New rules for inter-corporate dividends

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The 2015 federal budget introduced a number of amendments to subsection 55(2) of the Income Tax Act (the Act) that could have an impact on the tax treatment of certain inter-corporate dividends. Draft legislation released on July 31 kept most of the original proposals intact.

The following is a summary of the key changes and their possible impact.

Subsection 55(2)

Subsection 55(2) is an anti-avoidance rule intended to prevent the conversion of a taxable capital gain into a tax-free inter-corporate dividend. For example, it was intended to stop transactions where an Opco would pay a significant tax-free dividend to a Holdco, and then sell the shares of Opco for a much lesser amount. Due to its largely subjective "purpose" test and the availability of a number of exceptions that can get you out of the rules (for example, safe income dividends and butterfly reorganizations), subsection 55(2) has always been a very complicated provision to understand. Another key exception is the paragraph 55(3)(a) exception for related party dividends (this provision is addressed more fully below).

If subsection 55(2) applies, the portion of the inter-corporate dividend that is not sheltered by one of the exceptions is converted to proceeds of disposition, resulting in a taxable capital gain.

There are five main changes to the rules:

1 Broadening of the "purpose test"

2 Limitation on scope of related party exception

3 Changes for inter-corporate stock dividends

4 Allocation of safe income to certain types of shares

5 Changes to the Part IV tax exception

In its 2015 budget, the Department of Finance explained the mischief that it was trying to prevent. By using an inter-corporate dividend to cause the fair market value (FMV) of a share to fall below cost or the shareholder's cost of properties to increase, the shareholder could use the unrealized loss to shelter an accrued capital gain in respect of other property.

However, the proposals can potentially have a much broader impact than this. They apply to inter-corporate dividends received after April 20, 2015.

Broadening of the "purpose" test

One of the most notable differences between the old rules and the proposed rules is the addition of new "purpose" tests that could cause subsection 55(2) to apply. Under the old purpose test, subsection 55(2) could only apply where the purpose of the dividend was to reduce a capital gain on any share of capital stock immediately before the dividend was paid. Although this test continues to apply, the new added tests are no longer tied to a reduction in a capital gain, but can also apply where one of the purposes of the dividend is to effect either (a) a significant reduction of the FMV of any share or (b) a significant increase in the aggregate cost of property to the dividend recipient. This test can potentially be extremely broad, since the threshold for satisfying the "one of the purposes" test could be quite low. Adding to the subjectivity involved regarding what would constitute a "significant" reduction or increase, these new tests have created considerable uncertainty as to how they will be interpreted by the Canada Revenue Agency (CRA).

Limitation on scope of related party exception

The old rules also provided a related party exception to subsection 55(2) as long as the inter-corporate dividend was not paid as part of a series of transactions or events that involved an unrelated party. This exception applied to all types of dividends—cash dividends, stock dividends, deemed dividends, dividends-in-kind, etc.—and was commonly relied upon as a means to avoid subsection 55(2) in related party situations. However, effective for dividends received after April 20, 2015, the rules have been changed so that this exception now only applies to subsection 84(2) dividends and subsection 84(3) deemed dividends. This now puts all significant cash dividends that satisfy the "one of the purposes" tests at risk.

Changes for inter-corporate stock dividends

Under the old rules, the amount of a stock dividend for tax purposes was generally equal to the increase in paid-up capital of the issued shares (generally nominal). As a result, stock dividend shares could avoid being caught by subsection 55(2) as the amount of the dividend would be nominal. The proposed changes will essentially deem the "amount" of an inter-corporate stock dividend for purposes of applying section 55 to be the FMV of the issued shares. Consequently, high-low inter-corporate stock dividends that were previously not subject to a section 55 risk are now fully exposed.

Allocation of safe income to certain types of shares

One of the exceptions to being caught by subsection 55(2) is to show that the dividend was paid out of "safe income." The proposals have changed the way in which safe income is applied to dividends. Under the old rules, safe income could theoretically attribute to preferred shares if the preferred shares were entitled to share in the income of the corporation during the holding period. It was not always clear as to how this would apply to discretionary dividend preferred shares; however, this was seldom an issue due to the related party exception.

The proposed rules clarify that no safe income can attribute to dividends paid on discretionary dividend or dividend streaming shares (on the assumption that such shares cannot increase in value). Also, since safe income can only be applied to shares with a gain, no safe income can be allocated to loss shares. This was never an issue under the old rules; however, the new purpose tests discussed above provide that subsection 55(2) can now apply in loss situations.

Changes to the Part IV tax exception

Under the old rules, subsection 55(2) did not apply to any portion of a dividend for which the recipient was subject to Part IV tax that was not refunded to the recipient as a consequence of the payment of a dividend to a corporation (where that payment was part of the series of transactions or events). The new rules have narrowed the Part IV tax exception by providing that subsection 55(2) does not apply to any portion of a dividend for which the recipient was subject to Part IV tax that was not refunded to the recipient as a consequence of the payment of a dividend by the corporation as part of the series. This now includes situations where the corporation receives a dividend refund by paying a dividend to any person, including an individual, as part of the series.

What does this mean going forward?

A strict interpretation of the draft rules could cause the following types of common transactions involving inter-corporate dividends to be caught where a) the amount of the dividend is significant and b) one of the new "purpose" tests is satisfied:

- Asset protection transactions
- Capital gains exemption purification transactions
- The payment of dividends on dividend streaming shares

The CRA has confirmed that standard in-house loss consolidation arrangements, whereby dividends are paid on preferred shares between related companies, would not be within the ambit of the new purpose test. On the other hand, a standard creditor proofing technique involving the declaration of a large cash dividend by an operating company to a holding company would generally satisfy one of the new purpose tests. In this situation, the company would have to rely on the safe income exception to avoid having the dividend reclassified as a capital gain. The CRA's unfavourable position on this matter has increased the importance of safe income on hand.

The proposed changes to Section 55 have added significant uncertainty and complexity to what was already a very complex section of our tax rules. The CRA has stated that, over time, this uncertainty should be lessened as future rulings and interpretations are issued. In the interim, there are means of structuring most transactions to ensure that one of the exceptions permitted in the Act are met. Nevertheless, extreme care should always be taken when planning transactions involving inter-corporate dividends.

Please contact one of our firm's tax practitioners if you would like to discuss how these new rules might impact you and your corporation.

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