value of its assets and the degree of control which is given by the shares over the company in question.[115]

Part 3 - Treatment of Capital Gains and Losses

The liability of a taxpayer to pay tax on a capital gain having been established and the amount of the gain having been computed, the treatment of such a gain in the hands of that taxpayer must be considered. It is in this area that there is revealed the most significant differences in the tax liability of corporations and individuals, which should weigh heavily on a person's mind when he is considering investing in or transferring a business or other assets to a corporation.

As a general rule, where a capital gain realised in certain circumstances would be taxable, a capital loss realised in the same circumstances will be deductible against capital gains of the same taxpayer and possibly against other income. This right of set-off may extend beyond gains and income of the same year in which the loss is incurred to gains or income of future or past years. On the other hand, for various policy reasons, capital losses realised on certain types of assets are disallowed completely. As this disallowance does not extend to shares of corporations holding such assets, the possibility arises of avoiding it by transferring such assets to corporations and taking the loss on shares in that corporation. The set-off of capital losses and the possibility of avoiding loss disallowances by the use of corporations is dealt with in this part of this chapter in section A.

Secondly, the question is discussed in section B as to how far it is possible to set off non-capital losses, e.g. trading losses, against capital gains of the same or other years. It will be seen that the answer to this question seems to depend on the way in which capital gains are taxed. If, as in Canada for all taxpayers and in the U.K. for corporations, capital gains are regarded as ordinary income, such set off is possible, but if, as in the U.K. taxation of capital gains realised by individuals, capital gains are taxed separately, then it is not possible.

Thirdly, is considered in section C the existence of any exemptions from taxes on capital gains available to individuals and corporations.

Lastly and most importantly, there are described in section D the rates of tax payable by taxpayers on capital gains. The different rates payable by individuals and corporations are one of the most significant factors to be examined when considering the tax advantages or disadvantages of corporations.

A. Capital Losses

1) Deductions of capital losses from capital gains and other income

In the first place, capital losses for the accounting period, year of assessment or taxation year (as the case may be) are set off against capital gains accruing in the same period.[116] Further, in so far as the losses exceed the gains of the same period, they are carried forward (and termed "net-capital losses" in Canada) and set off against any capital gains arising in future years.[117] This is the general rule which is subject to certain variations and modifications within the two systems.

While the right to carry forward capital losses in the U.K. takes precedence over the statutory right to set off non-capital losses and other deductions against the chargeable gains portion of "profits",[118] in Canada the reverse is true.[119] On the other hand, before carrying "net-capital losses" forward to future years, Canadian Law gives the additional right to set off such losses against gains of the immediately preceding year.[120]

In two respects, Canadian individuals are in a more advantageous position in regard to the set-off of capital losses. In the first place, individuals, but not corporations, are permitted to set off capital losses of the current year and then "net-capital losses" against up to one thousand dollars of other income in each taxation year, in so far as such amount of income is available after deducting other losses of the current year and "non-capital losses".[121] There seems no reason in principle for not allowing corporations the benefit of this provision. Rather it seems to be the case of the Act giving relief to the individual where small amounts are involved, on the basis that corporations are not so much in need of such relief. In the second place, corporations are disadvantaged by section III(4), which provides that where "control[122] of the corporation has been acquired[123] by a person who did not, at the end of the preceding year, control the corporation", "net-capital losses" accruing in any year prior to the year in which control is obtained cease to be deductible from the corporation's income, either in the year when control is obtained or any later year. This is analogous to the rule found in section III(5), which forbids the carry-forward of non-capital losses on a change of control of the corporation, but, in fact, it extends the policy followed by this section, in that that section also requires a change in the corporation's business. It is notable that although the U.K. Act contains a provision [124] which has a similar effect to section III(5), it has no provision equivalent to section III(4), so that there is no cessation of the carry forward of capital losses on the change in control of a corporation.

It has been suggested that it is illogical and harsh to allow (where this is allowed)[125] the deduction of trading and other non-capital losses from capital gains, but not the deduction of capital losses from trading and other non capital income.[126] The argument against allowing this is that it is much easier for a taxpayer to manipulate his disposals so as to realise capital losses than it is to artificially create trading losses.[127] It would appear that this is true[128] and the question becomes one of balancing the practical necessity to restrict losses against fairness to the taxpayer. It may be that a compromise solution, fairer than the present absolute prohibition, would be to extend the limited rights of deduction given to individuals to deduct capital losses from one thousand dollars of non-capital income. There is one further difficulty which would have to be overcome if capital losses are to be deductible from non-capital income. As individuals under U.K. Law pay a lower rate of tax on capital gains than on other income,[129] they would gain an unmerited advantage from being able to set off capital losses against income on which the higher rate of tax is payable.

(II) <u>The disallowance of capital losses</u>

There are several provisions found in both systems which disallow capital losses realised on certain types of assets, e.g. personal use property[130] and depreciable property[131] in Canada and, in the U.K., motor vehicles[132] and depreciable property.[133] However, there is only one express provision disallowing capital losses realised on shares in a corporation which are caused by the depreciation of such assets held by the corporation. This is section 46(4) of the Canadian Act, which provides that where it may reasonably be regarded that, by reason of a decrease in the fair market value of any personal use property of a corporation, any capital gain from the disposition of a share in the corporation has been reduced or become a loss or any such loss has become greater, the amount of the gain or loss is deemed to be the amount it would have been but for the decrease. Apart from this provision, there is no express provision to prevent the exploitation by the taxpayer of this unequal treatment of shares and the assets they represent. It could be, however, that, in Canada, the provisions of section 55 of the Act,[134] which generally prevent a taxpayer artificially reducing a gain or increasing a loss, will be applied in this situation.

B. Set off of non-capital losses against capital gains

It has already been shown how, in Canada, both for individuals and corporations, taxable capital gains and allowable capital losses are included when computing ordinary income. In this respect capital gains are regarded as a separate source of income, along with income from business, property and employment, and may be reduced by any deductions allowed by the Act which are not expressly referable to any of the other sources. Further, in so far as income from those other sources is not sufficient to absorb available deductions which are exclusive to them, there will be losses which can be deducted from any excess remaining when "taxable capital gains" for the year have been reduced by any "allowable capital losses" for the year.[135]

In so far as the losses from those other sources exceed the taxpayer's income for the year, they are termed "non-capital losses" and may be set off first against the prior year's income and then against the income of the five following years, in the same manner as they are set against income of the current year.[136] The right of carry-back and carry-forward is lost in the case of business losses accruing to a corporation, if there is a change of control of the corporation accompanying a change in the business of the corporation.[137]

Turning to the U.K., one finds the first significant consequence arising from the fact of individual taxpayers being subjected to two different taxes -- Capital Gains Tax on capital gains and Income Tax on other income. In only one very limited situation is the individual allowed to treat capital gains as income for the purpose of making deductions there from. This is when the alternative rate of tax is applied.[138] The position of corporations is more similar to that of their Canadian counterparts. Several important provisions of the I.C.T.A. 1970 allow deductions for the purposes of Corporation Tax from the "profits" of an accounting period. It has already been noted that the term "profits" includes chargeable gains.[139] In particular, there is section 177(2), which allows trading losses in a current accounting period to be set against "profits" of the same or preceding accounting period and section 248 provides for the deduction of charges on income paid by a company in an accounting period to be deducted from the "total profits" of that accounting period. "Charges on income" are defined to exclude payments otherwise deductible in computing profits,[140] capital payments, distributions and payments made otherwise than for valuable consideration (except for certain charitable covenants), but does include interest and annuities, payments for royalties, patents and mining rents and royalties.[141]

It is difficult to see why corporations only and not individuals should get the benefit of these rights. On the other hand it might be argued that individuals pay a reduced rate of tax on capital gains and they might in any case be reluctant to use up losses derived from other income sources against this lower rate income.

C. Exemptions

Both systems provide exemptions for individuals, which are not available to corporations and trusts.

In Canada there are two relevant provisions. In the first place, section 39(2) deducts from the aggregate capital gains and losses for a year from disposing of foreign currency the sum of 200 dollars. This section is expressed to apply to individuals, which clearly excludes corporations, but would appear to include trusts in view of section 104(2), which provides that trusts are to be taxed as if they were individuals. In the second place, where an individual ceases to be resident in Canada, so that there is a deemed disposal of his assets for proceeds equal to their market value under section 48, he is only charged on capital gains to the extent they exceed 5000 dollars. A corporation and a trust[142] in a similar situation will be deemed to dispose of all their property, but all their capital gains will be taken into account.[143]

Otherwise, except in one case,[144] there are no exemptions either for corporations or for individuals where only a small amount of gains are realised in a taxation year.

In the U.K. there are two provisions which grant exemptions to individuals exclusively where small amounts are involved. Thus, by section 57 of the F.A. 1971, an individual is not charged to Capital Gains Tax if the aggregate amount or value of consideration received for all disposals of assets in a year of assessment does not exceed five hundred pounds, although any losses realised in a year must be set off against any gains for that year, even if no tax is payable on them under this section. Further, by section 27(2) of the F.A. 1965, a gain accruing to an individual on a disposal by way of a gift of an asset, the market value of which does not exceed one hundred pounds, is deemed not to be a chargeable gain, but there is no exemption when the total value of several gifts made in a year exceeds one hundred pounds. These two provisions are useful, in that they avoid the administrative inconvenience and expense of calculating gains of small amount where only a small amount of tax would in fact be payable. They are possibly a further legacy of the separate taxation of capital gains and other income in the case of individuals.

Finally, reference is made to a U.K. exemption for which there is no Canadian equivalent. Although this applies to individuals only, it is obviously inappropriate for corporations and is included here as an example of equality of treatment accorded to a taxpayer, whether he carries on his business as an individual proprietorship or through a closely controlled corporation.

By section 34 of the F.A. 1965 where an individual who has attained the age of 60 years disposes of the whole or part of a business which he has owned for ten years, then any capital gain is reduced by the amount of 10,000 pounds if he has attained the age of 65 years and this figure is reduced by 2000 pounds for every year by which his age falls below this. This relief only applies to gains realised on assets used in the business, which include goodwill, but not investments.[145] The relief also covers the situation where a taxpayer disposes of shares in a family trading company,[146] where he has in the last ten years been a full time working director of the company.[147] In this case, the part of the gain available for relief is that proportion that the value of the assets used in the company's business[148] bears to the value of all its assets.[149] A disposal of shares caused by the liquidation of the company is also within the provision, except to the extent that its business assets are distributed in specie.[150] The ten year requirement is satisfied if for part of the period the business was owned directly and for the balance by the family company.[151] Thus the businessman's relief is not affected, whether he carries on business personally or through the medium of a company.

D. Rates of Tax

The differing rates of tax payable by individuals and corporations are one of the most significant factors in considering the advantages or disadvantages of holding assets through a corporation. A taxpayer's conduct may be governed by whether the corporate rate is greater or lesser than his personal rate. There are found in both systems significant variations in the rates applied to individuals and the rates applied to corporations.

Taking the Canadian system first, it has already been noted that only half of any capital gain or loss is included in income.[152] The obvious effect of this is that capital gains are taxed at only half the rate that is applied to other income. Moreover, the same rates are not payable by both individuals and corporations. The former pay progressive rates[153] ranging from 17% on the first five hundred dollars of taxable income to 47% on amounts above sixty thousand dollars for the year 1972 (the 17% figure being reduced gradually to 6% in 1976) and, in addition, a provincial tax in the region of 30%,[154] calculated as a percentage of the federal tax. The maximum personal rate will thus be in the region of 61%.[155] On the other hand, corporations pay a flat rate of 50%[156] for 1972 which is reduced by 10%[157] of the corporation's taxable income earned in a year in a province (but not the North West Territories or the Yukon Territories).[158] This is not the final story, however, as half of the tax paid by private corporations on taxable capital gains and investment income is refundable when these amounts are distributed.[159]

In the U.K., individuals also pay tax at a different rate from that paid by corporations, but capital gains are not, as in Canada, subject to the progressive tax rates which apply to other income. They are charged to a flat rate of 30%.[160]

Even so, for the purposes of comparison it will be useful to outline briefly the progressive Income Tax system found in the U.K. All income is charged at a standard rate of 38.75%[161] (30% for the year 1973 - 1974, when it is termed the "basic rate").[162] In addition, if the total income of the individual exceeds a prescribed amount, a higher set of Surtax[163] (after 6th April 1973 simply termed "the higher rate or rates")[164] rates are applied and if (after 6th April 1973) investment income exceeds a prescribed amount, there is an Investment Surcharge payable.[165] The surtax rates for 1972-3 (which are paid in addition to the standard rate) have not been fixed, but for 1971-2 they began at 10% on the first five hundred pounds of the amount by which total income exceeds two thousand pounds and ended at 50% on total income in excess of fifteen thousand pounds,[166] and the higher rates of tax set for the year 1973-4 begin at 40% on the first one thousand pounds of the amount by which total income exceeds five thousand pounds and end at 75% of total income in excess of twenty thousand pounds.[167] The basic rate is not payable when the higher rates are payable,[168] but the Investment Surcharge, which is fixed at 15% for the same year, is payable in addition to the higher rates.[169] Thus the maximum rate payable on investment income in the year 1973-74 will be 90%.

There is one exception to the rule that capital gains accruing to individuals are not brought within the progressive Income Tax system, although this is more in the way of relieving provision for low income taxpayers. Under section 21 of the F.A. 1965 an individual resident or ordinarily resident in the U.K. can, if the result would be a reduction in tax payable on capital gains, pay Income Tax and Surtax (or the higher rates and the Investment Surcharge for the year 1973-74) on an amount equal to half the net capital gains realised in a year if the total amount of such gains does not exceed five thousand pounds and, in any other case, on an amount equal to two thousand five hundred pounds plus the excess of gains over five thousand pounds. These amounts are treated as the highest part of income, but the individual can set off most personal allowances against them(but not losses).[170] The alternative rate is not available in connection with the disposal of an asset which the individual acquired (otherwise than as a legatee) within the two years prior to the disposal from a person who was connected with him.[171] The result of this provision is that an individual paying only standard or basic rate Income Tax will pay in year 1972-73 a rate of 19.375% on capital gains and in the year 1973-74 a rate of 15%, but as the individual's income increases, so that he is paying Surtax or the higher rate or rates and the Investment Surcharge, the advantages will cease. However, in no case will the rate payable exceed 30%.

U.K. corporations pay a standard rate of Corporation Tax on their "profits".[172] This rate is set by Parliament for each financial year (April 1st - March 31st) in the Finance Act following such year[173] and the rate set for 1971-72[174] is 40%. As from April 1st 1973, as already mentioned,[175] a fraction of capital gains accruing to corporations will not be included in "profits" for Corporation Tax purposes. In view of the fact that the Government has announced its intention to make this fraction for the first year two-fifths and the corporate rate 50%, corporations[176] will pay an effective rate of 30% on gains, i.e. the same as the standard rate for individuals.

The position of individuals under both systems is very similar, although this would not seem to be the case at first sight. Whereas in Canada half of any capital gain is included in income subject to progressive rates of tax, giving an effective maximum rate of 30-1%, the same result is achieved in the U.K. by virtue of a maximum rate of 30% coupled with the alternative basis, which allows the application of progressive rates up to the maximum rate. On the other hand, the taxation of corporate gains is more generous in Canada, though less so after 1st April 1973.

Several consequences flow from the differing rates payable by corporations and individuals on the one hand and from the differing rates payable by both corporations and individuals in respect of capital gains and other income on the other hand. In regard to the former, whether an individual will transfer an asset to a corporation will to some extent depend on whether the corporate tax rate exceeds his own. If it is higher, it may be advisable to hold assets outside a corporation, but if it is lower, the opposite is true.[177] However, the answer to this question cannot depend solely on differing rates payable. It may be desired to distribute to shareholders capital gains realised by the corporation, in which case the tax treatment of corporate distributions will have to be considered. The tax treatment of a distribution may nullify the benefit gained from a low corporate rate.[178]

Regarding the differing rates referable to capital gains and other income found in both systems, there is an obvious inducement for taxpayers to have their receipts treated as capital gains as opposed to ordinary income. This is more fully discussed in the relevant chapters.[179] However, the general effect is that shareholders may aim to realise corporate surpluses as capital gains, e.g. by means of a capital distribution from the company or by disposing of shares in the market, instead of receiving dividends from the corporation, which are taxable as ordinary income.

On the whole, non-resident taxpayers pay the same rates of tax as residents, so the general position outlined above is equally applicable. However, there are some differences. The limited nature of the liability of non-resident taxpayers to pay tax on capital gains and the confinement of the U.K. alternative rate of tax to resident individuals has already been mentioned, but there is, in addition, a

Canadian provision[180] which imposes an extra tax of 25% on every corporation (other than one that was throughout the year a Canadian corporation)[181] that carries on business in Canada in respect of its taxable income[182] or taxable income earned in Canada,[183] as the case may be. The purpose of this tax is to equalise the position of non-resident companies which carry on business in Canada through branches or agencies with that of those companies which have incorporated Canadian subsidiary companies.[184] Whereas the non-resident withholding tax[185] is paid in respect of distributions made by such subsidiaries, it is not paid on remittances of profits by a Canadian branch office to its owners. Thus the additional rate of tax is made to equal that of the non-resident withholding tax[186] and certain deductions are allowed from the taxable amount, so that the actual sum taxed approximates the income that would be earned by a subsidiary and distributed by it to the parent.[187] In particular, any corporation which is a non-resident throughout the year can deduct the amount of any taxable capital gains arising from dispositions of taxable Canadian property which are not used in carrying on the business.[188]

The application of the section to all non-Canadian corporations means that not just non-resident corporations, but a few resident corporations, will be paying the tax.[189]

Further, such companies will pay the tax on all the capital gains for which they are liable, not merely those arising on assets used in their business.[190] This seems somewhat anomalous in view of the purpose of the section.

Part 4 - Particular Corporate Dispositions

As a general rule, the same events will constitute disposals or dispositions and the effect of such disposals or dispositions will be the same for the purpose of taxing capital gains, whether a corporation or an individual is involved. However, in two areas special rules must be considered which arise from the special nature of corporations. In the first place, there is the effect of corporations issuing and dealing in their own shares or securities and, in the second place, the effect of a disposal of assets by a corporation to a person or corporation to which it is closely related, whether by virtue of control, shareholdings, being the member of the same group of companies or otherwise.

In regard to the latter, it is necessary to return to remarks in the introduction to chapter one concerning the necessity for the Law to consider the dual aspect of the separate legal personality of a corporation as against its shareholders and the possible close connection between them, with resulting necessity for anti-avoidance provisions and tax relieving provisions. The same factors are important here. The closeness of the corporation to its members or other persons with which it is closely related gives opportunity to avoid tax by disposing of assets at excessive or low consideration or by manipulating the timing of disposals. On the other hand, the disposal may be to another corporation which is controlled by the same persons as control the transferor, so that there is no real change in ownership of the assets.

There is no need to consider the general rules applicable which are the same as described in chapter one, but it is necessary to consider the special anti-avoidance and relieving provisions relating to corporate disposals.

A. Dealings by a corporation with its own shares

The nature of a share issue, from a tax point of view, depends to a large extent on the point of view taken of the nature of a corporation. Looking at the corporation as a separate legal entity from its shareholders, one would perhaps say that the issue of shares is a disposal of assets in return for a capital sum and that this sum is taxable as a capital gain. On the other hand, if the corporation is considered as a form through which individuals can make joint investments, then the share is no more than a receipt or acknowledgement by the corporation of the shareholder's investment in it and is not an asset of the corporation which it can acquire and dispose of just like its business assets.[191] In practice, the latter view has been adopted in the Canadian and U.K. systems. This is provided for in Canada by section 54(c)(vi)-(vii) of the Act, which defines the term "disposition" so as to exclude the issue by a corporation of any bond, debenture, share or similar interest in a corporation. Although there is no such express statutory provision in the U.K., it is generally recognized that the issue of shares does not give rise to a disposal of them.[192] Apart from the theoretical considerations, in practice, it would seem to be clearly undesirable to have the full amounts received by a corporation on an issue of shares taxed in its hands as a capital gain.[193]

The position is less clear, when it comes to the acquisition and reissue by a corporation of its own shares. There is little problem in the U.K., as the acquisition by a corporation of its own shares is illegal and ultra vires, but, in Canada, the question is a significant one, as the trend appears to be for Corporation Statutes to give this power to corporations incorporated under them.[194] As will be shown in the next chapter,[195] a corporation will not be able to use this power to distribute its accumulated surpluses in the form of the purchase price of shares, on which the shareholders pay tax at capital gains rates only. This is the result of section 84 of the Act which deems all the acquisition price to be a dividend in the shareholder's hands, except in so far as it constitutes a return of paid up capital and except when the acquisition is in the open market, when section 181 of the Act imposes a special tax on the corporation in respect of the same amount. However, if the corporation's own shares are transferred to it in consideration of property sold by the corporation to the shareholder or in settlement of obligations or debts owed by the shareholder to the corporation, the question also arises, as to whether a receipt by the corporation of an amount comprising its own shares will be treated in the same way as a receipt of cash or other property. It is submitted that this is the case. Not only is there no statutory provision excluding such consideration from the computation of capital gains or income accruing to the corporation, but the exclusion of such amounts would open up opportunities for tax avoidance. Further, it does not appear that the same arguments which justify an issue of shares not being a disposition would be applicable here. The corporation is receiving a valuable asset which it can realise by reissuing. Thus the sale by a corporation of property to a shareholder in return for some of its own shares would, if the parties were dealing at arms length, result in a disposition of that property for proceeds of disposition equal to the value of those shares.[196] It seems clear that an acquisition of its own shares by a corporation will cause a disposition of those shares by the shareholder.[197]

The same arguments which were used to justify not treating as a disposition of property an issue of shares by a corporation[198] might also be used to justify the same treatment of a reissue of shares previously acquired by the corporation from its own members. However, the argument would be somewhat weaker, particularly in the case where the corporation makes a habit of dealing in its own shares. The shares have been issued once and are acquired as an asset with value at a definite cost, so that the capital gain accruing during the corporation's holding of the share can be measured. However, it would seem that the same section of the Canadian Act,[199] which prevented an initial issue of shares being a disposition would also apply to a reissue of its own shares. The section not only expressly excludes from the meaning of disposition an issue of shares, but "any other transaction that, but for this subparagraph, would be a disposition by a corporation of a share in its capital stock".

Finally, there is the question of the acquisition cost to the shareholder of shares issued to him by the corporation. This will be governed by the rules discussed in the first chapter. Thus the acquisition cost will be the actual cost to the shareholder of acquiring the shares,[200] unless the corporation does not deal with him at arms length,[201] or the special provisions apply which allow a taxpayer to transfer assets to a corporation without being taxed on any capital gains accrued to those assets.[202] Even where the parties do not deal at arms length, as has already been noted, it may be that section 22(4) of the F.A. 1965 does not apply to determine the acquisition cost to a shareholder of shares issued to him by a corporation, in view of the fact that the section appears to require that the asset in question be both disposed of and acquired and it would appear that the shares have not been disposed of by the corporation when it issues them.[203]

Special rules apply where shares are issued in the course of a reorganization, amalgamation or reconstruction of a company[204] and where shares are issued as bonus or rights issues (in the U.K.)[205] or stock dividends (in Canada)[206]

B. Disposals or dispositions to associated persons

As mentioned in the introduction to this part of this chapter, there are two types of provisions which will be considered in order - anti-avoidance and relieving provisions.

1) Anti-avoidance provisions

There must here be distinguished two types of anti-avoidance provisions. There are the rules already discussed in chapter one, which apply equally to disposals by corporations and there are special rules relating to disposals to shareholders.

a) General provisions

As noted above, section 69 of the Canadian Act and section 22(4) of the U.K. Act apply equally to disposals by corporations as they do to disposals by individuals. However, in regard to disposals by corporations there must be considered further the statutory definition of "related person" and "connected person". Both section 251 of the Canadian Act and paragraph 21 schedule 7 of the F.A. 1965 define circumstances when two corporations are "related" or "connected" to each other. Generally this will be where the corporations are controlled by the same persons or by persons who are themselves "related" or "connected". Otherwise, a corporation is "related" or "connected" to a corporation or an individual in the same circumstances that an individual would be "connected" or "related" to a corporation, e.g. if one controls the other.[207]

The Canadian and U.K. restrictions on losses contained in section 85(4) of the Canadian Act and paragraph 17 schedule 7 F.A. 1965 also apply to disposals by corporations.[208] In addition, in Canada, by section 40(2)(e) a capital loss is deemed to be nil if it results from a disposition of property by a corporation to a person controlling it or to a corporation controlled by the same person as controls it. This subsection is somewhat harsher than section 85(4), in that at least under the latter subsection there is some compensating relief from the adjustment of the cost base of the shares. This enactment of section 40(2)(e) brings the Canadian rules roughly into line with the U.K. rules, as paragraph 17 already covers the situation covered by this subsection.[209] On the other hand, the U.K. provision does not completely nullify the loss as does the Canadian provision.

b) <u>Provisions affecting dispositions to shareholders</u>

Both systems have provisions specifically directed at dispositions to shareholders, which determine the proceeds of disposition of the corporation and the acquisition cost of the assets disposed of to the shareholder.

Where the corporation distributes property to a shareholder as a dividend in kind, it is deemed to dispose of that property for proceeds equal to market value, by virtue of section 52(1) of the Canadian Act, which amount is deemed to form the shareholder's acquisition cost.[210]

In any other case, where property of a corporation has been appropriated in any manner whatever for the benefit of a shareholder, either for no consideration or for consideration less than market value, then, by section 69(4) of the Act, if the sale of that property at fair market value would have increased the corporation's income for the year, for the purposes of determining the corporation's income for the year, it shall be deemed to have sold the property for its fair market value. Section 69(5) of the Act applies an identical provision to appropriations made by the corporation on its winding up, save that it applies even where the shareholders has given full consideration.

There is no limit in either section 52(1) or in sections 69(4)-(5) as to the type of property to which they apply.

Several questions arise in connection with the provisions of sections 69(4)-(5) which to some extent are derived from the fact that they are a direct transposition from the old act to the new act of provisions which were directed at preventing a corporation avoiding realising income on a disposal of its trading stock, by disposing it to shareholders outside the ordinary course of business to realise a capital gain.

In the first place, section 69(4) does not apply where it receives consideration equal to or more than the market value of property appropriated. In this situation, presumably, the proceeds of disposition of the corporation will be the actual proceeds received and the actual cost to the shareholder will form his acquisition cost.[211] The continued application of section 69(5), in spite of such consideration being given by the shareholder, prevents the corporation arguing that the cancellation of the member's shares is full consideration for the property distributed.

In the second place, they do not operate when the sale would decrease the corporation's income, i.e. produce a loss. When considering whether the sale of a corporation's property appropriated to shareholders on a winding up would decrease or increase the corporate income, one commentator has suggested[212] that the section is ambiguous as to whether you should look at each item of property in turn or consider the whole of the corporation's property which is caught by the section (i.e. to see if there is an overall net gain or loss) and that the latter alternative is preferred as being fairer to the company. It would seem that this can only be true in so far as it refers to all the corporation's property distributed to each shareholder, as the section uses the words "property ... appropriated ... to .. a .. shareholder". If the section does not apply because the sale of the assets in question would produce a loss, there will be a disposition of those assets under normal rules for the actual proceeds received, unless the parties do not deal at arms length, when section 69(I) will apply. Moreover the loss may be disallowed under section 40(2)(e).[213]

In the third place, even where sections 69(4) and 69(5) do apply they do not determine the acquisition cost to the recipient. Thus this cost will be the actual consideration given, unless the disposition amounts to a gift, when section 69(I)(c) will deem the acquisition cost to be equal to the fair market value of the property received.[214] It would seem reasonable that the acquisition cost to shareholders of property appropriated to them in a winding up would be the value of the property which they give up to receive such property, i.e. the value of their shares in the corporation which are cancelled in the winding up. However, there is some doubt as to whether this is the correct position in view of the position taken by the Revenue Authorities undertthe old Act that depreciable property received by shareholders in the same circumstances had an acquisition cost to them of nil.[215] To the extent that the amount distributed constitutes a deemed dividend,[216] under section 84 of the Act, there is no problem, since, by reason of section 52(I) of the Act, where a taxpayer has acquired property and an amount in respect of its value has been included in computing his income, that amount is added to the cost base of that property. However, this leaves open the question of the acquisition cost of property received which is not a deemed dividend, but a return of paid up capital.[217]

Lastly, there is the problem concerning the interrelation of section 52(2) and section 69(5). The general effect of section 84 of the Act is that, on a winding up of the corporation, all payments made to shareholders are deemed to be dividends, except in so far as they merely return subscribed capital.[218] If these deemed dividends consist of distributions in kind, do they constitute dividends in kind within the meaning of section 52(2)?[219] This would be of advantage to the shareholders, in that it would give them an acquisition cost equal to market value and to the company in that it would allow it to realise losses, but it would leave little scope for the operation of section 69(5). It has been suggested by one commentator that section 52(2) only applies to dividends paid in the ordinary course of the corporation's business and that section 69(5) applies to distributions made on a winding up by virtue of the rule of statutory interpretation that a particular enactment will overrule a general enactment.[220] However, the matter is not free from doubt, as on the clear words of section 84 and section 52, there seems no reason why the dividend deemed by section 84 should not be considered dividend in kind within the meaning of section 52.

The way to avoid the difficulties surrounding sections 69(4) and 69(5) is to dispose of the assets in question prior to the winding up to the shareholders for proceeds equal tothe fair market value of the assets. This will ensure that the shareholders receive a cost base in the assets equal to fair market value and that the corporation will realize any losses.[221]

In the U.K., there is no distinction drawn between dividends in kind and other distributions made to shareholders.

Section 22(4)(a) of the F.A. 1965, which has already been referred to in connection with non arms length dispositions, also makes express provision for dispositions by corporations to shareholders. It deems a person's acquisition of an asset and the disposal of it to him to be for proceeds equal to market value of the asset "where he acquires the asset otherwise than by way of a bargáin at arms length and in particular where he acquires it by way of gift or by way of distribution from a company in respect of shares in the company."

There are several points to be made in connection with this section and for purposes of comparison with the Canadian provisions.

In the first place, there are none of the difficulties found in connection with the Canadian provisions as to the shareholder's acquisition cost and where the disposal of the property for proceeds equal to market value would produce a loss, although such loss could be disallowed under the provisions discussed at the beginning of this section.

In the second place, the section applies to distributions. Section 233 I.C.T.A. 1970[222] sets out an extensive definition of the term "distribution" for the purpose of Income and Corporation Tax, but there is no section which applies section 233 for the purposes of section 22, so that the term must be given its normal meaning. This is important because although the definition in section 233 is wide enough to cover almost any disposal of property to shareholders, it specifically excludes distributions made on a winding up. Thus the section will apply both while the company is a going concern and when it is being wound up and it would seem that the term "distribution" is wide enough to cover both dividends in kind and appropriations of assets to individual shareholders.

Moreover, not only do the U.K. provisions prevent the corporation avoiding tax by transferring assets in artificial transactions to their members, but they prevent close companies[223] assisting their shareholders to reduce potential gains on their shares by transferring assets to them at a low consideration. Thus, by para. 18 sched. 7 F.A. 1965, if a close company transfers assets to any person by way of bargain not made at arms length and for consideration less than the market value of those assets, the difference between those two amounts is apportioned among all the shares held in the company and the amount apportioned to each share goes to reduce its cost to its holder. Although, on the face of it, this provision continues to apply when the amount apportioned is taxed as part of its recipient's income,[224] the Revenue have indicated that they will not enforce it in such a situation.[225] It thus appears that the provision will not have a wide scope of operation, in view of the very comprehensive provisions including corporate distributions in shareholders' income.

ii) Tax Relieving Provisions

Here are considered various provisions which have effect when a corporation transfers assets to another corporation with the result that there is no change in the underlying beneficial ownership of those assets, except for a change in the legal form of the holding. In other words, they apply where the transferee corporation is controlled directly or indirectly (i.e. through other corporations) by the same shareholders as control the transferor corporation.

The transfer of assets may also involve, in connection with the reorganization of one or more corporations, an exchange by shareholders of their shares for shares in the new company or an extinguishing of those shares consequent upon the liquidation of the company. The provisions which allow a tax free transfer of assets to another corporation in such situations will be discussed in chapter five.

Of the two sets of provisions now to be discussed neither has an exact equivalent in the Canadian Act, so that in both cases the U.K. position will be set out and be followed by a discussion of to what extent (if any) Canadian Law provides relief in the same situation. First will be set out the provisions which permit corporations to transfer assets to corporations within the same group of companies at no tax cost and then the rules which permit a tax free transfer of foreign business assets to foreign corporations.

(a) Inter Group Transfers

Having considered the anti-avoidance provisions in this and the previous chapter, it can be seen that a disposition by a company to a company which it controls, which controls it, or which is controlled by another company, which also (whether directly or indirectly) controls it, will not only generally result in the proceeds of sale being deemed to equal the market value of the asset disposed of, but there will be some sort of limitation on the deductibility of losses incurred. On the other hand, where there is a group of two or more companies which is under the control of one parent corporation, it is also clear that a transfer between the members of the group is not a disposition where there is a real change in ownership of the assets transferred. Rather the whole group should be likened to one large corporation which is allocating and reallocating assets between its various branches.

Thus, U.K. law treats groups of resident companies as one entity and ignores transfers between group members, so that the acquisition cost of the member who actually acquires an asset from an outsider forms the acquisition cost of the whole group and in particular for the group member who finally disposes of the asset to an outsider.

First must be considered the definition of a "group of companies" for the purpose of these provisions. A precise definition is set out in the I.C.T.A. 1970,[226] but the general effect is that a "group of companies" comprises a principal company and any company or companies in which it holds, as beneficial owner directly or indirectly,[227] 75% of the issued share capital[228] and if a principal company is itself a member of a group under the above definition, then its own subsidiaries[229] are also members of that group.[230] Thus the same persons will ultimately control through the principal corporation of each group at least 75% of the issued share capital of all its subsidiaries.[231]

Section 273(I) of the I.C.T.A. 1970 provides that if a member of a group disposes of assets to another member of the same group, the asset is deemed to be disposed of for proceeds of such amount as will give rise to neither a capital gain or loss. The acquirer takes over the disposer's acquisition date when the asset was acquired prior to the 6th April 1965.[232] Certain transactions are excepted from the above rule, which are as follows:

(a) <u>Transactions involving trading stock.</u> The effect of such a transaction depends on whether the asset is trading stock in the hands of both the acquiring and disposing company or is a capital asset in the hands of one and trading stock in the hands of the other. In the former case, the rule has no application[233] and, in the latter case, the act lays down special rules which, as a rule, result in the asset being deemed to be disposed of for proceeds equal to market value and acquired at a cost equal to this amount.[234]

(b) The disposal of a debt by one group member which is <u>effected by satisfying the debt or any part of it.</u>[235] It should be noted that generally a disposal of a debt by the original creditor will not give rise to a chargeable gain or allowable loss,[236] but this does not apply to any "debt on a security", which is defined[237] to include loan stock (whether secured or unsecured) of any company. Thus the redemption of debentures of one group member held by another group member may give rise to a capital gain or loss.

(c) The disposal of redeemable shares on the occasion <u>of their redemption.</u>[238]

(d) The disposal of shares resulting from a "capital <u>distribution" made by one group member to another.</u>[239]

The general principle behind these exceptions is that the rule in section 273 should only apply where there is an actual physical transfer of non trading assets and not where the disposal in question is a disposal of shares or debentures by their holder when the company makes a return of capital. However, in spite of the fact that the above exceptions preclude the disposers of shares or debentures from obtaining the deferral of a capital gain, it is not clear whether they also preclude the corporation returning capital from doing so, if that return of capital is by way of a transfer of assets in specie.[240]

Reference has already been made to section 33 of the F.A. 1965,[241] which permits any taxpayer to defer a capital gain arising on the disposal of an asset used in a business, if the proceeds are used to acquire a new asset to be used in the business.[242] Section 276 of the I.C.T.A. 1970 provides that for the purposes of this rule "all the trades carried on by members of a group of companies shall be treated as a single trade". The result of this is to treat all the members of a group as one entity for the purposes of this rule, so that it will apply where one member disposes of an asset, but a different member of the group acquires the new asset and the condition that the assets be used in the business of the taxpayer is satisfied if the assets are used in any business carried on by any group member.[243]

The above rules, which allow the tax free transfer of assets between group members, were open to abuse by corporations for tax avoidance purposes, with the result that various anti-avoidance provisions have been enacted, which are recounted below.

(i) <u>Assets held by a company leaving a group</u>.

As above mentioned, a charge to corporation tax may arise when an asset is disposed of outside the group. To avoid this, it was easy to transfer the asset to be sold outside the group to a company within the group specially formed for this purpose and then to sell the shares in this company to an outsider. This procedure is met by section 278, which deems the company whose shares are sold outside the group to have disposed of and reacquired any asset, which it acquired within the last six years from a fellow group member, at the date of actual acquisition for proceeds equal to market value at that date. The section also applies when the company leaving the group owns an asset, to which a chargeable gain has been carried forward on a replacement of a business asset under section 33 of the F.A. 1965.[244]

The section does not apply in three situations in which there can be no tax avoidance intention. These are as follows:

(a) When the asset was acquired from another group member, which leavesthe group at the same time, and the two companies themselves form a group.[245]

(b) Where the corporation leaves the group as a result of being wound up or as a result of some other company being wound up.[246]

(c) By section 278 A, where the companyleaves the group as the result of a particular type of merger, effected by exchanging shares or debentures in the company for shares or debentures in a company outside the group.

(ii) Shares in a subsidiary leaving the group

Section 279 was enacted to avoid a specific situation, which arises when a corporation owns shares in a subsidiary which have appreciated in value. To realise this gain tax free, it was possible to incorporate a company outside the group and then to dispose of the shares in the subsidiary to this company in return for an issue of shares. This couldbe done at no tax cost to the parent company because of para. 6 sched. 7 of the F.A. 1965[247] and the new company received the shares at market value, so that it could dispose of them at no tax cost. This is avoided by deeming the parent company to have disposed of and reacquired the original shares in its subsidiary for proceeds of sale equal to their market value just before the reorganization.[248]

(iii) Depreciatory transactions

It has been seen that, by virtue of section 273, assets can be transferred from one group member to another without any capital gain being realised. As it stands, this would allow group members to strip a subsidiary member of its assets at no tax cost and then to dispose of the shares held by the group members and realize a capital loss. To counter this, section 280 of the I.C.T.A. 1970 provides that any loss resulting from the disposal by one group member of shares or securities in another group member must be reduced by the amount that appears to the Inspector of Taxes to be just and reasonable having regard to any "depreciatory transactions". The latter term is defined as "any disposal of assets at other than market value by one member of a group of companies to another" or any other transaction to which at least two group members were parties, one of whom must be the company whose shares are disposed of at a loss.[249] In assessing the amount by which the loss is to be reduced, the Inspector must make the decision on the footing that the loss should not reflect a reduction in the value of the company's assets caused by a "depreciatory transaction", in so far as the transaction increased the assets value of any other member.[250] On the other hand, on a disposal of shares or securities of any other company which was a party to a depreciatory transaction by reference to which a loss reduction was made, within six years of such transaction, the Inspector must reduce any gain by such amount as seems just and reasonable having regard to the effect of the transaction on those shares of securities.[251] Thus the section, in effect, prevents the deferral of tax on accrued gains on corporate assets.

Turning to the Canadian system in our search for tax relieving provisions for inter-group transfers, one must stop at section 85 which was described in the previous chapter.[252] This applies to transfers to corporations by corporations, as it applies to transfers by individuals, and, in this case, is subject to the same limitations. It hardly needs to be pointed out how deficient this is as compared with the U.K. provisions. It will cover one situation only that is covered by the U.K. provisions, i.e. the transfer of assets to a subsidiary corporation and then only to the extent that consideration is received in the form of shares. It will not apply to transfers to parent companies or to fellow subsidiaries within the same group of companies. In view of the fact that section 69(1)(b) will deem the proceeds of a transfer to equal market value where assets are transferred to a controlling corporation or to a corporation controlled by the same persons as control the transferor or (where section 85 does not apply) to a subsidiary corporation and that sections 40(2)(e) and 85(4) will, in the case of the first, nullify and, in the case of the latter, restrict the deductibility of any losses,[253] the absence of group relief in Canada has been much criticized.[254] The tax avoidance provisions in this area are very effective, but there is no recognition of the other side of the corporate situation, i.e. that the group of companies controlled by one company is in substance one large corporation organized into several branches. Tax avoidance provisions of equal force exist in the U.K., but these are countered by the provisions of section 273, as limited by the other provisions just described.

Three defects in the U.K. system just described should be noted which, a fortiori, also exist in the Canadian system. In the first place, although sections 258-264 of the I.C.T.A. 1970 set out a procedure for one group member to utilize the trading losses and other reliefs of another group member, there is no such procedure in connection with capital losses and this has been criticized.[255] In practice, it is possible to get round this by arranging that all disposals of assets within a group to outsiders are made by only one group member.[256] The second defect is that although an individual is allowed by both systems to transfer assets to a corporation controlled by him without recognition of any gain or loss,[257] if a corporation transfers assets to a shareholder who is an individual there is no tax relief, even where the shareholder controls the corporation, so that there is no real change in the substantial ownership of the asset.

Finally, in so far as non-resident companies are liable to pay tax on capital gains, they will be subject to all the anti-avoidance provisions which have just been described in this chapter, but will obtain the benefit of none of the complementary tax relieving provisions.

(b) Transfers of assets to non-resident companies

Section 268 of the I.C.T.A. 1970 applies when a company resident in the U.K., which carries on a trade outside the U.K. through a branch of agency, transfers the trade carried on there, together with its assets (or assets other than cash), to a company not resident in the U.K. and the business is transferred wholly or partly for shares or for shares and loan stock, but so that the shares held by the transferor amount to at least 25% of the ordinary share capital of the transferee company. Any capital gain is actually calculated in respect of each asset and apportioned between the shares and loan stock received on the one hand and the other consideration on the other hand according to market value at the date of transfer.[258] Tax must be paid on the amount apportioned to the latter, but is deferred on the amount apportioned to the former, until the happening of certain specified events.[259]

The provision is similar to the one which permits individuals to defer capital gains arising when they transfer assets comprised in a business to a corporation,[260] but differs in some respects. In the first place, the deferral extends to the proportion of any gain attributable to loan stock, unlike the former provisions. In the second place, the deferral only endures for a period extending up to the first of the specified events to take place.[261] It may very well be that this would be the disposal ofthe shares or loan stock received from the transferee company, but there would still be the difference that a mere partial disposal of such shares or loan stock will make the whole gain immediately taxable.

It was noted in connection with para. 15 sched. 19 of the F.A. 1969 that there was no express limitation in the section to companies resident in the U.K. It would thus appear that an individual can transfer assets to a foreign corporation and getthe benefit of this provision. Whereas this provision applies to both foreign and non-foreign assets, section 268 only applies to foreign assets. Regard should also be had to the provisions which exempt an individual who is resident or ordinarily resident in, but not domiciled in, the U.K. from tax on gains arising on foreign assets, until they are remitted to the U.K.[262]

Lastly, it should be noted that there is no Canadian provision which defers a capital gain on a transfer of assets to a foreign corporation. The reason for this was stated in the Government's White Paper, "Proposals For Tax Reform", to be that if a tax free "roll-over" into foreign corporations were permitted, gains might "slide through the Canadian tax net untouched"[263] and it does seem that there could be a tax avoidance or evasion problem if a taxpayer were allowed to "roll-over" assets situated in Canada into a foreign corporation in return for shares. However, the same reasoning would not apply in the case of a transfer of foreign assets to a foreign corporation.

Moreover, a corporation resident in Canada, just like any other resident taxpayer, is deemed to dispose of all its property other than taxable Canadian property for proceeds equal to its fair market value if it ceases to be resident in Canada.[264] It can avoid this, if it is a Canadian Corporation,[265] by making an election and giving the Minister security for the tax it would otherwise have paid.[266] In this case the property, in respect of which the election is made, is treated as taxable Canadian property,[267] i.e. if disposed of by it while non-resident, there may be taxable capital gains or allowable capital losses. The election is also available for individuals, but not for trusts.[268] When a taxpayer becomes resident in Canada, he is deemed to acquire all his property, except taxable Canadian property and property in respect of which the election was made, at a cost equal to its market value.[269] Thus the taxpayer is only liable for gains arising while he resides in Canada.

Part 5 - Special Corporations

The rules already discussed in this chapter are generally applicable to the corporations now to be mentioned, but are modified in many particular respects. The basic object of most of these corporations is to combine the investment funds of numerous individual investors into one common fund, so that the corporation becomes the direct holder of the investments and the individual investor obtains shares in the corporation. The special treatment of these corporations is founded on a general policy which aims at treating them as a conduit only between the actual investments and their shareholders. In this chapter is discussed the definition and nature of such institutions and the taxation of income and capital gains in their hands as it is realised, although, in fact, many of the most important provisions which given them their characteristic conduit nature are found in the following chapter on distributions. The degree of integration of personal and corporate taxation achieved and the methods used to achieve it vary from one corporation to another.

Also included under this head are institutions which do not fall so easily into the above paragraph. Unit and mutual fund trusts are not corporations, but they do serve similar functions to those of the investment institutions there described, and not only are they to a great extent given the conduit treatment, but they are in many areas either treated as, or in a similar fashion to, corporations. On the other hand, insurance companies are corporations, but only part of their function involves the investment of their investors' money. They conduct a profitable business for their shareholders, but also, in the case of life insurance companies, act as investment vehicles for their policyholders. Therefore they are dealt with here, but from their policyholders' point of view and not that of their shareholders.

The holders of shares or units in these institutions are generally taxable on capital gains realised when they dispose of them as in the case of any other assets. The special rules applicable to shares, which were described earlier in this chapter, also apply to shares in such of these institutions as are corporations. Even units in unit and mutual fund trusts will often be treated similarly to shares. Thus the identification rules will apply to them.[270] Further, there are express provisions in both systems which tend to put them in the same position as shares. In Canada, certain units are included in the definition of taxable Canadian property and, in the U.K., certain units are equated with quoted shares and securities for the purpose of the computation rules.

A. Non-resident Owned Investment Corporations

The purpose of this corporation is to allow non-residents to pool their resources and put their money into Canadian investments through the means of a corporation, without suffering any greater tax burden than if the investment had been made directly. The qualifying conditions[271] for such a corporation, which must be complied with throughout the period following incorporation[272] up to the end of the tax year in question, require that all the issued shares and debentures[273] be owned by non-residents[274] or other non-resident owned investment corporations and generally restrict the main business of the corporation to that of holding and making investments. The corporation must make an election within 90 days of the commencement of its first tax year commencing after 1971[275] and once its status is lost through failing to comply with the conditions, it cannot be regained. The definition thus excludes corporations carrying on an active business and generally[276] corporations with resident shareholders.

In regard to capital gains accruing to such a corporation the tax treatment is favourable in two ways. In the first place, just as non-resident persons are only liable for capital gains arising from dispositions of "taxable Canadian property"[227] so are non-resident owned investment corporations.[278] In the second place, the rate of tax payable is only 25%,[279] although the effect of this advantage is nullified by the fact that the whole amount of capital gains and losses are included in income (and not just half). As, however, the act provides a method for distributing such capital gains at no tax cost to the member in receipt of the distribution,[280] a non-resident shareholder will be in no worse position through realising the gain through the corporation than if he had realised it personally, unless his personal rate of income tax is less than 50%. Moreover he will be better off if his personal rate exceeds 50%.

A similar position exists in regard to income other than taxable capital gains which accrues to the non-resident owned investment corporation. The Act contains provisions which ensure that the only tax paid on income arising from investments held by the corporation is the withholding tax paid when this income is distributed to its members.[281]

Shares in these corporations are not expressly included in the Act's definition of taxable Canadian property, but in view of the fact that it is unlikely that such a corporation would ever be a public corporation,[282] it appears that they will usually be such by virtue of being shares in a non-public corporation resident in Canada.[283] Thus the non-resident taxpayer will be taxable on capital gains realised on their disposal.

There are no special provisions in the U.K. for non-residents making investments in the country through the means of a corporation. Therefore, except in regard to assets used in a trade or business carried on in the U.K.,[284] the non-resident will be clearly worse off to hold assets through a corporation situate in the U.K. Such a corporation will pay corporation tax at normal rates to the same extent as any other resident corporation, even though a non-resident person in the same situation would pay no tax.

B. <u>Investment Corporations and Trusts</u>

Both systems provide for a type of corporation which from a tax point of view acts simply as a conduit between its shareholders and its investments in connection with capital gains accruing to it. In Canada, they are termed "investment corporations" and, in the U.K., "investment trusts". The conditions of qualification require that the shares in the corporation be widely spread among the public[285] and that the main business of the corporation be the making and holding of investments. Thus the U.K. act requires that "the company's income is derived wholly or mainly from shares or securities"[286] and the Canadian Act requires that at least 80% of the corporation's property throughout the year consist of "shares, bonds, marketable securities, or cash",[287] and that "not less than 95% of its income for the year was derived from, or dispositions of, "these investments.[288] It will be noted that the reference to "income" in the U.K. condition does not include a reference to capital gains, whereas the Canadian provision clearly does so. The conditions further require that a certain amount of the corporation's yearly income be distributed,[289] but this amount is calculated without reference to capital gains accruing in the year and, in fact, the investment trust's articles of association or memorandum of association are required to prohibit" the distribution as dividends of surpluses arising from the realization of investments".[290] Both acts place limits on the size of individual investments that can be made in one company by the investment corporation or investment trust.[291]

In addition to the above conditions common to both systems, there are conditions peculiar to each system. Thus in Canada, a minimum amount of its "gross revenue" must arise in Canada[292] and there is a limit on the size of one taxpayer's holding in the investment corporation[293] and, in the U.K., the conditions recorded above are minimum conditions which must exist before the company can be approved by the Board of Trade.

Taxable capital gains are included in the investment corporation's income and charged to Income Tax as are such gains accruing to other corporations. Double taxation is avoided by the use of a tax refund available when the corporation distributes its capital gains.[294]

On the other hand, the profits of an investment trust are computed by including only a fraction of its chargeable gains. These gains are reduced by five eighths or such other fraction in future years as Parliament may determine.[295] As the Corporation Tax rate is to be fixed at 40% for the financial year 1972, such gains will be taxed at an effective rate of 15%. It will be noted that this is the same rate as will be paid by individuals under the alternative rate[296] as from 6th April 1973. Double taxation of gains accruing to investment trusts is avoided by a procedure which gives the shareholder a tax credit in respect of tax payable by him on any capital gain realised on a disposal of shares in the company.[297]

The above treatment of capital gains accruing to investment trusts and investment corporations must be contrasted with the taxation of other income accruing to such corporations. In Canada, the corporation pays tax at a rate of 25% on such income[298] and the shareholder is given full credit for this by virtue of the standard dividend tax credit given in respect of taxable dividends.[299] On the other hand, in the U.K., the corporation is in the same position in respect of such income as is any other corporation and distributions from it are treated as ordinary distributions. Thus in this respect the investment trust is somewhat disadvantageous to investors.

C. Mutual Fund Corporations

This is a corporation which is very similar to the investment corporation, but without many of the restricting conditions attached to that corporation. There are three basic conditions. In the first place, it must be a "Canadian Corporation"[300] and a "public corporation";[301] in the second place, "its only undertaking was the investing of funds of the corporation"[302] and, finally, shares issued by the corporation amounting to 95% of the fair market value of all its shares issued must either have conditions attached to them "requiring the corporation to accept, at the demand of the holder thereof and at the price determined and payable in accordance with the conditions, the surrender of the shares, or fractions or parts thereof, that are fully paid" or "be qualified in accordance with the prescribed conditions relating to the redemption of shares".[303]

The tax treatment of capital gains in the hands of mutual fund corporations is the same as for investment corporations. Further, there is the same right to a refund of tax paid on capital gains when such gains are distributed and, in addition, a similar right when it redeems its shares.[304]

An investment corporation will also qualify for the latter right if it satisfies the above three conditions necessary for it to be a mutual fund corporation.

Although the mutual fund corporation would thus appear to be a much more flexible instrument, with equal tax benefits so far as capital gains are concerned, in fact there is a great incentive to qualify as an investment corporation. The reason is that such a corporation pays a rate of 25% on its income other than capital gains.[305]

D. Unit Trusts

Unit trusts are provided for in the tax systems of both countries, although the provisions made are various in their methods and effects. Generally such trusts are treated as ordinary trusts, unless statute provides otherwise, so that an account of the general law governing trusts is required. On the other hand, in many situations the rules applicable to trusts are excluded and the unit trust is treated as a company.

First will be considered the statutory definitions found of unit trusts. In Canada, a unit trust is defined[306] under two alternative definitions either of which is sufficient, but it must in any case be "an inter vivos trust the interest of each beneficiary under which was described by reference to units of the trust".[307] The first alternative is simply a condition as to the redemption of trust units similar to that found in connection with shares in a mutual fund corporation.[308] The other alternative places restrictions on the activities of the trust and makes it subject to "prescribed conditions relating to the number of its unit holders, dispersal of ownership of its units and public trading of its units",[309] but there are no redemption requirements. In fact the limitations are similar to those imposed on investment corporations[310] -- the only undertaking of the trust must be the "investing of funds of the trust";[311] it must be resident in Canada;[312] at least 80% of its property throughout the year must consist of shares, bonds, mortgages, marketable securities, cash and certain rentals and royalties;[313] 95% of its income must be derived from, or dispositions of, its above investments;[314] and there is a limitation on the size of any one investment held by the trust in a single corporation.[315]

In the U.K., a distinction must be drawn between authorised and unauthorized unit trusts. The former are defined[316] as "a unit trust scheme in the case of which an order of the Board of Trade under section 17 of the Prevention of Frauds (Investments) Act 1958" or the equivalent Northern Ireland Act is in force.[317] A unit trust scheme is defined as "any arrangement made for the purpose of, or having the effect of, providing facilities for the participation by persons as beneficiaries under a trust in the profits or income arising from the acquisition, holding, management or disposal of securities or any other property whatsoever".[318] An unauthorized trust is simply one which is not authorised. The Prevention of Frauds (Investments) Act sets out the conditions on which the Board will approve an authorised unit trust.[319] These conditions concern the type of trustee which is acceptable and lay down minimum contents for the trust deed. In particular the trust deed must give the unit holder the right to require the manager of the trust to purchase his units, but there are no conditions concerning the investment activities of the trust[320] or the distribution of its income.

In Canada, unit trusts are taxed as ordinary trusts, which in turn are taxed as if they were individual taxpayers.[321] As a result, capital gains accruing to the unit trust are included in the computation of the trust's income in the same manner as they are included in an individual's income. However, the rate of tax will generally be higher. Under Section 122(I), the rateof tax payable by an inter vivos trust[322] (including a unit trust) on its income is the greater of 39%[323] and the rate payable by an individual on the same income.[324] This puts the trust in a similar position to that of a company paying a fixed corporate rate of 50% and means that the trust will never pay less tax than an individual beneficiary would, but may pay more. A non-resident unit trust is in the same position as a non-resident individual. In particular, it is only liable for capital gains arising from dispositions of taxable Canadian property.[325]

As in the case of an ordinary trust, a unit trust makes a disposition of property when it makes a "transfer of property of the trust to any beneficiary under the trust".[326] Further, the parties to such a transfer will possibly not be dealing at arms length,[327] in which case the proceeds of disposition would be deemed to be market value.[328] Two rules concerning dispositions of ordinary trusts do not apply in the case of unit trusts. In the first place, unit trusts are not deemed to dispose of their assets every 21 years for proceeds equal to the market value of those assets[329] and, in the second place, the provisions which deem trustees to dispose of assets for proceeds equal to their adjusted cost base[330] when the assets are being transferred to beneficiaries in total or partial satisfaction of their capital interests in the trust are not applicable to unit trusts.[331]

The trustees of any trust, whether resident or non-resident, can avoid paying tax on income arising, if that income is payable[332] in the year it arises to its beneficiaries, i.e. in the case of a unit trust its unit holders. The amount so payable is deducted from the trust's income[333] and included as part of the beneficiary's income.[334] However, this procedure is not available if both trust and beneficiary are not resident in Canada.[335] This right of deduction not only ensures that the trustees are not taxed on income and capital gains accruing to them, but that these amounts are taxed at the individual rates of the beneficiaries who are entitled to them. In the case of non-resident beneficiaries entitled to such income, the non-resident withholding tax is payable, but only when the income is distributed.[336]

Turning now to the taxation of U.K. unit trusts one can fairly quickly dispose of authorised unit trusts, which, by virtue of section 354(I) of the I.C.T.A. 1970 are treated as companies "resident in the U.K., whose business consists mainly in the making of investments and the principal part of whose income is derived therefrom".[337] Similarly, its unit holders are treated as if they are shareholders in the company.[338] The consequence is that, as regards income and capital gains, the taxation of authorised unit trusts is the same as the taxation of investment trusts.[339] There is, however, one provision which allows a reduction in the chargeable gains accruing to authorised unit trusts when the trust is contracting, i.e. when it redeems more units in a year than are purchased, and so is forced to dispose of trust assets to meet the difference.[340] The object is to prevent the double taxation of capital gains arising from the disposal of such assets - once in the hands of the trust and once in the hands of the unit holder[341] - and to provide relief to the trust.

The treatment of unauthorised unit trusts is a little more complex. Although, by virtue of section 45(8) of the F.A. 1965, a unit trust scheme is treated for Capital Gains Tax purposes as if it were a company and as if the rights of unit holders were shares in the company, the unauthorized unit trust pays[342] Capital Gains Tax on its capital gains and Income Tax on its other income. The effect of treating the trust as a company is to exclude the complicated rules applicable to trusts which cause deemed disposals of the trust's assets on the happening of certain events.[343] On the other hand, it also excludes the rule which treats capital gains realised by a trustee as capital gains of a beneficiary who is absolutely entitled as against the trustee to the settled property.[344] Thus the trust is simply taxed on its capital gains as if it were an individual, but without the benefit of the alternative rate available to individuals.[345]

This position should be contrasted with that in respect of other income realised by a unit trust, in respect of which the absence of any express statutory provision requiring the trust to be treated as a company means that the ordinary trust rules apply. Thus, if a unit holder has a vested right to such income as it arises, whether paid out immediately or not,[346] or the income is in fact paid out to the beneficiary as it arises,[347] then it is treated as income of the beneficiary and taxed at his personal rates. In any other case, the trustee is charged to the standard or basic rate of tax (as the case may be), but not to Surtax or the higher rates.[348]

The unit holder in a unit trust holds a capital asset and will be taxed on any capital gain realised in respect of it, the only complication being that by virtue of sections 45(8)of the F.A.1965 and 354 of the I.C.T.A. 1970 the holder will be treated as disposing of shares in a company and not units of a trust.[349] As in the case of shares, non-resident unit holders in unit trusts resident in the U.K. will not be liable for capital gains arising when they dispose of their units.[350] The case is different in Canada, since units held by non-residents in unit trusts resident in Canada are included within the definition of taxable Canadian property given in section 115(I)(b) of the Act,[351] so that the holder will be taxed on any gain realised on a disposal.

Earlier in the chapter, it was pointed out how it would be possible for a non-resident taxpayer to avoid liability in respect of taxable Canadian property, by transferring such property to a non-resident corporation and disposing of the shares in that corporation and not the property. The Act contains a provision which appears to be designed to counter attempts to carry out a similar scheme using a non-resident unit trust. Section 53(2)(j) applies when a resident taxpayer purchases a unit in a non-resident unit trust from a non-resident person, at a time when the fair market value of all the taxable Canadian property held by the trust exceeds in value one half of all the trust's assets.[352] The section requires that there be calculated the capital gains[353] which have accrued to such taxable Canadian property, but which have not yet been realised, and that the resident purchaser deduct from the adjusted cost base of the purchased units that part of those capital gains which is attributable to those units. This prevents the avoidance of tax caused by a non-resident unit holder of a non-resident unit trust disposing of his units in that trust for a capital gain, which reflects capital gains accrued to taxable Canadian property held by the trust, instead of the trust disposing of that property directly and paying tax on the realised gains. It does this by throwing on to the resident purchaser[354] of units in the trust the liability for any of those accrued gains.

Of course, it will not work in practice as long as the units are transferred to other non-residents.

Where the prices of units in a U.K. unit trust are published daily by the managers of the trust, then for the purpose of applying the transitional provisions for computing gains on assets held on the 6th April 1965[355] and the statutory rules for determining the market value of assets,[356] they are treated as if they were shares or securities quoted on a recognized stock exchange, except that, in the case of the valuation provisions, the value is ascertained with reference to the buying price published, not to any quoted price on a stock exchange.

A comparison of Canadian and U.K. unit trusts is very difficult in view of the unequivocal treatment of the latter as corporations and the application to the former of the ordinary trust rules slightly modified. The unauthorised unit trust can be compared with the Canadian unit trust in regard to the treatment of income other than capital gains, this being the only case where a U.K. unit trust is treated as a trust. Here, in fact, the position of both systems is very similar, the only difference being that in the U.K. the unit holder need not be entitled actually to receive payment of income in the year it arises. Even so, it is apparent that the U.K. unit trusts should be compared to the Canadian investment corporation and mutual fund corporation. The unauthorized unit trust is obviously in an unfavourable position in regard to capital gains realised by it, being taxed as if it were a corporation with none of the reliefs available to these other institutions, but the authorised unit trust is similar to the mutual fund corporation in the lack of special treatment for income other than capital gains and the special refunds or credits given in respect of tax paid on capital gains on a redemption of shares or units. Even the Canadian unit trusts reveal a tendency to be treated as companies, with the minimum 50% rate of tax, the exclusion of the rules deeming periodic dispositions of their assets and the treatment of their units as taxable Canadian property.

E. Mutual Fund Trusts

A mutual fund trust under Canadian Law must satisfy three conditions.[357] In the first place, it must be a unit trust under either of the alternative statutory definitions which is resident in Canada. In the second place, its only undertaking must be the investing of funds of the trust and, lastly, it must comply with "prescribed conditions relating to the number of its unit holders, the dispersal of ownership of its units and the public trading of its units". The mutual fund trust is thus rather similar to an unincorporated version of the mutual fund corporation or the investment corporation depending on which alternative definition of unit trust is complied with.

Income accruing to a mutual fund trust (including capital gains) is taxed in the same way as that accruing to unit trusts,[358] except that the rate of tax payable on taxable capital gains is in all cases a flat federal rate of 39%, to which is added the provincial rate.[359]

In addition to the right of the trustees to deduct from income amounts payable to beneficiaries in the year they arise, a mutual fund trust is able to obtain a refund of tax paid by it on capital gains when it redeems its beneficiaries' units.[360] This removes any element of double taxation arising in connection with capital gains, which were not payable in the year they arose, but accumulated, and gains which are accrued, but not realised, at the redemption date.[361]

A unit of a mutual fund trust held by a non-resident taxpayer is taxable Canadian property, if at any time during such of the period of 5 years immediately preceding its disposition as is after 1971, not less than 25% of the issued units of the trust belonged to the taxpayer, to persons with whom he did not deal at arms length or to both these categories of person.[362] If a taxpayer's units are taxable Canadian property, then he will be liable for any capital gains resulting from their disposal. It will be noted that the test here applied to these units is the same as that applied to shares in public corporations,[363] including, in particular, mutual fund and investment corporations.

The mutual fund trust reveals the same tendencies to be treated as a corporation as the Canadian unit trust In fact, the indications are even stronger in the case of the mutual fund trust, with its flat rate applicable to capital gains and the right to obtain a refund of part of the taxes paid by it on capital gains, which puts it in a similar position to mutual fund corporations in particular. There is no equivalent of the mutual fund trust in the U.K. Its function is performed by the unit trust.

F. Mortgage Investment Corporations

The Federal Government of Canada has proposed to amend the Income Tax Act by adding section 130.1 to provide for Mortgage Investment Corporations. A detailed definition is proposed which will limit the scope of the provisions to corporations the bulk of the investments of which consist of mortgages over real estate.[364] In particular, it must be a "public corporation" and a "Canadian Corporation"[365] and its only undertaking must be the "investment of its funds" and it must not "manage or develop any real property"[366] and it must have at least 100 shareholders, none of whom hold more than 25% of its issued shares.[367]

The corporation pays no Income Tax on capital gains accruing to it in a year to the extent that they are paid out to shareholders as capital dividends within the period commencing 91 days after the beginning of the year and ending 90 after the end of it.[368] There are similar provisions allowing the corporation to deduct from its income taxable dividends paid out of income other than capital gains.[369] Thus, provided the corporation distributes all its income and capital gains within the requisite period, only the shareholders will be taxed on the corporate earnings.

G. Insurance Companies

In both countries insurance companies are liable for Income or Corporation Tax (as the case may be), just as are other companies. However, because of the peculiar nature of their business and, in particular, their dual roles as insurer (with its consequent long term contingent liabilities, which must be provided for with sufficient reserves) and investment medium, special rules are required which must be considered. This applies chiefly to life insurance corporations.

Section 138(I) of the Canadian Act deems certain types of insurance companies[379] to be carrying on an insurance business for profit and provides that their income from that business shall be computed in the same manner as for other corporations, except that its income from such business is deemed to include income from property and taxable capital gains. This general rule is modified in several respects in connection with life insurance corporations.

In the first place, the income of a life insurance company carrying on business in Canada is limited to its income from carrying on such business and, in particular, it includes income and capital gains arising from property "used by it in the year in, or held by it in the year in the course of, carrying on" such business".[371] Income from such business carried on abraad and income and capital gains arising from property used in such business is excluded.

In the second place, in computing the corporation's income, there may be deducted various amounts set out in the Act as reserves in connection with its current policies.[372]

Finally, the full amount of gains and losses arising from the disposition of "Canada Securities" are taken account of in computing income of a life insurance corporation.[373] A "Canada Security isddefined in section 138(12)(c) as a "bond, debenture, mortgage, hypothec or agreement of sale that is non-segregated property used by it in, or held by it in the course of carrying on its life insurance business in Canada". In addition, theaamount of any discount received or premium paid on the purchase of such a security is respectively added to and deducted from its income at the date of purchase[374] and the principal amount of the security forms its cost for the purpose of computing any gain or loss on a subsequent sale.[375]

The Act gives the life insurance company the opportunity to compete with the investment institutions described previously[376] by permitting them to set aside reserves in connection with life policies which "vary in amount depending upon the fair market value of a specified group of assets" and such reserves are termed "segregated funds".[377] Any income or capital gain accruing to the fund is treated as income or capital gain accruing to the policyholder, if so allocated to him by the corporation, and is not included in the corporation's income.[378] There is no double taxation of such income, as it is not included in the policyholder's income when it is actually paid out.[379] This contrasts with the inclusion in the policyholders' income of payments made to them by the corporation otherwise than out of a segregated fund to the extent such payments exceed the cost to the recipient of the policy.[380] However, even here, to the extent that such sums are payable out of policy reserves or consist of dividends, both of which are deductible in computing the corporation's income, these sums also will only be taxed once in the hands of policyholders.[381]

It was to counteract the tax deferral advantage obtained from such payments only being taxable when paid to policyholders that a 15% tax on "taxable Canadian life investment income" of a life insurance corporation has been imposed.[382] This only applies to investment income which has not borne normal Income Tax, i.e. it will apply to the amounts deducted from the corporation's income in respect of policy reserves and dividends.[383] However, the term "taxable Canadian life investment income" does not include capital gains, except those arising from the disposition of Canada securities, but is obtained by deducting various amounts from the corporation's investment income and, in particular, such income as is attributable to segregated funds[384] and payments made to policyholders in respect of their policies in so far as such payments are included in income.[385] The latter two deductions follow from the purpose of the special tax to attack only that income, in respect of which there would otherwise be a tax deferral.

In the U.K., the law aims at the same policy of avoiding the double taxation of capital gains accruing to the life insurance corporation, both in the hands of the corporation and in the hands of policyholders, but whereas the Canadian law to a large extent taxes the policyholder rather than the corporation, in the U.K. the corporation bears the main burden.

Insurance companies generally are subject to

Corporation Tax as are other companies but, as in Canada, there are special rules for life insurance corporations. The Crown has the option[386] to tax life insurance corporations either on their income from investments plus capital gains after deduction of management expenses,[387] but with no deductions in respect of policy liabilities, or on their trading profits as calculated under normal Income Tax rules, with full deductions being allowed for policy reserves and with a deduction of so much of these profits as "belongs or is allocated to, or is reserved for, or expended on behalf of, policyholders".[388] The crown will in most cases opt for the former alternative, on the grounds that the assessment on that basis is usually larger and is simpler to calculate.

Up to the 6th April 1973, where a company carrying on life insurance business had capital gains arising from the disposal of "investments held in connection with its life insurance business" the tax payable on such part of those gains "belongs or is allocated to, or is reserved for, or expended on behalf of policyholders" was at a rate equal to that payable by individuals, i.e. at present 30%.[389] A similar right existed in respect of other income which reduced the tax rate to 37.5%.[390] As payments made to a policy holder in respect of their policies do not cause a disposal of those policies for Capital Gains Tax purposes[391] and are not otherwise included in his income, no more tax will in general be paid on capital gains and other income so distributed than if it had accrued to the policyholders direct.[392]

As from the 6th April 1973 the reduced rate for capital gains is abolished, but it continues for other income. However, because of the general provisions introduced by the F.A. 1972, which reduce by a fraction capital gains accruing to all companies,[393] the effective tax position remains the same.

The U.K. Act also relieves the life insurance company from liability in respect of its income from carrying on its business abroad. There is exempted from Corporation Tax by section 315 of the I.C.T.A. 1970 all income and capital gains arising from assets which form its "foreign life assurance funds",[394] which is the reserve of the company for its foreign life assurance business.

It may happen that a life insurance company will, under the terms of a life insurance policy, transfer investments or other assets to the policy holder instead of making a cash payment. In this case, there is undoubtedly a disposition by the company of the assets transferred[395] and the only question which arises is as to the proceeds of disposition of the company and the acquisition cost of the recipient policyholder. This problem is solved in the U.K. by section 321 of the I.C.T.A. 1970, which deems the company's disposal and the policyholder's acquisition cost to equal the market value of the assets transferred. There is no express Canadian provision, so that it must be assumed that, unless the parties do not deal at arms length,[396] the proceeds and the acquisition cost will equal the value of the right given up by the shareholder in order to receive the assets in specie, as being the actual cost of the policyholder and the value of the benefit gained by the company. On the other hand, if the value of the property received has been included in the policyholder's income as proceeds of disposition of his policy under section 148(I)(a),[397] then this value will apparently form the acquisition cost, by virtue of section 52(I) of the Act, which requires the addition to the cost of any asset of any part of its value included in its owner's income.

Part 6 - Conclusion

The first two parts of this chapter explored the general liability of corporations and shareholders in respect of capital gains realised by them and the rules for computing those gains. They show that there is little in the way of a significant difference in the treatment of different taxpayers and different assets. Both systems impose a lighter liability on non-resident taxpayers, but this is expected. Indeed, the liability imposed on non-residents by the Canadian Act is much heavier than the corresponding U.K. liability and has been the subject of much criticism. Further, although there are different computation rules in both systems for shares and securities, these differences appear to be of a more procedural than substantial nature. Thus an individual will generally be liable to tax in the same circumstances as a corporation would be and a member's shares are in substance treated as other capital assets.

Real differences are found in the Part 3 discussion of the treatment of capital gains and losses. There are, to begin with, some differences in the rights given to different taxpayers to set off their losses, but more important is the low rate of tax paid by all taxpayers on capital gains as compared with other income and the flat rate of corporate tax, which may exceed or be exceeded by the individual rates of shareholders. The latter may, depending on the situation, either discourage individuals from holding assets within a corporation or encourage them to do so. The former factor induces taxpayers and particularly shareholders to obtain their receipts in a form which will produce a capital gain and not ordinary income. These two factors are of prime importance for the purposes of the discussions in the following two chapters on corporate distributions and accumulations.

The provisions discussed in Part 4 revolve around the same problems and principles as those considered in Chapter One. In the latter case, the concern was for the acquisition cost to the shareholder of shares and other property received from a corporation in return for a transfer of assets and the degree of recognition of capital gains resulting from the transfer, while, in the former case, it is the tax position of a corporation issuing shares and transferring assets to another corporation or individual, with which or whom it is closely associated, that is dealt with. There are in each case anti-avoidance provisions and tax relieving provisions, which in effect breach the corporate veil and recognize the essential identity of transferor and transferee. It has already been noted how the Canadian system, by simply applying the same provision to corporations as applies to individuals, fails, in most situations, to give relief to corporations in respect of gains arising from dispositions to other corporations which are under the same control as them and how both systems fail to relieve corporations when transfering assets to their controlling individual shareholders.

The institutions described in the last part of the chapter are corporations and trusts which, to the extent that statute does not otherwise provide, are treated as any other corporations or trusts. However, by satisfying certain conditions restricting their activities and powers and protecting their members, they qualify for special tax advantages. Although most of these only take effect when distributions are made, so that they come within the scope of the next chapter, some, e.g. low rates of tax paid on capital gains by U.K. investment trusts and authorised unit trusts, are of direct relevance to this chapter. Moreover, even at this stage, it can be seen how the U.K. treatment of unit trusts leaves very little scope for the operation of the ordinary trust rules, by treating them as corporations for many purposes. In Canada, there is no such express provision, but the treatment of trusts generally tends towards that of corporations and this is still more pronounced in the case of unit and mutual fund trusts.

NOTES

1 This is speaking loosely, as strictly speaking a shareholder has no legal or equitable interest in corporate property.

2 This refers to shares obtained by purchase or subscription for cash and to shares obtained in return for a transfer of property.

3 In fact, shares may also form part of a corporation's assets.

4 There are, in the U.K., certain anti-avoidance provisions which can make shareholders liable for what is their corporation's primary liability to pay Corporation Tax on capital gains - see text at nn. 42-52 infra.

5 For instance, the disallowance of capital losses in Canada resulting from a decline in the value of personal use property held by the corporation - see text at nn. 130-134 infra.

6 Examples of these companies are investment corporations and trusts and mutual fund corporations.

7 S. 249(I)

8 S. 20(I) F.A. 1965

9 See s. 115(I)-(2) I.C.T.A. 1970, as an example, which provides for tax on business income in the U.K. being paid on income arising in the accounting period of the business ending in the prior year of assessment.

10 Thus, in Canada, business income of an individual is taxed on the basis of income earned in the fiscal period (for a definition of this see s. 248(I)) ending in each taxation year - S. 11(1)

11 S. 249(I) and s. 248(I) in Canada and 247(I) I.C.T.A. 1970 in the U.K.

12 See n. 11 supra

13 See n. 11 supra

14 S. 2(I) and s. 248(I)

15 S. 19(I) and s. 20(I) F.A. 1965

16 S. 238(I) and (3) I.C.T.A. 1970

17 S. 238(4) I.C.T.A. 1970

18 S. 265 I.C.T.A. 1970

19 S. 250 I.C.T.A. 1970

20 Corporations are expressly excluded from the benefit of the section by s. 265(3) I.C.T.A. 1970

21 S. 45(6) F.A. 1965

22 For a discussion of the problems surrounding this provision see G. Wheatcroft and A. Park Capital Gains Taxes paras. 4-08 & 9 and 22-08 to 22-10.

23 In the U.K., there may be a tax free roll-over of assets into the corporation for an individual. In Canada, in no case will this be so -- see Part 3 of Chapter One.

24 S. 41 F.A. 1965 in the U.K. and s. 91 in Canada - see PartII of Chapter Four Sections B and C.

25 S. 39(I) F.A. 1965, s. 498 I.C.T.A. 1970 and s. 100 F.A. 1972 in the U.K. and s. 126 in Canada.

26 S. 126(7)(c)

27 CCH Canadian Ltd. Explanation of Canadian Tax Reform (1972) 327

28 S. 115(1)(b)

29 For the definition of "public corporation" see the Conclusion to Chapter Three (text at nn. 281-92)

30 J. Halley International Income - Canadian Bar Papers on Tax Reform 1971 243 at 250.

31 S. 116(5)

32 There is some difficulty in determining what constitutes reasonable enquiry under the section - P. Walker Acquisitions from Non-residents: Section 116 - 20 Canadian Tax Journal 131 at 135-6 (1972). See generally the same article for a discussion of other problems surrounding the section. For the Government's view as to what constitutes reasonable enquiry and for an account of the procedure to be gone through under the section, see Information Circular 72-17 issued on the 10th July 1972.

33 S. 116(6) was added by s. 38(5) 1973 Bill C-170.

34 The reference to bonds and debentures is odd, seeing as these are not expressly included in the list of taxable Canadian property.

35 S. 246(2)(b) I.C.T.A. 1970

36 G. Wheatcroft and A. Park supra n. 22 at paras. 22-03 &4

37 Article 12(3) of the Agreement

38 Articles 12(1) and 12(2) of the Agreement. Immoveable property is defined in article 5(2) and permanent establishment in article 4. Excluded from moveable property are ships, aircraft and moveable property pertaining to them.

39 See article 8 of the Canada - U.S.A. Agreement as another example.

40 Even if the taxpayer held such assets personally, he would be taxable on any gains - see preceding discussion.

41 See text at nn. 29-30 supra.

42 For the meaning of "capital distribution" see para. 3 sch-7 F.A. 1965 and Part 1 of Chapter Three Section D (text at nn. 98-9) - s. 266(5) I.C.T.A. 1970.

43 I.e. on a winding up.

44 S. 266(4) I.C.T.A. 1970

45 S. 266(3) I.C.T.A. 1970

46 Para. 19(4) provides that references to a gift include references to any transaction otherwise than by way of a bargain made at arms length so far as money or money's worth passes under the transaction without full consideration in money or money's worth. For the nature of a non-arms length bargain see Part 2 of Chapter One (text at nn. 25-31) and text at n. 207 infra.

47 See n. 46 supra.

48 See Part 4 of this chapter Section B.

49 For the definition of "group of companies" see s. 272 and text at nn. 226-31 infra.

50 S. 277(2) I.C.T.A. 1970

51 S. 278(5) I.C.T.A. 1970 - see text at nn. 244-6 infra.

52 S. 279(4) I.C.T.A. 1970 - see text at nn. 247-8 infra.

53 "Disposition" and "proceeds of disposition" have their ordinary meaning, but are partially defined in s. 54(c) and s. 54(h) respectively.

54 "Adjusted cost base" is defined in s. 54(a) and see s. 53 for adjustments to the adjusted cost base of non-depreciable property.

55 S. 19(I) F.A. 1965. "Disposal" has its ordinary meaning, but is partially defined in s. 22(2) of the same act.

56 Para. 4 sch. 6 F.A. 1965.

57 Ministry of National Revenue <u>Tax Reform and You</u> - <u>Valuation Day</u> 13

58 S. 40(1)(b) in Canada and s. 23 F.A. 1965 in the U.K.

59 S. 3(b)

60 S. 38

61 S. 93(2) F.A. 1972

62 See text at nn. 175-6 infra.

63 "Valuation day" is defined in s. 24 I.T.A.R. The prescribed days are 22nd December 1971 for publicly traded shares and securities and 31st December 1971 for other assets - Ministry of National Revenue <u>Tax Reform and You</u> - <u>Capital Gains</u> 9.

64 For an explanation of the effect of this section and an example of its application, see Ministry of National Revenue, supra n. 63 at 9-10.

65 S. 26(7) I.T.A.R.

66 S. 20(1) I.T.A.R.

67 S. 26(5) I.T.A.R.

68 These will include debentures - s. 26(12)(e) I.T.A.R.

69 This is defined in s. 26(12)(a) I.T.A.R. as the principal amount of the obligation if purchased at a discount of less than 5%, the actual cost if purchased at a premium less than 5% or, in any other case, the principal amount plus the proportion of the discount or minus the proportion of the premium which is apportioned to the period prior to 1972 if the discount or premium is spread evenly over the life span of the obligation.

70 S. 24 I.T.A.R. and see n. 63 supra.

71 Para. 23 sch. 6 F.A. 1965.

72 Para. 22(2) Sch. 6 F.A. 1965.

73 Para. 22(4) sch. 6 F.A. 1965.

74 Id.

75 S. 32 F.A. 1968.

76 Para. 1(3) sch. 11 F.A. 1968.

77 There is no exclusion of companies, as for 26(7) I.T.A.R.

78 See Chapter Five

79 Para. 3 sch. 11 F.A. 1968.

80 For the meaning of a "group of companies" see s. 222 I.C.T.A. 1970 and text at nn. 226-31 infra.

81 Para. 2 sch. 11. The time limit for making the election is two years from the end of the year of assessment or accounting period in which the disposal took place - para. 1(6) sch. 11.

82 For an example of the application of the time apportionment formula see G. Wheatcroft and A. Park, supra n. 22 at para. 21-39.

83 This assumes that s. 55 of the Canadian Act does not prevent an election which would reduce a gain or increase a loss - see Part 2 of Chapter One (the last paragraph).

84 Para. 29 sch. 6 F.A. 1965

85 Bonds or debentures are identical to other bonds or debentures if in each case the debtor and the rights attached (except as to principal amount) are the same -s. 47(3).

86 S. 47(2)

87 For an example of the application of these rules, see Ministry of National Revenue, supra n. 63 at 6.

88 These provisions also apply to securities (para. 2(8)) and to all other identical assets - para. 2(7).

89 Para. 2(1)

90 Para. 2(2). For an example of the operation of these provisions, see G. Wheatcroft and A. Park supra n. 22 at para. 12-07.

91 Para. 2(5)

92 Thus, if the disposal would be in breach of a restriction attached to shares received as an employee, they would come from the other shares - <u>Simon's Taxes</u> Vol. C Para. C6.402.

93 S. 26(3) - see this part of this chapter Section B (text at nn. 63-6).

94 For accounts of the application of these transitional identification rules, see <u>Interpretation Bulletin I.T. 78</u> issued 31st December 1971 and Ministry of National Revenue, supra n. 63 at 11.

95 The rule also applies to debentures and other identical assets.

96 S. 32 and sch. 11 F.A. 1968 and paras. 26 and 22 sch. 6 F.A. 1965.

97 See Chapter Five.

98 See Part 1 of Chapter Five Section A (text at nn. 8-11)

99 It seems that the two expressions will be given the same meaning.

100 S. 44(3)

101 For example, the holding is worth more because it gives control of the company or is worth less because it is a minority holding - G. Wheatcroft and A. Park, supra n. 22 at para. 18-08.

102 Para. 22(3) sch. 6 F.A. 1965.

103 S. 24 I.T.A.R. - see n. 63 supra.

104 Ministry of National Revenue, supra n. 63 at 14

105 [1948] 2 A.E. 379.

106 At 384.

107 G. Wheatcroft and A. Park, supra n. 22 at para. 18-12 in the U.K. and in Canada, G. Ovens and I. Campbell Notes on Price and Value Problems in Canada 18 Canadian Tax Journal 206 (1970) and G. Ovens Preliminary Notes on Canadian Price and Value Problems Resulting from Tax Reform 19 Canadian Tax Journal 401 (1971).

108 Untermeyer Estate v A.G. of B.C. [1929] S.C.R. 84

109 For accounts of these principles see G. Wheatcroft and A. Park, supra n. 22 at paras. 18-12 to 18-15, K. Carmichael Share Valuation - Real or Hypothetical 1971 British Tax Review 349, G. Ovens and I. Campbell, supra n. 107 and G. Ovens, supra n. 107.

110 I.e. s. 44(3) and Para. 22(3) sch. 6 F.A. 1965 in the U.K. and s. 26(11) I.T.A.R. in Canada.

111 Ministry of National Revenue, supra n. 63 at 14 and G. Ovens, supra n. 107 at 402-3 and 406.

112 G. Ovens and I. Campbell, supra n. 107 at 213-4 and G. Wheatcroft and A. Park, supra n. 22 at para. 18-15.

113 G. Ovens, supra n. 107 at 403.

114 Ministry of National Revenue, supra n. 63 at 14.

115 G. Ovens and I. Campbell, supra n. 107 at 208-10 and 213-4.

116 S. 3(b) in Canada and s. 20(4) F.A. 1965 and s. 265 I.C.T.A. 1970 in the U.K.

117 S. 111(1)(b) in Canada and s. 20(4) F.A. 1965 and s. 265 I.C.T.A. 1970 in the U.K.

118 S. 177(2), s. 248 and s. 304-5 I.C.T.A. 1970 and s. 74 Capital Allowances Act 1968 - see text at nn. 139-41 infra.

119 S. 111(1)(b)(i)

120 S. 111(1)(b)

121 S. 3(e) and s. 111(1)(b)(ii)

122 "Control" is not defined by statute and so will have its judicially determined meaning - see Chapter One Part 2 (text at n. 29).

123 See E. Mockler Business and Property Income 1971 Conference Report Canadian Tax Foundation 382 at 386, where it is pointed out how broad is the effect of the restriction, in that the transmission on death of shares amounting to a controlling interest will cause a change of control.

124 S. 483 I.C.T.A. 1970.

125 See this part of this chapter Section B.

126 P. Whiteman Fundamental Defects of the Capital Gains Structure 1970 British Tax Review 46. A fortiori, the same arguments are relevant to the position of the U.K. individual, who cannot even deduct non-capital losses from capital gains.

127 Honourable E. Benson, Minister of Finance Summary of 1971 Tax Reform Legislation 30.

128 L. Seltzer The Nature and Tax Treatment of Capital Gains and Losses 106-7 and 112-115.

129 See this part of this chapter Section D.

130. S. 40(2)(g)(iii). Personal use property is given a lengthy definition in s. 54(f), but basically means property owned by a taxpayer which is used primarily for his personal use and enjoyment.

131 S. 39(1)(b)(i)

132 S. 27(1) F.A. 1965

133 Para. 6 sch. 6 F.A. 1965. The disallowance is only to the extent of capital allowances received.

134 For an account of s. 55 see Part 2 of Chapter One (last paragraph).

135 S. 3.

136 S. 111(1)(a) and s. 111(8)(b).

137 S. 111(5)

138 S. 21 F.A. 1965 - see text at nn. 170-171 infra. However, even here, trading losses cannot be set against capital gains - s. 21(2)(a).

139 S. 238(4) I.C.T.A. 1970.

140 In this connection, see s. 251(2) and (3), which limits the interest and other payments which are otherwise deductible in computing income from any source.

141 S. 248(2)(3)(5)(6)(8). See also s. 74 ofthe Capital Allowances Act 1968, which allows depreciation allowances to be deducted from "profits", in so far as they exceed the income of the trade in which the asset in question is used and s. 304-305 I.C.T.A. 1970, which allow, in the case of certain investment and insurance companies and unit trusts, the deduction of expenses of management from "total profits".

142 Trusts are expressly excluded by s. 48(1) from the benefit of the exemption.

143 For a fuller account of s. 48, see text at nn. 264-9 infra.

144 S. 91(2) - see Part 1 of Chapter Four Section C (text at nn. 78).

145 S. 34(2)&(6)

146 A "family company" is defined as one in which the taxpayer owns 25% of the voting rights or one as to which 75% of the voting rights are exercisable by the member and his family and 10% are exercisable personally - S. 34(6). "Family" is also defined in the section.

147 S. 34(1)(b)

148 See n. 145 supra.

149 S. 34(3)

150 Para. 2(1) sch. 10 F.A. 1966.

151 Para. 2(3) sch. 10 F.A. 1966.

152 S. 38 - see Part 2 of this chapter Section A (text at nn. 58-60).

153 S. 117. Note that there are income averaging provisions in s. 118 and s. 61, which aim at eliminating the more harsh results of the progressive system and personal allowances contained in s. 109 and s. 110, neither of which are available to corporations. Note also that the personal rates have been reduced and the allowances increased as a result of the 1973 budget (now 1973 Bill C-193).

154 In B.C. the rate is 30.5% - s. 4(3)(g). Income Tax Act.

155 Thus the maximum rate in B.C. is 61.335%.

156 S. 123. Under S.C. 1972 c. 9, s. 123.1 was added to the Act to provide that the tax otherwise payable by a corporation for its 1972 tax year and for so much of its 1973 tax year as falls within 1972 is reduced by 7%. Although it was proposed in the 1973 budget (now Bill 1973 C-192) to reduce corporation taxes on manufacturing and processing profits, this will not affect capital gains.

157 S. 124. Each province imposes a tax on corporate income, which in B.C. is 10% for 1972 (S. 5(1) Income Tax Act) and which brings the overall corporate rate back up to 50%. For 1973 the B.C. rate is 12%.

158 For the years following 1972 the basic corporate rate of 50% is reduced by 1% per year, until it reaches 46% in 1976 - S. 123.

159 S. 129 - see part 2 of Chapter Three Section B. Note also the various refunds given to and low rates of tax paid by the various investment institutions described in Part 5 of this chapter.

160 S. 20(3) F.A. 1965.

161 S. 62 F.A. 1972

162 S. 66 F.A. 1972

163 S. 3 I.C.T.A. 1970

164 S. 32(1)(b) F.A. 1971

165 Id.

166 S. 63 F.A. 1972

167 S. 66(a) 1972

168 S. 32(1)(a) F.A. 1971

169 S. 32(1)(a) and s. 66(1)(b) F.A. 1972

170 S. 21 (2) F.A. 1965

171 S. 21(5) F.A. 1965. The term "connected person" is defined in para. 21 sch. 7 of the same Act. See Part 2 of Chapter One (text at nn. 25-31) and text at n. 207 infra.

172 S. 238 I.C.T.A. 1970. The term "profits" includes chargeable gains - s. 238(4).

173 S. 238 I.C.T.A. 1970. Although companies are assessed on the profits of an accounting period (s. 247), the rate is fixed for Financial Years, so that if different rates are fixed for adjoining years and the accounting periods do not coincide with them, the profits of the former are apportioned to the latter on a time basis. - S. 243(3).

174 S. 64 F.A. 1972. This Act also provides a low rate of tax for corporations whose profits do not exceed £25000, but for our purposes, this is not important, as the low rate does not apply to capital gains - Section 95.

175 See Part 2 of this chapter Section A (text at nn. 61-2)

176 1972 budget speech at 833 Parliamentary Debates House of Commons (5th series) 1363.

177 As the corporate rates are fixed, this depends on the particular rate of an individual, but it appears that the corporate rate in the U.K. will never be less than the individual rate.

178 Regard should also be had to s. 33 F.A. 1965, which allows a deferral of tax on capital gains realised when business assets are disposed of and replaced by other business assets. The cost price of the new asset is reduced by the gain on the old asset. Thus tax on gains may be deferred indefinitely.

179 See Chapter Four and Five.

180 S. 219. Certain corporations are exempt, e.g. banks, s. 219(2)

181 For the definition of "Canadian corporation" see Part 3 of Chapter One (text at n. 59)

182 "Taxable income" is defined in s. 2(2) and applies to corporations which are resident at any time in the year, It includes all taxable capital gains.

183 "Taxable income earned in Canada" is defined in s. 115(1) and applies to corporations resident throughout the year. It includes all taxable capital gains on taxable Canadian property.

184 Honourable E. Benson, supra n. 127 at 58.

185 S. 212

186 As the rate of witholding tax for the years 1972-5 is to be 15%, the special tax is also at that rate for those years - s. 11 I.T.A.R.

187 Thus ordinary Income Tax paid can be deducted (s. 219 (1)(e)-(f))and also an allowance for reinvestment of earned income - s. 219(1)(h).

188 S. 219(1)(d)

189 For the definition of "Canadian corporation" see Part 3 of Chapter One (text at n. 59)

190 There is some relief for such corporations in that by s. 219(1)(g) a corporation which has at any time been resident in Canada in a year can deduct any foreign tax credit to which it is entitled and one half of its net foreign income from business and property and one half of its foreign taxable capital gains.

191 See P. Kirkpatrick Tax Consequences of a Corporation Dealing with its own Stock, 13 Tulane Tax Institute 85 at 85-6 (1964)

192 G. Wheatcroft and A. Park, supra n. 22 at para. 11-11.

193 This will be the case as the corporation will have no acquisition cost in respect of the shares.

194 See, for example, s. 256 B.C. Companies Act.

195 See Part 1 of Chapter Three Section C.

196 For a discussion of the American position see D. Watts Recognition of Gain or Loss to a Corporation on a Distribution of Property in Exchange for its Own Stock 22 The Tax Lawyer 161 (1968-9)

197 S. 54(c)(ii)(A)

198 See text at nn. 191-3 supra

199 S. 54(c)(vii)

200 For an account of these rules, see Part 1 of Chapter One.

201 For an account of the applicable rules when the parties do not deal at arms length, see Part 2 of Chapter One and text at n. 207-9 infra.

202 For an account of these provisions, see Part 3 of Chapter One.

203 G. Wheatcroft and A. Park supra n. 22 at para. 11-11.

204 See Parts 1 and 2 of Chapter Five.

205 See Part 2 of Chapter Five (text at n. 116)

206 See Part 1 of Chapter Three Section C (text at n. 47)

207 See Part 2 of Chapter One (text at nn. 25-31)

208 Note that the wider definition of "connected person" is also relevant for the purposes of para. 17 - see Part 2 of Chapter One (text at nn. 40-1)

209 It should be noted that s. 40(2)(e) is perhaps narrower than para. 17, as the latter applies to all disposals to connected persons, whereas the former only applies where the control relationship exists. As to the meaning of control see n. 122 supra.

210 By s. 26(17) I.T.A.R., added by s. 75(7) 1973 Bill C-170 the acquisition cost of property received by way of dividend in kind prior to 1972 is the market value at the time of receipt.

211 If the corporation and shareholder do not deal at arms length and the value of the consideration given by the latter exceeds the value of the property appropriated, then the corporation's proceeds of disposition will equal the fair market value of the property disposed of (s. 69(1)(b)) and the shareholder's acquisition cost will equal that amount (s. 69(1)(a)) - see Part 2 of Chapter One and text at n. 207 supra.

212 D. Ewens <u>The Winding Up of Corporations Otherwise than under Section 88</u> 21 Canadian Tax Journal 1 at 4-5 (1973)

213 See text at nn. 208-9 supra.

214 S. 69(1)(a) will not be relevant, as it will only apply when the consideration given by the member exceeds in value the property received from the corporation.

215 D. Ward Tax Considerations Relating to the Purchase of Assets of a Business Corporate Management Tax Conference 1972 22 at 24.

216 For the meaning of the expression "deemed dividend", see Part 1 of Chapter Three Section C.

217 R. Brown Capital Reorganizations Corporate Management Tax Conference 1972 114 at 132.

218 See n. 216 supra.

219 D. Ewens, supra n. 212 at 8-9.

220 Id

221 Id at 1-2

222 See Part 1 of Chapter Three Section C (text at nn. 68-70)

223 For the definition of "close company" see Part 1 of Chapter Four Section A (text at nn. 13-19).

224 See Part 1 of Chapter Three Section C.

225 G. Wheatcroft and A. Park supra n. 22 ar Para. 11-23. The provision does not in any case apply to transfers between members of a group of companies.- para. 5(1) sch. 13 F.A. 1967.

226 S. 532 and s. 272

227 "Indirectly" here means through intermediary subsidiaries. The percentage of any indirect holding held by a parent in a subsidiary is obtained by multiplying together all the percentages of the direct holdings hold by each corporation in the chain of corporations between the parent and the ultimate subsidiary - s. 532.

228 S. 272(1) and 532.

229 Subsidiary here refers to any company which is a member of a group of which a principal company is the head.

230 S. 272(3)

231 In fact, the indirect percentage holding of the ultimate parent corporation, calculated as set out in n. 227 supra, may be less than 75%, for instance where one company has a 75% holding in one company which in turn has a 75% holding in another company - Simon's Taxes Vol. D. Para. D2.622.

232 S. 275(2)

233 S. 273(1) only applies "so far as relates to Corporation Tax on chargeable gains".

234 S. 274. The deemed disposal may be by the acquiring or disposing corporation, depending on the situation.

235 S. 273(2)(a)

236 Para. 11(1) sch. 7 F.A. 1965.

237 Para. 5(3)(b) sch. 7 FA. 1965.

238 S. 273(2)(b)

239 S. 273(2). For the meaning of "capital distribution," see n. 42 supra.

240 See J. Talbot and G. Wheatcroft Corporation Tax para. 4-30 where the view is taken that the corporation also is precluded by the exceptions.

241 See n. 178 supra.

242 The deferral is obtained by deducting the amount of any gain from the acquisition cost of the new asset.

243 S. 276 does not apply where the asset is disposed to or acquired from another group member.

244 This is limited to assets which have replaced other assets acquired from group members within the six year period - S. 278(3) and s. 278(1).

245 S. 278(2) and 4(c).

246 S. 278(1)

247 See Part 1 of Chapter Five Section B (text at nn. 70-6)

248 For a fuller account see Simon's Taxes Vol. D Para. D2.631.

249 S. 280(1) and (2). For the purpose of this rule one or more members of the group may be non-residents.

250 S. 280(5)

251 S. 280(6)

252 See Part 3 of Chapter One.

253 See Part 2 of Chapter One (text at nn. 40-41)

254 S. Edwards _Corporations and Shareholders_ 1971 Conference Report Canadian Tax Foundation 124 at 134-5.

255 P. Whiteman, supra n. 126.

256 _Simon's Taxes_ Vol. D Para. D2-663.

257 See n. 252 supra.

258 S. 268(2) and (4)

259 S. 268(2)

260 Para. 15 sch. 19 F.A. 1969 - see n. 252 supra.

261 The events listed in s. 268(2) are as follows: (a) The transferee company disposes, or partly disposes, of the assets, or ceases to use them, or is wound up or dissolved, or (b) The transferor company disposes of all or any of the shares or loan stock issued by the transferee company in return for the transfer, or (c) The expiration of a period of ten years beginning with the transfer, or (d) the passing of a resolution or the making of an order, or any other act, for the winding up of the transferor company (unless that company is not in fact wound up).

262 S. 20(7) F.A. 1965 - see text at nn. 20-1 supra.

263 Honourable E. Benson Minister of Finance _Proposals for Tax Reform_ Para. 3.47.

264 S. 48(1). Note the partial exemption for individuals other than trusts - see text at nn. 142-3 supra.

265 For the definition of "Canadian corporation" see Part 3 of Chapter One (text at n. 59).

266 s. 48(1)

267 s. 48(2)

268 s. 48(1)

269 s. 48(3)

270 Note that s. 46(2) of the Canadian Act, which restricts losses realised on shares if they are caused by the depreciation of personal use property held by a corporation, also applies to trusts - see text at nn. 130-4 supra.

271 These are set out in s. 133(8)(d) I.T.A. and s. 59 I.T.A.R.

272 Or 18th June 1971, if later. The company must be incorporated in Canada.

273 S. 59 I.T.A.R. provides that for the period up to the 1976 tax year only 95% of issued shares and debentures need be held by non-residents.

274 Other than foreign affiliates (defined in s. 95(1)(b) - see Part 1 of Chapter Four Section C (text at nn. 58-62)) of residents of Canada - s. 133(8)(d)(i)(A).

275 S. 133(8)(d)(v)

276 See n. 273 supra.

277 See Part 1 of this chapter Section B.

278 S. 133(1)(c)

279 S. 133(3)

280 See Part 3 of Chapter Three Section A.

281 In fact the corporation pays a tax equal in amount to the withholding tax rates (s. 133(5) and s. 59 I.T.A.R.), but this is refunded when that income is distributed (s. 133(6) and (8)(a). However, whereas the rate payable on capital gains is 25%, until the 1976 tax year the rate on other income is 15%. In that year, it will go up to 25%.

282 There is no legal prohibition on its being a public corporation. Rather, it is unlikely that it would ever be large enough.

283 S. 115(1)(b)(iii) For an account of the liability of non-residents in respect of capital gains see Part 1 of this chapter Section B.

284 In regard to businees assets, the non-resident would be fully taxable, even if he held the assets personally - see Part 1 of this chapter Section B (text at nn. 35-6)

285 The corporation must be a Canadian corporation and a public corporation in Canada -s. 130(3)(a)(i). In the U.K., it must be a close company, the shares of which are not quoted on a recognised stock exchange - s. 359 (1) and (1)(c) I.C.T.A. 1970. For the definition of "Canadian corporation" see Part 3 of Chapter One (text at n. 59), of "public corporation" see the Conclusion to Chapter Three (text at nn. 281-92) and of a "close company" see Part 1 of Chapter Four Section A (text at nn. 13-9).

286 S. 359(1)(a) I.C.T.A. 1970.

287 S. 130(3)(a)(ii)

288 S. 130(3)(a)(iii)

289 S. 130(3)(a)(viii) in Canada and s. 359(1)(e) I.C.T.A. 1970 in the U.K.

290 S. 359(I)(d)

291 S. 359(1)(b) in the U.K. and s. 130(3)(a)(vi) in Canada.

292 S. 130(3)(a)(iv) "Gross revenue" is defined in s. 248(1) and does not appear to include capital gains, so that investment corporations could hold substantial foreign investmentsfor the purpose of realising capital gains - D. Ward Current Tax Planning Para.73.1(d).

293 S. 130(3)(a)(vii)

294 See Part 3 of Chapter Three Section C.

295 S. 93(2) F.A. 1972

296 See text at nn. 170-1 supra.

297 See n. 294 supra.

298 S. 130(1)

299 See Part 1 of Chapter Three Section A.

300 S. 131(8)(a). For the definition of "Canadian Corporation" see Part 3 of Chapter One (text at n. 59).

301 S. 131(8)(a). For the definition of "public corporation" see the Conclusion to Chapter Three (text at nn. 281-92).

302 S. 131(8)(b). This prevents the corporation carrying on an active business, e.g. dealing in securities - D. Ward, supra n. 292 at para. 73.4(c)

303 S. 131(8)(c)

304 S. 131(2)(a)(i)(B) - See Part 3 of Chapter Three Section B

305 S. 130(1) The mutual fund corporation pays normal tax rates in respect of its income.

306 S. 108(2)

307 Id

308 S. 108(2)(a) - see text at nn. 300-3 supra. Thus it will be noted that there is no limitation on the activities which may be undertaken by the trust, other than practical ones arising from the fact that the unit holder can at any time redeem his units, so that part of the trust funds must be kept liquid - D. Ward, supra n. 292 at para. 113.1(a) and 73.4(d).

309 S. 108(2)(b)(vi)

310 See this part of this chapter section B (text at nn. 285-91).

311 S. 108(2)(b)(ii)

312 S. 108(2)(b)(i)

313 S. 108(2)(b)(iii)

314 S. 108(2)(b)(iv)

315 S. 108(2)(b)(v)

316 S. 358 I.C.T.A. 1970

317 In fact, unauthorised unit trusts are rare, being forbidden from offering their units to the public - J. Talbot and G. Wheatcroft Corporation Tax Para. 21-12A.

318 S. 26(1) Prevention of Frauds (Investments) Act 1958

319 See s. 17 and the 1st sch.

320 Para. 1.1st sch.

321 S. 104(2). Trusts have no right to make personal deductions (s. 104(3)) and where there is a deemed disposal of their assets through their ceasing to be resident, they do not receive the exemption available to individuals - see text at n. 143 supra.

322 Certain inter vivos trusts resident on and since 18th June 1971 simply pay the individual rates of tax - s. 122(2).

323 Assuming a provincial rate of tax equal to 30%, this makes an overall tax rate of 50% - see Part 3 of this chapter Section D (at n. 157 and text).

324 S. 122(1)

325 For a discussion of the liability of non-residents in respect of capital gains, see Part 1 of this chapter Section B.

326 S. 54(c)(iii)

327 See Part 2 of Chapter One.

328 Id

329 S. 104(4) - (5) and s. 108(I)(j)

330 This, of course, has the advantage that no gain or loss accrues to the trust.

331 S. 107 and s. 108(I)(j)

332 An amount is payable if actually paid in a year or if the beneficiary is entitled to have it so paid - s. 104(24).

333 Section 104(6)

334 S. 12(1)(m) and s. 104(13)

335 S. 104(7). On the other hand, such amounts will not be subject to the witholding tax when paid out. Thus such a beneficiary may be in no worse position through the income accruing to the trust.

336 S. 212(1)(c). This will not be the case where, as a result of income being designated by the trustees, the amount is exempt from that tax - see Part 3 of Chapter Three Section D (text at nn. 216-20).

337 S. 354(1) I.C.T.A. 1970

338 Id

339 As to which, see this part of this chapter Section B.

340 S. 355 I.C.T.A. 1970.

341 The price he receives for the units will reflect these gains which will thus be taxed again as a capital gain onthe units. These provisions will be discussed more fully later - see Part 3 of Chapter Three (text at n. 238).

342 The provisions of F.A. 1965, as they stand, apply to all taxpayers. It is s. 238 of the I.C.T.A. 1970 which excludes corporations paying Corporation Tax from Capital Gains Tax.

343 These provisions are found in s. 25 F.A. 1965.

344 S. 22(5) F.A. 1965.

345 S. 21 F.A. 1965.

346 Simon's Taxes Vol. E. Para E6.313

347 Simon's Taxes Vol. E. Para. E6.308-310.

348 Simon's Taxes Vol. E. Para. E6.302. It should be noted that there was an announcement in the 1973 budget speech that trusts would also be subjected to the Investment Surcharge - see 1973 Budget speech dated 6th March 1973.

349 As to the significance of this, see Part 3 of Chapter Three Section D (text at n. 245).

350 See n. 325 supra.

351 S. 115(1)(b)(vii)

352 See D. Ward, supra n. 292 at para. 113.3(c)(ii), for a discussion of the practical difficulties of enforcing this provision and the possibilities of avoiding it.

353 There is no set off for accrued capital losses.

354 See n. 352 supra.

355 Para. 22(1)(b) sch. 6 F.A. 1965 as amended by s. 114(2) F.A. 1972.

356 S. 44(4) F.A. 1965 as amended by s. 114(2) F.A. 1972.

357 S. 132(6)

358 See this part of this chapter Section D.

359 S. 122(3)

360 See Part 3 of Chapter Three Section E.

361 Contrast the position with that of the unit trust, for which there is no tax refund on redemption of units.

362 S. 115(1)(b)(viii). For a discussion of the liability of non-residents in respect of capital gains see Part 1 of this chapter Section B.

363 See s. 115(1)(b)(vi)

364 S. 130.1(6). S. 130.1 is being added to the Act by the Residential Mortgage Financing Act (at present 1973 Bill C-135).

365 Id. For the definition of "public corporation" see the Conclusion to Chapter Three (text at nn. 281-92). For the definition of "Canadian corporation" see Part 3 of Chapter One (text at n. 59).

366 S. 130.1(6)

367 Id.

368 S. 130.1(1) and (4) - see Part 3 of Chapter Three Section F.

369 S. 130.1(1)-(2) The Act treats the dividends in the hands of shareholders as interest, as if the shareholders personally owned the corporation's mortgages.

370 In practice, it will cover all insurance companies.

371 S. 138(2) applying to income from carrying on the life insurance business, s. 138(9) applying to investment income and s. 142(1) applying to capital gains.

372 S. 138(3)

373 S. 138(3)(b), s. 138(4)(b) and s. 138(11)

374 S. 138(3)(d) and s. 138(4)(c)

375 S. 138(11) and (12)(b)

376 I.e investment corporations, mutual fund corporations. etc.

377 S. 148(1)(b)

378 S. 148(1)(b) and s. 138(3)(a)(vi) in respect of income other than capital gains and s. 142(2) in respect of capital gains.

379 S. 148(3)(b)

380 S. 148(1)(a). The cost of the policy is the sums paid to acquire it, e.g. premiums - s. 148(9)(a)

381 S. 138(3)

382 S. 208(1). W. Carlyle <u>Taxation of Life Assurance Proceeds</u> 17 Canadian Tax Journal 321 at 324 (1969)

383 S. 209

384 S. 209(1)

385 S. 209(3)(c)

386 <u>Simon's Taxes</u> Vol. D Para. D4.505.

387 S. 304-6 I.C.T.A. 1970.

388 S. 309 I.C.T.A. 1970.

389 S. 311 I.C.T.A. 1970.

390 S. 310 I.C.T.A. 1970.

391 S. 28(2) F.A. 1965. This rule does not apply if the policyholder is not the original holder and acquired the policy for consideration in money or money's worth.

392 This is only a general statement, which is not quite correct where the policyholder's income is low and the alternative rate of Capital Gains Tax is available to him in respect of gains realised personally.

393 S. 93(2) F.A. 1972. S. 311. I.C.T.A. 1970 is repealed by this Act.

394 This concept is defined in S. 315 I.C.T.A. 1970.

395 This would seem to be the case even where the asset forms part of the company's segregated fund. Although the Act generally treats the fund as if it were the policyholder's, in fact it remains the company's property.

396 In this case the proceeds will equal the market value of the asset under s. 69(1)(b) of the Act - see Part 2 of Chapter One.

397 As to this, see Part 3 of Chapter Three Section G.

CHAPTER III

CORPORATE DISTRIBUTIONS AND CAPITAL GAINS

This chapter is concerned with the tax treatment of distributions made out of capital gains by corporations and certain trusts to their members and the extent to which distributions out of such gains and out of other income result in capital gains or losses to the recipients which are taxed as such. It will consider the question as to how far the statutory treatment of distributions brings about the integration of the taxation of these entities and that of their members, so that the member receiving the distribution is in the same position as if he had personally realised the income distributed.

In the preceding chapter the beneficial treatment of capital gains, as opposed to other income, realised by taxpayers was pointed out. The obvious result of this is that, in order to obtain full integration in respect of capital gains, not only is it necessary that any tax paid by the entity realising the gain be regarded as a prepayment of tax by the member to which it is distributed,[1] but that the gain of the entity should remain a capital gain in the hands of the member. In the case of other income, the first requirement is equally applicable, but the second is satisfied as long as the distribution is ordinary income in the shareholder's hands, unless it is from some special source to which special benefits are attached, e.g. foreign income with its foreign tax credit.

The only types of provision found in both systems which apply to all types of corporation are those which treat the tax paid by the corporation as a prepayment of their shareholders' tax.[2] These are the dividend tax credit and the right given to corporations to deduct from their income dividends received from other corporations, which are discussed immediately following this introduction.

However, in applying these rules, both systems draw a distinction between those distributions which are ordinary income in the hands of their recipients (termed "income distributions" in this thesis) and those which lead to capital gains or losses in these hands (termed in this thesis "capital distributions"). The distinction is not, as might be expected, made by reference to the nature of the source in the corporation, i.e. capital gains or other income, from which the distribution is made, but according to the timing or nature of the distribution itself.[3] In practice, this distinction is less important in Canada, since, except in the case of mutual fund corporations,[4] all corporate distributions are income distributions other than those which simply return paid up capital. In the U.K., the position is the same until the corporation is wound up, when all distributions made are deemed to be capital distributions. There is, however, a limited opportunity here for the share-holder to pay the lower capital gains tax rates on distributions of not just corporate capital gains, but other income. On the other hand, there is no dividend tax credit for capital distributions, nor can a corporation receiving such a distribution deduct it from its income.

In addition to the rules which apply to all corporations, there are in both systems, but particularly in Canada, rules which apply only to certain types of corporations. These reinforce the effect of the general rules[5] and go further to ensure that, in many cases, capital gains and other income from particular sources realised by these corporations retain their particular character when distributed to individual shareholders.

In the first place, there are Canadian provisions which completely integrate the taxation of private corporations and their shareholders in respect of capital gains and investment income.[6] Thus the line drawn between private and public corporations becomes very important, as only the latter are governed solely by the general rules discussed above. On the other hand, no distinction is drawn in the U.K. between public and private corporations.

In the second place, even certain public corporations and kindred institutions are given the benefit of such additional provisions. The types of institution referred to here are those which act as investment vehicles for that part of the general public which may not want to incur the risk of making direct investments in trade or industry[7] and which were described in the last part of the preceding chapter. For example, they include investment corporations and trusts, mutual fund corporations, unit trusts and mutual fund trusts. The general Government policy towards such institutions is tottreat them as mere conduits between the investments they hold and their members. However, the extent to which this is achieved and the methods used to achieve it vary with each institution.

This chapter will be divided into three parts, the first dealing with the general rules applicable to all corporations, the next discussing the modifications of these rules enacted in Canada for the benefit of private corporations and the last concerning the various modifications of these rules applicable to the public investment vehicles referred to above.

Part 1 - Rules Applicable to all Corporations

The rules discussed in this section are those applicable to all corporations, which aim to a greater or lesser extent at imputing corporate taxes on distributed income and gains to recipient shareholders. Basically, this involves dealing in Sections A and B with the dividend tax credit given to individual shareholders and the right of corporate shareholders to deduct dividends received from their income, but references are also required to the foreign tax credits available where distributions are received from a foreign source. The important distinction between income and capital distributions must also be drawn and explained in Sections C and D. Finally, reference is made in Section E to the Canadian provisions which allow corporations to distribute their pre-1972 surpluses at nil tax cost in the case of capital gains and at reduced tax cost in the case of other income.

A. Taxation of income distributionsin the hands of individuals.

Dividends paid by non-resident or resident companies are in both countries prima facie taxable as income in the hands of individual shareholders,[8] whether paid out of corporate capital gains or other income.[9] However, both systems provide a tax credit for dividends paid to resident shareholders, which to a greater or lesser extent gives credit for tax already paid by the corporation.

In Canada, a tax credit is given on dividends received from taxable Canadian corporations by resident shareholders equal to one third of that dividend.[10] In the case of ordinary income (i.e. other than capital gains) accruing to corporations, on which the corporation pays tax in the region of 50%, this clearly represents only a partial credit, but in the case of capital gains, on which the corporation pays only half the rate applicable to other income, there is a full tax credit for the corporate tax.[11] In the case of dividends received from non-resident companies there is only a partial credit for corporate tax, since although full credit will normally be given for withholding tax, payable on the dividend to a foreign government,[12] none is given for the tax paid to that government by the corporation when the income or capital gain accrued.

In the U.K., up to the 6th April 1973, there was no tax credit for resident shareholders in receipt of dividends from resident companies. The corporation when making the payment simply deducted from the dividend the standard rate of Income Tax, which satisfied the shareholders' liability for that tax.[13] Thus the double taxation of corporate capital gains was complete. However, as from that date a credit is given for corporate tax equal to the basic rate of Income Tax, so that a taxpayer paying the basic rate of tax only will incur no further tax liability in respect of dividends received from resident companies.[14] This system gives only a partial credit for corporate tax paid on income other than capital gains, as the corporate tax rate is to be set at 50%, but, in respect of capital gains which are to be charged to an effective corporate tax rate of 30%, the credit is complete.

However, even though the credit given to the shareholder is fully adequate to cover the tax paid by the corporation on a capital gain , the system still falls down in a number of respects. Most important, the distribution of a capital gainaas a dividend causes the gain to lose its capital nature and become ordinary income in the hands of the shareholder. In Canada, the effect of this is that the whole amount of the capital gain is included in the individual's income,which doubles the normal rate of tax paid on it. In the U.K., the gain becomes subject to the basic rate of Income Tax, Surtax or the higher rates of Income Tax and the Investment Surcharge, as opposed to the maximum rate of 30% payable by individuals on capital gains accruing to them. In both systems, it means that the capital gain realised by the company is not available for set off against the shareholder's capital losses.[15]

Moreover, whereas, in the U.K. system, a low income shareholder can reclaim the difference between his actual tax liability and the dividend tax credit where the latter exceeds the former, this is not possible in the Canadian system.[16]

One further complication in the U.K. system must be referred to. As from 1st April 1973 any resident corporation making a distribution to its shareholders must at that time pay over an advanced instalment of Corporation Tax (termed "advance Corporation Tax") equal to the amount by which the dividend is grossed up for the purpose of computing the shareholder's income.[17] This advance Corporation Tax can be set off against the corporation's liability to Corporation Tax of the same year,[18] or if the latter amount is insufficient, against the same liability of the previous two years[19] and then of any future year.[20] However, it is not permitted to set off advance Corporation Tax against the corporation's liability to pay Corporation Tax on its capital gains in any of those years.[21] This makes it difficult but not, in view of the carry forward and carry back rights, impossible to set off advance Corporation Tax paid on a distribution of capital gains.

Shareholders, who are non-residents in either system, do not receive any credit for corporate taxes. In

Canada a witholding tax of 25%[22] is deducted from the amount of any dividend paid to a non-resident by a resident corporation. In the U.K., although the non-resident shareholder does not get the benefit of the dividend tax credit,[23] as the Act provides[24] that no assessment to the basic rate of Income Tax can be made on such a person receiving a dividend, the only effect of this bar would appear to be that the non-resident could not obtain a repayment of the credit. The non-resident may be liable to pay additional tax, if he is liable to pay the higher rates and the Investment Surcharge.[25] In both systems, the non-resident suffers the disadvantage that dividends may be paid to him by resident companies out of capital gains for which the non-resident would not have been liable if they had accrued to him direct, i.e. the assets sold by the company to realise the gain are not taxable Canadian property or property used in a business in the U.K.[26]

B. <u>Taxation of income distributions in the hands of corporations</u>.

Both systems permit dividends to be passed through intermediary corporations to individual shareholders at no tax cost. However, the corporations for which this is possible are limited. In Canada, dividends from non-resident and resident companies are included in the recipient's income, as they are for individuals,[27] but without being grossed up.[28] There is no dividend tax credit, but a resident corporation is allowed to deduct from its income dividends received from taxable Canadian Corporations and other resident corporations which it controls.[29] Further, such a corporation can deduct a proportion of dividends received from a non-resident corporation where the latter carried on a business through a permanent establishment[30] in Canada from the 18th June 1971 up to the date of the dividend.[31] Subject to one exception,[32] resident companies have no further right to deduct from their income dividends received from non-resident companies, but they do have the same rights to a foreign tax credit as do individuals.[33]

The U.K. Act enacts the general rule that dividends received from resident companies are not chargeable to Corporation Tax.[34] Thus it is wider than the Canadian provisions in applying to all resident companies, but narrower in the fact that it in no circumstances applies to dividends received from non-resident companies. On the other hand, the foreign tax credit available is wider than the credit available to individuals and Canadian taxpayers. Not only is there a full credit for the withholding tax paid on the distribution,[35] but also if the resident company controls, or is the subsidiary of a company which controls, 10% of the voting power in the company paying the dividend, credit is given for a proportion of the tax paid by the foreign company on the income or gain distributed when it was earned.[36]

Prior to the 1st April 1973 all dividends paid by companies resident in the U.K. were only payable after the standard rate of Income Tax had been deducted by the company at source.[37] As resident corporations were not liable to pay Income Tax, they were entitled to have the amount deducted repaid, but the Act limited the ways in which this could be done. Generally such income received by a resident corporation (which income was termed "franked investment income") had to be set off against the corporation's own liability to deduct and account for Income Tax from its own distributions of the same or future years,[38] but there were provisions allowing the corporation to receive actual repayment of the tax by setting off any surplus franked investment income against trading losses, management expenses of an investment company and certain capital allowances.[39] The effect of these provisions was to encourage the company to make distributions. After the 6th April 1973, the system remains basically the same, save that franked investment income becomes the amount of the dividends received as they are grossed up for the purposes of the tax credit available to individuals.[40] The recipient corporation does not obtain the tax credit, but can obtain repayment of the amount of the gross up in a similar fashion to that in which it could obtain repayment of franked investment income under the old system.[41] Thus, if the dividend is finally passed through the intermediary corporations to a non-corporate shareholder, the tax position will be the same as if those intermediaries had not existed.

Non-resident companies in respect of dividends received from resident companies are in the same position as non-resident individuals and, in particular, such companies receiving dividends from U.K. companies pay Income Tax on those dividends[42] and not Corporation Tax.

To the extent that a corporation receiving a dividend from another corporation is not permitted to deduct it from its income or, in the case of dividends received from non-resident corporations, does not receive full credit for foreign tax paid, the existence of intermediary corporations increases the tax burden on corporate gains. Even where the dividend is fully deductible from income in Canada, the flow through may not be complete, as either the paying or recipient corporation may be required to pay an additional tax on the dividend when it is paid from the designated surplus of the paying corporation.[43] Further, even where full credit is given for the foreign tax paid on a dividend received from a non-resident company, the same disadvantages follow from the transformation of a capital gain, by virtue of its distribution, into an income receipt as occurred in the case of individuals receiving dividends.[44]

C. What is an income distribution?

No problem arises when a corporate distribution is made as a dividend in cash payable to each shareholder in amounts varying according to the size of his shareholding. This is clearly an income distribution, in respect of which the individual shareholder receives the dividend tax credit and the corporate shareholder is entitled to an exclusion from its income. However, even where the tax credit gives full credit for corporate tax paid, as is the case with capital gains, the shareholder may pay personal rates of Income Tax on the distribution, which are far in excess of the corporate rate. As a result, it may be of some advantage to such a taxpayer to obtain a distribution of corporate earnings in the form of a capital distribution, on which he pays only capital gains rates of tax, in spite of the fact that he will thereby deprive himself of the dividend tax credit.[45] In the absence of hindering statutory provisions, the ways of obtaining capital distributions are numerous, as, for example, direct capital dividends, redemptions and acquisitions of shares by the corporation, the liquidation of the corporation or the reduction of its capital. In fact, both systems have very comprehensive provisions to ensure that the extraction of corporate surpluses by virtue of most of these methods will not result in a capital distribution, but in an income distribution. Their general effect is to limit capital distributions to those which, in reality, return capital to shareholders.

Before dealing with these provisions, mention will first be made of two Canadian provisions which clarify the position in connection with two types of distributions, which could in any case be regarded as ordinary dividends - dividends in kind and stock dividends. The former are expressed in the Act to be dividends of an amount equal to the market value of the property distributed[46] and the latter to be dividends of an amount equal to the increase in the paid up capital of the corporation caused by the dividend.[47]

Turning to distributions of a capital nature which are deemed to be dividends, the statutory provisions are more complex. Their effect is to deem a distribution or payment to be a dividend to the extent that it exceeds the lesser of the paid-up capital of the shares, in respect of which the distribution is made, and the paid-up capital limit of the corporation.[48] The provisions operate on distributions made in the three following situations:

a) "Where funds or property of a corporation resident in Canada have ... been distributed or otherwise appropriated in any manner whatever to or for the benefit of the shareholders of any class of its capital stock on the winding up, discontinuance or reorganization of its business".[49]

b) "Where a corporation resident in Canada has redeemed, acquired or cancelled in any manner whatever ... any of the shares of its capital stock."[50] This head does not apply when head (a) applies nor when the shares in question are acquired in the open market. Under section 182 of the Act, a corporation (other than a non-resident owned investment corporation) which redeems or acquires preference shares issued on or before 18th June 1971 at a premium, is required to pay a tax on that premium of 20% or 30%, depending on the date the shares were issued and the size of the premium. Where the section applies, the deemed dividend rules do not operate on the whole acquisition or redemption price, but on the difference (if any) between the paid up capital of the shares in question and the paid up capital limit of the corporation.[51]

c) "Where a corporation resident in Canada has reduced the paid up capital in respect of any shares of any class of its capital stock otherwise than by way of a redemption, acquisition or cancellation of those shares or a transaction described in" head (a).[52]

The effect and intention of these provisions is that the corporation is only able to pay out its accumulated surplus, over and above the subscribed capital, to shareholders by way of a dividend which is taxable in their hands.

The Act also deals with two other situations to the same effect, which could otherwise involve the distribution to shareholders of such surplus without it being taxed in their hands as a taxable dividend.[53] Where the corporation increases the paid up capital of a class of its shares, without there being a corresponding increase in the corporation's assets or a corresponding decrease in the corporation's liabilities or the paid up capital of another class of shares, and the increase is not by way of a stock dividend,[54] there is deemed to be a dividend paid to the shareholders of the class of shares in question equal to the increase.[55] This is intended to prevent corporations capitalizing profits and then paying them to shareholders as tax free repayments of capital, but has the unfortunate effect of deeming a dividend every time the corporation issues shares, the par value of which exceeds the value of the property given in return.[56] Section 181 of the Act applies where the corporation purchases its own shares in the open market and imposes a tax on the corporation equal to 25% of the amount by which the purchase price exceeds the lesser of the paid-up capital of the shares purchased and the paid-up capital limit of the corporation. This provision has the same object as the deemed dividend provisions, but as it would not be possible in the circumstances to deem the vendor to receive a dividend, the 25% tax is imposed on the corporation to compensate for the fact that the shareholder will only pay tax at capital gains rates.[57]

In fact, to the extent that the paid-up capital of the corporation exceeds its paid-up capital limit, even the paid-up capital of shares can only be returned by way of a deemed dividend. The paid-up capital limit[58] of a corporation is equal to its paid up capital less its paid up capital deficiency (if any), which[59] is roughly a computation of capital losses accruing to the corporation prior to 1972. Its deduction from the paid up capital ensures that the corporation is not able to distribute accumulated income disguised as a capital repayment.[60] The paid-up capital deficiency is decreased and hence the paid-up capital limit is increased to the extent that, by virtue of the above rules, a return of paid-up capital is deemed to be a dividend.

Finally reference should be made to section 15 of the Act, which deems certain benefits conferred on shareholders by companies, otherwise than by way of dividend, to be included in their income. The benefit is not deemed to be a dividend, so that the dividend tax credit is not available, and the amount is not deductible from corporate shareholders income.[61] The section does not apply to benefits conferred as the result of "the reduction of capital, the redemption of shares or the winding up, discontinuance or reorganization of its business or otherwise by way of a transaction to which sections 84, 88, or Part II applies."[62] The question arises as to whether payments made to or benefits conferred on shareholders by non-resident companies, which would be within this exemption if made by resident companies, are also exempt from the operation of section 15. Since sections 84 and 88 only apply to resident companies,[63] the answer depends on whether the whole exception refers to transactions within those sections or whether the words "the reduction of capital, the redemption of shares or the winding up, discontinuance or reorganization of its business" have an independent operation. On a strict reading of the section, the latter interpretation seems the more correct and it would have a more reasonable result. The opposite interpretation would have the unfortunate result that capital payments arising from reorganizations of foreign companies would be included in shareholders' income, without even the benefit of the dividend tax credit. However, any capital gain arising from a disposition of members' shares caused by the capital payment would be excluded from income by virtue of section 39 of the Act.[64]

Generally whether a distribution received from a non-resident company is a dividend or a capital distribution is dependent on general company law, since section 84 has no application to non-resident companies. However, the provisions of section 52 are applicable to determine the effects of dividends in kind and stock dividends. Further, the acquisition, redemption or cancellation of shares by the company, whether it arises from a capital distribution or purchase, will lead to a disposition of those shares and a capital gain or loss, although this is subject to the above comments regarding section 15.[65]

The U.K. Act in section 233 sets out a very wide definition of the term "distribution" which brings within its ambit the following situations:

(a) "any dividend paid by the company, including a capital dividend;"[66]

(b) "any other distribution out of the assets of the company (whether in cash or otherwise) in respect of shares in the company, except so much of the distribution, if any, as represents a repayment of capital on the shares or is, when it is made, equal in amount or value to any new consideration given for the distribution:"[67]

(c) "Where on a transfer of assets or liabilities by a company to its members or to a company by its members, the amount or value of the benefit received by a member (taken according to its market value) exceeds the amount or value (so taken) of any new consideration given by him, the company shall be treated as making to him a distribution of an amount equal to the difference:"[68]

(d) "any interest or other distribution out of assets of the company in respect of (certain) securities of the company (except so much, if any, of any such distribution as represents the principal thereby secured)."[69]

The effect of the above provisions is that any distribution made to the holders of shares will constitute an income distribution, whether made out of capital gains or other income, except in so far as it represents a return of capital. The position is thus the same as is found in Canada, subject to two exceptions. First and most significant, this definition of distribution does not operate when the company is in course of winding up. Thus any distribution made in the course of winding up, whether it be a return of capital or payment out of accumulated earnings, will be a capital distribution, unless it is a dividend within the ordinary meaning of the word. In the second place, there is no concept equivalent to the paid-up capital deficiency, so that it will be possible, where there have been capital losses prior to 6th April 1965, to distribute accumulated earnings as a repayment of capital.

The definition covers distributions in kind and applies to distributions benefitting one member only which are not in the nature of ordinary dividends.[70]

Section 284(1)-(2) of the I.C.T.A. 1970 includes in the income of the shareholder[71] of a close company[72] any expense incurred by the company "in or in connection with the provision ... of ... benefits or facilities of whatever nature" for him. This is the nearest U.K. equivalent to section 15 of the Canadian Act, but the provision applies to a much narrower range of companies. Its scope is further narrowed by section 284(4)(b), which excludes from its operation any benefit arising "on or in connection with a transfer of assets or liabilities by the company to him, or to the company by him", although such benefits will in any case, be caught by the provisions of section 233 of the same act, and by section 284(4)(a) which excludes the section when the benefitting shareholder is the company's parent company owning 51% of its shares or the shareholder and close company are both companies which are 51% subsidiaries of another company. On the other hand, there is no problem, as there is for section 15, in regard to non-resident companies and benefits caught under this section are distributions, in respect of which the dividend tax credit is available.

Since the section is expressed to be "subject to such exceptions as are mentioned in" section 233, it also does not apply to benefits provided while the company is being wound up. Thus it is apparent that the section is aimed at the more indirect services provided for shareholders, which do not fall under section 233 as not being dividends, distributions out of assets or involving a transfer of assets.

In regard to distributions of shares and securities, the U.K. provisions are more complicated. Stock dividends are not generally treated as income distributions, except in certain carefully defined situations. As will be seen later, they do not even cause a disposal of the recipient's existing holding, but they are added to it and will only be taxed to the extent that all or part of the holding is subsequently disposed of for a capital gain.[74] The exceptional cases that do give rise to taxable income in the hands of the shareholder are as follows:

a) The issue of bonus securities or bonus redeemable shares[75]

b) Where share capital of any kind is issued following a repayment of share capital,[76] which has taken place after the 6th April 1965, the lesser of the paid-up value of the shares issued and the amount repaid is an income distribution.[77]

c) Where the company issues share capital as fully paid up otherwise than for new consideration[78] after 6th April 1965 and the company then makes a repayment of capital on those shares, such amount repaid to the extent of the paid-up capital of the shares is deemed an income distribution.[79]

Thus the provisions are obviously aimed at preventing companies from distributing their accumulated income as capital by use of a share issue and capital repayment on those or other shares. Such provisions are unnecessary in Canada because of the provisions which include all stock dividends in income and which deem dividends when the company capitalizes its income reserves.

Where shares of any class of the corporation are replaced by a greater number of shares of the same class in the same proportion for all shareholders (generally known as a stock split), it appears that in the U.K. the same provisions will apply as apply in the case of stock dividends.[80] Thus the new shares would be regarded as the same holding as the old holding. In Canada, such a reorganization would not be a stock dividend and provided there is no change in the interest, rights or privileges of the shareholders and no concurrent change in the capital structure of the company or in the rights and privileges of other shareholders, the Revenue Authorities accept that the position is as in the U.K.[81] Where the stock split was not proportional or equal among shareholders and one benefitted at the expense of another, it would seem that the provisions discussed in the chapter on Corporate Reorganizations which deem there to be a gift where one shareholder uses hisppower in a company to benefit another,[82] would apply. The stock split could be a useful device for avoiding the U.K. and Canadian rules which include stock dividends in income.[83] Where the corporation making the split has undistributed income and capital gains, the shareholder could sell that part of the new holding which reflects these amounts and realise them in the form of a capital gain. Such a procedure might, however, fall foul of the general anti-avoidance provisions discussed in the following chapter.[84]

These anti-avoidance provisions will also be important generally in the field of corporate distributions. Any attempt to distribute corporate gains or income, which could otherwise be distributed as a dividend, in the form of a capital distribution and which is not caught by the provisions already discussed in this chapter, will probably come within the scope of these provisions.[85] This would not be the case where the capital distribution is of a type expressly recognised by the statutes, e.g. returning paid-up capital in both systems and liquidation distributions in the U.K.[86]

Subject to these comments on the general anti-avoidance provisions found in the Act, an examination of the U.K. system reveals two opportunities for shareholders to obtain distributions of corporate surpluses in capital form, which are not found in Canada, i.e. stock dividends and distributions made during winding up. There are no U.K. provisions imposing taxes on corporations purchasing their own shares, although this is probably not significant, in view of the fact that, under U.K. Company Law, such an act would in any case be illegal and ultra vires. Further, even though the U.K. Act follows the Canadian Act in limiting capital distributions made while the company is a going concern to returns of capital on shares, the Act is more generous, in that "capital" here is deemed to include any premium at which shares were issued, provided the issue was for new consideration provided by the issuee and the premium was not subsequently used to pay up other shares.[87] The Canadian Act limits the permitted capital repayment to the nominal value of the shares in question,[88] in spite of the fact that the shares may have been issued at a premium.

As in Canada, the nature of a distribution received from a non-resident company - whether it is an income or capital distribution - must depend on general company law.[89] If they are dividends in the normal sense of the word, they are included in the recipient's income, but, if otherwise, they are capital distributions causing disposals of the recipient's shares.

In both systems, the general rules just described, which determine the nature of corporate distributions, apply where resident companies are concerned in regard to distributions to both resident and non-resident shareholders. However, as far as capital distributions are concerned, this is subject to the limited nature of the liability of non-resident taxpayers to pay tax on capital gains realised by them.[90]

D. Capital distributions

The preceding discussion of the scope of corporate distributions included in shareholders' ordinary income has shown that virtually all that would otherwise be regarded as a distribution of capital is brought within this category. Save for the exceptional cases referred to, all that remains to constitute a capital distribution is a return of paid-up capital. It is now necessary to discuss the effect of these capital distributions on the recipient members' shares.

Section 54(c)(ii)(A) of the Canadian Act includes in its definition of the term "disposition" any transaction or event whereby any "share, bond, debenture, note, certificate, mortgage, hypothec, agreement of sale or similar property, or an interest therein, is redeemed in whole or in part or is cancelled." Clearly the term will also include, under its normal meaning, the direct purchase or acquisition by a corporation of its own shares.

Many of these transactions which give rise to dispositions of shareholdings will also give rise to deemed dividends under section 84 of the Act. This leads to a possibility of shareholders being double taxed, in that amounts which are deemed to be dividends in their hands will also form part of the proceeds of disposition of their shares. In fact this possibility is expressly negatived by section 54(h) of the Act, which expressly excludes from those proceeds any part of a sum received from a corporation which is deemed to be a dividend. A similar problem could arise in connection with the provisions which tax corporations in respect of the redemption of preference shares and purchases of shares in the open market.[91] Although there is no express provisions removing the difficulty in this case, the low rate of tax paid by the corporations under these sections to some extent equalises the overall taxation of corporate surpluses resulting from such transactions and that resulting from the ordinary deemed dividend rules.

However, the result of excluding from shareholders' proceeds of disposition the amount of any deemed dividend means that the actual proceeds taken into account will equal the paid up capital of the shares or the corporation's paid-up capital limit. This means that there will be in many cases a strong probability of a capital loss resulting, which will be some compensation for the distribution being deemed a dividend in the first place.[92] Such losses will not be full compensation for this, because of the limited rights of set off available for capital losses.[93]

There is clearly no disposition of a member's shares when the deemed dividend results from an increase by the corporation in its paid-up capital. However, the member involved is allowed to increase the adjusted cost base of his shares by the amount of the dividend,[94] so that it is not taxed again as a capital gain if the shares are subsequently sold. This puts the shareholder in the same position as if the increase had been distributed to him and he had used it to make a capital contribution to the company.[95]

Where there is a reduction in capital which does not result in shares being wholly cancelled, the tax position depends on whether the deemed dividend provisions of section 84(2) or section 84(4) apply. There is no problem in the latter case, since by virtue of section 53(2)(iv) there will be a reduction in the adjusted cost base of the members' shares to the extent that the amount received does not constitute a deemed dividend. However, if the reduction takes place "on the winding up, discontinuance or reorganization of its business", section 84(2) will apply and although section 53(2)(iv) still operates to reduce the cost base of the members' shares, there is no exclusion from the amount of the reduction of any deemed dividend. As a result this amount will be taxed again in the form of an increased capital gain or reduced capital loss if the shares are subsequently disposed of. It is not clear whether a partial reduction of a share's capital results in a partial disposition of that share,[96] but in any case the proceeds of disposition will not include the amount of any deemed dividend.[97]

As for the U.K. system, one need do little more than refer to paragraph 3 of schedule 7 of the F.A. 1965, which provides that "where a person receives or becomes entitled[98] to receive in respect of shares in a company any capital distribution from the company ... he shall be treated as if he had in consideration of that capital distribution disposed of an interest in the shares". A "capital distribution" is defined as "any distribution ... including a distribution in the course of dissolving or winding up the company ... except a distribution which in the hands of the recipient constitutes income for the purposes of Income Tax."[99] As has been seen, the only possible capital distribution which can be made while the corporation is a going concern is a return of paid-up capital, so that there is greater likelihood of a capital loss resulting than a capital gain. Thus the position is similar to that in Canada.

In this connection note should be made of the U.K. provision which empowers the Inspector of Taxes, if he is satisfied that the amount of a capital distribution is small[100] compared with the value of the shares in respect of which it is made, to direct that the distribution shall not result in a disposal of those shares, but shall simply be deducted from the cost base of those shares.[101] This is a useful provision which eliminates trouble and expense when the gain or loss is derisory.

As regards distributions made in the course of a winding up, the position is radically different in the U.K., as a substantial capital gain is a likely result.

Where a capital distribution is passed through an intermediary corporation there is no provision in either system to pass it through in that form to ultimate shareholders, as there is for income distributions. Thus, there will be a disposal of the shares held by each intermediary corporation and if that corporation redistributes the amount received, whether it be an income or capital distribution will depend on the rules just described. This is of little significance in Canada, where capital distributions are likely to have only small tax consequences, but in the U.K. the distribution and redistribution of one sum could lead to a chain of capital gains.[102]

Capital distributions have the disadvantage that there is no tax credit attached to them for any corporate taxes. Individual shareholders in a high Income Tax bracket will be adequately compensated by the low rates of tax payable on capital gains, but shareholders at the other end of the scale might be better off with the credit.[103] This might lead to a conflict of interest within the corporation between high and low Income Tax bracket shareholders, the former demanding that the corporation retain its accumulated earnings and the latter that they be distributed as income. A similar conflict might arise between resident and non-resident shareholders. Whereas the latter are only in very limited circumstances liable for tax on capital gains arising from shares, they will suffer tax on income distributions made to them.[104] The desire of high bracket or non-resident shareholders to realise corporate surpluses as a capital gain may not necessarily take the form of a demand for capital distributions, as it may not be possible[105] or practicable[106] to do this. However, it is possible to realise such surpluses as capital gains by selling the shares in question.[107] A solution of this conflict between these opposing groups of shareholders is not easy, seeing as a distribution of current earnings which pleases one group, automatically prejudices the other. One solution would be for the different groups of shareholders to invest in different companies, but this is not always practical. The only other possible solution, which might solve the conflict between different groups within a company, would appear to involve the necessity of having different classes of shares for different groups of shareholders. This would not be wholly satisfactory in this case, in view of the fact that a distribution made to one class of shareholders would reduce the value of all the classes, unless the rights of the class receiving the distribution to participate in accumulated income were in some way limited.[108]

Where the corporation and the shareholder do not deal at arms length, the question arises as to whether the shareholders' disposal of his shares will be subject to the provisions found in both systems which deem the proceeds of such disposals to equal the market value of the asset disposed of and which nullify or restrict capital losses arising from such disposals.[109] In the U.K., the answer to this question will depend on whether the corporation can be said to acquire the shares, as the relevant provisions appear to require both an acquisition and a disposal of the assets in question; and it would seem to be stretching the meaning of "acquisition" to apply it in these circumstances. A similar, but weaker, argument may be made against the applicationoof the relevant Canadian provisions, which require the "disposition" of assets to the corporation.[110]

Although the Canadian and U.K. systems reach the same result with the general inclusion in income of all distributions, except payments made in return of paid up capital, which cause disposals or dispositions of the recipient's shares, the method used to achieve this in each case is wholly different. Whereas the U.K. Act makes an express distinction between income and capital distributions and expressly dêfines the latter as including all payments not falling within the former category, the Canadian provisions are less precise on this. The same effect is achieved by virtue of one set of provisions which deem all distributions to be income distributions, save in so far as they return paid-up capital, by an overlapping set of provisions which deem the same transactions, which give rise to deemed dividends, to cause dispositions of members' shares and finally some provisions which attempt to remove the areas of double taxation caused by the other provisions. The failure to make a general distinction between the two types of distribution leads to the difficulties arising in connection with reductions of capital.

Furthermore, the different methods followed in the two systems lead to an overall difference in approach to the process of determining the nature of any distribution. The general result of the Canadian provisions is that payments made by a corporation to its shareholders are deemed first of all to repay to the shareholder the paid-up capital on his shares and only when this is all repaid, is the balance deemed to be a dividend.[111] On the other hand, in the U.K., there is no such presumption in favour of a prior return of capital. Rather each distribution must be examined on its merits to see if it falls within the definition of those distributions which are included in the recipient's ordinary income. If it does not, then it is a capital distribution.

E. <u>1971 Capital Surplus On Hand</u>.

The Canadian provisions which are to be discussed here are those which allow Canadian Corporations[112] to distribute their pre-1972 surpluses without that distribution being included in the recipient's income.

The Act distinguishes between capital gains and other income accruing prior to 1972 and sets up two separate accounts - 1971 capital surplus on hand[113] and 1971 undistributed income on hand.[114] The latter can as a result of the corporation paying a tax under Part IX[115] of the Act amounting to a rate of 15% be converted into tax paid undistributed surplus on hand.[116] The corporation is authorised by section 83(1) to elect to declare a dividend out of both tax paid undistributed surplus on hand and 1971 capital surplus on hand, which is not taxable in the hands of the shareholder, but goes to reduce the adjusted cost base of his shares.[117] However, no dividend may be paid from 1971 capital surplus on hand until all the 1971 undistributed income on hand has been converted into tax paid undistributed surplus on hand.[118]

Difficulties arise in connection with these provisions in two areas which will be largely removed by legislation now passing through Parliament. First, the Act requires that the corporation designate precisely to what extent a dividend being paid out of each account and if an amount which is designated as being payable out of an account in fact exceeds the amount in that account or the dividend is designated as payable out of 1971 capital surplus on hand when there remains in existence some unconverted 1971 undistributed income on hand,[119] a tax is payable by the corporation equal to 100% of the amount by which the dividend is designated incorrectly.[120] This position is to a great extent remedied by the terms of the 1973 budget.[121] First of all, it permits corporations to make a blanket election to pay the 15% tax on all its 1971 undistributed income on hand so that, following the election, provided that all the assessed tax is paid, there will be no possibility of subsequently finding some outstanding 1971 undistributed income on hand as a result of some earlier miscalculation.[122] Second, it will no longer be necessary to designate precisely to what extent a dividend is paid from each of the two surplus accounts -- tax paid undistributed surplus on hand and 1971 capital surplus on hand. After an election is made the dividend will deemed to be paid primarily from tax paid undistributed surplus on hand and only when this is exhausted, out of 1971 capital surplus on hand.[123] However, the penalty tax will be payable to the extent that the election is made when the tax paid undistributed surplus on hand is exhausted and there remains outstanding 1971 undistributed income on hand. In any case it does not seem that an erroneous election affects the treatment of the actual distribution in the hands of the recipient shareholder.[124]

A second difficulty arises on the liquidation of the company, when the corporation makes a distribution in specie of its assets to its shareholders and those assets include assets held on the 31st December 1971. There will be a disposition of those assets, leading to a possible increase in the 1971 capital surplus on hand,[125] although the corporation will be unable to take advantage of this by paying a further dividend.[126] The distribution of assets will itself be a deemed dividend, except to the extent it returns paid-up capital, but it seems clear that there could be no election to pay a dividend out of 1971 capital surplus on hand, which was itself brought into existence by virtue of that dividend.[127] Further, as the election has to be made inrrespect of the full amount of the dividend and the whole amount distributed on a winding up (save for the return of paid-up capital) constitutes a deemed dividend, it is necessary to make a separate distribution of all a corporation's 1971 capital surplus on hand prior to winding up, if the benefit of having this account is not to be lost.[128] Budget resolution 23[129] removes both these difficulties encountered when winding up a company, by allowing the distribution made on a winding up to be made from 1971 capital surplus on hand created by that distribution[130] and by allowing the election to be made forpart of a dividend only.

Dividends paid from 1971 capital surplus on hand and from tax paid undistributed surplus on hand are passed through intermediate corporations without any further tax liability being incurred. This is done by adding the dividends paid out of the pre-1972 surpluses to the relevant surplus of the recipient corporation, so that the latter can declare a tax free dividend in respect of the same amount.[131]

There are no equivalent provisions in the U.K. allowing the tax free distribution of capital gains accruing prior to the 6th April 1965.[132] Thus, although gains realised prior to that date esdape tax when they are realised, they are subject to the ordinary rules of taxation when distributed.

Part 2 - The rules applicable to Private Corporations

The degree of integration of personal and corporate taxation achieved by the rules just discussed in the first part of this chapter is only partial at best. The dividend tax credit is a full credit for corporate taxes in the case of capital gains only and even this benefit may be outweighed by the transformation of corporate capital gains into ordinary income on distribution. Furthermore, the opportunities to reduce taxes by receiving corporate earnings in the form of capital distributions is very limited. Thus, in the absence of additional relieving provisions, the taxpayer who conducts his business or holds his property through the corporate form could suffer a tax disadvantage.

However, many of these disadvantages are removed under the Canadian system where the corporate form in use is the private corporation. In fact, the act achieves the complete integration of personal and corporate taxation in regard to capital gains and investment income, assuming only that such income is distributed and not retained within the corporation. This is carried out by granting two basic rights to these corporations which will now be discussed - a right to declare tax free capital dividends discussed in section A and a right to a refund of half the corporate taxes paid on capital gains and investment income discussed in section B.

The U.K. system makes no recognition of the distinction between private and public corporations[134] and gives no such rights to private corporations as are given by the Canadian system.

A. Capital Dividends

It has already been seen[135] how, although a corporation only includes half a capital gain in its income and full credit is given to a shareholder when the gain is distributed for the tax paid by the corporation on that gain, because the whole amount of the distributed gain is included in the recipient's income, more tax is paid on the gain than would have been the case had the gain accrued direct to the shareholder in the first place.

Section 83(2) of the Act permits a private corporation to elect, as to the full amount of a dividend, that it be a capital dividend which not only is excluded from the recipient's income, but requires no adjustment to be made to the adjusted cost base of his shares. The amount elected must not exceed its "Capital Dividend Account" which is an account basically consisting of half the corporation's capital gains, less its capital losses and previous capital dividends.

The section thus means that the untaxed half of the corporation's capital gains can be distributed without being taxed in the corporation's hands or in the hands of the shareholder, leaving only the other half to be taxed in the corporation and as part of the shareholder's income when distributed.[136] This power is, however, subject to one limitation. The election can only be made when the corporation has no tax paid undistributed surplus or 1971 undistributed income on hand remaining.[137] This may make the election impossible for some companies, although it may be possible to devise some scheme whereby these sums are paid out in a dividend, but retained by the company.[138] If the election is made and the amount of the dividend exceeds the "Capital Dividend Account" or there remains some tax paid undistributed surplus or 1971 undistributed income on hand, there is a tax payable by the corporation equal to 100% of the amount by which the election is in error.[139]

Similar difficulties to those which occur in connection with 1971 capital surplus on hand on the winding up of a corporation also arise in oonnection with capital dividends.[140] The election has to be made for the full amount of a dividend and a distribution of assets in specie will itself create capital gains and add to the "Capital Dividend Account". These difficulties are removed by the same provision of the 1973 budget and in the same manner.[141]

If a capital dividend is paid to another private corporation, the latter simply includes it in its capital dividend account,[142] so that it is available for redistribution by it as a capital dividend. If the recipient is a corporation which is not private, then it forms part of its general surplus and can only be redistributed as an ordinary dividend taxable in the hands of an individual shareholder, although it will not in fact be taxable in the hands of that corporation. Thus the capital dividend can be passed through any number of intermediary private corporations without additional tax consequences, but the intervention of a non-private corporation will lead to the cancellation of any advantages derived from declaring a capital dividend and put the shareholder in the same position as he is in under the rules described at the beginning of this chapter.

B. Refundable Dividend Tax

These Canadian provisions must be considered closely together with the Capital Dividend provisions just described, as for private corporations and resident shareholders they complete the integration of personal and corporate taxation of capital gains.[143]

Section 129 of the Act allows a private corporation to obtain a refund of tax equal to one dollar for every three dollars it pays out in dividends in a year,[144] but not so that the refund exceeds its "refundable dividend tax on hand" at the end of the year". As the latter fund[145] includes half the tax paid by the corporation on its Canadian and foreign investment income and taxable capital gains, this means that the corporation will obtain a refund of this tax (provided that dividends are paid) and pay a net rate of 25% on this income. Full credit is given to shareholders for such a tax rate by the dividend tax credit.[146]

The "refundable dividend tax" machinery is also used to discourage the retention of dividends[147] received by a private corporation and to encourage their redistribution. This is carried out by imposing a tax of 33 1/3% on every dividend received by a private corporation from a corporation which it does not control,[148] when the dividend is deductible from its income.[149] The tax when paid is added to the "refundable dividend tax on hand"[150] and consequently refunded as the dividends on which it was paid are redistributed.[151]

As soon as a private corporation ceases to be private, it loses the benefit of any outstanding "refundable dividend tax on hand",[152] so that such corporations should before ceasing to be private[153] make sufficient distributions to ensure that all their refundable tax is refunded. Moreover, there are provisions in the Act to reduce the "refundable dividend tax on hand" when the full amount of Canadian tax was not paid in the first place, because e.g. the company received a foreign tax credit or suffered losses in an active business which are set against its investment income or capital gains.

Part 3 - <u>Investment Institutions</u>

In the last part of the preceding chapter, the statutory definition and general nature of these institutions were examined, together with the taxation of capital gains and income as it is realised in their hands. It was then noted that the most important provisions for promoting the integration of personal and corporate taxation in regard to these organizations lay in the field of corporate distributions and these provisions are now discussed in this chapter. It is these provisions which realise their conduit nature which has been referred to.

However, it is impossible to say that absolute integration is the aim in regard to all these institutions. Rather the degree of integration achieved varies from one institution to another. Generally it seems that the most beneficial treatment is afforded to those institutions which have to comply with the most rigorous conditions. Thus the investment corporation and the non-resident owned investment corporation are the ones which, of all these institutions, realise the greatest degree of integration and the very detailed conditions which they have to satisfy to qualify as such have already been noted.[154] It does seem reasonable to ensure that the greater the beneficial treatment given, the less likely it is that the institution to which it is given will be able to carry out activities which do not merit such treatment.

For other organizations complete integration only exists to the extent that income and gains are distributable immediately as they arise. This is the case for Canadian unit trusts, mutual fund trusts (except to a limited extent in regard to capital gains) [155] and mortgage investment corporations. In this way the Act combines a policy of integrating the taxation of these institutions and their members with one discouraging the retention by such institutions of their earnings, which may lead to tax avoidance where the tax rate paid by the institution is exceeded by the personal tax rates of its members. Such a policy of discouraging accumulations of earnings is also shown in the case of most of the other investment institutions, although the actual methods used in practice to achieve this are different for each of them.[156]

Finally, in the case of many of these institutions, it will be seen that the relief given is basically limited to capital gains realised by them. Thus, for example, mutual fund corporations have the right to declare tax free capital gains dividends and to obtain refunds of federal taxes paid by them on capital gains when they distribute them and, in the U.K., investment and authorised unit trusts pay a very low tax rate on capital gains, for which a credit is given to members when they dispose of their shares or units. On the other hand, it should be noted that much of the income other than capital gains received by these investment institutions will consist of dividends which are excluded from their taxable income.

A. <u>Non-resident owned investment corporations</u>

As has already been pointed out,[157] a non-resident owned investment corporation is only taxable on capital gains arising from the disposition of taxable Canadian property. Moreover, the Act provides a means whereby such gains and other capital gains in respect of which the corporation is not taxable can be distributed to shareholders without further tax consequences. The corporation is empowered[158] to elect as to the full amount of a dividend that it be a capital gains dividend to the extent that the elected amount does not exceed the "Capital Gains Dividend Account". The latter account consists[159] of capital gains realised from the disposition of "Canadian Property"[160] and shares in other non-resident owned investment corporations, as reduced by capital losses from the same source and previous capital gains dividends. As such capital gains dividends are not subject to the non-resident witholding tax[161] and not otherwise taxable in the hands of the recipients,[162] the non-resident shareholder is generally in the same position as if the capital gains in question had accrued to him direct. However, in three respects this may not be the case. First, the personal rate of the non resident shareholder may exceed or be less than the rate payable by the non-resident owned investment corporation. Second, although capital gains arising from the disposition of foreign property[163] are not taxable in the hands of the corporation, their exclusion from the capital gains dividend account means that the withholding tax will be payable when such gains are distributed.[164] Third, although the definition of Canadian property will usually include taxable Canadian property, this is not expressed in the Act, so that there may be property which falls within the definition of the latter, but not the former. In this situation, the withholding tax would be payable on the distribution of gains arising from the disposition of taxable Canadian property.[165]

The same problems arise in the course of winding up a non-resident owned investment corporation in connection with the right to declare capital gains dividends as exists in the case of the right to declare dividends out of 1971 capital surplus on hand, but the same provision of the 1973 budget will remove these difficulties.[166] Moreover, the Act provides that a dividend is only a capital gains dividend to the extent it exceeds the corporation's 1971 undistributed income on hand.[167] Thus it will generally be necessary to eliminate this account before a capital gains dividend can be declared. On the other hand there is no penalty tax payable in the case of an erroneous election.

Capital dividends received from private corporations are included in the non-resident owned investment corporation's ordinary income, whereas capital gains dividends received from other non-resident owned investment corporations do not form part of ordinary income, but are added to the recipient's capital gains dividend account.[168] In fact, the final tax result to the non-resident shareholder is in either case the same, save that the withholding tax will be payable on the capital dividend when distributed.[169]

There are special rules in the Act for computing the corporation's pre-1972 surpluses. The non-resident owned investment corporation's 1971 capital surplus on hand is deemed to include so much of its 1971 undistributed income on hand as accrued while the corporation was a non-resident owned investment corporation.[170] Thus such pre-1971 income can be distributed tax free, without it first being converted into tax paid undistributed surplus by payment of the 15% tax. This is only necessary for pre-1971 income accruing while the corporation was not a non-resident owned investment corporation and if it has always had this status, then it will have no 1971 undistributed income on hand.

As section 182 of the Act does not apply to non-resident owned investment corporations, there is a reduction in the double taxation of gains arising when the corporation redeems preference shares. However, this still exists, as section 181 applies on the purchase of shares in the open market.[171]

/ The non-resident owned investment corporation is deemed to be neither a Canadian corporation nor a private corporation, except for the purposes of subsection 83(1)[172] and sections 87[173] and 219.[174] Thus the refundable dividend tax has no application and the corporation has no power to declare capital dividends.

As already noted, there are no special U.K. provisions governing non-resident owned companies resident in the U.K.[175]

B. Mutual Fund Corporations

The rules governing distributions made by mutual fund corporations attempt with some success to remove the defect found in the ordinary rules that although the shareholder is given full credit for the corporate tax paid on capital gains, he receives as ordinary income what accrued to the corporation as a capital gain. Thus the mutual fund corporation can elect as to the full amount of a dividend that it be a capital gains dividend,[176] which is not included in computing the shareholder's income for the year " as income from a share of capital stock of the corporation, but shall be deemed to be a capital gain of the taxpayer for the year from the disposition of capital property".[177] The amount of the dividend must not exceed the corporation's "capital gains dividend account"[178] at the time of the dividend. The right to declare capital gains dividends is not affected by the existence of any 1971 undistributed income on hand, but the corporation must be a mutual fund corporation throughout the whole year in which the dividend becomes payable[179] and where the amount of the dividend exceeds the amount of the capital gains dividend account, there is a penalty tax payable by the corporation equal to one third of the excess.[180]

The result of the above is that income accruing to the corporation in the form of capital gains can also be passed on to shareholders in that form. However, they also have the effect of depriving the shareholder of the dividend tax credit,[181] so that another mechanism is needed to prevent capital gains being taxed both in the hands of the shareholder and in the hands of the corporation. This is done by provisions which refund to the corporation the federal (but not provincial) tax,[182] which it has paid on capital gains, when it makes distributions in the form of capital gains dividends or on a redemption of its shares.[183] In the latter case there is a formula which computes the realised and unrealised capital gains accrued to the company's assets at the date of redemption and attributes to the shares redeemed a proportion of this amount (termed the "capital gains redemptions").[184] The actual refund for a year, which can only be claimed by a corporation which is a mutual fund corporation throughout the whole year, is equal to 20% of the year's capital gains dividends and capital gains redemptions.[185] The consequence is that not only is a refund given in respect of share redemptions for taxes paid on realised capital gains, but for taxes that will be paid on presently accrued, but unrealised gains.

Moreover, as section 84 of the Act does not apply to mutual fund corporations,[186] any sums paid to a shareholder on a redemption of his shares will not be deemed to constitute a dividend except in so far as they return paid-up capital, but will amount to a capital distribution leading to a disposal of the shares of the recipient and produce a capital gain or loss.[187] It would thus seem that there is nothing to stop a mutual fund corporation making use of the transactions, which in the case of other corporations are caught by section 84, to distribute in the form of capital accumulated income, particularly in the case of income other than capital gains in respect of which the Act gives the mutual fund corporation no special rights of refund.[188] However, it might be argued that section 15 of the Act would include in shareholders' income any payment made to them by the company otherwise than by way of dividend. This would depend on the correct interpretation of the exception to this section for payments made "on the reduction of capital, the redemption of shares or the winding up, discontinuance or reorganization of its business, or otherwise by way of a transaction to which section 84, 88 or Part II applies". This was discussed earlier in this chapter,[189] but if the interpretation there suggested is correct, then section 15 would not apply in the situation now being dealt with.

The redemption of shares by a mutual fund corporation should not be effected by a purchase on the open market for two reasons. In the first place, a tax will be payable by the corporation under section 181 and in the second place, such a purchase may not constitute a redemption for the purpose of the tax refund provisions.[190]

The mutual fund corporation is treated just like any other corporation as far as concerns the taxation of income other than capital gains although, in practice, this is not so significant as first appears, as much of this income will consist of dividends which are deductible from income[191] and to this extent the shareholders will be no worse off through investing in a mutual fund oorporation. However, the mutual fund corporation is deemed to be a private corporation for the purposes of paying the 33 1/3% tax payable by private corporations on certain dividends received by them. As for private corporations generally, this tax is refunded when the dividends, in respect of which it is paid, are redistributed.[192]

All dividends paid to non-resident shareholders, except for capital gains dividends,[193] are subject to the non-resident withholding tax. Moreover, the treatment of capital gains dividends in the hands of non-resident recipients is uncertain. Such dividends are deemed to be "a capital gain of the taxpayer for the year from the disposition of capital property",[194] but non-residents are only taxable on gains arising from the disposition of taxable Canadian property and the corporation may hold and dispose of property other than taxable Canadian property. The most fair and sensible course would be to apportion these gains between taxable Canadian property and other property disposed of by the corporation, but there is no statutory authority for this.[195]

The effect of the above provisions is that shareholders (whether resident or non-resident)[196] are generally in the same position in regard to capital gains accruing to the corporation and distributed to them, as if they had accrued direct to those shareholders. Not only is a full refund given to the corporation on taxes it has paid or will pay in respect of capital gains, but income accruing to the corporation in the form of capital gains retains that form when distributed to shareholders, whether it is distributed as it arises or is accumulated and distributed on a share redemption. The Act goes further, since by the exclusion of section 84 it permits income other than capital gains accruing to the corporation to be distributed as a capital distribution, which will lead to a capital gain or loss in the hands of the shareholders.

However, the integration achieved in respect of capital gains might be thought to fall down in two respects. First, it is common for mutual fund corporations to declare dividends in favour of their shareholders without actually distributing the amount declared, which is reinvested by the corporation. Double taxation might be thought to result because, on a subsequent disposition of his shares, the shareholder might realise a capital gain which reflected in part these reinvested earnings, on which he will already have been taxed as a dividend. It appears, however, that such reinvested dividends would amount to a capital contribution made by the shareholder to the corporation, which, by virtue of section 53(1)(c) of the Act, leads to an increase in the adjusted cost base of his shares to the extent that the contribution increases their value.

Second, there is no express provision for the flow through to shareholders of the foreign tax credit available in respect of foreign capital gains. However, it does not seem that this is necessary, since the right to make capital gains dividends and to obtain refunds of federal tax is not limited where the corporation does not pay the full federal tax on a gain because of a foreign tax credit.

Finally, it should be mentioned that a non-resident shareholder in a mutual fund corporation, whose shares do not amount to taxable Canadian property,[197] may obtain a tax advantage if the corporation makes no distribution of income or capital gains to him until he redeems his share. In this situation, the shareholder will not be liable for tax on his capital gain, there is a good possibility that no liability to witholding tax would arise in respect of the distribution[198] and the corporation would still get its refund of tax.

C. Investment Corporations and Trusts

Investment corporations in Canada have the same right to declare capital gains dividends and the same right to a refund of federal Income Tax paid on capital gains as do mutual fund corporations,[199] save that the provisions allowing a refund in the case of a redemption of shares do not apply unless the investment corporation also qualifies as a mutual fund corporation.[200] In fact, if an investment corporation qualifies as a mutual fund corporation or vica versa, then all the rules applicable to each corporation separately will apply to the one corporation, except that a mutual fund corporation which is also an investment corporation or an investment corporation which is also a mutual fund corporation will never be treated as a private corporation for the purpose of the refundable dividend tax paid on dividends received.[201]

The application of section 84 of the Act may put investment corporations at a disadvantage as compared with mutual fund corporations, as it means that payments of capital to shareholders, as for instance on a redemption of share capital, will, except to the extent they merely return paid-up capital, be deemed to be dividends. Even though the investment corporation could utilize its power to declare capital gains dividends and so obtain a refund of tax paid by it on capital gains and its shareholders would receive the dividend tax credit in regard to other income distributed, the power given to the mutual fund corporation could be more advantageous. First, in connection with the power to declare capital gains dividends of the investment corporation, similar problems arise as to its utilization in respect of deemed dividends as were referred to in the discussion of 1971 capital surplus on hand of a company being wound up[202] and these problems are not in this case removed by the provisions of the 1973 budget. Second, the refund allowable in respect of capital gains dividends does not extend to tax that will be payable on capital gains as yet accrued, but unrealised. Finally, it is probably in the interests of high Income Tax bracket shareholders to receive capital gains as opposed to ordinary income in spite of the consequent loss of the dividend tax credit. Thus an investment corporation may find it desirable to qualify as a mutual fund corporation, particularly if its shares are redeemable.

The main advantage of an investment corporation over a mutual fund corporation is the 25% rate of Income Tax paid by the former on its income other than capital gains.[203] Full credit is given for such a rate of tax by the ordinary dividend tax credit.[204]

In the U.K., it has already been seen how capital gains accruing to investment trusts are reduced by a fraction,[205] so that the effective rate of corporation tax paid is equal to the rate payable by an individual when the alternative rate applies fully, i.e. 15%, and how other income is treated just as in other corporations.[206] It must now be recorded that distributions, whether from capital gains or other income, are in general subject to the ordinary provisions governing such, although in three ways the effect of these provisions is modified and softened.

First, much of the investment trust's income will consist of dividends which are deductible from its income for Corporation Tax purposes and investment trusts are given the additional right of deducting from their profits expenses of management.[208] To the extent that income is not taxed because of these provisions, there will be no additional taxation resulting from the use of the investment trust as a medium of investment. In this respect it is similar to the Canadian mutual fund corporation.

Second, a tax credit is given to the shareholders when there is a capital distribution resulting[209] in a disposal of their shares and a capital gain. Section 112 of the F.A. 1972 provides that on a disposal of shares in an investment trust resulting in a capital gain,[210] the shareholder is entitled to a tax credit equal to the least of the following three amounts:

(a) The amount of the tax payable

(b) 15% of the capital gain

(c) 15% of all the shareholder's capital gains for the year.

The provision applies in the case of both corporate and non-corporate shareholders.[211] The effect is to give a full credit for tax paid by the corporation on capital gains or tax to be paid on as yet unrealised gains and a partial credit in respect of other income.

Third, the conditions of qualification for an investment trust require that "the distribution as a dividend of surpluses arising from the realization of investments is prohibited by the company's memorandum or articles of association".[212] Thus, although there is no tax credit (other than the ordinary dividend tax credit) in respect of capital gains distributed otherwise than by way of a capital distribution, non is required as such a distribution would be a breach of its conditions of qualification. In the case of distributions of income other than capital gains, otherwise than by way of a capital distribution, the ordinary dividend tax credit is available.[213]

An investment trust is rather similar to a mutual fund corporation in Canada, without its power to declare capital gains dividends. In the case of both a redemption of shares will lead to a refund of or credit for tax paid by the corporation on its capital gains, a disposal of members' shares and a consequent gain or loss and a conversion of accumulated income into capital gains. On the other hand, in the U.K. this will be limited to redemptions taking place on a winding up of the company.[214]

D. Unit Trusts

It was shown in the last chapter[215] how a Canadian unit trust can escape the payment of tax on its income (including capital gains) if that income is payable in the year it arises to a beneficiary, in which case it is taxed as part of that beneficiary's income.

However, before the question as to whether the taxation of unit trusts and their unit holders is fully integrated can be answered, two further questions must be raised. First, does the income received from a particular source retain its nature when distributed, e.g. does a capital gain accruing to a unit trust remain a capital gain in the hands of a unit holder when distributed to him? Second, supposing the trust's income is not payable to its unit holders in the year it accrues, so that it is taxed as part of the trust's income, is that income taxed again when eventually it is distributed? If so, does the recipient receive any credit for or does the trust receive a refund of the tax paid by the trust on such income?

Taking the first question, section 104 of the Act provides that where income is included in a unit holder's income as being payable to him in the year it arises to the trust, the trustees may designate such income to be payable out of capital gains,[216] dividends which are taxable in the hands of the recipient,[217] dividends which are not so taxable[218] and foreign income,[219] in which case the beneficiary is treated as if he had personally received such income from that source.[220]

There is one limitation on this power. If the trustees designate an amount payable to a non-resident beneficiary as being payable out of capital gains, this amount is not deductible from the trust's income and is not included as part of the beneficiary's income. This compensates for the fact that although in general all payments of trust income made to a non-resident beneficiary are subject to the non-resident withholding tax, payments of income designated by the trustees as payable out of capital gains are not so liable.[221] The Act provides[222] that such a designation has the effect that the distribution is treated as a "taxable capital gain for the year of the particular beneficiary from the disposition of capital property". There is here the same problem of the treatment of such distributions in the hands of the non-resident beneficiary as in the case of capital gains dividends made by mutual fund corporations.[223] In view of the fact that the designation of amounts of income payable to non-resident beneficiaries as payable out of capital gains will result in those amounts being included in the trust's income and a possible liability on the beneficiary to pay tax on a capital gain, it may be better not to designate the amount, so that it is deducted from the trust's income and simply liable to the withholding tax when it is paid out.[224]

There are no provisions which permit the trustees to designate capital losses accruing to the trust, so that they are then treated as the beneficiaries' losses.

In answer to the second question it appears that a later distribution of income, which has already been taxed in the hands of the trustees, will not in general be taxed as part of the recipient's income,[225] but may have capital gains consequences. Thus it seems that there will be a disposition of units in a unit trust leading to a capital gain or loss when the unit "is redeemed in whole or part or cancelled",[226] but that any amount paid on any other occasion "as, on account or in lieu of payment of, or in satisfaction of a distribution or payments of capital, otherwise than as proceeds of disposition"[227] is simply deducted from the adjusted cost base of the unit. Although the latter type of payment does not lead to an immediate capital gain it is obvious that the effect of reducing the adjusted cost base of the units is to cause a bigger gain or smaller loss when the unit is finally disposed of. The only question here arises as to the meaning of "capital" for the purposes of this provision. It would appear to cover capital gains distributed by the trust [228] and it could be argued that it referred also to accumulations of other income.[229] The consequences of the above provisions are that either a distribution of accumulated income and capital gains will be in redemption or cancellation of trust units, when there will be an immediate capital gain or loss realised by the unit holder, or there will be a potential liability to an increased capital gain or reduced capital loss. In either case income, which has already born tax in the hands of the trust, is taxed again as a capital gain when it is distributed.

This position is modified where the income distributed has already been taxed as income in the hands of a beneficiary as being payable to him in the year it arose. The Act provides that such income will not be taxed again as income in the hands of the beneficiary.[230] Moreover, although it would seem that accumulations of such income may form part of the proceeds of disposition of a unit holder on the redemption or cancellation of his unit or cause a reduction in the adjusted cost base of his unit as a distribution of "capital",[231] this will be counteracted by section 52(6), which is to be added to the Act by section 12(3) of Bill C-170 (1973). This will, in effect, raise the cost base of the unit by the amount of any trust income included in the beneficiary's income and reduce it when the income is distributed. Thus such income will not, for the most part, be taxed again in the hands of the beneficiary as a capital gain on his unit. However, in regard to the untaxed half of capital gains, this will not be the case as this provision only applies to the taxed half of capital gains.[232]

The meaning of the term "capital" also has great significance when it comes to making distributions to non-resident unit holders. Section 212(1)(c) of the Act imposes the witholding tax on all payments of income made by a resident trust and section 212(11) of the Act deems all payments made by a trust to non-resident beneficiaries to be out of trust income except in so far as they comprise "a distribution or payment of capital". If "capital" does not include income and capital gains taxed in the hands of the trust and accumulated by it, then such amounts will be subject to the witholding tax when they are paid out.

The moral of the above discussion must be that to maximise tax advantages unit trusts should be set up in such a way that all their income is payable or paid to unit holders as it arises. This does not necessarily require that such income actually be distributed. It could be reinvested by the unit trust and by virtue of section 12(3) of Bill C-170 described above, there would be no double taxation of such amounts if a unit is disposed of for a capital gain which reflects such reinvestments.

Turning now to the U.K., the tax treatment of distributions made by authorised unit trusts is the same as for distributions made by investment trusts.[233] Thus the normal rules applying to company distributions apply, save that a tax credit is given to the unit holder when he disposes of his shares and there is a capital gain.[234] In the context of corporate distributions, this means that the credit is given when the shares are disposed of as the result of a capital distribution and it has been pointed out how, in practice, this means distributions made on a winding up in the case of an investment trust.[235] However, this credit will have a different scope of operation in so far as it applies to authorized unit trusts, because of the different way in which they are organized.[236] Whereas investment trusts are companies whose shares are saleable and purchaseable on the open market, so that the shareholders can easily obtain the benefit of the credit by disposing of shares in this way and the narrowness of the scope of the credit in regard to disposals caused by capital distributions is not so important, units of authorized unit trusts are not so saleable and purchaseable, but are disposed of by the unit holder requiring, at his option, the trust to redeem his units and acquired by purchase from the trust. Although it would seem arguable that amounts paid to a unit holder are, except to the extent they simply return capital, income distributions and taxable in the hands of the unit holders as such, it appears that, in this situation, where the redemption is at the option of the shareholder, the unit trust must be treated as a purchaser of the units and as making a capital distribution, so that there is full scope for the operation of the credit.[237] As a result, there will be full credit given to the unit holder on the redemption of his units for Corporation Tax paid by the trust on realised capital gains and for tax to be paid on accrued, but unrealised, gains and a partial credit given in respect of tax paid on income other than gains.

However, if the above be the correct position, then section 355 of the I.C.T.A. 1970 becomes superfluous. This allows the trust to deduct from its profits for Corporation Tax purposes a fraction of its capital gains, when the capital sums paid out by the trust in redemption of units exceed capital sums received in payment for the purchase of units. The fraction which is deductible is the amount of the excess over the total consideration received by the trust from disposals of assets made during the year, the aim of the provision being to exclude from Corporation Tax the proportion of capital gains realised by the trust attributable to the assets disposed of to meet the excess. Thus this prevents double taxation of those gains, which will be reflected in the gain realised by the unit holder on his redeemed unit.[238] However, a full credit is already given by virtue of the provisions previously described.

As in the case of investment trusts, there is no special credit given to shareholders or refund given to the trust in respect of tax paid on capital gains or other income when that income is distributed otherwise than by virtue of a capital distribution. However, in such a case, the ordinary dividend tax[239] credit will apply and, in view of the effective rate of 15%[240] paid by the trust on capital gains, it will be a full credit. On the other hand, when making such a distribution of capital gains the trust will have to pay advance Corporation Tax double in amount to the actual tax for which it will otherwise be liable to pay on the gain and it may have difficulty in setting this off against its own eventual liability.[241] To the extent that the income of the trust comprises dividends which are deductible from its income, the tax result will be as if there had been no intermediary unit trust.[242]

As for unauthorized unit trusts, it would seem that the general rule applicable to trusts, to the effect that a distribution of accumulated income or capital gains will not be taxed as ordinary income in the hands of the recipient, will apply also here.[243] On the other hand, in the case of ordinary trusts, it would also be the case that such a distribution would not result in a chargeable gain to the beneficiary, arising from a disposal of his interest in the trust caused by it.[244] However, in the case of unauthorised unitttrusts the position is not so beneficial. The treatment of such trusts as companies for Capital Gains Tax purposes would appear to bring into operation paragraph 3 of schedule 7 of the F.A., 1965, which deems there to be a disposal of a share in a company when its owner receives a capital distribution, i.e. one which is not included in his income.[245]

This very ûnfavourable position in respect of distributions made by unauthorised unit trusts appears to be very similar to that of Canadian unit trusts. The only way to avoid double taxation of income other than capital gains is to distribute such income in the year it arises to the beneficiary entitled. This puts the trust into a similar position to that of the Canadian trust, although in the latter case the income need not be actually distributed in the year it arises, as long as it is payable in that time. However, in the U.K., this will not work in the case of capital gains realised by the trust, as regular distribütions of capital gains will be taxed as ordinary income in the recipients hands, as well as being taxed as capital gains in the hands of the trust.[246] There are no U.K. provisions which attribute capital gains realised by unit trusts to their unit holders and treat them as capital gains in their hands, although where income of an unauthorized unit trust is treated as income of the unit holder, he will get the benefit of the dividend tax credit.[247] As already mentioned,[248] the treatment of authorized unit trusts is very similar to that of mutual fund corporations as regards the redemption of shares and although the trust has no power to declare capital dividends, this is to some extent compensated for by the very low rate of tax paid by it on capital gains.

E. Mutual fund trusts

Mutual fund trusts are treated in exactly the same manner as unit trusts,[249] but are given two distinct tax advantages, which must be referred to.

First, the limitation on the deductibility of income payable to non-resident beneficiaries in the year it arises, because it is designated by the trustees as being payable out of capital gains, does not apply.[250] As this amount remains exempt from the non-resident witholding tax when it is paid out, its taxability depends on the treatment of the deemed capital gain in the hands of the non-resident. If the correct treatment of such gains is to apportion them between the gains realised by the trust from the disposal of taxable Canadian property and other gains, so that the unit holder is only taxable on the former, then the unit holder is no worse off through holding assets through the unit trust than if he held them personally.[251]

Second, the mutual fund trust has the same right to a refund of federal tax paid by it on capital gains on the redemption of its units, as has a mutual fund corporation.[252] Thus, although to get the maximum tax advantage a mutual fund trust should in general, like a unit trust, be so constituted that its income and capital gains are payable to its unit holders in the year they arise, in the case of a mutual fund trust only, an equal tax advantage can be obtained by accumulating capital gains and distributing them on the redemption of units of the trust.

There is, however, one tax disadvantage attached to mutual fund trusts. The provision[253] which passes through to trust beneficiaries, in relation to trust income which is treated as part of their income, the benefit of dividends paid to the trust out of pre-1972 surpluses and capital dividends received by the trust is limited in the case of mutual fund trusts to capital dividends.[254] However, it appears that dividends received by a mutual fund trust out of pre-1972 surpluses, to the extent that they represent income payable to a unit holder in the year it arises, will still not be included in the unit holder's income, seeing as the Act requires the beneficiary to include in his income only amounts that would otherwise have formed part of the trust's income[255] and dividends received from pre-1972 surplus would not in any case have formed part of that income.[256]

The mutual fund trust is equated with the mutual fund corporation in one other respect. Units held by a non-resident taxpayer will be regarded as taxable Canadian property in the same circumstances as shares in a mutual fund corporation.[257] This means that the possible advantage available to non-resident shareholders in mutual fund corporations, which make no distributions until they redeem their shareholders' shares, will also be available to non-resident unitholders in mutual fund trusts, where their units do not constitute taxable Canadian property.[258]

F. Mortgage Investment Corporations

The double taxation of income and capital gains accruing to such corporations is avoided by permitting them to deduct from income for the year so much of these amounts as it distributes in the year they are realised.[259] The integration of the personal and corporate taxation in respect of these deductible amounts is completed by provisions that result in corporate capital gains and other income retaining their nature in the hands of shareholders. Thus the corporation is empowered to elect as to the full amount of a dividend paid from these amounts that it be a capital gains dividend,[260] which is deemed to be a capital gains of the recipient taxpayer for the year from the disposition of capital property.[261] The dividend, in respect of which such an election is made, must not exceed the corporation's net capital gains for the year, as reduced by any previous capital gains dividends declared in that year,[262] and an excess election imposes a liability on the corporation to pay tax equal to three quarters of the excess.[263] As regards income other than capital gains, which will mostly consist of mortgage interest, a dividend which is deductible by the corporation in computing its taxable income for the year is treated as interest in the hands of the recipient shareholder.[264]

Dividends paid to non-resident shareholders are subject to the witholding tax,[265] except in case of capital gains dividends which are exempt.[266]

In so far as the capital gains and other income of the corporation are not distributed as they arise, distributions are treated just as distributions made by any other corporation.

7. Insurance corporations

Again, nothing need be said about insurance corporations other than life insurance corporations, as the tax treatment of distributions is the same for such corporations as for any other corporations. In considering the tax treatment of distributions made by Canadian life insurance corporations, it is necessary to distinguish income of the corporation accruing to that part of its assets known as the segregated fund and other income.

If allocated by the corporation to the policyholder, the former income is treated as the policyholder's income[267] and there are further provisions ensuring that that part of that income which is from foreign sources,[268] or comprises taxable dividends[269] or taxable capital gains[270] retains these characteristics in his hands. However, that part of this income which consists of dividends paid to the corporation out of pre-1972 surpluses is expressly excluded from the amount which can be allotted to the policyholder.[271]

The policyholder must include in his income "the proceeds of the disposition[272] of an interest in the policy that he became entitled to receive in the year "less" the adjusted cost basis[273] of the policy to the policyholder as of the time of the disposition."[274] Expressly excluded from the policyholder's proceeds are payments made from the segregated fund.[275] This means that all income and capital gains accruing to the segregated fund are taxed once only at the policyholder's rates of tax, as even payments made to the policyholder representing the untaxed half of capital gains and dividends received which were paid to the corporation out of pre-1972 surpluses are not taxed in the policyholder's hands.[276] In so far as the proceeds of disposition comprise amounts not paid from the segregated fund, they may be paid from amounts which are deductible from the corporation's income, both when computed for the purposes of ordinary Income Tax and for the purposes of the special tax under section 208 of the Act.[277]

The Act contains special rules for computing the 1971 capital surplus on hand[278] and the 1971 undistributed income on hand[279] of life insurance corporations. The principles remain the same, but the changes are required, because the full taxation of such corporations was only commenced in 1968.

Life insurance corporations are excluded from the benefit of the right given by section 112 of the Act to deduct dividends received from their income. However, it is given two alternative rights which to a large extent compensates for this. Section 138(6) gives it the right to deduct that proportion of its total dividends received from Canadian corporations as is attributable to its income as computed for the purposes of ordinary Income Tax. Section 208(2)(b) gives it a similar right in respect of its income as computed for the purposes of the special 15% tax on investment income.

In the U.K. also, income and capital gains accruing to a life Insurance corporation and paid to a policyholder are taxed once only, but with the difference that they are taxed at a fixed rate in the hands of the corporation and not at the personal rates of the policyholder. Payments made in respect of a policy are not included in income and it is provided by section 28(2) of the F.A. 1965 that "No chargeable gain shall accrue on the disposal of, or of an interest in, the rights under any such policy of assurance or contract (i.e. a policy of assurance or contract for a deferred annuity on the life of any person) except where the person making the disposal is not the original beneficial owner and acquired the rights or interest for a consideration in money or moneys worth. Subject to this rule, the "occasion of the payment of the sum or sums assured by a policy of assurance or the first instalment of a deferred annuity, and the occasion of the surrender of the policy of assurance or the rights under a contract for a deferred annuity, shall be the occasion of a disposal of the rights under the policy ... or contract ..."[280] In Canada life insurance policies are completely excluded from the capital gains rules.

In both systems, the treatment of distributions made to shareholders by life insurance corporations is the same as for such distributions made by other companies.

Part 4 - Conclusion

The detailed rules governing distributions made by corporations to their shareholders have now been discussed. They reveal a Government policy in both countries which, as a general rule, favours only a partial integration of personal and corporate taxation. However, the relaxation of this policy in favour of private corporations in Canada and certain specialised investment institutions in both systems, for which a much greater degree of integration is provided, results in three different sets of tax rules for three different types of corporations. It only remains now to consider the justification for the differing treatment of each type and to draw any further general conclusions which are suitable.

Perhaps the most important distinction is the one drawn in Canada between public and private corporations. The lack of any such distinction in the U.K. and[281] its significance to the Canadian taxpayer, for the purpose of determining his tax liability, require a lengthy treatment. The Act defines a private corporation as a "corporation that, at the particular time, was resident in Canada, was not a public corporation, and was not controlled,[282] directly or indirectly in any manner whatever, by one or more public corporations".[283] A public corporation is defined in the Act as a corporation resident in Canada which satisfies one of two alternative conditions.[284] Either "a class or classes of the capital stock of the corporation were listed on a prescribed stock exchange in Canada"[285] or "it complied with prescribed conditions relating to the number of its shareholders, dispersal of ownership of its shares, public trading of its shares and size of the corporation"[286] and it either elected to be a public corporation or was designated as such by the Minister.[287] Similarly, it will cease to be a public corporation if it complies with "prescribed conditions relating to the number of its shareholders, dispersal of ownership of its shares and public trading of its shares"[288] and it makes an election[289] or the Minister makes a designation.[290] The result of these definitions is that resident companies controlled by other resident public corporations are not private corporations and nor are non-resident companies of any kind, but a resident company, which is a subsidiary of a non-resident company which would generally be regarded as a public company,[291] may be a private corporation.[292] The fact that a company is not within the definition of the term "private corporation" does not make it a public corporation, although it will be taxed as a public corporation.

The essence of the distinction drawn between public and private corporations follows that drawn in the government's white paper "Proposals for Tax Reform" between closely and widely held companies.[293] The white paper proposed a system which would lead to a full integration of the taxation of corporations and shareholders in the case of closely held companies and partial integration in the case of widely held companies. The preferential treatment of closely held corporations was justified on the grounds that such companies compete with unincorporated proprietorships and partnerships and so the shareholders of such corporations should as far as possible be put in the same position as if they were carrying on an unincorporated business. On the other hand, it was argued that widely held companies did not compete with unincorporated businesses, but with other widely held companies and, in particular, foreign companies which were taxed in a manner similar to the proposed Canadian system. Further, they were able to pass on to their customers half of their tax burden. It would seem that this reasoning forms the basis of the present system.

Following this reasoning, the distinction was criticised on the basis that certain private corporations were large enough to compete with public corporations and to pass on to customers their tax burdens and so the proposed system gave them an unwarranted tax advantage.[294] However, acceptance of this argument does not necessarily involve a wholesale rejection of idea of making such a distinction between two types of corporations. Rather, it requires a reappraisal of the basis upon which the distinction is made in the first place, to consider whether the distinguishing line could not be drawn at a point which meets this criticism.

The argument put forward by those who support the complete integration of personal and corporate taxation is that the corporation is no more than the legal form in which its shareholders carry on business and is in essence the same entity as them. The Royal Commission on Taxation applied this reasoning to all corporations,[295] but this approach was flatly rejected by the Government in its white paper and eventually in the Act, except in the case of private corporations. This conclusion is supported by many modern writers, who point out how the shareholders of large corporations have become passive investors and how the corporations themselves have come under the control of strong and independent managements who are devoted more to promoting the interests of the corporation as a separate entity than as the alter ego of its shareholders.[296]

Having justifiably excluded public companies from the benefit of integration, it is now necessary to take up the criticism that many private companies are to be compared with public corporations, rather than individual proprietorships or partnerships. From a theoretical point of view, it does seem desirable to restrict the benefits of integration to those corporations which are, in reality, incorporated partnerships or proprietorships, since these are the only corporations, the utilization of which involves no more than a change in the legal form in which the business in question is carried on. Moreover, it would seem possible to put such a system into operation by treating all corporations as public corporations, but givingto corporations, for which integration is proposed, the right to elect to be taxed as a partnership.[297]

However, on several grounds, it seems that such a system may be impractical. In the first place, there would seem to be some difficulty in drawing up regulations which would draw a line fairly and without anomalies between the two types of corporation. It is all very well to state that integration is to be provided for corporations which, in reality, represent only a change in the legal form in which a taxpayer holds his property, but this is no test which can be applied in practice. There is need of regulations referring to the number of shareholders, dispersal of shareholdings etc. As was seen above, such are found in the Canadian regulations distinguishing public and private corporations. However, these are based on a well recognized and accepted Company Law distinction. Further, there are practical difficulties in operating the partnership option, which include, for instance, the amount of income to be allotted to shareholders where there are several classes of shares, liquidity problems for shareholders and the treatment of amounts attributed to non-resident shareholders.

Aside from the practical difficulties, when it is remembered that the integration provided in Canada for private corporations is complete only in the case of capital gains, investment income and a limited amount of active business income,[298] the distinction made between public and private corporations needs less justification. The full integration of the taxation of investment income and capital gains can be defended on the same grounds as the integration accorded to the investment institutions discussed in a later paragraph. The limit on the amount of active business income for which integration is granted meets the criticism that some private corporations compete with public corporations, by restricting complete integration in respect of such income to corporations which most obviously represent for their individual shareholders simply a change in the legal form in which they conduct their business.

Turning to the U.K., which has no special provisions integrating the taxation of private corporations and their shareholders, the above discussion leads to the conclusion that the failure to provide at least some form of partial integration on Canadian lines is a basic defect, the existence of which leads to some tax disadvantages for individuals using the corporate form to conduct their business or hold their property.

The distinction drawn in both systems between ordinary corporations and certain investment institutions, such as investment trusts and corporations and unit trusts, cannot be based, as in the case of the distinction between private and public corporations, on the close personal relationship between the corporation and its members, but can be justified by virtue of the passive nature of such institutions, which, in theory and practice, act simply as conduits between investor and investment. They are to be likened to trustees who make investments on behalf of their numerous beneficiaries, pay the income from such investments as it arises to them and any capital gains and other accumulated income when their interest in the trust is sold or redeemed. Thus these institutions are often required or encouraged to distribute most of their income and their members are often given the right to compell the corporation or trust to redeem their shares or units at their option.

Even where the two systems do provide some degree of integration, there seems to be more concern that it be granted in respect of corporate capital gains than in respect of other income. This is revealed, in particular, by the general treatment of corporate distributions and the special rules affecting mutual fund corporations and trusts in Canada and investment and authorized unit trusts in the U.K. The reasons for this distinction appear to have their roots in those reasons which are believed to justify a more lenient tax treatment of capital gains throughout the length and breadth of the two tax systems.[299]

Finally, there should be mentioned the fundamental distinction found in the U.K. system, but not in the Canadian system, between corporate distributions to shareholders made while the corporation is a going concern and those made in the course of its liquidation. Although it has the merit of simplicity, in so far as it is necessary to determine the effect for tax purposes of a distribution made after the company has ceased to carry on business, it is difficult to otherwise justify provisions which have the effect of altering the tax treatment of corporate surpluses distributed to shareholders according to when the distribution is made. This is especially so, because the inapplicability of the dividend tax credit to distributions made in the course of a winding up means that the change brought about by the liquidation commencing benefits only those shareholders paying the highest rates of Income Tax. The Canadian system has the merit that distributions of corporate surpluses have the same consequences whenever they are made.

NOTES

1 The same effect may be achieved by other methods. Thus, in Canada, in some situations certain corporations may obtain a refund of corporate tax on a distribution.

2 There are also transitional provisions which allow all corporations to distribute their pre-1972 capital gains at no tax cost and their pre-1972 other income at reduced tax cost - see Part 1 of this chapter Section E.

3 In Canada, certain institutions are allowed to make capital distributions known as "capital dividends" and "capital gains dividends" which can only be made out of capital gains - see Parts 2 and 3 of this chapter.

4 See Part 3 of this chapter Section B (text at nn. 186-9).

5 Thus, both private and certain other types of corporation are given rights to a refund of corporate taxes when they make distributions - see Parts 2 and 3 of this chapter.

6 The Act gives full integration to Canadian Controlled Private Corporations in respect of a limited amount of active business income - s. 125 in conjunction with the dividend tax credit.

7 The reference to the public nature of these institutions is a general one only. Some of the institutions coming under this head are more likely to have the characteristics of private corporations, e.g. non-resident owned investment copporations.

8 S. 90(1) and s. 82(1) in Canada and s. 232(1) I.C.T.A. 1970 as amended by s. 87 F.A. 1972 in the U.K.

9 For what constitutes an income distribution see this part of this chapter Section C.

10 S. 82(1)(b) increases by one third the amount of the dividend included in the shareholder's income and s. 121 allows a deduction from tax of an amount equal to four fifths of the gross up. This results in a full one third tax credit, because the provincial tax is calculated as a percentage of the federal tax after the credit has been deducted. A "taxable Canadian corporation" is a Canadian corporation (for the definition of which see Part 3 of Chapter One (text at n. 59))which is not exempt from tax - s. 89(1)(i)).

11 For examples of the operation of the credit and more detailed discussions see Interpretation Bulletin I.T. 67 dated 13th September 1972, Canadian Institute of Chartered Accountants Tomorrow's Taxes 103 and R. Dart Overview of Proposed Treatment of Corporate Source Income 1971 Conference Report Canadian Tax Foundation 112 at 113-4.

12 S. 126(1) and (7)(c). Certain dividends received from foreign affiliates of the taxpayer are deductible from income-s. 90(2) and see Part 1 of Chapter Four Section C (text at n. 80).

13. S. 232 I.C.T.A. 1970.

14 The method followed is for the dividend to be grossed up by an amount equal to the basic rate of Income Tax, i.e. three sevenths when this is 30%, for this amount to be included in income (s. 232 as amended by s. 87 F.A. 1972) and for a credit to be given equal to the gross up-s. 86 F.A. 1972.

15 This is less significant in Canada than in the U.K., as in that country only is it possible for individuals to set capital losses against ordinary income (including dividends) to a limited extent - see Part 3 of Chapter Two Section A .

16 There is no carry forward or carry back of the Canadian credit to other years, so that if it is not fully used in the year it arises, it lapses.

17 S. 84 F.A. 1972. See n. 14 supra.

18 S. 85(1) F.A. 1972.

19 S. 85(3) F.A. 1972.

20 S. 85(4) F.A. 1972

21 S. 85(6) F.A. 1972

22 S. 212(2). For the tax years 1972-5 inclusive the rate is 15% - s. 10 I.T.A.R.

23 The Act gives the Government power to negotiate tax treaties which give non-residents the benefit of the dividend tax credit - s. 98(2) F.A. 1972.

24 S. 87(5) F.A. 1972.

25 S. 87(2) F.A. 1972 and s. 32(1) F.A. 1971.

26 For a discussion of the liability of non-residents in respect of capital gains, see Part 1 of Chapter Two Section B.

27 S. 82(1) and 90(1).

28 See n. 10 supra.

29 S. 112(1). For the purpose of this section, "control" is defined in s.112(6)(b). A taxable Canadian corporation is a Canadian Corporation (for the definition of which see Part 3 of Chapter One (text at n. 59)) which is not exempt from tax - s. 89(1)(i).

30 "Permanent establishment" is to be defined in regulations.

31 S. 112(2). The deductible amount is the proportion of the dividend that "the taxable income earned in Canada" of the paying corporation for the immediately preceding year is of the total income of the company for that year. "Taxable income earned in Canada" is defined in s. 115 and includes capital gains and business income.

32 The exception relates to certain dividends received from foreign affiliates - see Part 1 of Chapter Four Section C (text at nn. 80 and 85-9).

33 S. 126(1) and (7)(c). The credit is not available in respect of dividends received by the corporation from foreign affiliates - see Part 1 of Chapter Four Section C(text at nn. 80 and 85-9).

34 S. 239 I.C.T.A. 1970.

35 S. 498 I.C.T.A. 1970

36 S. 498(4) I.C.T.A. 1970. S. 506 of the Act provides that the proportion of such tax for which a credit is given is equal to the proportion that the dividend bears to the paying corporation's profits.

37 S. 232 I.C.T.A. 1970. By virtue of s. 256 I.C.T.A. 1970, where a company pays a dividend to a company of which it is a 51% subsidiary or to a company which is a 51% subsidiary of the same company of which the paying company is also a 51% subsidiary or to a company which is a member of a consortium (defined in the section) which owns the paying company and the paying company is a

trading or holding company (defined in the section), the payer and the recipient can elect that no Income Tax be deducted. This is continued after 1st April 1973 by Part II of sch. 15 F.A. 1972. It is another example of recognition given to the group of companies as a single entity.

38 S. 240 I.C.T.A. 1970.

39 S. 254 I.C.T.A. 1970.

40 S. 88 F.A. 1972. See n. 14 supra and text.

41 S. 88 and s. 89 F.A. 1972. Instead of setting the franked investment income against the recipient's liability to account for Income Tax deducted from its own distributions, it is set against its liability to pay advance Corporation Tax at the time of making distributions in the current or future years.

42 They are liable to pay Income Tax at the basic rate, which liability is satisfied by the payment of advance Corporation Tax by the company, and, if applicable, at the higher rates and the Investment Surcharge -s. 232 as amended by s. 87 F.A. 1972 and see text at nn. 23-6 supra.

43 S. 192 and see Part 2 of Chapter Four Section A.

44 See text at nn. 15-6 supra.

45 The incentive is even stronger where, as is the case with ordinary income, the credit is only partial. See S. Edwards Corporations and Shareholders 1971 Conference Report Canadian Tax Foundation 124 at 127.

46 S. 52(2)

47 S. 52(3) and s. 248(1). This provision also provides that the acquisition cost of the shares is equal to the amount included in income. Where the shares were received in a pre-1972 stock dividend, there is no statutory provision, but the Revenue in Interpretation Bulletin I.T. 88 dated 30th January 1973 state that it will be the amount included in income under the old act.

48 S. 84. For the meaning of "paid-up capital limit" see n. 57 infra.

49 S. 84(2)

50 S. 84(3)

51 S. 84(3)(a). Where shares are acquired or redeemed under s. 182 and at the same time outside that section, the deemed dividend in respect of the latter is calculated as normal, although the paid-up capital limit of the corporation is reduced by the amount of the paid-up capital of the shares acquired or redeemed under s. 182.

52 S. 84(4)

53 The act uses the term "taxable dividend" to refer to any dividend other than a tax free dividend paid under s. 83, i.e. dividends paid from pre-1972 surpluses (see this part of this chapter Section E) and capital dividends (see Part 2 of this chapter Section A)- s. 89(1)(j)).

54 A stock dividend is anyway included in income.

55 S. 84(1)

56 R. Brown <u>Capital Reorganizations</u> Corporate Management Tax Conference 1972 114 at 123-4.

57 Id at 126-7.

58 Defined in s. 89(1)(e).

59 Defined in s. 89(1)(d)

60 Ministry of National Revenue <u>Tax Reform and You - Corporate Tax Guide</u> 46.

61 There are numerous cases holding that no dividend tax credit is available. See, for instance, <u>Sabat v M.N.R.</u> (T.A.B.) 55 D.T.C. 321. See further CCH. Canadian Ltd. <u>Canadian Tax Reporter</u> para. 4652.

62 S. 15(1)(d). For s. 88 see Part 3 of Chapter Five. Part II of the act comprises s. 181-2, which have just been discussed.

63 Part II of the act is not expressly confined to resident companies.

64 See the Canadian Institute of Chartered Accountants, supra n. 11 at 232, where the latter interpretation is taken. It is there assumed that the effect of a capital payment being included in income under s. 15, where there is also a disposition of shares, will be that the proceeds of disposition are deemed to be nil, so that there will be an allowable loss equal to half the adjusted cost base of the shares. However, it appears that s. 39 of the act does not have this effect. Rather it simply excludes the gain from income.

65 If the capital payment is a payment in kind and is included in income under s. 15, the cost to the shareholder of the property received will equal the amount included in income, ie. its value - s. 52(1) and see Part 4 of Chapter Two Section B (text at nn. 216-7).

66 S. 233(2)(a) I.C.T.A. 1970. Capital dividends are taken to mean dividends paid out of capital gains - J. Talbot and Wheatcroft Corporation Tax para. 9-11.

67 S. 233(2)(b) I.C.T.A. 1970. S. 237(1) I.C.T.A. 1970 defines "new consideration" so as to exclude consideration provided out of the assets of the company and, in particular, excludes amounts retained by the company by way of capitalizing a distribution.

68 S. 233(3) I.C.T.A. 1970. See n. 67 supra.

69 S. 233(2)(d). This only applies to certain securities defined in the section. Generally they are securities in the nature of shares, e.g. interest varies with profits and bonus securities issued in respect of shares.

70 See, in particular, head (c). The other heads probably require distribution to holders of all the shares of a class - J. Talbot and G. Wheatcroft, supra n. 66 at para. 9-16.

71 In fact, the section refers to "participators", not shareholders, For the meaning of this term see Part 1 of Chapter Four Section A (text at n. 14).

72 For the meaning of "close company" see Part 1 of Chapter Four Section A (text at nn. 13-9).

73 See Part 1 of Chapter Four Section A (text at n. 17)

74 Para. 4 sched. 7 F.A. 1965 and see Part 2 of Chapter Five Section A (text at n. 116).

75 S. 232(2)(c) I.C.T.A. 1970.

76 There are provisions to exclude the section when the previous capital repayment consists of a genuine redemption of preference shares - s. 234(2) I.C.T.A. 1970.

77 S. 234(1) I.C.T.A. 1970.

78 See n. 67 supra.

79 S. 235 I.C.T.A. 1970.

80 See n. 74 supra. Even if the stock split does not come within the statutory definition of "reorganization of a company's share capital" given in the paragraph, it will probably come within the general meaning of the term.

81 Interpretation Bulletin I.T. 65 dated 8th September 1972.

82 See Part 2 of Chapter Five Section C. Such a benefit might also constitute an income distribution under the provisions previously discussed in this section.

83 J. Talbot and G. Wheatcroft, supra n. 66 at paras. 9-20 and 21A.

84 S. 460 I.C.T.A. 1970 in the U.K. and s. 247 in Canada - see Part 2 of Chapter 4.

85 See I.R.C. v Brebner [1967] 2 A.C. 18 where there was a capitalization of profits, an issue of bonus shares and a reduction of capital to the extent of the capitalization I.R.C. v Parker [1966] A.C. 14, where a similar situation occurred, but bonus debentures were issued. S. 460 (or rather its predecessor) was applied in these cases. In Canada, see Giguere v M.N.R. (1972) 26 D.T.C. 1392 where the predecessor of s. 247 was applied when controlling shares in a corporation were sold to another company in return for preference shares in that company, which were then either redeemed or sold.

86 See Part 2 of Chapter Four Section B (text at nn. 187-9).

87 S. 235(4) I.C.T.A. 1970.

88 R. Brown, supra n. 56 at 115.

89 G. Wheatcroft and A. Park Capital Gains Taxes para. 11-09

90 For a discussion of the liability of non-residents in respect of capital gains see Part 1 of Chapter Two Section B.

91 See s. 181-2 and text at nn. 51 and 57 supra.

92 S. Edwards, supra n. 45 at 131 and D. Ewens The Winding-Up of Corporations Otherwise Than Under Section 88 21 Canadian Tax Journal 1 at 7 (1973), where it is suggested that where the shareholder is a corporation, losses sustained on a disposal of shares because of a deemed dividend may be disallowed as a result of s. 112(3) - see Part 2 of Chapter Four Section A (text at n. 138).

93 For an account of the rights of taxpayers to set off capital losses see Part 3 of Chapter Two Section A.

94 S. 53(1)(b)

95 Such a capital contribution will generally increase the adjusted cost base of the shares - s. 53(1)(c) and see Part 1 of Chapter Five Section A (text at n. 85).

96 There is no definition in the act of "part disposition" and that given in the Ministry of National Revenue's publication "Tax Reform and You - Capital Gains at 6 is of little help. However, as the definition of "disposition" in s. 54(c) includes a cancellation of shares, then it would seem that a part disposition would include a part cancellation.

97 If s. 84(2) applies, this is expressly provided for in s. 54(h). There is no such express provision for s. 84(4), but it must be presumed that s. 39 applies, which excludes from income capital gains otherwise included.

98 For a discussion of when a shareholder becomes entitled to a capital distribution on a winding up see G. Wheatcroft and A. Parks, supra n. 89 at para. 11-17.

99 Para. 3(4)

100 The Revenue will generally consider a distribution small when it is less than 5% of the value of the shares in respect of which it is made - Simon's Taxes Vol. C. Para. C6.414.

101 Para. 3(2).

102 On the other hand this effect may be avoidable by using the provisions which allow companies to transfer assets tax free to members of the same group - see Part 4 of Chapter Two Section B. In fact, in Canada, it appears that there could be a chain of capital losses accruing to corporations, rather than gains.

103 See I. Caron Investment Income of Private Corporations, Dividend Tax Credit and Foreign Corporations Canadian Bar Papers on Tax Reform 1971 Canadian Bar Association 177 at 180-3 and 188-9.

104 See n. 26 supra.

105 Capital distributions are technically possible, but clearly insignificant in the context.

106 In the U.K., it may be impractical or undesirable to liquidate the company or issue bonus shares. The latter would, in any case, have to be sold to obtain cash.

107 Both systems have developed provisions to attack avoidance devices centred around this possibility - see nn. 84-5 supra.

108 For example, preference shares.

109 See Part 2 of Chapter One and Part 4 of Chapter Two Section B (text at nn. 207-9).

110 For a fuller discussion of the applicability of these provisions to the disposal of shares resulting from a capital distribution, see R. Brown, supra n. 65 at 132-3.

111 Ministry of National Revenue, supra n. 60.

112 For the definition of "Canadian corporation" see Part Three of Chapter One (text at n. 59).

113 Defined in s.89(1)(1).It includes that portion of capital gains realised after 1971 on assets held on the 31st December 1971 as is attributable to the period prior to 1972 and capital gains realised prior to that date.

114 Defined in 196(4).

115 S. 196(1).

116 Defined in s. 89(1)(k).

117 S. 83(1)(c)(d) and s. 53(2)(a)(i)

118 S. 83(1)(b).

119 These difficulties arise, for the most part, because of the difficulty in calculating the two accounts and particularly because it is often uncertain whether profit from the sale of an asset is an income or a capital profit - J. Smith Pre-Implementation Surplus 1971 Conference Report Canadian Tax Foundation 328 at 335.

120 S. 184(1). The extraordinary amount of tax, which is obviously designed more as a penalty than to raise revenue, has been much criticised - R. Dart, supra n. 11 at 123 and J. Smith, supra n. 119 at 336-7.

121 See now the amendments to the Act contained in 1973 Bill C-170.

122 S. 196(1) as amended by s. 63(1) 1973 Bill C-170.

123 S. 83(1) as amended by s. 24(1) 1973 Bill C-170.

124 J. Smith, supra n..119 at 335.

125 Where this distribution brings s. 69(5) into operation (as to which, see Part 4 of Chapter Two Section B (text at nn. 210-1)), there is some doubt as to whether this section operates to increase the 1971 capital surplus on hand, as the deemed sale is expressed to be "for the purpose of determining the corporation's income for the year" only - D. Ewens, supra n. 92 at 9-11.

126 The whole distribution (save for the return of paid-up capital) made on winding up is deemed to be one dividend by s. 84(2) - see text at nn. 48-50 supra.

127 S. 83(1) refers to the accounts as they existed "immediately before the particular time", i.e. the time of the dividend - D. Ewens, supra n. 92 at 9-11.

128 See n. 126 supra.

129 Now s. 88(2) added to the Act by s. 27(4) 1973 Bill C-170.

130 The new section deems the assets distributed to have been disposed prior to the actual distribution for the purposes of computing 1971 capital surplus on hand.

131 S. 89(1)(l)(iv) and s. 89(1)(k)(iii). Note that a Canadian corporation, which receives a dividend paid to it by a corporation controlled by it out of tax paid undistributed surplus on hand, can obtain a refund of the Part IX tax paid by its subsidiary in respect of the dividend. In this case, the amount of the dividend, together with the refund, forms part of the recipient's 1971 undistributed income on hand - s. 196(2) and (4)(c) as amended by s. 63(2) 1973 Bill C-170 and s. 89(1)(k)(iii). For the definition of "Canadian corporation" see Part 3 of Chapter One (text at n. 59).

132 This was the date when Capital Gains and Corporation Tax were introduced.

133 For the definition of "private corpporation" see text at nn. 281-92 infra.

134 A distinction is recognized between close companies and other companies for tax avoidance purposes only - see Part 1 of Chapter Four Section A.

135 See text at nn. 15-6 supra.

136 Half the tax paid by the corporation on this half of the gain is refunded when it distributes it (see this Part of this Chapter Section B) and full credit is given to the shareholder in respect of the half tax not refunded by virtue of the ordinary dividend tax credit - see Part 1 of this Chapter Section A.

137 S. 83(2)(a)(i) and (ii). This requirement is removed in respect of tax paid undistributed surplus by s. 24(2) 1973 Bill C-170.

138 For example, by stock dividends or by the shareholders loaning back the dividend.

139 S. 184(2).

140 See text at nn. 125-130 supra.

141 See now s. 88(2), added to the Act by s. 27(4) 1973 Bill C-170. There was a further difficulty also removed by this provision. The capital dividend account for the year is calculated by reference to the state of affairs existing at the end of the previous year. The result of this is to deprive the private corporation of the benefits of gains realised in the period immediately before the completion of winding up and, in particular, of gains realised by virtue of distributions in specie. In this situation, for the purposes of computing the capital dividend of account, the Act deems the assets to be disposed prior to the actual distribution and deems a tax year to end just after this - D. Ewens, supra footnote 92 at 9-11.

142 S. 89(1)(b)(ii).

143 Honourable E. Benson Minister of Finance Summary of 1971 Tax Reform Legislation 41

144 S. 129(1)

145 S. 129(3)

146 See Part 1 of this chapter Section A. This results in complete integration, not just for capital gains, but also for investment income - Honourable E. Benson, supra n. 143 at 39-40. The complete integration does not extend to non-resident shareholders, dividends paid to whom are still subject to the withholding tax, although the corporation still gets the refund.

147 Dividendsare not included in the definition of investment income for the purpose of the refundable dividend tax. The aim of the tax is not merely to discourage the retention of income by a corporation, but to ensure that if the dividends received by a corporation are retained by it, the corporation pays a tax which is roughly equivalent to what the shareholder would have paid had the dividends been redistributed - Honourable E. Benson supra n. 143 at 38.

148 S. 186(1). "Control" is defined in s. 186(2). The tax is payable by the recipient of a dividend, even if the payer is controlled by it, as long as the payer obtains a refund of tax because of the payment.

149 See Part 1 of this chapter Section B.

150 S. 129(3)

151 S. 129(1)

152 S. 129(1) requires that in order to obtain a refund, the corporation must be private at the end of the year for which the refund is claimed.

153 As to when a corporation is private and when it is not see text at nn. 281-292 supra.

154 See Part 5 of Chapter Two Sections A and B.

155 See text at nn. 186-9 infra

156 Thus the investment corporation and trust must, by virtue of their conditions of qualification, distribute each year a minimum proportion of their income - see Part 5 of Chapter Two Section B. (text at nn. 289-90). On the other hand, mutual fund corporations pay the same tax on dividends which they receive as do private corporations - see text at n. 192 infra.

157 See Part 5 of Chapter Two Section A.

158 S. 133(7.1).

159 Defined in s. 133(8)(c)

160 Defined in s. 133(8)(b) and s. 206.

161 S. 212(2)

162 This is the case with non-resident shareholders, but it would appear that such dividends would be included in the income of a resident shareholder by virtue of s. 82(1), although no dividend tax credit would be available because s. 134 deems the non-resident owned investment corporation not to be a Canadian corporation - see Part 1 of this Chapter Section A.

163 Foreign property is all property other than Canadian property-s. 133(8)(b) and s. 206.

164 Ward <u>Current Tax Planning</u> Para. 71.3.

165 Id at para. 72.16A. The definition of "capital gains dividend account" makes a deduction of the tax paid on gains arising from taxable Canadian property, even if the property in question is not also Canadian property.

166 See text at nn. 125-130 supra.

167 S. 133(7.1)(a)

168 S. 133(8)(c)(ii)

169 Although the capital dividend is subjected to rates of tax equalling that of the non-resident withholding tax in the hands of the corporation, this is refunded when the dividend is redistributed, but the dividend will then be subject to the withholding tax -see Part 5 of Chapter Two Section A (at n. 281).

170 S. 133(5). The reason for this provision is that pre-1972 income earned while the corporation was a non-resident owned investment corporation has already been subjected to a tax equal to the withholding tax This provision enables it to be distributed free of withholdingtax, but does lead to a reduction in the adjusted cost base of the recipient's shares, which may be important to the extent they constitute taxable Canadian property.

171 See text at nn. 51 and 57 supra.

172 This section gives the company power to pay tax free dividends from pre-1972 surpluses - see Part 1 of this chapter section E.

173 This section gives the company power to amalgamate with other companies without realising capital gains - see Part 1 of Chapter Five Section A.

174 This section imposes a special tax on non-Canadian corporations carrying on business in Canada - see Part 3 of Chapter Two Section D (text at nn. 180-90).

175 See Part 5 of Chapter Two Section A (text at n. 284).

176 S. 131(1)

177 S. 131(1)(b)

178 Defined in s. 131(6)(b) to include the corporation's capital gains reduced by its capital losses and previous capital gains dividends.

179 S. 131(1)

180 S. 184(2)

181 S. 131(1)(b) deems the dividend not to be income from a share.

182 In fact there is a partial refund of provincial tax - D. Ward, supra n. 164 at para. 73.6(b)(i). See also s. 131(9) added by S.C. 1972 c. 9.

183 S. 131(2)

184 S. 131(6)(a)

185 S. 131(2)

186 S. 131(4)

187 S. 54(c)(ii)(A). For s. 84 see Part 1 of this chapter Section C and for s. 54(c)(ii)(A) see Part 1 of this chapter Section D.

188 Id. Note that the shareholder does not get the dividend tax credit in respect of such income if s. 84 does not apply, so that the non-application of this section may do little more than compensate for this.

189 S. 15(1)(d) - see text at nn. 61-5 supra.

190 See text at n. 57 supra and D. Ward, supra n. 164 at para. 73.6(a).

191 See Part 1 of this chapter Section B.

192 S. 131(5), s. 186 and s. 129 - see Part 2 of this chapter Section B.

193 S. 212(2)

194 S. 131(1)(b)

195 D. Ward, supra n. 164 at para. 73.3(c)(ii)

196 In the case of non-resident shareholders this depends on the treatment of capital gains dividends in their hands.

197 For an account of the liability of non-residents in respect of capital gains see Part 1 of Chapter Two Section B.

198 It should escape as a capital payment, but see D. Ward, supra n. 164 at Para. 113.7(f)(ii) for an opposing argument.

199 S. 130(2)(a)

200 S. 130(2)(b)

201 S. 131(5). The reason is that the conditions of qualification of an investment corporation require it to distribute most of its income - s. 130(3)(a)(viii) and see Part 5 of Chapter Two Section B (text at nn. 289-290).

202 See text at nn. 125-230 supra. The problem arises from the fact that the election for the capital gains dividend must relate to the full amount of the dividend, but section 84 deems the whole of a distribution to be one dividend, and also that the distribution itself may create capital gains available for distribution as a capital gains dividend, although as the company is being wound up, there will be no further opportunity to declare such a dividend.

203 S. 130(1). The low rate is only available if the corporation in that year satisfies the income distribution requirement - see n. 201 supra and Interpretation Bulletin I.T. 98 dated 30th April 1973.

204 See Part 1 of this chapter Section A.

205 See Part 5 of Chapter Two Section B

206 Id

207 See Part 1 of this chapter Section B.

208 S. 304 I.C.T.A. 1970. Note that "profits" include capital gains (s. 238(4) I.C.T.A. 1970).

209 As to the meaning of "capital distribution" see Part 1 of this chapter Section D. Note that a redemption of shares will only result in a capital distribution of significance when it takes place in a winding up.

210 Thus the section operates not only when the disposal is the result of a capital distribution, but when it results from any other transaction.

211 S. 112(4)F.A. 1972.

212 S. 359(1)(d) I.C.T.A. 1970.

213 See Part 1 of this chapter Section A.

214 There is no provision for the investment trust which excludes the normal scope of income and capital distributions. The exclusion of s. 84 of the Canadian Act in connection with mutual fund corporations equates the position of that company with that of U.K. companies generally in regard to distributions made on a winding up, but also goes further to permit all capital distributions within the meaning given to that term by company law to have capital gains effects on shareholders.

215 See Part 5 of Chapter Two Section D (text at nn. 321-325).

216 S. 104(21)

217 S. 104(19)

218 S. 104(20)

219 S. 104(22)

220 The sections referred to in nn. 216-9 supra give to the unit holder the benefit of the dividend tax credit on dividends received by the trust and the foreign tax credit in respect of foreign income of the trust and where the trust has realised capital gains or received non-taxable dividends, i.e. dividends paid from pre-1972 surpluses or capital dividends, treat the unit holder as if he had realised or received them.

221 S. 212(1)(c).

222 S. 104(21)

223 See text at nn. 193-5 supra. This arises from the fact that non-residents are only liable for capital gains realised on taxable Canadian property and there is no provision to apportion the designated amounts between taxable Canadian property and other property disposed of by the trust.

224 D. Ward, supra n. 164 at para. 103.1(f)

225 Id. at para 103.2(g) and para. 113.3(c)(i) and Simon's Taxes Vol. E paras. E6.306 and 314.

226 S. 54(c)(ii)(A)

227 S. 53(2)(h)

228 D. Ward, supra n. 164 at para. 113.3(c)(ii)

229 For the treatment of a trust's accumulated income as capital see Simon's Taxes Vol. E paras. E6.306 and 314.

230 S. 104(13)

231 CCH Canadian Ltd. Canadian Tax Reporter Vol. 2 para. 50-285.

232 These sections refer to the word "income" which includes only half of capital gains and losses - s. 3.

233 S. 354 I.C.T.A. 1970- see this part of this chapter Section C.

234 S. 112 F.A. 1972 - see text at nn. 209-11 supra.

235 See n. 209 supra.

236 See Simon's Taxes Vol. C para. C6.165.

237 See Simon's Taxes Vol. H Supplement on F.A. 1972 at the commentary on s. 112.

238 See Simon's Taxes Vol. C para. C6.163.

239 See Part 1 of this chapter Section A.

240 S. 93 F.A. 1972 - see Part 5 of Chapter Two Section C (text at nn. 295-7).

241 Much of its income will be dividends which are deductible from itts income and much of the balance may be set off against management expenses - s. 304 and s. 354 I.C.T.A. 1970 and see n. 242 infra. Even if income remains on which Corporation Tax is payable, there is the rule which prevents advance Corporation Tax being set off against an eventual tax liability in respect of capital gains - s. 85(6) F.A. 1972 and see text at nn. 17-21 supra.

242 See Part 1 of this chapter Section B and text at nn. 207-8 supra.

243 Simon's Taxes Vol. E Para. E6.306-14, but see n. 246 infra

244 Para. 13 sch. 7 F.A. 1965.

245 See text at nn. 98-9 supra.

246 Simon's Taxes Vol. E. para E6.310. Whereas for capital gains purposes the trust is treated as a company, for Income Tax purposes it is treated as a trust. Thus the trust as a company is charged to tax on capital gains as they arise and if the trust makes regular distributions of its capital gains, they will be included in the beneficiaries' income under the ordinary trust rules which include regular payments made by trustees in a beneficiary's income, even if made from capital or accumulated earnings.

247 S. 86(5) F.A. 1972.

248 See Part 5 of Chapter Two Section D (last para. of text).

249 This ignores the different rates of tax payable, as to which see Part 5 of Chapter Two Section E.

250 S. 104(9) - see text at n. 221 supra.

251 The purpose of the exception in the case of mutual fund trusts appears to be to put them on a par with mutual fund corporations, which can declare capital gains dividends in favour of non-residents, which are not subject to withholding tax- see text at n. 193 supra.

252 S. 132(1) and s. 132(4)(a)-(b)

253 S. 104(20)

254 S. 132(3)

255 S. 104(13)

256 S. 83(1)(c). However, the position resulting from limiting the operation of s. 104(20) is not clear. It has been suggested that it may have the effect of dividends paid from pre-1972 surpluses being included in the beneficiaries' income - D. Ward, supra n. 164 at para. 113.6(a).

257 S. 115(b)(viii)-see Part 5 of Chapter Two Section E.

258 See text at nn. 197-8 supra.

259 See Part 5 of Chapter Two Section F.

260 S. 130.1(4)

261 S. 130.1(4)(b)

262 See n. 260 supra.

263 S. 184 as amended by 1972 Bill C-209 (now 1973 Bill C-135.)

264 S. 130.1(2)

265 Id. and s. 212(1)(b)

266 S. 212(2) as amended by 1972 Bill C-209(now 1973 Bill C-135). The same problem arises in connection with the treatment of such dividends in the hands of non-resident shareholders as with the capital gains dividend payable by mutual fund corporations - see text at nn. 193-5 supra.

267 S. 148(1)(b) and s. 56(1)(k). See generally on the policyholder's liability in respect of such income, Interpretation Bulletin I.T. 87 dated 18th January 1973.

268 S. 148(5)

269 S. 148(4)

270 S. 142(2)

271 S. 148(1)(b)

272 S. 148(2) - There is a disposal of an interest in a policy when a policy dividend is received and the amount of the dividend forms the proceeds of disposition. "Disposition" is defined in s. 148(9)(c). Note the exceptional events which are not disposition, in particular, where the policy matures on death. Note also s. 148(7), which deems the proceeds of the policy to equal its value when it is disposed of to someone with whom the holder does not deal at arms length.

273 Defined in s. 148(9)(a) as the cost of acquiring the policy, including premiums paid, less the amount of any previously received proceeds, e.g. policy dividends.

274 S. 148(1)(a) and s. 56(1)(j)

275 S. 148(3)(b). In fact the fund is treated as if it were the policyholder's own property. Premiums paid, which are spent by the insurer on additions to the segregated fund, are not added to the adjusted cost basis of the policy - s. 148(3)(a)(i). Any transfer of assets out of the fund is treated as a premium payment by the insured(s. 148(3)(a)(ii) and any transfer of assets from another fund to the segregated fund is treated as resulting in a disposition by the insured of his policy - s. 148(3)(c)). For more details see Interpretation Bulletin I.T. 87 dated 8th January 1973.

276 These amounts remain in the segregated fund, even if not allocable to the insured.

277 S. 138(3) and s. 209(3)(c).

278 S. 89(2)

279 S. 196(5)

280 S. 28(3) F.A. 1965.

281 Unless is counted the anti-avoidance provisions directed at close companies - see Part 1 of Chapter Four Section A.

282 "Control" is not defined by statute, so that the judicially determined meaning must apply - see Part 1 of Chapter One (text at n. 29).

283 S. 89(1)(f)

284 S. 89(1)(g)

285 S. 89(1)(g)(i)

286 S. 89(1)(g)(ii). This would include corporations whose shares are not listed, but are "traded over the counter" - Honourable E. Benson Minister of Finance Proposals for Tax Reform Para. 4.43.

287 S. 89(1)(g)(ii)(A) and (B)

288 S. 89(1)(g)(iii) added by S. 28(1) 1973. Bill C-170.

289 S. 89(1)(g)(iii)(A)

290 S. 89(1)(g)(iii)(B)

291 As it is non-resident, it cannot be a public corporation as defined above.

292 R. Dart, supra n. 11 at 112 and W. Goodlet Bill C-259 and the Private Corporation 1971 Conference Report Canadian Tax Foundation 306 at 306.

293 at Paras. 4.19-20 and 4.34-5.

294 S. Edwards The White Paper - Corporations 18 Canadian Tax Journal 83 at 83-5 (1970).

295 Volume 4 Chapter 19 of the Report.

296 See, for instance, J.K. Galbraith The New Industrial State and A.A. Berle Power Without Property and R.W. Parsons An Australian View of Corporation Tax 1967 British Tax Review 14 at 31-40.

297 In the white paper closely held companies were not only given the benefits of full integration under the proposed general rules of taxation, but were also to be permitted to make a partnership election. However, in the Act the election was scrapped along with the complete integration given to closely held corporations, which was reduced to a complete integration in respect of capital gains and investment income given to private corporations. Canadian controlled private corporations are also granted complete integration in respect of active business income up to a certain amount (s. 125 in conjunction with the dividend tax credit).

298 Id

299 For a discussion of the merits and demerits of taxing capital gains equally with other income, see L. Seltzer The Nature and Tax Treatment of Capital Gains and Losses. In particular the arguments are summarised at 281-89.

CHAPTER IV

CAPITAL GAINS AND CORPORATE ACCUMULATIONS

The tax treatment of corporate distributions discussed in the previous chapter established the total tax burden of income and capital gains realised and distributed by a corporation. This burden was shown to be generally greater than on income and gains earned directly by individuals. Moreover, even where the taxation of the company and its shareholders is completely integrated, the integration provisions require that the corporation's earnings be distributed before they operate.

However, distribution to shareholders means that the amount distributed will form part of the recipient's income and be taxed at his personal rates of tax. Since the individual's rate of Income Tax may be significantly higher than the flat rate payable by corporations, as was demonstrated in chapter two,[1] there is an obvious inducement for individuals to use the corporate form as a means to hold property or conduct a business. If the income arising is retained in the corporation and not distributed, there may be significant tax savings.

Thus is revealed an important motive for corporations to accumulate income and the reasoning behind the various provisions referred to in earlier chapters, which aim to discourage corporations from retaining their earnings. For example, there is the refundable tax payable by Canadian private and mutual fund corporations on their dividend income,[2] the right of Canadian private corporations to obtain refunds of part of the tax paid by them on capital gains and investment income[3] and the U.K. provisions which limit the way in which companies can recover Income Tax deducted from dividends paid to them.[4] In Part 1 of this chapter there will be a discussion of further provisions found in both systems which encourage corporate distributions, but by the more direct method of attributing income and capital gains realised by certain corporations to their shareholders as they arise.

In discussing these provisions, particular importance must be attached to their effect on the shares of members to whom income and capital gains are attributed. This importance derives from the direct relationship between the size of a corporation's accumulations and the value of its members' shares. As a corporation accumulates income, the shares will rise in value and as it distributes income, their value will fall. If shares are sold before income is distributed, there will be a capital gain representing accumulated income, which will be taxable as such. This is reasonable, since the shareholder will not also be taxed on the eventual distribution, when made by the company. However, it is evident that if a provision attributes corporate earnings to a member, it should also raise the cost to the member of his shares by a corresponding amount, so that the shareholder will not be taxed, on a subsequent disposal of his shares, on a capital gain representing accumulated income, on which he has already been taxed. Equally, if attributed income is later distributed before the member disposes of his shares, his acquisition cost should be reduced accordingly.

This possibility of shareholders realising their share of a corporation's accumulated surplus as a capital gain accounts for a further motive for a corporation to refrain from making distributions. This is the lower rate of tax payable on capital gains than on other income, which was shown in chapter three to lead to a desire on shareholders in high Income Tax brackets to receive corporate distributions in a form which would result in a capital gain in their hands. Although statutory provisions have for the most part eliminated this possibility, there are opportunities for such shareholders to achieve a similar effect by selling their shares.[5] There are in both systems comprehensive provisions, which are discussed in Part 2 of this chapter,[6] aiming at converting such capital gains into ordinary income and other related provisions, but they do not generally affect a genuine sale of shares which is not entangled in some avoidance scheme.

Further, it is possible for corporations to exploit the drop in the value of shares resulting from a distribution of accumulated income, by obtaining a distribution which is deductible from its income and selling the shares to realise the capital loss resulting from this drop. Provisions countering such transactions are also discussed in Part 2 of this chapter.[7]

Most of the provisions preventing shareholders realising corporate surpluses as capital gains were first enacted in the period before there was a tax on capital gains, so that the avoidance possibilities were much greater. Many now argue that these technical and complex provisions are no longer necessary, in view of the introduction of this tax.[8] The Governments of both countries take the opposite view.[9] The question is one of balancing the administrative complexity and the uncertainty caused by these provisions against the tax revenue loss resulting from their absence, since the aim of such provisions to ensure that corporate surpluses are taxed in the hands of shareholders in a consistent manner, in whatever form they are received, is a desirable object. As was demonstrated by the Report of the Royal Commission on Taxation a basic requirement of a system which would remove both the inconsistencies in the taxation of corporate surpluses in the hands of shareholders and the need for these anti-avoidance provisions would be that the full amount of capital gains be taxed as part of ordinary income at ordinary rates of tax.[10]

Part 1 - Provisions encouraging corporate distributions to Shareholders.

The Canadian and U.K. provisions which encourage corporate distributions by giving a refund of corporate taxes paid were discussed in the previous chapter and there only remains those which attribute corporate income to shareholders. Only the U.K. has provisions attributing to shareholders the income of resident close companies, but both systems have such provisions in relation to non-resident companies. The latter provisions are perhaps more significant than the former, in that they tax,as they are realised, income and capital gains which would otherwise escape taxation completely until actually distributed to the resident shareholder. They are designed (inter alia) to prevent resident taxpayers, who are fully taxable on their foreign income and capital gains, avoiding this tax by transferring their income producing assets to a foreign corporation, which does not pay tax in the shareholder's home country, and allowing such a corporation to accumulate its income and gains. Such a corporation may pay foreign taxes, but these may be much lower than the home country's taxes.

A. The close company provisions - U.K.

These provisions, which apply both before and, in modified form, after 1st April 1973,[11] are expressed not to apply to capital gains realised by the companies they apply to,[12] so that such gains will not be taxed as part of the shareholder's income until they are distributed. However, these provisions are important for capital gains purposes, because of the effect that attributing corporate income to shareholders has on the cost base of the latters' shares.

The companies affected are "close companies", which are defined in section 282(1) of the I.C.T.A.1970 as companies which are under the control of five or fewer participators or of participators who are directors.[13] Generally speaking, a participator is one who has some interest in the company's shares or debentures or can otherwise appropriate to himself company assets or income.[14] The definition of control is drawn very widely[15] and rights of control of associated persons are treated as belonging to one person.[16] Expressly excluded from the operation of the provisions are non-resident companies,[17] certain companies with a degree of public ownership[18] and companies controlled by non-close companies.[19]

The Act sets a standard below which a company's distributions in an accounting period of income other than capital gains arising in that period must not fall.[20] Failure of compliance has differing effects, depending on whether the failure occurs before or after the 1st April 1973. In the former case, the company pays Income Tax at the standard rate on the shortfall,[21] which is also apportioned among the participators of the company and included in their income for Surtax purposes.[22] The Surtax is assessed on the participators, but if not paid within 28 days, is payable by the company.[23] Under the new system, the shortfall in distributions is apportioned among participators as before,[24] but although they are charged to Income Tax at the higher rates on the apportioned amounts, they are credited for tax at the basic rate, so that only the excess over this is payable.[25] The company is not liable to pay Income Tax on the shortfall at the basic rate[26] nor, except in limited circumstances, advance Corporation Tax.[27] However, it will be liable to satisfy the members' liability to pay Income Tax at the higher rate if not satisfied by them personally within 30 days.[28]

The result is that in both cases the situation is the same as if the amount apportioned to shareholders had been distributed to them and they had paid, in respect of it, the standard rate of Income Tax and Surtax or the basic rate and the higher rates (as the case may be).[29] However, it is clear that if the participator at this moment sells his shares, he may realise a capital gain attributable to the accumulated corporate income, on which full taxes have already been paid under the above provisions, so that he is put in the same position as if he had received a distribution on which he paid both Income Taxes and Capital Gains Taxes. This double taxation could be avoided by increasing the cost base of his shares by the amount of income apportioned to him, as reduced by the amount of any taxes paid on it under the above provisions and by reducing this cost base by the same amount when this income was finally distributed. However, the only permitted cost base adjustment is an increase equal to any Surtax or higher rate Income Tax paid by the shareholder personally and not any such tax which is paid on his behalf by the company[30] and the increase is not allowed if the income in respect of which this tax is paid is ultimately distributed.[31]

There are provisions which, in the long run, even out the position if shortfalls of distributions in one year are made up in a later year, but this will not help the particular shareholder who disposes of his shares before this occurs.[32] Thus, Income Tax paid by the company on previous shortfalls can be recovered[33] and amounts previously subjected to Surtax or the higher rates of Income Tax can be deducted from the participator's income for the purposes of those taxes,[34] when excess distributions are made in a later year.

Although these provisions do not apply to corporate capital gains, they do apply to dividends received by a close corporation, which are otherwise deductible from its income for Corporation Tax purposes.[35] However, in view of the fact that the corporation can set off its franked investment income against any liability to pay Income[36] or advance Corporation Tax under these provisions the only difference that this will make is to make the dividends received liable for Surtax or the higher rate of Income Tax.[37] In regard to such income the combination of these close company provisions and the general rules respecting the set off of franked invest ment income has broadly the same effect as the tax paid by private corporations in Canada on dividends received, which is refunded when they are redistributed,[38] the main difference being that, in the former case, the extra tax paid to encourage distribution relates to the personal rates of tax of individual shareholders, while, in the latter case, the rate is a fixed rate meant to represent the tax payable by an individual shareholder on the dividend whose personal rate is equal to 50%.

B. <u>Income and capital gains accruing to non-resident companies - U.K.</u>

There are two relevant provisions to be considered here. The first is of only indirect concern being primarily aimed at preventing individuals transferring assets to non-residents to avoid payment of U.K. Income Tax, but the second is of direct significance, being directed at capital gains accruing to non-resident companies.

(1) <u>Transfers of assets to non-residents to avoid Income Tax.</u>

Section 478 of the I.C.T.A. 1970 is a very wide provision, which applies (inter alia) whenever, as the consequence of a transfer of assets, any individual[40] has power to enjoy[41] any income of a person resident or domiciled out of the U.K., which, if it were income of that individual, would be chargeable to Income Tax. The effect of the section is to deem such income to be income of the individual for Income Tax purposes. The section obviously covers the case where a taxpayer transfers assets to a non-resident corporation in return for shares or debentures issued to an individual, who may be or not be the same person as the transferor.[42] Our main concern here is that there is no provision made to increase or reduce the cost base of the individual's shares in such a corporation, as income of the corporation is attributed to him and distributed. The result is that income of the corporation, which has been taxed as if it had been distributed, is likely to be taxed again in the form of a capital gain realised on a disposal of the individual's shares. As income which is taxed under this section is not taxed again when actually received,[43] such income should be paid out (if possible) before any sale of shares takes place.[44]

(11) Capital Gains Accruing to Non-Resident Companies

Section 41 of the F.A. 1965 provides that where a capital gain is realised by a non-resident company, which would be a close company if it was resident in the U.K., a proportionate part[45] of that gain shall be deemed to be a capital gain of each shareholder of the company who, at the time the gain accrues, is resident or ordinarily resident, and if an individual, domiciled in the U.K.[46] The rule does not apply in the four following situations:

1. Within two years the gain is distributed to shareholders or creditors, whether by way of income or capital distribution.[47]
2. Gains arising from a disposal of tangible property used only for the purposes of a business carried on wholly outside the U.K.[48]
3. Where the company is personally liable to tax on the gain.[49]
4. Gains arising from disposals of certain currency and debts used for the purposes of a trade carried on outside the U.K.[50]

Gains may be reapportioned through any number of non-resident intermediary corporations, which would be close companies if resident, until ultimate resident shareholders are reached.[51] Capital losses cannot be apportioned among shareholders, as can capital gains, but may be used to reduce the amount of any capital gains realised in the same year.[52] There is no carry forward or carry back provisions in respect of such losses.

There are two alleviating provisions which should be mentioned. In the first place, for the purposes of this section, the provisions which deem transfers of assets between members of the same group of companies to be for a consideration which produces neither a gain nor a loss are applied to groups of non-resident companies, so that such a transfer by a non-resident company, which would otherwise produce a capital gain attributable to its shareholders under the section, is deemed not to realise a capital gain.[53] A non-resident group is defined as either, (1) a group of companies, none of the members of which reside in the U.K., or (2) in the case of a group, two or more members of which reside outside the U.K., the members of that group which do so reside outside the U.K.[54] Thus the U.K. system extends its notion of the group entity to non-resident companies, but expressly excludes from the operation of this concept transfers between a resident and non-resident member of the same group. In the second place, if the corporation pays the tax on the capital gains on behalf of its shareholders, it is expressly provided[55] that this shall not constitute a payment by the corporation to the shareholder. Apart from this provision, such provision could be regarded as a distribution to the shareholder.

Finally, it is provided that any tax payable by the shareholder under this section and not reimbursed to him by the company can be added to the cost base of his shares.[56] This is clearly inadequate, as the shareholder could still, on a disposal of his shares, realise a capital gain reflecting capital gains accumulated by the corporation and already charged to him under section 41, which would again be taxable in his hands. To prevent double taxation here, it would be necessary to increase the cost base of the shares by the full amount of the gain, as reduced by the tax paid on it. Further, there is no provision to deduct the amount by which the cost base is increased, in the event that the gain, in respect of which it was increased, is distributed.

Even if the capital gain is distributed by the company to avoid the above problems, unless the distribution takes place within two years of being realised, when section 41 has no application,[57] it appears that the gain may be taxed again as an ordinary distribution, as there is no express provision excluding such distributions from income.

C. Income and capital gains accruing to non-resident companies - Canada.

The Act sets up a very complex system of taxing income and capital gains realised by non-resident corporations which are foreign affiliates of resident taxpayers. These provisions are primarily designed to prevent the avoidance of Income Tax caused by resident taxpayers holding investments in tax haven companies.

The definition of a foreign affiliate set out in the Act requires that a non-resident company satisfy one of four alternative conditions[58] which can be briefly summarised as follows:

(1) the company is controlled directly or indirectly by the resident taxpayer

(2) the taxpayer owns directly or indirectly[59] 25% of the voting power of the company

(3) the taxpayer has a direct or indirect "equity percentage" of at least 50% in the company

(4) the taxpayer owns directly of indirectly 5% of the voting power of the company and elects that the company be his foreign affiliate.[60]

The only comment which need here be made on the above is as to the meaning of the term "equity percentage",[61] which is important, not just for the purpose of defining what is a foreign affiliate, but for determining the proportion of income accruing to the foreign affiliate, which is to be attributed to the resident shareholder. The equity percentage is the highest of the percentages of the shares of each class in the capital of the foreign affiliate which are owned by the taxpayer.[62] One thing is clear from this definition. There is no need that the taxpayer in any way control the corporation. A minority holding in the corporation is consistemt with it being a foreign affiliate of the taxpayer.

Where there arises to a foreign affiliate of a resident taxpayer taxable capital gains, investment income (other than dividends from other foreign affiliates) or non-active business income (termed in the Act "foreign accrual property income"),[63] a proportion of such income is deemed to form part of such a taxpayer's income in the tax year of the taxpayer, in the course of which the tax year of the foreign affiliate, in which the income arose, terminates.[64] The same rule applies to certain dividends paid by one foreign affiliate of a resident taxpayer to another foreign affiliate of the same taxpayer out of certain active business income earned by the former.[65] The proportion of such sums included in arresident taxpayer's income is in substance[66] equal to the taxpayer's "equity percentage" in the corporation.[67] In view of the fact that it is theoretically possible for the equity percentage to exceed one hundred per cent, the situation could occur of more than 100% of the foreign affiliate's taxable capital gains and other income affected being attributed to the resident shareholder.[68] Even where this is not the case, the equity percentage may not be a true indication of a shareholder's entitlement, being determined by reference to the shareholder's holdings in a class of shares having limited rights to income.[69] Thus more income could be attributed to the shareholder than could ever be actually distributed to him, even if he could force a distribution.

Taxable capital gains of foreign affiliates are computed in the same manner as those of resident taxpayers, except that in place of the normal transitional provisions for assets held at the beginning of the capital gains tax system, the Act provides that any part of a capital gain or loss of a foreign affiliate that accrued prior to its becoming a foreign affiliate[70] is not subject to the above provisions.[71] The Act follows the U.K. provisions in its treatment of capital losses accruing to foreign affiliates, which are not attributable directly to shareholders, but go to reduce foreign accrual property income for the year in which they are realised. There is no provision for carrying back or forward to other years excess capital losses. In addition, there is a similar exception for capital gains arising from dispositions of tangible[72] assets used exclusively in a foreign business.[73]

There are provisions designed to give full credit to resident corporations in respect of foreign tax paid by their foreign affiliates on inter-affiliate dividends and foreign accrual property income included in their income,[74] but only a partial relief is given to individuals in the same situation amounting to a simple deduction from the amount included in income of foreign income or profits tax paid on that amount.[75] The individual is given some consolation when the income is actually distributed to him, as he will receive the normal foreign tax credit for foreign withholding taxes paid.[76] The corporation receives no such credit.[77] Under section 41 of the U.K. Act the gain accruing to the non-resident company is deemed to have accrued to the resident shareholder, so that the normal foreign tax credit will be available. The provisions of section 91 do not operate where the amount of income involved after making all required deductions for foreign taxes paid does not exceed five hundred dollars.[78] Moreover, the Minister has power to allow the taxpayer to deduct a reserve, if foreign currency difficulties would otherwise mean that he would suffer hardship.[79]

It is obvious, following criticisms previously made of the equivalent U.K. provisions, that some adjustment is required by equity to the adjusted cost base of the shares of a taxpayer, who has been taxed on income earned by a foreign affiliate of his. In this respect, however, the Canadian system is much more adequate than the U.K. system. Section 92(1) of the Act increases the cost base of members' shares by the full amounts actually included in their income after deductions of their foreign tax allowances and reduces it when such amounts are eventually distributed. Moreover, when such amounts are eventually distributed to shareholders they are deductible from the recipient's income.[80] Thus these provisions ensure that capital gains and other income of a foreign affiliate are taxed once in the hands of the resident shareholder and no further.[81] However, there is one defect in the system so far as resident corporate shareholders are concerned, which stems from the preferential allowances they receive for foreign taxes paid on the amounts included in their income. These allowances do not take the form of a tax credit, but of a deduction from income of twice the amount of foreign tax paid.[82] As a result, the adjustment to the cost base of the corporation's shares and the permitted deduction from income of amounts distributed by its foreign affiliate, representing income already taxed in the hands of the corporate shareholder, is not the full amount of the foreign income actually accumulated by the foreign affiliate, but that amount as reduced by the foreign tax paid on that income.[83] Thus an amount of the foreign affiliate's income equal to this foreign tax will be taxed again in the recipient corporation's hands, either as a capital gain on its shares or following a distribution of that income.[84]

To complete the discussion of capital gains realised by foreign affiliates, it is now necessary to consider those gains that are excluded from the definition of foreign accrual property income, i.e. gains arising from the disposition of tangible business assets, the untaxed half of capital gains and that proportion of realised capital gains which relates to the period prior to the company becoming a foreign affiliate. These are not taxed by Canada as they arise, so that the only question is as to their tax treatment when distributed. This in turn depends on which of the three surpluses, among which the Act divides a foreign affiliate's assets, these amounts fall into. The three surpluses are the exempt surplus, the taxable surplus and the pre-acquisition surplus. Although regulations specifying the exact contents of these surpluses have yet to be issued, the government has indicated its proposals in a general way.[85] It appears that the amounts one is here concerned with must fall into the pre-acquisition surplus, in view of the fact that this is expressed to include everything not contained in the other two and the stated contents of the exempt and taxable surplus do not include capital gains other than those included within the meaning of foreign accrual property income.[86] The corporate, but not the individual, shareholder is given the right to deduct from its income the full amount of dividends paid out of exempt[87] and pre-acquisition surplus[88] and a partial right to deduct dividends paid from taxable surplus to the extent of foreign taxes paid in respect of the income comprised in them.[89] Thus the corporation will by given some advantage in respect of capital gains accruing to its foreign affiliates, which are not included in foreign accrual property income, in that they will not be taxed in its hands when distributed. However, the Act also provides that the recipient of a dividend, whether a corporation or not, must reduce the cost base of his shares to the extent the dividend is paid from pre-acquisition surplus.[90] The deductibility of the dividend in the hands of the resident corporation is consistent with the other Canadian provisions, which allow dividends to flow through intermediary corporations without additional tax consequences, but the cost base reduction, which leaves both individual and corporate shareholders with a potential capital gain,[91] shows that the true purpose of the pre-acquisition surplus is, as its name suggests, to be a repository for income and gains accruing to a foreign affiliate in the period before it attained this status, so that the final regulations when issued may change this point.

At the beginning of this chapter, two possible ways of a shareholder realising corporate accumulations were recognized -- one by direct distribution by the company to the shareholder and the other as the result of a capital gain realised on a disposal of his shares. It was noted how the tax consequences would differ depending on which way was adopted. Two provisions of the Act concerned with foreign affiliates allow a taxpayer, who is prejudiced by the adoption of one method, to elect to be treated as if the other had been used. Section 93(1) applies when a resident corporation disposes of shares in a foreign affiliate or a foreign affiliate of a resident taxpayer disposes of shares in another foreign affiliate of the same taxpayer and a capital gain results. The resident taxpayer can in each case elect that the capital gain[92] be treated as if it were a dividend paid by the foreign affiliate. However, to take advantage of the election, the taxpayer must compute the capital gain without regard to any adjustments made to the cost base of the shares disposed of, consequent on income of the foreign affiliate being included in the taxpayer's income. The advantage of making the election is that the deemed dividend may be deductible from the resident corporation's income, as being payable out of one of the three surpluses before mentioned, and no tax will be payable on the capital gain. Further, if the disposer is a foreign affiliate, the deemed dividend may be from a source which excludes it from being included in the resident taxpayer's income and the capital gain will not increase the disposer's foreign accrual property income.

The reverse situation is brought about by provisions which permit a resident corporation to deduct the balance of any dividend paid to it by a foreign affiliate out of its taxable surplus to the extent it is not otherwise deductible.[93] However, the cost base of the shares of the recipient corporation must be reduced by the amount in respect of which the election is made. Thus the corporation exchanges a potential capital gain for a dividend immediately taxable in its hands.

Thus both systems have their provisions to prevent resident taxpayers avoiding tax in their home countries by letting their foreign income and capital gains accrue to non-resident companies. The defects in one system tend to be corrected in the other system, which in turn has defects corrected in the first system. Thus the Canadian system is so set up that the proportion of income and capital gains of a foreign affiliate attributed to a shareholder could be vastly different from the proportion which he could ever hope to receive in an actual distribution. The discrepancy here is all the harder to comprehend, as there would seem to be no innate difficulty in drafting provisions which reduce this effect, at least to the level found in the U.K. system.[94]

Further, the Canadian system, unlike the U.K. system, makes no attempt to apply the group concept to the situation where a resident taxpayer has several foreign affiliates, so that inter-affiliate transfers of assets may result in foreign accrual property income. This is, perhaps, hardly surprising in view of the lack of such provisions where domestic companies are involved. Similarly, while it seems that the U.K. provisions, which allow one or more corporations to reorganize themselves or amalgamate without tax consequences following from any capital gains realised, will also apply to non-resident companies,[95] the Canadian provisions are all, except in one case, applicable to resident corporations only, so that capital gains arising from the reorganization or amalgamation of foreign affiliates may lead to foreign accrual property income being produced.[96]

The main defect of the U.K. provisions is the failure to provide adequate adjustments to the cost base of members' shares to compensate for their being taxed on income and capital gains which are not distributed to them, but retained by the company.

Finally, both systems fall down in places concerning the distribution of income and capital gains to shareholders who have already been taxed on the amount being distributed. This is found in the U.K. under section 41 of the F.A. 1965 and in Canada regarding the distribution of capital gains not included in foreign accrual property income. These omissions tend to prove the pure anti-avoidance intentions behind these provisions. There is no attempt to integrate the taxation of non-resident company and resident shareholder, except in so far as is necessary to ensure that full tax rates of the home country are paid on foreign income.

D. Income and capital gains accruing to non-resident unit trusts.

Section 94 of the Canadian Act applies the foreign affiliate provisions just discussed to non-resident trusts. This will include unit trusts under one of the alternative definitions,[97] but not unit trusts complying with the other alternative definition or mutual fund trusts, both of which must be resident in Canada.[98] The method utilised is to deem for the purposes of the foreign affiliate provisions every non-resident trust to be a "corporation, having a capital stock of a single class divided into one hundred issued shares each of which has full voting rights under all circumstances.[99] Beneficiaries in such a trust are deemed to own a number of those shares equal to the proportion of the shares of the class that the market value of his capital interest in the trust bears to the market value of all the capital interests in the trust, or, if greater, the proportion that the market value of his income interest in the trust bears to the market value of all the income interests in the trust.[100] The alternative definitions of the term "foreign affiliate" can then be applied to determine whether the trust is a foreign affiliate of its beneficiaries.

Several problems arise from the application of the foreign affiliate provisions to non-resident trusts. First, just as where a non-resident corporation is involved, it is possible for the beneficiaries to be charged to Income Tax on more than one hundred per cent of the trust's income or on more income than they would ever be entitled to. This effect is enhanced in the case of a non-resident trust where the income and capital beneficiaries of the trust are different persons, in which case it is possible for the aggregate equity percentage to equal two hundred per cent.[101] As this situation is unlikely to occur in the case of unit trusts, this effect may be less of a problem.

The second problem concerns the relation of these provisions to the other provisions which permit trustees to deduct from their income amounts which are payable to beneficiaries in the year they arise and which treat such amounts as income of the beneficiaries, even if not immediately distributed.[102] It would appear that the Revenue Authorities will not be able to assess the beneficiaries twice on the same income under both sets of provisions, but must choose one.[103] Moreover, even if the assessment is made under the foreign affiliate provisions, there would seem to be good argument that the income remains deductible from the beneficiaries' income, when finally distributed, and, until distributed, the beneficiary can increase the cost base of his unit by the amount of such income, as the income is still payable in the year it arises to the beneficiary.[104]

Third, there are no provisions in the Act (other than the limited ones referred to in the last paragraph) either for making adjustments to the cost base of the beneficiary's interest in the trust, as a result of the trust income being attributed to him under the foreign affiliate provisions, or for making such income deductible from the beneficiary's income when paid out. In the latter case, the rules previously discussed in connection with distributions of accumulated income and gains by unit trusts will be applicable.[105]

In the U.K., section 42 of the F.A. 1965 contains provisions which attribute capital gains realised by non-resident trusts to their resident beneficiaries, but these will have no application to unit trusts, because of section 45(8) of the same Act,[106] which provides that unit trusts are to be treated as companies for Capital Gains Tax purposes. Thus it is necessary to look at the provisions of section 41 of the Act, which attributes capital gains realised by non-resident close companies to their resident shareholders.[107] It is possible that this section could apply to an unauthorised unit trust, but not to an authorised unit trust, which is, by virtue of section 45(8), to be treated for Capital Gains Tax purposes as if it were a company resident and ordinarily resident in the U.K.

Further, it would appear that section 478[108] of the I.C.T.A. 1970 will also apply to income arising from assets transferred by a resident taxpayer to a non-resident unauthorised unit trust.

In both systems, trusts and unit trusts are, as far as the anti-avoidance provisions being discussed in this part of this chapter are concerned, put on a footing of equality with corporations, which is of a degree not shown in any other area of the two systems. However, in Canada, it has been done rather loosely without full regard to the relation of these provisions to the other provisions governing the taxation of trusts and without those provisions which are even found in these provisions as they affect companies, which reduce their harshness and eliminate much of the double taxation which would otherwise arise.

Part 2 - Provisions designed to prevent the extraction of corporate surpluses in the form of capital gains.

Following from the differing tax rates payable by all taxpayers on capital gains and other income, there is found in both the U.K. and Canada numerous provisions designed to prevent shareholders receiving, as capital gains, corporate surpluses, which they would otherwise obtain in the form of dividends taxable as ordinary income in their hands.

The basic transaction which is attacked is in two stages, although there are an infinite number of variations on the basic pattern and one of the stages may exist without the other. Stage one is the sale or other disposal of shares for a capital gain, which represents corporate assets presently available for payment of a dividend or income which the corporation is expected to earn in the near future. The second stage consists of a purchase by a corporation, individual or other body, which, by virtue of its special tax position, is able to minimize or eliminate completely the tax payable on an actual distribution made to it following completion of the purchase. Such taxpayers are corporations which can deduct from their income dividends received from another company and realise a capital loss by disposing of their shares after payment of the dividend; exempt taxpayers e.g. charities which are not liable to pay Income Tax on any dividend received; share dealers who, if corporations, can deduct from their income any dividend received and, in any case, can treat any loss from disposing of the shares after payment of the dividend as a trading loss which will cancel out any tax liability on the dividend when received; and, finally, non-resident taxpayers who are in Canada only liable to pay a small witholding tax on dividends received.[109] Such transactions which aim at extracting corporate surpluses as capital gains are known as "dividend stripping".

The provisions now to be dealt with aim at counteracting the tax advantages received by both seller and purchaser. Some are applicable to particular transactions, but because of the continuing ability of taxpayers to get round such provisions, the Governments of both countries have found it necessary to enact very wide ranging provisions giving discretionary powers to the tax authorities, which have been much criticized by commentators for the complexity and uncertainty they create.[110]

Before discussing these provisions, it should be pointed out that the Revenue Authorities have had some success in attacking these transactions without their aid. In particular, it has been held in several cases that losses realised by dealers on shares purchased in the course of such transactions are artificial losses outside the normal course of trade and therefore not allowable.[111] However, there are other cases on very similar facts where such losses were upheld[112] and which are very difficult to distinguish from the first cases.[113] Moreover, it appears that the court will look through very artificial devices aimed at stripping corporate surpluses as capital gains and treat them simply as distributions made by the company to its shareholders under the ordinary provisions discussed at the beginning of the previous chapter.[114] However, the situations when it will do so are not at all clear.

A. Canada

(i) Designated Surplus

Section 192 of the Canadian Act provides that where a corporation has received from a corporation resident in Canada and controlled by it a dividend, which is deductible from its income under section 112(1)[115] of the Act, it shall pay a tax of 25% on that part of the dividend which is paid out of designated surplus. One corporation is expressed to control[116] another for the purposes of this section if more than 50% of its issued share capital with full voting rights belongs to the other corporation, to persons with whom the other corporation does not deal at arms length[117] or to the other corporation and persons with whom the other corporation does not deal at arms length. A dividend is only payable out of designated surplus to the extent it exceeds the control period earnings of the corporation.[118] The Act defines in detail both the corporation's designated surplus and its control period earnings, but the former is basically the undistributed income of the corporation earned prior to the corporation being taken over[119] and the latter the undistributed income earned after control was obtained.[120]

In dealing with the operation of the designated surplus provisions on capital gains realised by a corporation, it is again necessary to distinguish between public and private corporations.[121] The designated surplus of a non-private corporation includes both dividends received by it and taxable capital gains,[122] but not capital gains which form part of the 1971 capital surplus on hand,[123] which are unaffected by these provisions. As neither the definition of designated surplus nor the definition of control period earnings includes the untaxed half of capital gains, it appears that such amounts will remain locked in the corporation until such time as those two accounts are exhausted, when they can then be paid out as an ordinary taxable dividend.[124] In the case of the private corporation, the Act preserves the integration of personal and corporate taxation in connection with investment income and capital gains, by excluding these amounts from designated surplus,[125] including them in control period earnings[126] and leaving the corporation with its right to distribute the untaxed half of capital gains as a capital dividend.

The purpose of these provisions is to meet the situation where the individual shareholder sells his shares to a company and so pays only half tax rates on his share of the corporation's surplus, as represented by his capital gain on the shares. The designated surplus tax compensates for the reduced tax paid by the shareholder[127] and the deductibility of any dividend paid in the hands of the corporation. In order to prevent the corporation proceeding to realise a capital loss on a disposition of those shares following payment of the dividend, the Act further provides that the adjusted cost base of the shares of a recipient of a dividend paid out of designated surplus must be reduced by the amount of the dividend, less the tax paid under these provisions.[128]

Non-corporate share dealers, who control a corporation, are brought within the ambit of section 192 in the same manner as if they were corporations.[129] No special provisions are necessary for corporate share dealers. However, as the reduction in the cost base of shares caused by a dividend paid out of designated surplus can be of no significance to a dealer in shares, which will include the proceeds of disposition of its shares in its computation of trading income,[130] it was necessary to provide that a share-dealing corporation should be disallowed from deducting from its income any dividend paid to it out of designated surplus.[131] Thus the share dealer, whether incorporated or not, will be in the position of having to pay designated surplus tax, but will be able to realise a loss when he disposes of the shares in question, which he will be able to set off against the dividend which is included in its income. On the other hand, the non-dealing corporation can still deduct a dividend paid from designated surplus from its income, but is prohibited from realising a capital loss to the extent of the dividend.

Where a corporation[132] is controlled[133] by a non-resident corporation, a non-resident owned investment corporation or an exempt taxpayer[134] and it pays a dividend which would, if section 192 were applicable, be payable out of the payer corporation's designated surplus, the paying corporation is required to pay a tax of 15% of the dividend or if to an exempt taxpayer, 33 1/3% on the amount of the dividend.[135] The adjusted cost base of the shares of the recipient of the dividend is reduced in the manner mentioned above.[136]

However, the section does not apply where the exempt taxpayer, who controls the corporation, obtained all his controlling shares "by way of unconditional gift or unconditional bequest".[137] Similarly, the section does not apply where the person controlling the corporation is a non-resident individual. The effect of these provisions is thus to enforce payment by the corporation paying the dividend of a tax, which will compensate for the reduced tax paid by the individual selling his shares to the exempt or non-resident taxpayer, without actually affecting the tax position of these latter taxpayers. The tax paid in respect of the non-resident taxpayer is lower to allow for the non-resident withholding tax paid by it.

(ii) <u>Other provisions reducing losses arising from the disposition of shares</u>.

Further sections are enacted to apply when a corporate shareholder is not in a position to have control of a corporation, so that the designated surplus provisions do not apply, but there is nevertheless opportunity to obtain payment of dividends and then to realise losses by disposing of shares in respect of which the dividends were paid.

Section 112(3) of the Act applies where a corporation (other than a trader or dealer in securities) receives a dividend which is deductible from its income by virtue of section 112(1) - (2)[138] and provides that the amount of the dividend must be deducted from any loss arising "from transactions with reference to the share in respect of which the dividend was received", unless it is shown that the corporation owned the share for more than a year prior to the loss being incurred and did not own more than 5% of the class of shares in question at the time the dividend was received. Section 112(4) enacts a similar provision in connection with trading losses incurred by traders or dealers in securities as a result of disposals of shares. In both cases the loss is not reduced to the extent that the dividend is paid out of designated surplus.

Loss limitations are also imposed on losses arising from a disposal shares in a foreign affiliate[139] of a resident company, made either by the resident company or another of its foreign affiliates, in respect of dividends received from the foreign affiliate. The resident corporation must reduce its loss by the amount of any dividends received from a foreign affiliate, which are deductible from its income under section 113(1)[140] and the foreign affiliate, which incurs a loss, must reduce its loss by the amount of any dividends paid to it, except to the extent the dividend was paid from the other foreign affiliate's pre-acquisition surplus[141] and to the extent of any tax paid by the recipient of the dividend.[142]

These provisions thus prevent corporations using their privilege of deducting dividends from their income to create losses on their shareholdings. In addition, there should be noted the provisions of section 40(2)(g)(i), which deem a "superficial loss" of any taxpayer to be nil. The Act defines[143] a superficial loss as a loss arising from a disposition of property, where the property was acquired within a period of 30 days before or 30 days after the disposition. This would apply to a corporation or an individual which purchased shares, obtained payment of a dividend and then resold the shares at a loss within the 30 days period.

(iii) General anti-avoidance provisions

Finally, forming the rearguard of the Government's attack on dividend stripping operations, there is section 247 of the Act, which gives the Minister a wide discretion, which will enable him to counter most transactions of this kind. Although it to a great extent overlaps the provisions which have just been discussed and would be applicable even where they are applicable, it must be assumed that it will not be invoked unless the others fail to cover the situation.

In any case the Revenue Authorities cannot assess the same person on the same income twice. However, the result of invoking this section may involve taxing different people on what is in effect the same income.

The section allows the Minister to direct that an amount received by a taxpayer be included in his income and, in the case of an individual, that it be deemed to be a taxable dividend, where the amount was received "as part of a transaction ... or as part of a series of transactions ..., one of the purposes of which, in the opinion of the minister, was or is to effect a substantial reduction of, or disappearance of, the assets of a corporation in such a manner that the whole or any part of any tax which might otherwise have been or become payable under this Act in consequence of any distribution of income of accorporation has been or will be avoided"[144]. The amount received by the taxpayer must be either received as consideration for the disposition of shares, a payment made on a redemption or acquisition by a corporation of its own shares, a payment made on a reduction of capital, a payment made on a conversion of shares into shares of another class, or a payment that would, but for this section, be exempt income[145] in the hands of the recipient.

Thus, when a shareholder disposes of his shares for a capital gain, at a time when the corporation has assets available for distribution, to a body or person which is able to extract the dividend at a low or nil tax cost, the minister will be able to direct, by virtue of this section, that the proceeds of disposition received by the shareholder or part of them be treated as a taxable dividend in his hand[146] and that the purchaser include the amount of the dividend in its income, in spite of any right of deduction or exemption. In so far as the direction deemed the member's proceeds of disposition to be a dividend, any capital gain arising from the disposal would be excluded from income by virtue of section 39 of the Act, which excludes from income gains and losses otherwise included in computing income.

It has been suggested[147] that the mere sale of shares to a corporation followed by a dividend paid to the corporation, which it can deduct from its income, is not in itself within the terms of the section, unless there is some further Act which prevents the recipient corporation redistributing the amount received in the form of a dividend.[148] However, on a strict reading this would not appear correct, as the shareholder has received consideration for the sale of his shares and, by the dividend paid to the purchaser, there has been a reduction of assets of the paying corporation, with the result that no tax will be paid on a distribution of income by the corporation up to that amount. Rather reliance would have to be placed on the Minister's discretion and the lack of tax avoidance motive in carrying out the transaction.

There is no doubt that, in general, a simple sale of shares by shareholder with no ulterior motive is outside the scope of this section, but the question arises as to the effect on an innocent vendor of a dividend stripping operation carried out by the purchaser of his shares without his complicity.[149] It is not clear whether he could argue that he had no tax avoidance motive personally or whether the Minister can, in spite of his innocence, designate the proceeds of sale to be a dividend paid to him, on the grouds that the lack of tax avoidance motive must apply to the whole series of transactions. The strict wording of the section would seem to require the latter.

The taxpayer can appeal to the courts from a ministerial direction under this section and the court can confirm the direction, vary it or vacate the direction if it determines that none of the purposes of the transaction or series of transactions involved was to effect a substantial reduction of, or disappearance of, the assets of a corporation in such a manner that the whole or any part of any tax that might otherwise have been, or become, payable under the Act in consequence of any distribution of income of a corporation has been or will be avoided.[150]

Although section 247 was specifically enacted to counter dividend stripping transactions, in practice, the Revenue Authorities have also used the broad provisions of section 245(2) to attack such operations with some success. This section, which is looked at more thoroughly in the next chapter,[151] includes in a taxpayer's income the value of benefits conferred on him by another taxpayer, regardless of the nature of the transaction by which it takes place. The argument used was that the price received on a sale of shares in the course of a totally artificial dividend stripping operation was a benefit conferred by the company on the shareholder to the extent it represented undistributed income.[152]

B. United Kingdom

There is in the U.K. system no provisions equivalent to the Canadian designated surplus provisions,[153] which impose a special tax on corporations in respect of dividends paid to them by subsidiaries out of surpluses earned prior to their being taken over. There are, however, provisions which place limits on losses incurred by corporations on a disposal of shares by reference to previously received dividends which are deductible from their income and others which counter tax advantages accruing from the sale of shares to bodies which, because of their special tax status, receive dividends at little or no tax cost. As in Canada, the ultimate weapon in the Government's armory is a very broad anti-dividend stripping provision involving executive discretion, which would seem to be even broader than the Canadian provision in its scope.

(i) Provisions reducing losses resulting from a disposal of shares.

Section 281 of the I.C.T.A. 1970 provides that where a company (other than a share dealing company) holds 10% of a class of shares of another company and a distribution[154] is made to the company which materially reduces the value of those shares, section 280 of the same act[155] is applied, as if the distribution constituted a depreciatory transaction and the two companies were members of a group of companies. In other words, any loss realised on a disposal of those shares is reduced to the extent of the reduction in value caused by the distribution.[156] On the other hand, a subsequent capital gain arising from a disposal of the shares held in the company whose loss was previously reduced under the above provision, if realised within 6 years of the distribution in respect of which the loss was reduced, is reduced to the extent that the gain is attributable to an increase in corporate assets caused by the distribution.[157] The section does not necessarily defer the capital loss completely, but simply prevents the artificial creation of a loss caused by a deductible inter-corporate dividend. In this way its affect is less harsh than the equivalent Canadian provisions, which give no relief on gains realised on a later disposal of shares by a taxpayer, even though the gain is attributable to a dividend received, in respect of which a capital loss has been disallowed. However, the scope of the U.K. provision is not limited to disposals of shares following within a short time of their acquisition.

Section 476 of the same Act has substantially the same affect in respect of trading losses incurred by share dealing companies on a disposal of shares, as does section 281 in respect of capital losses realised by other companies. However, it does this without applying section 280 of the Act so that there is no relief where, on a subsequent disposal of shares in the share dealing company, a capital gain is realised, which is caused by the receipt of a dividend in respect of which a loss was disallowed.

Section 476, but not section 281, is limited to dividends received from resident companies. Thus the latter section will operate harshly in respect of distributions received from non-resident companies, as these are not even deductible from the recipient's income.

(ii) <u>Provisions dealing with short term purchases and sales of shares designed to avoid tax</u>.

The U.K. Act has several provisions designed to meet the situation where a shareholder, on whose shares a dividend is about to be declared, sells the shares, in order to realise the amount of the dividend as a capital gain, to a purchaser, which can use its special tax status to pay little or not tax on the dividend when paid. The original shareholder then buys back the shares when the dividend has been paid.

Thus, by section 469 of the I.C.T.A. 1970, where the owner of shares or securities agrees to sell or transfer them and by the same or any collateral agreement agrees to buy back or re-acquire them or acquires an option, which he subsequently exercises, to buy back or re-acquire them, then any interest or dividend paid in respect of those shares or securities to the purchaser is deemed to be income of the vendor and not of the purchaser. Moreover, it appears that the purchaser will still be liable to be taxed on any capital gain he realises on his disposal of the shares.[158]

Other provisions deal with the same and similar transactions from the purchaser's point of view. Where the purchaser is a dealer in shares or securities, section 469(4) provides that if in the purchase agreement or any collateral agreement there is an agreement to sell back or retransfer the shares or securities or an option for the dealer to sell back or re transfer them, which he subsequently exercises, then the transaction is ignored in the computation of the dealer's income. This provision, which will exclude any loss realised by the dealer on disposing of the shares, covers almost[159] exactly the same situations as are covered by the above provision which includes in the vendor's income the amount of any interest or dividend paid to the purchaser of his shares and to this extent complements it by ensuring that the purchase and sale are treated as if they had never occurred.

Sections 471-475 of the same Act apply to purchasers of shares or securities, whether or not the purchase agreement contains an agreement to resell or an option for resale or retransfer and whether or not any interest or dividend paid in respect of the shares or securities in question to the purchaser is deemed to be part of the vendor's income. However, the shares or securities purchased must be sold within six months of purchase or within one month if the purchase and sale are shown to have been carried out at current market prices and the sale is shown not to have been carried out pursuant to an agreement made before or at the time of the purchase. If the sections apply, any interest or dividend paid in respect of the shares or securities remains part of the purchaser's income, unless section 469 is also applicable, but if the purchaser is a dealer in securities, section 472[160] nullifies the possibility of a loss resulting on a disposal of the shares or securities involved by virtue of any interest or dividend being paid to the dealer. Further, if the purchaser is an exempt tax-payer, any such interest or dividend is taxed in the hands of the recipient as if there were no exemption[161] and if the purchaser is a trader other than a trader in shares and securities, there are provisions preventing the trader setting off any trading losses against such interest or dividend.[162] Thus, unless there is an actual agreement or option to repurchase, entered into by a vendor of shares at the time of the sale, the vendor's only tax liability will be to pay tax on his capital gain, although there may be more harmful consequences for the purchaser under the provisions described in this paragraph.

Lastly, reference should be made to section 480 of the I.C.T.A. 1970, which applies where a taxpayer sells a right to receive interest or a dividend in respect of shares or securities, without selling the actual investment. In the absence of statute it has been held[163] that sale proceeds resulting from such a transaction constitute a capital receipt, which is not taxable as income. This section does not alter this rule, but deems the interest or dividend, the right to which was sold, to be income of the vendor and not of the purchaser. However, it would appear that the sale of the right to receive the interest or dividend for a capital sum would amount to a part disposal of the shares or securities in question,[164] so that the vendor would also be liable to pay tax on a capital gain.[165]

Other than section 247 of the Canadian Act, there is no Canadian provision which will lead to a capital gain resulting from a disposal of shares being treated as a dividend in the hands of the disposing shareholders and no provisions at all which will deem a dividend paid following such a sale to be income of the vendor.

However, the Canadian Act does have a provision which has a similar effect in regard to debentures. Section 20(14) applies when a purchaser of a debenture receives interest in respect of a period commencing prior to the transfer. It apportions the interest between the period before and the period after the transfer and deems the amount apportioned to the latter period to be income of the transferor and not the transferee. The cost base of the debenture to the transferee is reduced by the amount of the interest apportioned to the transferor,[166] but as there is no equivalent deduction from the proceeds of disposition of the debenture to the transferor, the latter is still taxed on that part of any capital gain representing the interest which is attributed to him. Further, there are numerous Canadian provisions which will nullify any tax advantage obtained by a purchaser of shares in the sort of transaction to which the above U.K. provisions apply.[167]

(iii) General anti-avoidance provisions

Section 460 of the I.C.T.A. applies where, in any one of five specified circumstances and in consequence of a transaction in securities,[168] a taxpayer obtains a tax advantage.[169] The Board of Inland Revenue are authorized to make adjustments[170] that will negative this advantage, but not where the transaction was carried out either for bona fide commercial reasons or in the ordinary course of making or managing investments and none of the main objects of the transactions was to enable tax advantages to be obtained.

The five circumstances when the section comes into operation are as follows:[171]

(A) Where, in connection with the distribution of profits of a company, or the sale or purchase of securities followed by the purchase or sale of securities, a person is entitled to recover tax in respect of an abnormal dividend[172] which he receives, e.g. by way of an exemption from tax or a setting off of losses against profits or income. One situation covered by this head is where a share dealer purchases shares and obtains payment of a dividend, on which he pays no tax because he is able to set against it the loss he realises when he disposes of the shares following its payment. Similarly, it would be relevant in the case of a charity, which purchased shares and obtained payment of a dividend, on which, under general law, it pays no tax.[173]

(B) Where the same situation as in head (A) exists, but the taxpayer becomes entitled, in respect of securities held or sold by him, to a deduction in computing profits or gains by reason of a fall in the value of securities, resulting from the payment of a dividend or any other dealing with the company's assets. This head must be considered in the same sort of situations as in head (A), except that there is no requirement that there be an abnormal dividend.[174]

(C) Where one person becomes entitled to an abnormal amount by way of dividend or to a deduction in computing his profits or gains, by reason of the fall in value of securities caused by the payment of a dividend or other dealing with a company's assets, and this results from a transaction in consequence of which another taxpayer received consideration representing either existing assets of a company available for payment of dividends, future receipts of a company or the value of trading stock. Whereas heads (A) and (B) catch the body or person, to which the shareholder disposes his shares in the first stage of a dividend stripping operation, this head affects the shareholder and will generally result in his capital gain being turned into an ordinary income receipt.[175]

(D) Where, in connection with the distribution of profits of a company which is under the control[176] of not more than five persons[177] and the shares of which are not dealt with on a stock exchange in the

U.K., the taxpayer receives the consideration referred to in head (C) above. This applies to the same situations as head (C) above, but its vaguer wording makes it much wider in scope.[178]

(E) Where, in connection with the transfer of assets of a company, to which head (D) applies, to another such company or in connection with any transaction in securities in which two or more such companies are concerned, a taxpayer receives non-taxable consideration[179] which is, or represents the value of, assets available for distribution by such a company and consists of any share capital or security issued by such a company. When the share capital received consists of non-redeemable share capital, the section does not operate until the share capital is redeemed.[180]

It is clear that a simple sale of shares by a shareholder, who realises a capital gain representing undistributed corporate income, is not in itself within the terms of the above provisions. Some further action is required by the purchaser[181] However, it would appear that it would be enough if a corporate purchaser were to obtain payment to itself of a dividend which was deductible from its income.[182] Thus, the position would so far appear to follow that found under Canadian law by virtue of its equivalent section. Moreover, there seems to be the same possibility of an innocent vendor of shares being caught up in a tax avoidance scheme initiated by his purchaser without his knowledge and consent.[183] It is not clear whether such an innocent vendor would be able to argue that he came within the exception to the rule referred to in the following paragraph, in spite of an obvious tax avoidance scheme carried out by the purchaser or other parties. It appears from a strict reading of the section that the exception must be applicable to all the transactions which are in question.[184]

The opportunities for excluding a transaction from the operation of these U.K. provisions are much greater than those for excluding a transaction from section 247 of the Canadian Act.[185] The latter section applies even if only a subsidiary purpose of a transaction is to avoid taxes and there is no exception, similar to the one found in the U.K., for bona fide commercial transactions or transactions in the ordinary course of making or managing investments. In the U.K., a transaction fitting either of these two descriptions will escape if none of its main purposes is tax avoidance.[186]

A question arises as to whether the receipt of a capital distribution in the course of winding up a company[187] gives the recipient a tax advantage arising from a transaction in securities and falls within one of the five heads. He would appear to receive a tax advantage, in that he is obtaining a distribution of the corporation's accumulated profits and gains in the form of a capital receipt, but, in view of section 460(2) which deems a tax advantage to be obtained from a transaction in securities when it is obtained in consequence of the combined effect of the transaction and of the liquidation of the company, it is generally taken that a simple liquidation by itself is not enough.[188] On the other hand, when other transactions are coupled with the liquidation (e.g. it is proposed to reconstruct the company by liquidating the company and transferring excess assets to shareholders and assets necessary to continue the business of the company to a new company) these provisions would probably be operative.[189] This problem, concerning distributions made on a company's liquidation, does not arise in Canada.

In the U.K., there is a statutory scheme whereby the taxpayer can obtain binding clearances from the Revenue Authorities before a proposed transaction is entered into, provided full disclosure is made of all relevant facts.[190] In Canada, there is no such binding scheme in connection with section 247 of the Act, although there is a scheme whereby non-binding informal clearances can be given.[191] The U.K. section gives no express right to apply to the courts when section 460 is invoked, as is found in Canada in section 247(3), but the courts do have the final say as to whether the conditions exist which bring the section into operation.[192]

NOTES

1 See Part 3 of Chapter Two Section D.

2 S. 186 and s. 129 - see Part 2 of Chapter Three Section B.

3 S. 129 - see Part 2 of Chapter Three Section B.

4 See Part 1 of Chapter Three Section B (text at n. 37-41).

5 For a discussion of the possibilities of stock splits see Part 1 of Chapter Three Section C (text at nn. 80-4).

6 See, for example, s. 460 I.C.T.A. 1970 in the U.K. and s. 247 in Canada.

7 See, for example, s. 281 I.C.T.A. 1970 in the U.K. and s. 112(3) - (4) in Canada.

8 S. Edwards Corporations and Shareholders 1971 Conference Report Canadian Tax Foundation 124 at 128-9.

9 Honourable E. Benson Minister of Finance Summary of 1971 Tax Reform Legislation 42

10 Vol. 4 Chapter 19.

11 S. 94 and sch. 16-7 F.A. 1972.

12 S. 291(2) I.C.T.A. 1970 and sch. 16 Para. 10(2) F.A. 1972.

13 Defined in s. 303(5) I.C.T.A. 1970 and Para. 6 sch. 17 F.A. 1972.

14 S. 303(1), (2) and (7) I.C.T.A. 1970 and Para. 7 sch. 17 F.A. 1972.

15 S. 302(1)-(4) I.C.T.A. 1970 and Para. 5 sch. 17. F.A. 1972

16 S. 302(5)-(6) and s. 303(3)-(4) I.C.T.A. 1970.

17 S. 282(1)(a) I.C.T.A. 1970.

18 S. 282(1)(d) and s. 283 I.C.T.A. 1970.

19 S. 282(1)(d) and s. 282(4) I.C.T.A. 1970.

20 S. 290-5 I.C.T.A. 1970 and Paras. 8-14 sch. 16 F.A. 1972.

21 S. 289 I.C.T.A. 1970. The liability to pay Income Tax is treated like the corporate liability to deduct and account for such tax on its distributions. Thus any surplus franked investment income for the year can be set off against this liability - s. 289(3) and see Part1 of Chapter Three Section B (text at nn. 37-41)

22 S. 296 and s. 298 I.C.T.A. 1970.

23 S. 297 I.C.T.A. 1970.

24 Para. 1-2 sch. 16 F.A. 1972.

25 Para. 5 sch. 16 F.A. 1972

26 Para. 5 sch. 16 F.A. 1972. Thus the shareholder is treated as if he had received a distribution and a full credit for the basic rate of Income Tax.

27 Para. 7 sch. 16. However, as it does not pay the advance Corporation Tax on what is in effect a deemed dividend, it gets no credit against its ultimate Corporation Tax liability. So the corporation is in the same position as if it had paid the advance tax and then set it against its ultimate liability - see Part 1 of Chapter Three Section A (text at nn. 18-21)

28 Para. 6 sch. 16 F.A. 1972.

29 See nn. 26-7 supra.

30 Para. 18(1) sch. 6 F.A. 1965,as amended by Para. 2 sch. 24 F.A. 1972.

31 Para. 18(2) sch. 6 F.A. 1965, as amended by Para. 2 sch. 24 F.A. 1972.

32 The purchaser of the shares of such a shareholder will benefit to the extent that the company recovers any tax paid by it under these provisions and he will have a right to a deduction from his income, when income which has already borne the higher rates of Income Tax or Surtax is distributed - see nn. 33-4 infra.

33 S. 289(5) I.C.T.A. 1970.

34 S. 297(8) I.C.T.A. 1970 and Para. 5(6) sch. 16 F.A. 1972.

35 S. 291(2)(a) I.C.T.A. 1970 and Para. 10(2) sch. 16 F.A. 1972.

36 See n. 21 supra.

37 In so far as such dividends are received without deduction of Income Tax (see Part 1 of Chapter Three Section B)(at n. 37))this will not be the case. Such dividends will bear Income Tax under these provisions.

38 S. 129 and s. 186 of the Canadian Act - see Part 2 of Chapter Three Section B.

39 Honourable E. Benson, supra n. 8 at 41.

40 The transferor of the assets and the individual in question need not be the same person and nor need the transferor be an individual (Congreve v I.R.C. (1948) 30 T.C. 163). The individual must be ordinarily resident in the U.K., but it would not seem to be necessary that the transferor be resident.

41 Defined very broadly in s. 478(5) I.C.T.A. 1970.

42 See n. 40 supra. Note in particular s. 478(5)(b), which includes in the definition of "power to enjoy income" the situation where the "receipt or accrual of income operates to increase the value to the individual of any assets held by him or for his benefit". This would cover the holding of shares in a company, where corporate income was accumulated.

43 S. 480(3) I.C.T.A. 1970.

44 Note that by s. 478(3) these provisions do not apply if avoiding tax liability was not one of the purposes of the transfer of assets or the transfer was a bona fide commercial transaction.

45 The proportion is the proportion of the assets of the company that the shareholder would be entitled to if the company went into liquidation at the time the gain accrued - s. 41(3).

46 If the fraction of gain apportioned to a shareholder is less than one twentieth, the section does not take effect - s. 41(4).

47 s. 41(5)(a)

48 s. 41(5)(b)

49 s. 41(5)(c)

50 s. 41(5)(d)

51 s. 41(9)

52 s. 41(8)

53 Para. 22(1)-(2) sch. 20 F.A. 1968. Para. 22(3) applies s. 278-9 I.C.T.A. 1970 - see Part 4 of Chapter Two Section B (text at nn. 244-8).

54 Para. 23 sch. 20 F.A. 1968.

55 Para. 10 sch. 13 F.A. 1967.

56 s. 41(7)

57 s. 41(5)(a) and see text at n. 47 supra.

58 The main definition is in s. 95(1)(b), but this is supplemented by s. 95(4)-(5).

59 "Indirectly" here refers to control exercised through the medium of other intermediary foreign affiliates of the taxpayer - s. 95(4)(b)(ii). The voting power can be owned totally directly or totally indirectly or be of both types. These comments also apply to the two following definitions - s. 95(4)(a) and (b).

60 Rights, powers or shares held by persons who do not deal with each other at arms length are treated as if held by one person for the purposes of each alternative definition - s. 95(1)(b).

61 Defined in s. 95(4)(a).

62 For a fuller exposition of the meaning of this term and of the whole definition of "foreign affiliate" see The Canadian Institute of Chartered Accountants Tomorrow's Taxes 233-7 and A. Scace and D. Ewens Canadian Taxation of Foreign Affiliates 11 Osgoode Hall Law Journal 325 at 327-345 (1973).

63 Defined in s. 95(1)(a).

64 S. 91(1)(a)

65 S. 91(1)(b) and see Department of Finance News Release dated 4th August 1971 for the Government's proposals as to which dividends are to be included in the resident taxpayer's income and which not.

66 The actual procedure followed is for s. 91 to attribute to the resident taxpayer, in respect of each share owned by him in a foreign affiliate, a percentage of the affected income equal to the "participating percentage" of the share. By s. 95(1)(c) this is calculated for each share, as if the taxpayer had only this share and was calculating his equity percentage. However, the total of participating percentages for all his shares cannot exceed his actual equity percentage.

67 See n. 66 supra. For an example of the computation of participating percentages see S. Baker International Aspects 1971 Conference Report Canadian Tax Foundation 172 at 186-9.

68 S. Baker, supra n. 67 at 189, The Canadian Institute of Chartered Accountants, supra n. 62 at 235 and A. Scace and D. Ewens, supra n. 62 at 352-3.

69 Id

70 If the corporation was a foreign affiliate prior to 1st January 1972, it is deemed to have become one on that date.

71 S. 95(2) I.T.A. and s. 35(1)-(2) I.T.A.R.

72 The references to tangible assets in both systems excludes gains on intangible assets, e.g. goodwill.

73 S. 95(1)(a)(i)

74 S. 113(3)(b). See D. Ward Current Tax Planning Para. 63.2(e) where it is pointed out that this provision does not give a full credit when the corporate rate drops below 50%.

75 S. 113(3)(a)

76 S. 126(1)

77 S. 126(1)(a)

78 s. 91(2)

79 s. 91(3)

80 s. 90(2)

81 For an account of difficulties involved in making the cost base adjustments, particularly when the foreign affiliate ceases to be a foreign affiliate of one taxpayer and becomes one of another taxpayer see A. Scace and D. Ewens, supra n. 62 at 358-60.

82 s. 113(3)(b)

83 The income actually accumulated has already been reduced by the tax actually paid.

84 For a discussion of anomalies arising from the inclusion in a resident taxpayer's income of income of a foreign affiliate and the consequent cost base adjustments see the Canadian Institute of Chartered Accountants, supra n. 62 at 255-8.

85 See Department of Finance News Release dated 4th August 1971.

86 Canadian Institute of Chartered Accountants, supra n. 62 at 249.

87 s. 113(1)(a)

88 s. 90(3)

89 s. 113(1)(b). The allowed deductions are equivalent to a full credit for foreign taxes paid on the income out of which the dividend is paid, if the Canadian corporate rate is 50% and not quite a full credit if it is less than this - D. Ward, supra n. 74 at Para. 63.1(c).

90 s. 92(2). The section also applies to shares held by one foreign affiliate in another foreign affiliate of the same taxpayer, where the former receives a dividend paid from the pre-acquisition surplus of the latter.

91 The individual, of course, must include the dividend in income when he receives it, but he will, unlike a corporation, receive the foreign tax credit for foreign witholding tax paid - s. 126(1).

92 The taxpayer can only so elect as to part of the gain if the amount of underlying accumulated earnings prescribed in respect of his shares is less than the amount of the gain.

93 S. 93(2) and s. 113(2). For the amounts otherwise deductible see text at n. 89 supra.

94 For a fuller account of this and other related criticisms see Canadian Institute of Chartered Accountants <u>Notes for Discussion on Bill C-259 with Department of Finance Officials</u> 14.

95 See Chapter Five. Only s. 267 I.C.T.A. 1970 expressly applies to resident companies - see Part 1 of Chapter Five Section B (text at nn. 65-7).

96 All the Canadian provisions are expressed to apply to Canadian corporations (for the definition of which see Part 3 of Chapter One (text at n. 59)), except for s. 86 (see Part 2 of Chapter Five Section A and s. 51 and 77 (see Part 2 of Chapter Five Section B), which are silent on this and so presumably apply to non-Canadian corporations - see generally Chapter Five.

97 S. 108(2)(a) - see Part 5 of Chapter Two Section D (text at nn. 306-15).

98 S. 108(2)(b) and s. 132(6)(a) - see n. 97 supra.

99 S. 94(a)

100 S. 94(b)

101 S. Baker, supra n. 67 at 185-6 and 189-90.

102 See Part 5 of Chapter Two Section D (text at nn. 321-5)

103 S. 4(4) and D. Ward, supra n. 74 at para. 63.3

104 S. 104(13) and s. 52(6) and see Part 3 of Chapter Three Section D (text at nn. 230-2)

105 See Part Three of Chapter Three Section D.

106 See Part Five of Chapter Two Section D (text at nn. 342)

107 See this part of this chapter Section B.

108 Id.

109 This is not the case in the U.K., as non-residents are fully taxable on dividends received from resident companies.

110 See S. Edwards Corporations and Shareholders 1971 Conference Report Canadian Tax Foundation 124 at 128-30.

111 Bishop v Finsbury Securities Ltd. [1966] 3 A.E. 105, Thomson v Gurnville Securities Ltd. [1971] 3 A.E. 1071 and FA & AB Ltd. v Lupton [1971] 3 A.E. 948.

112 Griffiths v J.P. Harrison (Watford) Ltd. [1962] 1 A.E. 909

113 For attempts to reconcile these decisions see D. Carey Trade - The Elusive Concept 1972 British Tax Review 6 and Simon's Taxes Vol. B Para. B1.732.

114 This was done in Conn Smythe et al v M.N.R. and Atkinson v M.N.R. 1969 C.T.C. 558 and 566 respectively. The provision applied was S.81(1)of old Act, which is similar to s. 84(2) of present Act.

115 This means dividends received from Canadian corporations and resident corporations controlled by them section 112 and see Part 1 of Chapter Three Section B.

116 Defined in s. 192(4).

117 See Part 2 of Chapter One (text at nn. 25-29) and Part 4 of Chapter Two Section B (text at n. 207).

118 S. 192(5)

119 S. 192(13)-(19).

120 S. 192(8)-(9), (10.1)

121 For the definitions of these corporations and their differences see s. 89(1)(f)-(g) and the Conclusion to Chapter Three (text at nn. 281-292).

122 The definition of "designated surplus" includes a corporation's "income", which by s. 82(1) and s. 90(1) includes all dividends received. The deductions under s. 112 and s. 113 are made for the purpose of computing "taxable income". Taxable capital gains are also included in income - s. 3.

123 See Part 1 of Chapter Three Section E.

124 Thorne, Gunn, Helliwell and Christenson Tax Reform Proposals - Treatment of Corporate Distributions in the Hands of Canadian Shareholders 13.

125 S. 192(13)(b)(vi). The actual method used is to deduct from the designated surplus twice the amount of any refundable tax of the corporation - see Part 2 of Chapter Three Section B.

126 S. 192(9)(c)-(d). These provisions include in the corporation's control period earnings the refundable tax excluded from designated surplus by the provision referred to in n. 125 supra and any actual refunds of tax.

127 For a discussion of this aspect see R. Dart Computing and Reporting Problems Invitational Tax Reform Seminar Richard De Boo Ltd. 32 at 32-3.

128 S. 53(2)(a)(ii)

129 S. 192(2)

130 A capital gain is ignored to the extent that it is otherwise included in income - s. 39.

131 S. 112(5)

132 Other than non-resident owned investment corporations.

133 Defined as for s. 192-s. 194(3) and see text at nn. 116-7 supra.

134 Defined in s. 149 to include charities and the like.

135 S. 194(1)

136 S. 53(2)(a)(iii)

137 S. 194(6)

138 See n. 115 supra.

139 See Part 1 of this Chapter Section C.

140 This means dividends paid from exempt surplus, part of dividends paid from taxable surplus, but not dividends paid from pre-acquisition surplus - see text at nn. 85-90 supra.

141 Dividends paid from pre-acquisition surplus are already deductible from the cost of shares - s. 92(2) and see text at nn. 85-91 supra.

142 S. 93(2)-(3)

143 S. 54(i)

144 S. 247

145 For the definition of "exempt income" see s. 248 as amended by s. 69(2) 1973 Bill C-170.

146 For an example of the application of the predecessor of s. 247 see *Giguere v M.N.R.* (1972) 26 D.T.C. 1392. In this case, shareholders of one company with large amounts of undistributed income on hand sold their shares to another company in return for preference shares in the purchaser. They were assessed on the amounts received on the sale of some of those shares to the company's pension plan and on a redemption of others.

147 J. Barbeau and D. Parkinson *Dividend Stripping in Canada* 14-15

148 For example, by paying of a shareholder's loan made to assist the corporate purchaser to make the purchase of the shares - J. Barbeau and D. Parkinson, supra n. 147 at 15-6. The argument is that the recipient company can itself pay a dividend out of the dividend received.

149 J. Barbeau and D. Parkinson, supra n. 147 at 12 and CCH Canadian Ltd. *Canadian Tax Reporter* Vol. 2 para. 27-953.

150 S. 247(3)

151 See Part 2 of Chapter Five Section C.

152 See *Conn Smythe et al v M.N.R. and Atkinson v M.N.R. at [1969] C.T.C. 558 and 566 respectively.* In the

Supreme Court it was said in both cases that it was unnecessary to pronounce on the applicability of s. 245(2), as these transactions were clearly caught by s. 81(1) of the old Act. However, in both cases, the Exchequer Court applied s. 245(2) - see [1967] C.T.C. 498 and 379 respectively.

153 See this part of this chapter Section A.

154 "Distribution" here refers to income distribution as defined in s. 233 I.C.T.A. 1970 - see Part 1 of Chapter Three Section C.

155 See Part 4 of Chapter Two Section B (text at nn. 248-251).

156 S. 280(4)-(5) I.C.T.A. 1970.

157 S. 280(6) I.C.T.A. 1970.

158 Although Para. 2 Sch. 6 F.A. 1965 excludes from the computation of a capital gain any amount included in computing the taxpayer's ordinary income, this will not apply here, as the proceeds of disposition of the shares and the amount included in income are different amounts.

159 Not all the transactions which will result in the interest or dividend being deemed to be the vendor's income under s. 469 I.C.T.A., 1970 will result in a purchasing dealer in shares being subject to s. 469(4)- Simon's Taxes Vol. B Para. B1.725.

160 This section does not apply to purchasing share dealers in situations where s. 469(4) applies-S. 472(3).

161 S. 473(1) I.C.T.A. 1970.

162 S. 474 This is to prevent traders with trading losses buying securities on a short term basis, in order to set off their losses against the dividends and income received.

163 Paget v I.R.C. [1938] 2 K.B. 25.

164 See s. 22(2) F.A. 1965, which states that "there is a part disposal of an asset where an interest or right in or over the asset is created by the disposal, as well as where it subsists before the disposal, and generally there is a part disposal of an asset where, on a person making a disposal, any description of property derived from the asset remains undisposed of".

165 See n. 158 supra.

166 S. 53(2)(1)

167 See the Canadian provisions discussed in this part of this Chapter Section A.

168 "Securities" is defined in s. 467(1) I.C.T.A. 1970 to include shares and stock. "A transaction in securities" is defined by the same sub-section.

169 "Tax advantage" is defined by s. 466 I.C.T.A. 1970. For a discussion of the difficulties surrounding this definition see D. Carey The Stuff That Dreams are Made Of 1970 British Tax Review 28 at 29-31.

170 The wide power of the Board to make adjustments is set out in s. 460(3) I.C.T.A. 1970.

171 They are set out in s. 461 I.C.T.A. 1970.

172 "Abnormal dividend" is defined in s. 467(3) I.C.T.A. 1970

173 For further explanation of this head see Simon's Taxes Vol. B. para. B1.705.

174 For further explanation of this head see Simon's Taxes Vol. B. para. B1.706.

175 For further explanation of this head see Simon's Taxes Vol. B para. B1.707. In this case, if a capital gain realised by a shareholder on his shares is taxable in his hands as ordinary income, it will not also be taxable as a capital gain - Para. 2 sch. 6 F.A. 1965.

176 For the definition of "control" see s. 302(2)-(6) and Part 1 of this chapter Section A (text at nn. 15-6).

177 A company is excluded if controlled by one or more companies to which head (D) would not apply.

178 For further explanation of this head see <u>Simon's Taxes</u> Vol. B para. B1.708. For judicial decisions which recognised a direction that a shareholder's capital gain on his shares be treated as ordinary income see <u>I.R.C. v Cleary</u> [1968] A.C. 766 and <u>Greenberg v I.R.C.</u> and <u>Tunnicliffe v I.R.C.</u> both at [1971] 3 A.E. 136.

179 "Non-taxable" here means not subject to Income Tax or Corporation Tax on income as opposed to capital gains.

180 For further explanation of this head see <u>Simon's Taxes</u> Vol. B papa. B1.709.

181 <u>Simon's Taxes</u> Vol. B para. B1.702.

182 <u>I.R.C. v Cleary</u>, supra n. 178

183 See text at n. 149 supra.

184 For an account of the difficulties in determining whose intentions must be shown to be bona fide for the exemption to operate see D. Carey, supra n. 169 at 32-3.

185 See text at n. 144 supra.

186 S. 460(1) I.C.T.A. 1970.

187 For the tax consequences of liquidation distributions under normal rules see Part 1 of Chapter Three Section D (text at nn. 98-9)

188 <u>Simon's Taxes</u> Vol. B Para. B1.703 and P. Whiteman and G. Wheatcroft <u>Income Tax and Surtax</u> Para.18-18.

189 <u>Simon's Taxes</u> Vol. B. Para. B1.703.

190 S. 464 I.C.T.A. 1970.

191 J. Barbeau and D. Parkinson, supra n. 147 at 6-7.

192 See the numerous cases decided on this section, including those quoted in the foot-notes of this part of this chapter.

CHAPTER V

CORPORATE REORGANIZATIONS

Chapter five is concerned with the same principles and problems as were found in the discussion in chapters one and two of the provisions dealing with transfers of assets made by individuals to corporations and such transfers made by corporations to other corporations. Thus the provisions to be dealt with recognize the principle of not taxing a capital gain or loss unless there is a real change of ownership of the asset disposed of and not a mere change in the form in which it is held. In particular, a corporate reorganization or amalgamation may involve technical disposals by corporations of their assets to other corporations and by shareholders of their shares in return for a new holding of shares. Even though the assets remain under the same control and underlying ownership as previous to the transaction and the shareholders' interest and rights remain basically the same, these technical disposals will lead to capital gains or losses, in the absence of special provisions to the contrary. Such special provisions are found in both systems and their general effect is to defer the realisation of a gain until there is a real disposal of the asset or share.

The same anti-avoidance provisions that were discussed in chapters one and two in connection with transfers of assets by individuals and corporations will also have application in many of the situations covered in this chapter, to the extent they are not superceded by the various relieving provisions.

This chapter will be in three parts, the first dealing with corporate amalgamations, the second dealing with reorganizations of capital within a corporation and the third dealing with liquidations.

However, before commencing this discussion, one comment should be made regarding the range of institutions covered by the provisions to be discussed. By virtue of section 45(8) of the F.A. 1965, a unit trust scheme[1] is treated as a company and its unit holders as shareholders for the purposes of the Capital Gains Tax provisions of the F.A. 1965. This means that the U.K. provisions dealt with in this chapter, except section 267 of the I.C.T.A. 1970, also apply to unit trusts. Even section 267 applies to authorised unit trusts, which are treated as companies for Corporation Tax purposes by section 355 of the I.C.T.A. 1970. None of the Canadian provisions apply to unit or mutual fund trusts.

Part 1 - Corporate Amalgamations

A. Canada

Section 87 of the Canadian Act applies to a merger of two or more Canadian Corporations (known as predecessor corporations) to form one corporate entity (known as the new corporation) in such a manner that all the property, liabilities and shareholders of the predecessor corporations become the property, liabilities and shareholders of the new corporation.[2] The section expressly excludes the situation where one corporation acquires the property of another corporation by purchase or as the result of the winding up of another corporation.[3]

If section 87 governs an amalgamation, it dictates the tax consequences in three areas. First, it allows the tax free transfer of assets by the predecessor corporations to the new corporation; second it continues the tax position of the predecessor corporations into the new corporation and third, it allows the shareholders of the predecessor corporations to exchange their shares in those corporations for shares in the new corporation without being taxed on any capital gains. The terms of the section will be discussed in more detail under those three heads.

(i) Transfer of assets by the predecessor corporations to the new corporation.

Any capital property (other than depreciable property) is deemed to be acquired by the new corporation at a cost equal to the adjusted cost base of the predecessor corporations.[4] Similarly, any depreciable property is deemed to have the same capital cost and undepreciated capital cost to its acquirer as to the predecessor corporations.[5] Further provision is made for the tax free transfer of other assets to the new corporation, e.g. eligible capital property, accounts receivable inventory and resource properties.[6] Although the relevant provisions of the act only refer to the acquisition cost of the new corporation and do not expressly state that there is to be no disposition of those assets by the predecessor corporations, it must be assumed that this is the case. To argue the opposite would be to contradict the obvious intention of the whole section.[7]

Where the capital property in question was held by a predecessor corporation on the 31st December 1971, the new corporation is put in the same position as if it had acquired the property at the same time as the predecessor corporation, unless the latter did not also hold the asset on the 18th June 1971.[8] In this case, the cost of the property to the new corporation will be the adjusted cost base of the asset to the predecessor corporation, computed at that time according to the transitional provisions,[9] and when the new corporation subsequently disposes of the asset, it will not compute any gain or loss in accordance with those provisions, but will use as its cost the adjusted cost base as calculated at the date of the amalgamation.[10] In regard to depreciable property, the transitional provisions apply to the new corporation when he disposes of the property, as they would have done to the predecessor corporation, had it retained the property.[11]

(ii) <u>Continuation of the tax position of the predecessor companies into the new company</u>.

The Act contains numerous provisions designed to put the new corporation in the same tax position as the predecessor corporations. In particular, the following are relevant to this thesis:

a) <u>Paid-up capital deficiency</u>.[12] The total paid-up capital deficiencies of the predecessor corporations, less any 1971 capital surplus on hand of any such corporation, is added to the paid-up capital deficiency of the new corporation.[13]

b) <u>1971 Capital surplus on hand</u>.[14] The total 1971 capital surplus on hand of all the predecessor companies, less the paid-up capital deficiency of any such company, is added to the 1971 capital surplus on hand of the new corporation.[15]

c) Paid-up capital. There is no express provision of the Act carrying through to the new corporation the paid-up capital of the predecessor corporations. This is significant, in view of the fundamental principle running through the Act that a corporation should only be able to distribute its assets to shareholders in the form of a taxable dividend, except in so far as the distribution simply constitutes a return of paid-up capital. This raises the possibility of a corporation, which has suffered large post-1972 losses and which has a large paid-up capital, being amalgamated with a profitable corporation, which would then be able to distribute some of its accumulated profits in the form of a return of paid-up capital received from the other company. This is prevented in the case where one predecessor corporation owns shares in the other such corporation, i.e. in a vertical amalgamation, by providing that the paid-up capital deficiency of the new corporation be increased by the amount that the adjusted cost base of the shares in question is exceeded by the paid-up capital of those shares.[16] This amount should represent the capital deficiency in the corporation which has suffered the losses, unless the losses occurred after the shares were purchased. There is no such provision for the case where one predecessor corporation was not a shareholder of the other such corporation, but presumably section 247 of the Act could be invoked to counter attempts to profit from this.[17]

d) Foreign Affiliates.[18] Where a foreign affiliate of a predecessor corporation becomes a foreign affiliate of the new corporation, for the purpose of the foreign affiliate provisions, adjustments made to the adjusted cost base of the shares held in the foreign affiliate while they were held by the predecessor corporation are treated as if made while they were held by the new corporation[19] and exempt dividends received by predecessor corporations are deemed to have been received by the new corporation.[20] However, there is no indication of when the non-resident company is deemed to have become a foreign affiliate of the new corporation - at the date of amalgamation or the date when it became the foreign affiliate of the predecessor corporation.[21] In the absence of express provision, the former must presumably be the correct date.[22]

e) Losses. Neither income nor capital losses can be carried forward from the predecessor corporation to the new corporation.[23] The amalgamation may also cause a change of control in subsidiaries of a predecessor corporation and a consequent restriction on the right to carry forward losses in such a corporation. This provision prevents taxpayers avoiding the rule, which limits the carry forward of losses on a change of control of a corporation, by amalgamating a profitable company with a company with previous losses.[24]

f) Capital dividend account.[25] If the new corporation is a private corporation,[26] there must be included in the computation of its capital dividend account, capital gains and losses realised by the predecessor corporations while private corporations and capital dividends received and paid by those corporations.[27]

g) Refundable dividend tax.[28] If the new corporation is a private corporation,[29] the refundable dividend tax of a predecessor corporation is added to its own refundable dividend tax.[30]

h) Public and private corporations. The status of the amalgamated corporation will generally depend on the rules already discussed, which determine this matter for corporations in general.[31] However, it is expressly provided[32] that if any predecessor corporation was a public corporation, then so will the new corporation also be a public corporation. This is to prevent a public corporation converting itself into a private corporation by virtue of an amalgamation.

i) Losses on a disposal of shares. For the purpose of sections 112(3) and (4), which restrict losses incurred by corporations and share dealers on a disposal of shares by reference to dividends received,[33] dividends received by the predecessor corporations are deemed to have been received by the new corporation.[34]

j) Designated surplus.[35] Where a predecessor corporation was controlled by the same corporation that controls the new corporation, the designated surplus of the former is added to that of the latter.[36] In any other case, there is added to the designated surplus of the new corporation the amount that would have been the designated surplus of a predecessor corporation if control of it had been obtained immediately before the amalgamation.[37] There is, however, no provision to continue the control period earnings of the predecessor corporations into the new corporation, so that such amounts will possibly be locked into the corporation until all its designated surplus is paid out. In the case of private corporations, this amount includes the taxed part of capital gains and investment income.[38] It will thus be desirable to pay out such amounts prior to amalgamation (if possible).

Where a corporation amalgamates with a corporation which it controls, the controlled corporation is deemed to pay a dividend to its parent equal to the amount of its designated surplus,[39] so that the latter will be required to pay a tax of 25% of this amount. Otherwise it would be possible to avoid the designated surplus provisions by utilising an amalgamation between a parent company and its subsidiaries. To roughly compensate for this and to exclude the amount so taxed from any computation of the new corporation's own designated surplus, the Act provides that the latter's designated surplus shall be reduced by the amount by which the adjusted cost base of the shares held by the parent company in its subsidiary exceeds the paid-up capital of those shares.[40] This amount should approximately represent the subsidiary's accumulated surplus prior to control being obtained, which is designated because of that event.

k) <u>1971 undistributed income on hand.</u>[41] Except when the computation is made for the purpose of computing the designated surplus of the new corporation, there is added to the 1971 undistributed income on hand of the new corporation any 1971 undistributed income on hand of any predecessor corporation.[42]

l) <u>Non-resident owned investment corporations.</u>[43] The new corporation can only have this status if all the predecessor corporations are non-resident owned investment corporations.[44] There is no provision to add to the capital gains dividend account of the new corporation any such account of a predecessor corporation. There are, however, provisions which allow the flow-through of refundable tax paid on other income by the predecessor corporations.[45]

m) <u>Mutual fund corporations.</u>[46] Where the new corporation is a mutual fund corporation, the refundable capital gains tax on hand and the capital gains dividend accounts of the predecessor corporations are added to the respective amounts of the new corporation.[47] There is no provision to continue these in the case of investment corporations.

(iii) <u>Treatment of shareholders in the predecessor corporations</u>.

Where the shareholder redeives preference shares in the new corporation in return for preference shares in the predecessor corporations and receives no other consideration for his preference shares other than preference shares having substantially the same rights and conditions (except as to voting rights), he is deemed to dispose of the old shares and acquire the new shares for proceeds equal to the adjusted cost base of the old shares.[48]

A common shareholder will be in the same position in regard to any shares received in exchange for his common shares, provided that none of the common shareholders in his predecessor corporation (other than other predecessor corporations) receive consideration for their old shares other than shares in the new corporation and all the common shareholders in that corporation between them receive at least 25%[49] of each class of common shares issued by the new corporation.[50] As an alternative, the shareholder who owns common shares in two or more predecessor corporations will obtain the same relief in respect of shares of any description issued to him by the new corporation in exchange for his common shares, if he personally receives 80% of each class of common shares issued by it and if none of the common shareholders in those predecessor corporations receives consideration for their common shares other than shares of the new corporation.[51] Where several classes of shares are received by common shareholders, the cost is apportioned between them according to their market values at the date of the amalgamation.[52]

The effect of the latter provisions is somewhat anomalous, in that it may result in shareholders of one company obtaining relief, but not those of another company. The first alternative, which requires the common shareholders of each company to obtain 25% of each class of the common shares of the new corporation, has the consequence that shareholders of not more than four companies can obtain relief.[53] Further, if a shareholder qualifies by obtaining 80% of each class of the common shares of the new corporation, he may preclude other common shareholders of other predecessor corporations from obtaining the benefit of these provisions under the first alternative.[54] It would also be possible for the preference shareholders of predecessor corporations to qualify for relief, but not the common shareholders.

Shares received in exchange for old shares as a result of a pre-1972 amalgamation are deemed to have been acquired by the shareholder at costs equal to the cost of the old shares for which they were exchanged.[55] As regards shares held on the 31st December 1971, in exchange for which new shares are received as the result of a post-1971 amalgamation, the position is that the new shares will take over the acquisition date and cost and fair market value on valuation day of the old shares, provided that the shareholder receives only shares of the same type for his shares in the predecessor corporation i.e. common shares for common shares and preference shares for preference shares.[56] In any other case the transitional provisions[57] will be utilised to compute the adjusted cost base of the old shares, which will form their proceeds of disposal and the acquisition cost of the new shares, but the new shares are not deemed to be assets held by the shareholder on the 31st December 1971, so that the transitional provisions will not apply on a subsequent disposal of those shares.[58]

In regard to the shares held by predecessor corporations in other such corporations, there would appear to be a disposition of such shares by virtue of their being cancelled.[59] There would appear to be no proceeds of disposition,[60] so that the result should be a capital loss. However, it has been suggested that such a capital loss should not be recognized, because there is in reality no loss to the shareholder and because it is arguable that the loss is realised after the end of the last tax year of the predecessor corporation.[61] In practice, it does seem that no loss should be permitted, but, on the other hand, it would appear that there is technically a loss and that the above arguments are very weak.

Having discussed the tax consequences of an amalgamation governed by section 87, it is now necessary to consider briefly amalgamations which fall outside its ambit. First of all, it is clear that there will be a disposal by shareholders of their shares for proceeds equal to the value of consideration received by them for those shares,[62] but it is not so clear that there would always be a disposal of their assets to the new corporation by the predecessor corporations. The general position of company law appears to be that the new corporation is simply a continuation of the predecessor companies and not in fact a new company[63] and it should be remembered that even section 87 makes no express provision to exclude any possibility of a disposal of assets being made by predecessor corporations and that the section is expressed not to apply where the amalgamation takes the form of an acquisition of another corporation's assets by way of purchase. This suggests that the answer may depend on the facts of each case. There will clearly be a disposal of assets by predecessor corporations where assets are actually transferred to a newly set up corporation or to one of the existing corporations, but not where the amalgamation takes the form of a simple merger of the predecessor corporations as is, for example, provided for in sections 268-272 of the British Columbia Companies Act.

Similar considerations may govern whether the tax position of the predecessor corporations is continued into the new corporation, where section 87 is inapplicable.

B. United Kingdom

The basic rules governing company amalgamations are found in paragraphs 6 and 7 of schedule 7 of the F.A. 1965, as amended by later F.A.s, and section 267 of the I.C.T.A. 1970. The three aspects dealt with when considering section 87 of the Canadian Act will again be considered separately.

i) Transfer of assets to the new corporation.[64]

Section 267 of the I.C.T.A. 1970 applies where "any scheme of reconstruction or amalgamation[65] of a company involves the transfer of the whole or part of a company's business to another company"; at the time of the transfer both companies were resident in the U.K.; and the transferor receives no consideration for the transfer (otherwise than by the other companies taking over the whole or part of its liabilities). It provides that the assets included in the transfer are deemed to be disposed of by the transferor and acquired by the transferee for such proceeds as produce neither a capital gain or loss and that where those assets were held by the transferor on the 6th April 1965, the latter's acquisition of the assets is deemed to be the transferee's acquisition.

Thus, unlike the Canadian Act, the U.K. Act expressly relieves the predecessor companies from any possibility of tax arising in respect of capital gains accrued to assets disposed of to the new corporation and ensures that the latter company takes over fully the position of its predecessor companies in regard to assets held at the beginning of the Capital Gains Tax system. Moreover, although the U.K. provisions are expressed not to apply to trading stock of the transferor company,[66] there are other provisions which have a similar affect on such assets as does section 267 on capital assets.[67]

(ii) <u>The continuation of the tax position of the predecessor companies into the new company</u>.

The requirement for provisions to continue the tax position of predecessor companies into a new corporation formed by an amalgamation depends on the type of amalgamation which is offered by the Company Laws of the two countries. Whereas the Canadian Acts generally permit two or more companies to merge together to form one,[68] in the U.K. no special powers of amalgamation are given to companies,[69] so that any amalgamation must be carried out using the ordinary powers of companies to dispose of and acquire assets and to issue and acquire shares. Thus in Canada, the predecessor companies will cease to exist, while in the U.K. they will remain in existence as operating subsidiaries, where the amalgamation takes the form of a take over of one company by another, or as empty shells, where it involves the transfer of their assets to the new corporation in return for shares in the new corporation being issued to their shareholders. The Canadian Companies Acts would recognize amalgamations of this latter type, but they would clearly fall outside the scope of section 87 where they took the form of a take over and would probably do so in the other case, as involving the acquisition of another company's assets by way of purchase.

It is apparent that if the U.K. predecessor company remains in existence as an operating subsidiary, there is no call for special provisions to continue its tax position beyond the amalgamation. Rather the opposite is the case. The provisions of section 483 of the I.C.T.A. 1970 may apply, which eliminate the right to carry forward trading losses to future years, when there is a change in control of the corporation accompanying a change in its trade. There is no equivalent restriction on the carry forward of capital losses.

There is, however, a possible need for such continuation provisions when the amalgamation involves the predecessor companies transferring all or part of their assets to the new company. In fact the only relevant provisions are sections 252 and 253 of the I.C.T.A. 1970, which in effect treat the new company as the predecessor corporations for the purposes of the rules which govern depreciation allowances and permit the carry forward of trading losses to future years.

(iii) Treatment of Shareholders

Paragraph 6 of schedule 7 of the F.A. 1965 has effect when a company issues shares or debentures to a person in exchange for shares or debentures in another company and it applies paragraph 4 of the same schedule (which primarily deals with the situation where an internal reorganization of a company's capital takes place and is discussed later)[70] as if the two companies were the same company and the exchange was an internal reorganization of capital. Paragraph 4 provides that where shares or debentures are issued by a company in respect of existing shares in the course of a reorganization or reduction of share capital, the transaction shall not be treated as "involving any disposal of the original shares[71] or any acquisition of the new holding[72] ... but the original shares (taken as a single asset) shall be treated as the same asset acquired as the original shares were acquired".[73] Thus the new holding received as the result of the amalgamation is treated as if it had been acquired at the same time and for the same price as the original shares.

Paragraph 6 only gives relief if either the issuing company already has control[74] of the other company when it issues the shares or debentures in question or, as a result of the issue, the issuing company will have control of that other company or if the original offer to the shareholders of the other company by the issuing company was in the first instance conditional on sufficient of those shareholders accepting the offer to give to the issuing company control of the other company.[75] The last of these three conditions is fulfilled even if the offer is eventually made unconditional before there have been sufficient acceptances to give control,[76] but in the case where the offer is made to debenture holders, this last condition is not enough to bring paragraph 6 into operation, as the issuing company must already have control or obtain it as a result of the issue.

Whereas paragraph 6 looks to the situation where one company makes an offer to shareholders of another company, with or without the compliance of its management, paragraph 7 of schedule 7 requires an arrangement to be entered into between a company and its shareholders or debenture holders, for the purpose of or in connection with a scheme of reconstruction or amalgamation,[77] whereby "another company issues shares or debentures to those persons in respect of and in proportion to ... their"[78] existing holdings, which are either retained or cancelled. In this case also paragraph 4 is applied as if this were an internal reorganization of capital.

Where the shareholder receives a new holding consisting of several classes of shares or debentures, the total acquisition cost of the new holding will, unless the holding is disposed of in one lot, have to be apportioned among the classes. This will generally be done according to market values existing at the date of a subsequent part disposal of the holding. However, the Act provides a different rule[79] where one of the classes of shares is, within three months of the amalgamation, quoted on a recognised stock exchange in the U.K. or, in the case of a unit trust, one class of the units has its prices published regularly by the managers within the same period. The apportionment is then made according to market values on the first day of quotation or publication, as the case may be. This enables the shareholder to predict with certainty the apportionment to be made and does not leave him subject to the whims of fluctuating values on the stock exchange or in the manager's prices.

In Canada, the apportionment is made at the date of the amalgamation.

In determining the acquisition cost of shares or debentures received as the result of an amalgamation which took place prior to 6th April 1965, the same rules are used as were described above, by virtue of a general rule[80] of the Act that where a computation of a capital gain has to be made by reference to events occurring prior to that date, all the Capital Gains Tax rules are applied, unless specifically excluded. Where the new holding represents shares or debentures which were held on the 6th April 1965 and the amalgamation took place after that date, the new holding is deemed to have been acquired at the same time and at the same price as the original shares.[81] These provisions are superceded in the case of shares or securities not quoted on a recognised stock exchange. Where such a new holding was received as the result of an amalgamation taking place prior to the 6th April 1965, their cost base is determined by virtue of a deemed disposition andreacquisition for proceeds equal to market value, which is deemed to take place at that date.[82] Further, where the amalgamation occurs after the 6th April 1965 and such a new holding is received in return for shares or securities which were held at that date, there is a disposal and reacquisition of the new holding at the date of the amalgamation for proceeds equal to market value. Any gain or loss on a subsequent disposal is then calculated in two stages, first by applying the ordinary transitional provisions to compute the gain or loss up to the date of the amalgamation and second by applying the general Capital Gains Tax rules to compute any gain accruing thereafter.[83]

The U.K. provisions which relieve shareholders are clearly much wider in their scope of operation than the equivalent Canadian provisions. Not only are there no minimum shareholding requirements in the new company for shareholders in the predecessor companies, but the provisions also apply to debenture holders and to debentures issued by the new company, which is not the case in Canada.

Further, by virtue of the application of paragraph 4 by paragraphs 6 and 7, the U.K. provisions also provide for the situation where the shareholder or debenture holder receives any other consideration for his old holdings than shares or debentures or gives additional consideration for his new holdings. Under section 87 of the Canadian Act, the receipt of non-share consideration by shareholders will generally bar them from relief completely. In the U.K., the result is simply a part disposal by the shareholder or debenture holder of his original holding for consideration equal to the non-share or debenture consideration received.[84] The U.K. Act also provides that where a shareholder or debenture holder gives additional consideration for his new holding, this amount is added to the acquisition cost of the original holding.[85] There is no express reference to additional consideration being given in Section 87 of the Canadian Act, but this is probably covered by section 53(1)(c), which allows a shareholder to raise the adjusted cost base of his shares where he makes a capital contribution to the company otherwise than by way of loan, which cannot reasonably be regarded as a benefit to another shareholder who is a relative of his. The amount allowed is the increase in the fair market value of the shares caused by the contribution.

The type of amalgamation to which the U.K. provisions apply is also much broader. They apply to the situation where two or more companies amalgamate by transferring[86] their assets to one of those companies or to a new company set up for the purpose, which then issues shares or debentures to the existing shareholders or debenture holders of the transferring companies,[87] and to the situation where one company takes over another company by issuing its own shares or debentures to shareholders or debenture holders of another company in return for their existing holdings.[88] In both cases the predecessor companies remain in existence, but, in the former case, they are empty shells with no assets, which can be wound up with no tax consequences.[89] Section 87 of the Canadian Act applies equally to the situation where two or more companies amalgamate to form one company,[90] but does not apply where the amalgamation takes the form of a take over of one company by another, with the company taken over remaining in existence as a subsidiary of the other. The result is that shareholders under Canadian Law can only obtain relief if two companies merge with each other by consent and not when one takes over the other by dealing directly with its shareholders without the compliance of its management.[91]

Another type of reorganization which is possible by virtue of these U.K. provisions, but not by virtue of the equivalent Canadian provisions, is one involving the splitting up of one or more corporations and their shareholders into two. Thus a company could spin off a part of its business and transfer it to a new company under section 267, which would then issue shares or debentures to some or all of the existing shareholders or debenture holders of the first company.[92] If these shares or debentures are issued to some of the shareholders or debenture holders only in return for their existing holdings in the first company and these holdings are cancelled, then the result will be two completely different companies with different shareholders. There are many variations on this type of reorganization which can be carried out, some involving more than one existing company. A Canadian Corporation could transfer a part of its business to another company under section 85 of the Act, but the shares issued by the transferee would have to be issued to the transferor company and the requirement that the latter has to receive at least 80% of each class of shares issued by the former would make it difficult for other companies to join in.

As regards shares held by predecessor companies in other predecessor companies, which are cancelled as a result of the amalgamation, the Act makes no express provision. It would appear that the same comment must be made as was made in connection with the same matter in Canada; that is, that there should be no capital loss accruing to such corporations, because in reality there is no such loss, but technically there may be such a loss.[93]

Lastly, section 87 of the Canadian Act applies to Canadian Corporations[94] only. Equally section 267 of the I.C.T.A. 1970 only applies to transfers of assets between resident corporations.[95] However, there is no limitation in the Act on the application of paragraphs 6 and 7, so that it would appear that resident shareholders and debenture holders will get the benefit of these provisions when they receive new shares or debentures in return for their existing holdings, because of an amalgamation of two or more non-resident companies or even an amalgamation between a resident and non-resident company. The failure to apply the provisions of section 87 to non-resident corporations has been much criticized.[96]

If an amalgamation fails to come within the terms of paragraphs 6 and 7 or section 267, then there is no difficulty in predicting the consequences. The shareholders will dispose of their shares and the predecessor corporations their assets for proceeds equal to the actual consideration received.[97] The problem of continuing the tax position of the predecessor companies into the new company does not arise. However, it is much more unlikely that a reorganization will fail to come within these provisions than is the case in Canada.

Part 2 - Reorganizations of Capital

This part discusses the internal reorganization of a company's loan or share capital. In particular, three areas will be dealt with. First, there is the reorganization carried out at the instance of the company, whereby shareholders or debenture holders are issued shares or debentures in return for their existing holdings or the rights of those shares or debentures are altered; second, the exercise by a shareholder or debenture holder of rights attached to his holding to convert it into another form of holding; and, third, the tax consequences of an exercise of a power held by some person having control of a company, which has the result that value passes out of his shares and into shares of another person.

A. Reorganization carried out at the instance of the company.

In Canada, the relevant provisions of the Act are found in section 86. This grants relief to taxpayers "where, in the course of the reorganization of the capital stock of a corporation, a taxpayer has, after 1971, disposed of and the corporation has acquired shares of any class of the capital stock of the corporation."[98] The cost to the taxpayer of any consideration received from the corporation other than shares of the corporation is the fair market value of such consideration.[99] In regard to consideration received in the form of shares, the section distinguishes two types of shares - common shares and preference shares. The cost to the shareholder of any shares received, where he receives shares of one type only (whether of the same or of a different type from those disposed of), is deemed to equal the adjusted cost base of the shares disposed of, less the deemed acquisition cost of any non-share consideration received.[100] Where he receives shares of both types, the above acquisition cost is divided between the two types, any shares of a different type from those disposed of receiving the lesser of their fair market value and the whole amount and the balance (if any) going to the shares of the same type received.[101] The proceeds of disposition of the original holding are deemed to equal the deemed cost to the taxpayer of all the property received by him from the corporation,[102] so that there will never be a capital gain, unless the fair market value of the non-share consideration received exceeds the adjusted cost base of the shares disposed of and there will never in any circumstances be a capital loss.

The terms actually used in the section appear to place some limitations on its scope of operation. The word "reorganization"[103] is not defined, but its ordinary meaning would appear to exclude the case where shareholders exercise rights attached to their shares to convert them into other shares or debentures. The requirement that there be a disposal of the shares by the shareholders and an acquisition by the corporation may very well exclude certain types of reorganization where there is a disposal of the shares by the shareholder, but not an acquisition by the company.[104] The section does not give relief to debenture holders nor where debentures are issued by the company in respect of shares.[105]

Where the paid-up capital of the shares issued by the corporation, together with the fair market value of any other property given to shareholders in return for their existing shares, exceeds the paid-up capital of those shares, there will be a deemed dividend to the shareholders equal to the difference, but there will not be a deemed dividend by virtue of any paid-up capital deficiency in the corporation.[106] Even if for some reason there is no deemed dividend, section 15 of the Act could apply to include in the shareholder's income, as a benefit conferred on him by the company, the excess of the value of the property received by him over the value of the shares disposed of by him.[107] However, the operation of these provisions would mean that the shareholder would not be taxed on any capital gain realised by him from disposing of the shares[108] and that the adjusted cost base of his shares would be increased by the amount included in his income,[109] so that such amounts would not be taxed again as capital gains in his hands on a future disposal of the shares.

Where the shares disposed of were held by the shareholder on the 31st December 1971, the cost to the shareholder of the new shares will be the adjusted cost base of the old shares computed in accordance with the transitional provisions,[110] and, on a subsequent disposal of those shares, the ordinary rules will apply to calculate any gain. There is no express provision for shares received as the result of a pre-1972 reorganization, so that the cost of those shares will be the value of property given up for them.

Similar, but somewhat more flexible, provisions are found in the U.K. Paragraph 4 of schedule 7 of the F.A. 1965 applies in relation to any reorganization or reduction of share capital and provides that such transactions will not "be treated as involving any disposal of the original[111] shares or any acquisition of the new holding[112] or any part of it, but the original shares (taken as a single asset) and the new holding (taken as a single asset) shall be treated as the same asset"[113] acquired as the original shares were acquired.

The term "reorganization of a company's share capital" is defined to include any situation "where persons are, whether for payment or not, allotted shares in or debentures of the company in respect of and in proportion to (or as nearly as may be in proportion to) their holdings of shares in the company ..." and any case "where there are more than one class of share and the rights attached to shares of any class are altered ..."[114] Thus the paragraph will clearly apply to all the situations covered by section 86 and more. In the first place, relief is given where debentures are issued in return for shares, although not when shares or debentures are issued in return for debentures.[115] In the second place, there is no possible problem arising from the fact that there may be a disposal of shares by the shareholder, but not an acquisition of those shares by the company. In particular, the paragraph expressly includes the situation where the reorganization takes the form of an alteration of share rights.

Moreover, the provisions apply to situations which would not strictly be called reorganizations. In the chapter on corporate distributions,[116] it was pointed out how generally bonus issues of shares are not treated as income distributions, but as a capital receipt to the recipient. In fact, bonus issues, together with rights issues, fall within paragraph 4, so that when received they simply form part of the original holding of shares in respect of which they are received.

A reduction of share capital is not defined, but is expressly not to include the paying off of redeemable share capital.[117] However, it will enable a company to substitute debentures for preference shares, by virtue of a reduction of the capital represented by the preference shares, followed by an issue of debentures.[118] This cannot be done under section 86 of the Canadian Act.

Where the shareholder receives consideration for his shares other than shares or debentures, there is deemed to be a part disposal of the original holding, but without prejudice to the new holding being treated as being at one with it.[119] Thus the effect is similar to that of section 86 of the Canadian Act in this respect, save that in the latter case any gain resulting will usually be deferred until the shareholder eventually disposes of his shares after the reorganization. However, the U.K. Act goes further, by including within the scope of the provisions dealing with such additional consideration received consideration which the shareholder receives or is deemed to receive from other shareholders in respect of a surrender of rights derived from the original shares.[120] The effect of the provisions which deem a disposal of shares where an amount is received by a shareholder from a company which constitutes a capital distribution,[121] is expressly preserved[122] and, by virtue of paragraph 8 of schedule 10 of the F.A. 1966, where a member receives or becomes entitled to receive a provisional allotment of shares and he disposes of his rights, the consideration received is treated as a capital distribution.[123] The importance of a payment being a capital distribution lies in the right given in such a case, where the distribution is of a small amount, to postpone the incidence of a capital gain by deducting the amount of the distribution from the cost base of the recipient's shares.[124]

As in Canada, it is possible that the shares or other property distributed by a company to shareholders in the course of a reorganization may constitute income receipts in the hands of the recipients to the extent that their value exceeds the value of the property given up by the shareholder or a return of paid-up capital.[125] In this case any capital gain also arising would not be taxable,[126] but, on the other hand, there is no provision, as is found in Canada, to increase the cost base of the shares affected by the amount taxed as ordinary income, so that such amounts could be taxed again on a later disposal of those shares as a capital gain.

Any additional consideration given for the new holding is added to the adjusted cost base of the original shares and hence to that of the new holding.[127] Again, there is no express provision in Canada covering this aspect other than section 53(1)(c).[128]

As regards shares and debentures received as the result of a pre-6th April 1965 reorganization and shares or debentures received in the case of a reorganization taking place after that date for shares held on that date, the position is the same as for corporate amalgamations.[129]

The rules which apply in the case of amalgamations, both in the U.K. and Canada, for apportioning the deemed acquisition cost among a number of different classes of shares or debentures are also applied in the case of corporate reorganizations.[130]

Both paragraph 4 in the U.K. and section 86 in Canada apply both to resident and non-resident companies, so that resident shareholders of non-resident companies will obtain relief in respect of reorganizations of non-resident companies.

B. Conversion of shares and debentures.

There are two provisions in Canada dealing with the conversion of shares and debentures pursuant to a right attached to the holdings which are converted. Section 51 applies where "shares of the capital stock of a corporation have, after 1971, been acquired by a taxpayer in exchange for a preferred share, bond, debenture or note of the corporation ... the terms of which conferred upon the holder the right to make the exchange". The exchange is deemed not to have been a disposition of property and the cost to the taxpayer of the shares acquired is deemed to equal the adjusted cost base of the property for which they were exchanged.[131] The section is being amended to bring within its ambit the conversion of common shares into any other type of shares.[132] Tax relief is also given under section 77 of the Act to a taxpayer, where he acquires a bond of a debtor in exchange for a bond of the same debtor[133] and the terms on which the converted bond was issued conferred upon its holder the right to make the exchange. In this case the proceeds of disposition of the converted bond and the acquisition cost of the new bond are deemed to equal the adjusted cost base of the converted bond.[134] The term "bond" is not defined, but will presumably include debentures issued by a corporation.

As regards shares or debentures received as the result of a pre-1972 conversion and shares debentures received as the result of a post-1971 conversion of shares or debentures held on the 31st December 1971, the position is the same as for corporate reorganization.[135]

Paragraph 4 of schedule 7 of the F.A. 1965 is applied by paragraph 5 of the same schedule to "the conversion of securities as it applies in relation to the reorganization or reduction of a company's share capital".[136] A "conversion of securities"[137] is defined to include "a conversion of securities of a company into shares in the company",[138] a conversion at the option of the holder of the securities converted as an alternative to the redemption of those securities for cash"[139] and the conversion of shares or securities into securities as the result of a nationalization by the Government.[140] The new holding of securities received is thus deemed to have been acquired at the same time and price as the old holding and there is deemed to be no capital gain or loss resulting from the disposal of the latter.

It is clear that this provision will not be of relevance where the holdings being converted comprise either common or preference shares. However, in view of the definition of a "reorganization of a company's shares capital" contained in paragraph[141] 4 asincluding the allotting of shares or debentures in a company in proportion to a member's existing holdings of shares, it would appear that a conversion of shares into shares or debentures, brought about pursuant to a right attached to those shares, would come within the terms of paragraph 4 directly without the intervention of paragraph 5. Further, as paragraph 5 does not, unlike sections 51 and 77 of the Canadian Act, require that the conversion take place by virtue of a right attached to the securities in question, it appears that it would apply to a reorganization of loan capital carried out at the instance of the company. The Canadian provisions, unlike the U.K. provisions, fail to provide for the conversion of a share of any type into a debenture.[142]

The application of paragraph 4 means that the provisions of that paragraph dealing with the situation where the securities' holder receives or gives additional consideration in respect of the conversion also apply here.[143] There are no such provisions in Canada, save for section 53(1)(c), which was discussed previously.[144] However, this does not apply to debentures and does not meet the case where additional consideration is received in respect of shares or debentures converted. The most reasonable result in this situation would be a part disposal of the holdings to the extent of the additional consideration, but there is no authority for this. The only provision which might be of relevance is section 53(2)(iv), which requires the reduction of the cost base of shares in respect of any amount received before or after 1971 on a reduction of paid up capital, except to the extent that

that amount is deemed by section 84(4) to be a dividend received by the shareholder.

As regards securities held on the 6th April 1965, which are converted under paragraph 5 after that date, or securities acquired pursuant to a conversion occurring prior to that date, the rules described in the section on amalgamations are applicable.[145] The amalgamation rules also apply where the acquisition cost of a new holding of securities has to be apportioned among several classes.[146]

As in the case of the reorganization provisions, the conversion provisions in both systems apply to non-resident companies.

It could be argued that certain amounts received on a conversion of shares should be included in shareholders' income[147] on the same basis as under corporate reorganizations, but this seems less likely where the shareholder is simply exercising a legal right attached to his shares and the company is simply complying with an existing obligation.[148] Subject to this, the position will be the same as for reorganizations made at the instance of the company.[149]

C. Closely controlled companies - Anti-Avoidance Provisions

Where "a person having control[150] of a company exercises his control so that value passes out of shares in the company owned by him or by a person with whom he is connected, or out of rights over the company exercisable 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 ... by the person by whom they were owned or exercisable".[151] If the parties to the transaction do not deal at arms length,[152] the consideration received on the disposal is deemed to be the market value of what passes as a result of the exercise of control.[153]

The definition of control[154] for the purposes of this paragraph, on the face of it, clearly includes the case where two or more persons together satisfy the necessary conditions for control to be obtained. However, it has been suggested[155] that there are grounds in this case for limiting this definition of control, which is applied throughout the various taxing statutes, to the situation where the control is exercised by one person. Unless this latter argument is correct, which appears unlikely, this definition gives the paragraph a very wide scope.

It has also been suggested[156] that the person who has control must actually exercise it, so that it is not enough if he simply stands by and lets others do acts, which, if done by him, would bring the paragraph into operation. Although this argument appears to be technically correct, it is obvious that its correctness would result in the significance of the provision being reduced considerably.

The main problem arising in connection with this provision is the apparent conflict between it and the provisions which grant tax relief to shareholders when they receive a new holding of shares in the course of the various corporate reorganizations previously discussed in this chapter. If closely controlled company is reorganized internally or in relation to other companies, with the result that there is a drop in the value of the controller's interest and a corresponding increase in any other party's interest, the paragraph may deem a disposal of the controller's interest to have taken place.[157]

Although there is no express provision to this effect in Canada, such transactions will probably fall within the general anti-avoidance provisions. Thus, by section 245(2), where, as the result of one or more transactions of any kind, a person confers a benefit on a taxpayer, that person shall be deemed to have made a payment to the taxpayer equal to the amount of the benefit conferred, notwithstanding the form or legal effect of the transaction or that one or more other persons were parties to it or that there was no intention to avoid taxes. The payment is deemed (depending on the circumstances) to be included in computing the taxpayer's income, deemed to be a payment of income to a non-resident which is subject to thewithholding tax or deemed to be a disposition by way of gift. In a Gift Tax case[158] an identical section was applied in the same sort of situation as that for which paragraph 15 of the U.K. Act was intended, i.e. a taxpayer who controlled a company attempted to transfer the value of his majority shareholding to his sons, by causing the company to grant to all shareholders rights to subscribe for additional shares, which were taken up by the sons, but not by the father, and which had the effect of diluting the value of his own holdings. In that case, the father was deemed to make a gift of the shares for Gift Tax purposes, but it appears that there would now also be a disposition of an interest in his shares for proceeds equal to the market value[159] of the interest disposed of.[160]

It is thus clear that in contemplating a reorganization of closely controlled companies in either system, regard should be had to these anti-avoidance provisions. They make it difficult for the tax planner to make a gift of assets under the guise of a corporate reorganization, but they may also make life hard for the innocent.[161]

Part 3 - Corporate Liquidations

Only in Canada is there an express provision dealing with corporate reorganizations involving the liquidation of a corporation. Section 88 of the Act deals with the situation where "a Canadian Corporation has been wound up after 1971 and all the issued shares of the capital stock thereof were immediately before the winding up owned by another Canadian Corporation".[162] All property transferred to the parent company by the subsidiary is deemed to be disposed of for proceeds of disposition equal to its cost amount.[163] This is defined, in the case of depreciable property, as equalling its undepreciated capital cost[164] and, in the case of other capital property, as equalling its adjusted cost base.[165] In the former case, the parent also takes over the capital cost to the subsidiary where this exceeds the undepreciated capital cost.[166] Thus there will be no capital gains or losses realised by the subsidiary if it distributes assets in specie to the parent and does not sell the assets beforehand and distribute cash. Further provisions provide for the transfer at cost of non-capital assets.[167]

The acquisition cost of property received by the parent is deemed to equal the deemed proceeds of disposition of such property to the subsidiary.[168] In addition, the parent may write up the cost of capital property (other than depreciable property) received up to its market value, by allocating among such property the amount by which the adjusted cost base of its shares in the subsidiary exceeds the cost amount to the subsidiary of all its property and its cash (less any outstanding liabilities).[169] This ensures that the assets received take over the adjusted cost base of the shares and that the parent company will only be liable on capital gains realised, on a subsequent disposal of those assets, to the extent that they accrued while the other corporation was its subsidiary or while it personally owned the assets. On the other hand, where a large part of the price paid for those shares was attributable to goodwill or depreciable property, then it may not be possible to allocate fully the allowable amount.[170]

Where the property received by the parent was held by the subsidiary on the 31st December 1971, then the position would appear to be the same as for a new corporation resulting from an amalgamation under section 87 of the Act in respect of property held by a predecessor corporation on that date.[171] This includes the rule which puts the new corporation in the same position as if it had acquired such property at the same time and at the same price as the predecessor corporation, where the latter also held the property on the 18th June 1971.[172]

Although the subsidiary is allowed to transfer its assets to the parent corporation without incurring any liability to pay Income Tax on capital gains, the parent company is treated very much as any other company which receives a distribution on the liquidation of another company. Its only advantage is that the assets distributed in specie are valued at their cost amount to the subsidiary and not at market value. Thus there will be a dividend deemed to be paid to the parent by the subsidiary to the extent that the cost amount of the latter's property and its cash (less its outstanding liabilities) exceeds the paid-up capital limit of the corporation.[173] This means that designated surplus tax will be paid by the parent corporation, as if the whole of the subsidiary's designated surplus had actually been distributed in one dividend. In addition, the dividend will be payable from the various available tax free sources e.g. Capital dividend or capital gains dividend accounts and pre-1972 surpluses.[174]

Moreover, to the extent that the paid-up capital limit or, the cost of the subsidiary's assets plus its cash (less its outstanding liabilities) exceeds the adjusted cost base to the parent of its shares in the subsidiary, there will be a capital gain. On the other hand, the parent corporation can never realise a loss on its shares, as their proceeds of disposition are deemed to equal their adjusted cost base, unless this is exceeded by the paid-up capital limit of the subsidiary corporation or the cost amount of the subsidiary's property and its cash (less its outstanding liabilities), in which case the lesser of the latter two amounts forms the proceeds of disposition.[175]

There is an obvious limitation on the usefulness of section 88 in the requirement that both participating corporations must be Canadian corporations and that the parent corporation must own all the issued shares of the subsidiary corporation. However, the section will be useful in its limited sphere of operation.

In the U.K., although there is no express provision similar to section 88 of the Canadian Act, a similar effect could be achieved by the use of the group transfer provisions.[176] These would allow a 75% owned subsidiary company to transfer its capital assets[177] to its parent company for such consideration as would result in neither a capital gain nor a capital loss. A similar result could be brought about using section 267 of the I.C.T.A. 1970. The subsidiary corporation would remain in existence, but as an empty shell without any assets. Although any losses resulting from a disposal of the parent's shares in such a subsidiary, as a result of its liquidation or otherwise, would be disallowed in so far as they were caused by these transfers,[178] the desired effect would be achieved of liquidating the subsidiary at no tax cost to the parent company. This is perhaps not as satisfactory as having an express provision covering the whole transaction, but surely more important than such provision is one which allows one corporation to take control of another. Although a Canadian Corporation can liquidate a subsidiary corporation with reduced tax consequences, there is no Canadian provision, as is found in the U.K.,[179] which relieves shareholders when one company makes another its subsidiary.

In neither the U.K. or Canada is there any provision which allows a corporation to be dissolved and for its assets to be passed in specie to its individual shareholders without tax being levied on any capital gains realised, even where the corporation is controlled by a small number of persons and could be said to be an incorporated proprietorship or partnership[180] and merely the alter ego of its members.

Part 4 - Conclusion

The provisions discussed in this chapter reveal areas of recognition by the two systems of the principle stated at the beginning of this chapter, which holds that no tax liability should arise in respect of capital gains when a corporation disposes of its assets or a shareholder disposes of its shares, where the disposal causes no substantial change in the underlying ownership of the assets nor any effective change in the shareholder's rights. However, both systems appear to be somewhat selective in the areas in which they choose to apply this principle. Thus both accept it where companies are amalgamated and when there is an internal re-organization of a company's capital, but only the U.K. extends it to the situation where the amalgamation adopts the form of a take over of one company by another. Further, Canada alone recognises that there is no fundamental change in economic realities when a parent company liquidates its wholly owned subsidiary, but draws the line at applying the same principle to the liquidation of a company wholly owned by an individual or small group of individuals.

It is extremely difficult to rationalise the different approaches taken by both systems and the reasons for them both including some situations within the ambit of the relieving provisions and excluding others, e.g. the liquidation of a company by an individual shareholder owning all its shares. The answer seems to lie in the pragmatic approach of governments, which perhaps accept in theory the principle of not taxing unless there is some underlying economic change, but hesitate to accept the far reaching implications of its rigid application in practice and the increased opportunities for tax avoidance caused thereby and only implement it in practice when it is absolutely necessary.

It does in fact appear to be true that this principle is of too vague a nature to be suitable for direct practical application and that policy decisions have to be made which may not have a very good theoretical foundation. Further, opportunities for tax avoidance are raised by provisions giving beneficial tax treatment to corporate reorganizations, as is shown by the provisions discussed in some parts of this chapter which aim at counteracting them. However, the wide ranging anti-avoidance provisions,[181] which give large discretionary powers to the Revenue Authorities to nullify the effect of avoidance schemes and which have been mentioned at various points of this thesis, make it very difficult for such schemes to be successful and it might be thought that the existence of such a safeguard could justify the extention of these tax relieving provisions. These anti-avoidance provisions are at their broadest in Canada, even though the provisions allowing tax free reorganizations are at their weakest in that system. It would at least seem justifiable for each system to recognise, as situations justifying tax relief, the situations which are so recognised by the other system.

NOTES

1 For a definition of this term see Part 5 of Chapter Two Section D (text at n. 318).

2 S. 87(1)

3 Id

4 S. 87(2)(e)

5 S. 87(2)(d)

6 S. 87(2)(f)-(j), (b),(p)

7 P. Farwell Statutory Amalgamations Corporate Management Tax Conference 1972 82 at 92. It could also be argued that there is no disposition because the new corporation is in reality a continuation of the predecessor corporations - Id. at 87.

8 S. 26(3), (5) and (5.1) I.T.A.R.

9 S. 26(3)-(4) I.T.A.R.

10 Whether this is advantageous or not must depend on the facts of each case.

11 S. 20(1)-(1.2) I.T.A.R.

12 See Part 1 of Chapter Three Section C (text at nn. 58-60)

13 S. 87(2)(s)

14 See Part 1 of Chapter Three Section E.

15 S. 87(2)(r)

16 S. 87(3)(a)

17 For s. 247 see Part 2 of Chapter Four Section A.

18 For an account of foreign affiliates see Part 1 of Chapter Four Section C.

19 S. 87(2)(u) - See Part 1 of Chapter Four Section C (text at n. 80).

20 S. 87(2)(u) - see Part 2 of Chapter Four Section A (text at nn. 139-142).

21 This will be important for computing what proportion of the foreign affiliate's capital gains are to be included in foreign accrual property income. That proportion which accrued prior to the company becoming a foreign affiliate is not so included - see Part 1 of Chapter Four Section C (text at n. 70).

22 The only argument against it would be that the new corporation is really a continuation of the predecessor company.

23 S. 87(2)(w)

24 S. 111(4)-(5) - see Part 3 of Chapter Two Section A (text at nn. 122-4)

25 See Part 2 of Chapter Three Section A.

26 See nn. 31-32 infra.

27 S. 87(2)(z.1)

28 See Part 2 of Chapter Three Section B.

29 See nn. 31-2 infra.

30 S. 87(2)(aa)

31 See the Conclusion to Chapter Three (text atnnn. 281-292)

32 Added to the Act by s. 26(4) 1973 Bill C-170.

33 S. 112(3)-(4) - see Part 2 of Chapter Four Section A (text at n. 138)

34 S. 87(2)(x)

35 See Part 2 of Chapter Four Section A.

36 S. 87(2)(gg)(i)

37 S. 87(2)(gg)(ii)

38 See Part 2 of Chapter Four Section A (text at nn. 125-6)

39 S. 192(3)

40 S. 87(3)(b). For a fuller discussion of this see P. Farwell, supra n. 7 at 100-101.

41 See Part 1 of Chapter Three Section E.

42 S. 87(2)(hh)

43 See Part 5 of Chapter Two Section A and Part 3 of Chapter Three Section A.

44 S. 133(8)(d)

45 S. 87(2)(cc)

46 See Part 5 of Chapter Two Section C and Part 3 of Chapter Three Section B.

47 S. 87(2)(bb)

48 S. 87(4)(a)

49 This percentage is reduced by an amount equal to that percentage of the actual percentage of each class of common shares of the new corporation obtained by common shareholders of a predecessor corporation (other than other predecessor corporations) that the fair market value of the common shares of the predecessor corporation held by other such corporations is of the fair market value of such shares held by all other persons - s. 87(5).

50 S. 87(4)(b)

51 Id.

52 Id.

53 G. Tamaki Corporate Mergers, Rollovers and Designated Surplus 1971 Conference Report Canadian Tax Foundation 144 at 146. This may not be so if predecessor corporations held shares in each other - see n. 49 supra and text.

54 This may not be so if the predecessor corporations held shares in each other - see n. 49 supra and text.

55 This provision was added as s. 26(15) I.T.A.R. by s. 75(7) 1973 Bill C-170.

56 1973 Budget Resolution I.T.A.R. 7

57 S. 26(3)-(4) I.T.A.R.

58 Whether this is advantageous or not must depend on the facts of each case.

59 S. 54(c)(ii)(A)

60 If the parties do not deal at arms length, s. 69(1)(b) might deem the proceeds to equal market value, but this could only be if the predecessor corporation could be said to dispose of the shares to the new corporation - see Part 2 of Chapter One and Part 4 of Chapter Two Section B (text at n. 207).

61 P. Farwell, supra n. 7 at 106.

62 S. 54(c)(ii)(A) - see n. 60 supra.

63 P. Farwell, supra n. 7 at 87.

64 The amalgamated corporation will continue to be referred to as the "new corporation". Similarly, the term "predecessor corporation" will continue to be used.

65 Defined in s. 267(4) as a scheme of reconstruction of any company or companies or the amalgamation of any two or more companies. For an account of the judicial interpretation of the terms "reconstruction" and "amalgamation" see J. Shock <u>Reconstruction and Amalgamation</u> 1972 British Tax Review 226.

66 S. 267(2)

67 S. 137(1)(a) and s. 485 I.C.T.A. 1970. These two sections will generally ensure that a transfer of trading stock outside the normal course of business is for proceeds equal to market value. However, the actual proceeds may be used where the transferee uses the stock in a business which he carries on. This would normally be the case on an amalgamation.

68 See, for example, s. 268-72 of the B.C. Companies Act.

69 There are, however, as in Canada, powers given to the courts to expedite matters, to settle disputes and to protect various parties to the these transactions.

70 See Part 2 of this Chapter Section A.

71 "Original shares" are defined in Para. 4(1)(b) to mean, "the shares held before and concerned in the reorgan-iization".

72 "New holding" is defined in Para. 4(1)(b) to mean the shares or debentures which as a result of the reorganization "represent the original shares".

73 Para. 4(2)

74 Defined in s. 45(1) F.A. 1965 by reference to s. 302 I.C.T.A. 1970 - see Part 1 of Chapter Four Section A (text at nn. 15-16).

75 Para. 6(2)

76 G. Wheatcroft and A. Park Capital Gains Taxes Para. 12-30.

77 See Para. 7(3) for a definition identical to the one set out in n. 65 supra.

78 Para. 7(1)

79 Para. 7 sch. 10 F.A. 1966.

80 Para. 31 sch. 6 F.A. 1965.

81 Para. 4(2) sch. 7 F.A. 1965.

82 Para. 27(1) sch. 6 F.A. 1965.

83 Para. 27(2) sch. 6 F.A. 1965.

84 Para. 4(4) sch. 7 F.A. 1965.

85 Para. 4(3) sch. 7 F.A. 1965.

86 Under s. 267 I.C.T.A. 1970 - see text at nn. 64-7 supra.

87 The shares and debentures of existing holders are retained by them (they are worthless) - E. Weinberg Take Overs and Mergers Paras. 1709-16. Para. 7 sch. 7 F.A. 1965.

88 Para. 6 sch. 7 applies. An alternative procedure is for existing shareholdings to be cancelled and for new shares to be issued to the taking over company by the company being taken over. The taking over company would then still issue shares to the shareholders of the company being taken over - M. Weinberg, supra n. 87 Para. 7 sch. 7 F.A. 1965 applies to this alternative.

89 There is no express provision dealing with such a winding up, but the existing shareholders could make no gain or loss on the winding up, as the act deals expressly with the disposal of their shares in paras. 6 and 7 sch. 7 F.A. 1965. Further, although the company will have no assets, the new company which has acquired its shares will not be permitted to realise a capital loss resulting from the transfer of the predecessor company's assets to it, because such transfer will be a depreciatory transaction - see Part 4 of Chapter Two Section B (text at nn. 249-51).

90 The merger takes a different form from the U.K. amalgamation, but the result is basically the same.

91 If the company's management consent, then tax relief can be obtained by a merger under s. 87, but the parties may wish to create the parent - subsidiary relationship and may put this above the tax advantages to be gained under this section.

92 Paras. 6 or 7 sch. 7 F.A. 1965 would apply.

93 See text at nn. 59-61 supra.

94 For the definition of "Canadian corporation" see Part 3 of Chapter One (text at n. 59).

95 On the other hand, see s. 268 I.C.T.A. 1970 - see Part 4 of Chapter Two Section B (text at n. 258-262).

96 G. Tamaki, supra n. 53 at 149.

97 Unless the parties do not deal at arms length, when s. 22(4)(a) F.A. 1965 may apply. In regard to disposals of the shareholders' shares, for s. 22(4)(a) to apply there probably has to be both a disposal and an acquisition and it appears that there could be no acquisition here - see Part 2 of Chapter One and Part 4 of Chapter Two Section B (text at n. 207)

98 S. 86(1)

99 S. 86(1)(a)

100 S. 86(1)(b)(ii) and (c)

101 S. 86(1)(b)(i)

102 S. 86(1)(d)

103 For a discussion of the meaning of this word as found in s. 81(1) of the old Act see A. Stikeman Canada Tax Service Vol. B. 81-104 to 105.

104 R. Brown Capital Reorganizations Corporate Management Tax Conference 1972 114 at 142. It may be that a fundamental alteration of share rights might have this effect.

105 Such debentures will form part of the non-share consideration received.

106 S. 84 - see Part 1 of Chapter Three Section C, s. 84(5) and R. Brown, supra n. 104 at 140-41.

107 P. Walton Corporate Acquisition and Reorganizations 1971 Conference Report Canadian Tax Foundation 136 at 143. However, the transaction could come within the exception in s. 15(1)(d) - see Part 1 of Chapter Three Section C (text at nn. 61-4).

108 S. 39

109 S. 52(1) and S. 53(1)(b)

110 S. 26(3), (4) and (7) I.T.A.R.

111 See n. 71 supra.

112 See n. 72 supra.

113 Para. 4(2)

114 Para. 4(1)(a)

115 See text at n. 142 infra.

116 See Part 1 of Chapter Three Section C (text at n. 74).

117 Para. 4(7)

118 M. Weinberg, supra n. 87 at para. 1724.

119 Para. 4(4)

120 Para. 4(4)(b)

121 For what constitutes a capital distribution see Part 1 of Chapter Three Section D.

122 Para. 4(4)(a)

123 See n. 121 supra.

124 Para. 3(2) sch. 7 F.A. 1965 - see n. 121 supra.

125 It is not as certain in the U.K. as in Canada that such excess will be included in the shareholder's income, in view of the scanty provisions including in income a distribution made by a corporation in the form of shares. It seems unlikely that an issue of shares can constitute a "distribution out of assets" (s. 233(2)(b)) or a "transfer of assets" (s. 233(3)) or that a company issuing shares can be said to be incurring expense (other than administrativeexpense) in providing a benefit (s. 284). On the other hand it seems possible that the shareholder could be said to transfer assets to the corporation when it disposes of its shares in course of the reorganization - see Part 1 of Chapter Three Section C.

126 Para. 2 sch. 6 F.A. 1965.

127 Para. 4(3)

128 See text at nn. 84-5 supra.

129 See text at nn. 80-3 supra.

130 See text at nn. 79 supra.

131 S. 51(a)-(b)

132 S. 11 1973 Bill C-170.

133 Both bonds must have the same amount payable on maturity - s. 77(b).

134 S. 77(c)-(d). If the bond forms part of the holder's trading stock, the amount taken is the amount at which it was valued at the end of the last complete fiscal period of the business.

135 P. Farwell - Debt and Capital Gains Taxation 20 Canadian Tax Journal 101 at 104-5 (1972)

136 Para. 5(1)

137 Para. 5(3). "Securities" is defined in para. 5(3)(b), but includes only loan stock.

138 Para. 5(3)(a)(i)

139 Para. 5(3)(a)(ii)

140 Para. 5(3)(a)(iii)

141 See this part of this chapter Section A.

142 On the other hand, the convertibility of debentures into debentures under the U.K. Act is perhaps more limited.

143 Paras. 4(3)-(4) - see text at nn. 119-28 supra.

144 See text at nn. 84-5 supra.

145 See text at nn. 80-3 supra.

146 See text at n. 79 supra.

147 See Part 1 of Chapter Three Section C.

148 The only provision in the two systems which clearly continues to apply is s. 84(1) of the Canadian Act, which will apply if the conversion results in the company's paid-up capital being increased by more than the value of its assets - see n. 147 supra.

149 See text at n. 125 supra.

150 See n. 154 infra.

151 Para. 15(2) sch. 7 F.A. 1965.

152 See Part 2 of Chapter One (text at nn. 25-9) and Part 4 of Chapter Two Section B (text at n. 207).

153 Para. 15(1) sch. 7 F.A. 1965,

154 Defined in s. 45(1) F.A. 1965 by reference to s. 302 I.C.T.A. 1970 - see Part 1 of Chapter Four Section A (text at nn. 15-6).

155 G. Wheatcroft and A. Park, supra n. 76 at para. 7-18.

156 Id.

157 Id.

158 M.N.R. v Dufresne 67 D.T.C. 5105

159 S. 69(1)(c) will apply as the disposal is deemed to be a gift - see Part 1 of Chapter One (text at nn. 5 and 8)

160 See s. 43, which deals with part disposals.

161 G. Wheatcroft and A. Park, supra n. 76 at para. 11-12.

162 S. 88

163 S. 88(a) In the case of resource properties, the proceeds are deemed to be nil.

164 S. 248(1)

165 Id.

166 S. 88(f)

167 S. 248(1) & S. 88(a)

168 S. 88(c)

169 S. 88(c)-(d)

170 J. Ford Winding Up of a Corporation 1971 Conference Report Canadian Tax Foundation 154 at 156-7.

171 See text at nn. 8-11 supra.

172 S. 26(5) I.T.A.R.

173 S. 88(e)

174 For an account of this deemed dividend see A. Scace <u>The Purchase and Sale of Shares; Section 88 Winding-Up</u> Corporate Management Tax Conference 1972 51 at 71.

175 S. 88(b)

176 See Part 4 of Chapter Two Section B.

177 This does not cover trading stock, but see n. 67 supra.

178 The transfer of assets would be a depreciatory transaction - see Part 4 of Chapter Two Section B (text at nn. 249-51).

179 Para. 6 sch. 7 F.A. 1965 and see Part 1 of this chapter Section B.

180 There is, however, a U.K. provision which allows a corporation to transfer its assets to its liquidator at no tax cost and treats the liquidator's actions in relation to those assets as if they were the company's — s. 265(5) I.C.T.A. 1970.

181 S. 460 I.C.T.A. 1970 in the U.K. (see Part 2 of Chapter Four Section B) and s. 247 (see Part 2 of Chapter Four Section A) and s. 245(2) (see Part 2 of this chapter Section C) in Canada.

CONCLUSION

The aim of this thesis, as stated in its introduction, is a discussion of the taxation in the U.K. and Canada of capital gains realised by corporations and their shareholders and by unit trusts and mutual fund trusts and their unit holders and, in particular, the extent to which it accords with the principle laid down by the Canadian Royal Commission on Taxation that the form in which a business is carried on or property is held should have no adverse or advantageous effect on any person's tax liability. Now that the detailed statutory provisions found in the two systems have individually been considered, compared and assessed in relation to this principle, it only remains to see if some conclusions can be extracted from the mass of detail.

From the general principle of the Royal Commission there are derived two subsidiary principles which again should be considered. The first of these requires that capital gains and other income realised by a corporation and distributed by it to its members should suffer no more tax than if the same amounts had been realised directly by the member. Further, it requires that the same tax should be paid by a member on corporate earnings in his hands, no matter how they happened to reach those hands. Thus a shareholder should not be able to reduce his tax by selling his shares for a capital gain reflecting undistributed corporate earnings, on which he pays low rates of tax.

In fact the taxation of corporations and their shareholders was shown in Chapter Three to be only partially integrated for the most part, with a fuller degree of integration being granted in the case of private corporations in Canada and certain investment institutions in both systems. The agencies for this integration were the tax credit given to individual shareholders for corporate taxes, the deductibility of inter-corporate dividends and the varying special rights given to private corporations and the various institutions, e.g. low rates of tax, rights to pay special capital dividends, rights to obtain refunds of corporate taxes and special credits given to shareholders. It was concluded at the end of that chapter that, except for the failure of the U.K. system to enact special integrating provisions for private corporations, the degree of integration provided was in general a reasonable compromise.

However, the integration provisions discussed only apply, as a rule, in so far as the distributions, in respect of which they operate, are ordinary income in the recipient's hands. They do not apply to the extent that the distribution results in a capital gain in his hands. Even so, in light of the significantly lower rates of tax paid by all taxpayers on capital gains as opposed to other income, as shows in chapter two, it is still in the interests of taxpayers in the highest tax brackets to obtain corporate distributions in a form which will result in capital gains in their hands. Thus the statutes are replete with provisions, which were discussed in chapter three, to convert what would otherwise be capital receipts to the shareholder into ordinary income. Only in the U.K. is there any significant opportunity to obtain corporate distributions in capital form.

Moreover, the preference to obtain corporate earnings as a capital gain can be realised in other ways. In particular, if the corporation accumulates, rather than distributes, its income and capital gains, the shares in that corporation will rise in value accordingly. The shareholder can realise this rise in value by selling his shares for a capital gain. The provisions designed to attack this procedure were discussed in chapter four. The intention of these provisions is that there is nothing to stop a shareholder selling his shares for a capital gain on which he pays capital gains rates, unless it is part of some artificial tax avoidance scheme involving a sale to a purchaser whose special tax position enables him to obtain an actual distribution at low or nil tax cost.

However, their actual effect is often much broader.

Such schemes are additionally beneficial to shareholders in high income tax brackets because of the flat rate of tax paid by corporations, which is lower than the highest rates of personal income tax. A comparison of corporate and individual rates of tax was made in chapter two. Thus chapter four also deals with provisions found in both systems which discourage corporations from accumulating income. The methods of doing this are various, but include e.g. direct attribution of corporate accumulations to shareholders, special taxes on accumulated earnings and refunds of corporate taxes payable when distributions are made.

It can be seen that the low rate of tax payable on capital gains and the flat corporate rate being less than that paid by certain shareholders distort the system and require numerous provisions to counter the avoidance possibilities raised by them. On the other hand these anti-avoidance provisions, while making the tax system more complex, do have the merit of attempting to ensure the consistent tax treatment, in the hands of shareholders, of sums representing corporate surpluses, regardless of the fashion in which such sums come into their possession.

The second subsidiary principle derived from the

Royal Commission's main principle is a requirement that capital gains shall not be taxed if they result from a disposal which involves no change in the underlying beneficial ownership of the assets disposed of or which involve merely a change in the form in which they are held. Little more can be said about the application of this principle other than that sometimes it is recognised and sometimes it is not and that it is difficult to determine the basis on which the decision to recognise or not to recognise is made.

Chapter one described how both countries permit a taxpayer to transfer assets to a company in return for shares in that company without realising any capital gains accrued to those assets, but the circumstances in which this can be done are limited and differ in both systems. Moreover, as was shown in chapter two, while the U.K. has very broad provisions permitting tax free transfers of assets between members of groups of companies, the Canadian Act confines itself to the same narrow provision which applies on a transfer of assets by an individual to a company. The corporate reorganization provisions show significant differences between the two systems and omissions by both systems, which were discussed in chapter five.

At the conclusion of chapter five, it was emphasized how such distinctions in the application of the above principle to corporate reorganizations must not be grounded on theoretical considerations, but on pragmatic considerations of policy and tax avoidance. This reasoning should likewise be adopted when considering its application to the other areas covered by this thesis.

It seems, in general, that the legislators are much quicker to apply the Royal Commission's principle for the purpose of enacting tax avoidance provisions than for the purpose of enacting tax relieving provisions. The corporation is more readily identified with its members or other corporations under common control to prevent the corporate form being utilized to save taxes than it is to prevent additional taxation resulting from the use of this form. Thus the Canadian statute has very effective provisions which deem dispositions between related corporations to be for proceeds equalling the fair market value of the assets disposed of, but very limited provisions allowing a tax deferral on capital gains accrued to such assets, even though the transfer results in no substantial change in the underlying beneficial ownership of the asset. Similarly, the U.K. has anti-avoidance provisions charging close companies to Income Tax on their undistributed profits. These provisions recognize the power of shareholders over such corporations to prevent them avoiding tax by accumulating income within the corporation, but not so as to complete the tax integration of such shareholders and their members. It is to be hoped that legislators will in future bring the anti-avoidance and integration provisions more into line.

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TABLE OF ABBREVIATIONS

A. U.K.

F.A. 1965	Finance Act 1965 (c. 25)
F.A. 1966	Finance Act 1966 (c. 18)
F.A. 1967	Finance Act 1967 (c. 54)
F.A. 1968	Finance Act 1968 (c. 44)
F.A. 1969	Finance Act 1969 (c. 32)
I.C.T.A. 1970	Income and Corporation Taxes Act 1970 (c. 10)
F.A. 1971	Finance Act 1971 (c. 68)
F.A. 1972	Finance Act 1972 (c. 41)

B. Canada

I.T.A.	Income Tax Act 1971 (c. 63) This abbreviation is only used to avoid confusion. Generally, express reference to the Act is omitted, where it is obviously this act which is being referred to.
I.T.A.R.	Income Tax Application Rules (enacted in Income Tax Law Amendment Act 1971 (c. 64))