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Distribution of Corporate Surpluses Under the New Income Tax Act

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I. Historical Precis

During the years 1926 to 1938 many if the features concerning corporate distributions present in the current income tax act were enacted. Exemptions of inter-company dividends were allowed to avoid double taxation at the corporate level and triple taxation if such funds were paid to the shareholders, loans to shareholders and deemed dividends thereon, premiums paid to shareholders on security redemptions with their tax ability as dividends in the hands of the shareholders were all incorporated into the *Income War Tax Act.* In addition, the descretionary provisions of section 32A[1] were introduced empowering the Treasury Board if in their opinion transactions involved tax avoidance to tax such distributions.

In 1948 the *Income Tax Act* was completely re-written. Under these provisions corporations were directed to elect the method whereby they would distribute earned surplus to their shareholders. Distribution in the form of larger salaries were taxed in the hands of the recipient at his personal rate, dividends declared would again be taxed in the recipient's hands subject to the 20% dividend tax credit. The final form of distribution was found under section 105. Briefly this section allowed the disbursement of a company's earned surplus in the following circumstance:

(a) Upon the payment of 15% tax on pre 1950 earned surplus[2]

(b) For every dollar a company declared as a dividend, a similar amount could be paid out to shareholders upon the payment of 15% tax of the amount to be disbursed[3]

The government presumably was satisfied with 15% of the corporations retained income as it was possible through the definition of a dividend under the old income tax act to declare a non-taxable stock dividend consisting of redeemable preference shares with the corporation redeeming these shares which resulted in no additional tax either to the corporation or the recipient.

A major thrust of the 1948 *Act* was the elimination of the descretionary provisions given to the minister under section 32A of the *Income War Tax Act* and the introduction of the concept of designated surplus.[4] The consequence of the omission of the descretionary powers under section 32A of the *Income War Tax Act* set the stage for what has virtually been a 15 year battle between the tax payers and the taxing authorities.

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[1] *Income War Tax Act,* S.C. 1938, c. 48 and subsequent amendments.

[2] Section 105(1).

[3] Section 105(2).

[4] *Income Tax Act,* S.C. 1948, c. 52, s. 28(2).

Designated surplus was introduced into the 1948 *Act* to prevent one of the more obvious methods of "surplus stripping" — the distribution or elimination of corporate surpluses in a manner which avoids the payment of income tax by the person who ultimately receives the disbursement. Under the concept of designated surplus the undistributed income of a company became "frozen" if the company were to become a subsidiary company.[5] To the extent the dividends were paid out of designated surplus by the controlled corporation, the dividends were subject to ordinary income tax in the hand of the controlling corporation.[6] Only the surplus on hand at the time the subsidiary became a controlled corporation were designated and any subsequent surplus in the subsidiary corporation arose out of "controlled period earnings" and such surplus was not designated. Therefore dividends could be declared tax free between the two corporate entities.

The subsections of 28 were designed to prevent the following surplus stripping technique:

Company A Ltd.

Cash	4,000,000	Liabilities	2,000,000
Other Asset	2,000,000	Com. Stock	1,000,000
		Surplus	3,000,000
	6,000,000		6,000,000

Incorporate Company B Ltd.

Cash	1,000	Com. Stock	1,000
	1,000		1,000

(a) Incorporate a separate Company, B, by the shareholders of A, Ltd.

(b) Shareholders of A, Ltd. sell the shares of A, Ltd. at book value to B, Ltd. in return for a note or bond liability.

Company B Ltd.

Cash	1,000	Due to A Ltd. Shareholders	4,000,000
Investment A	4,000,000	Common Stock	1,000
	4,001,000		4,001,000

[5] *Ibid.*, s. 28(3).
[6] *Ibid.*, s. 28(1).

Company A Ltd. pays a dividend of $3,000,000 to B Ltd.

Company A Ltd.				Company B Ltd.	
Cash	1,000,000	Liabilities	2,000,000	Cash	Note Due
Other Assets	2,000,000	Com. Stock	1,000,000	3,001,000	4,000,000
				Invest. in	Common
	3,000,000		3,000,000	A 1,000,000	1,000
				4,001,000	4,001,000

B then redeems $3,000,000 of notes due to A Ltd. Shareholders.

Company A Ltd.		Shareholders	Company B Ltd.	
Cash	1,000,000	$3,000,000 capital gain from sale of their stock of A Company to B Company	Cash	1,000
Other Assets	2,000,000		Invest. in A	1,000,000
				1,001,000
			Note Due	
Liabilities	2,000,000		A Co.	1,000,000
Com. Stock	1,000,000		Com. Stock	1,000
	3,000,000			1,001,000

Reconsidering section 28(2), we see section 28(1) has no effect where:

(a) a dividend was paid by a corporation that was resident in Canada and that was controlled by the receiving corporation.

(b) the payer corporation had undistributed income (designated surplus) on hand at the end of its last complete taxation year before control was aquiced.

In the above circumstances the controlled corporation may not deduct (a) or (b).

The capitalization-of-earnings approach of surplus stripping was blocked with the concurrent operation of subsections 81(2) (3) and (4). The purpose of these subsections was to specifically place the earned surplus of a going-concern in the same position as the earned surplus of a corporation about to be wound-up, discontinued or reorganized.[7]

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[7] *Ibid.*, s. 81(1).

Under section 81(3) the following stripping technique was blocked:

Company A Ltd.

Cash	4,000,000	Liabilities	2,000,000
Other Assets	2,000,000	Com. Stock	1,000,000
		Surplus	3,000,000
	6,000,000		6,000,000

1. Capitalize the surplus into redeemable preferred shares.

Company A Ltd.

Cash	4,000,000	Liabilities	2,000,000
Other Assets	2,000,000	Com. Stock	1,000,000
		Surplus	3,000,000
	6,000,000		6,000,000

2. Have the company redeem the preferred shares.

Company A Ltd.

Cash	1,000,000	Liabilities	2,000,000
Other Assets	2,000,000	Com. Stock	1,000,000
	3,000,000		3,000,000

Shareholders — by preferred share redemption — $3,000,000, a capital gain.

Note that under section 81(3) where the whole or any part of a corporation's undistributed income on hand has been capitalized, a dividend shall be deemed to have been received and prorated amongst the shareholders who held shares prior to the capitalization.

To skirt the problems of sections 28 and 81, tax consultants devised a technique that avoided the restriction embodied in controlled corporations. This technique was accomplished in the following manner:

Company A — Balance Sheet

Cash	4,000,000	Liabilities	2,000,000
Other Assets	2,000,000	Com. Stock	1,000,000
		Surplus	3,000,000
	6,000,000		6,000,000

1. At the outset, the shareholders of A Company sell the shares to stockbroker B at book value or fair market value. At this point then the shareholders have $4,000,000.
2. The company pays a dividend of all its undistributed surplus to the shareholders (broker).

Company A Ltd.

Cash	1,000,000	Liabilities	2,000,000	Stockbroker	
Other Assets	2,000,000	Com. Stock	1,000,000	Dividend	3,000,000
	3,000,000		3,000,000		

3. The stockbroker then sells the shares to the original shareholders at book value, $1,000,000, taking a $3,000,000 loss from the sale of shares.

Net Cash Position

Company A Ltd.		Shareholders		Stockbroker	
Cash	1,000,000	Sale of Shares	4,000,000	Purchase of	
Other Assets	2,000,000	Less purchase		Shares	4,000,000
		of shares	1,000,000	Sale of Shares	1,000,000
	3,000,000				
		Net Cash	3,000,000	Trading Loss	3,000,000
				Div. Rec.	3,000,000
				Net Cash Flow	—

The broker reports a dividend income of $3,000,000 and deducts his $3,000,000 trading loss; thus he pays no tax.

NOTE: This strip could be effected by:

(a) tax exempt persons (charities)

(b) non-residents

(c) a dealer in securities

In 1955, parliament legislated section 105 B making the provisions of section 28 apply to:

(a) a non-resident corporation

(b) a person exempt from tax under 62 (other than a personal corporation)

(c) a trader or dealer in securities

As a consequence, if "a" and "b" receive funds (defined in the *Act* as designated surplus) they pay a tax equal to 15% of the disbursement, whereas "c" would be subject to a 20% tax.

In 1958, the *Income Tax Act* was amended to allow for the amalgamation of certain corporations by way of section 85(1). In turn, however, the amendment also allowed for the reduction of undistributed income of the amalgamating companies by what amounted to "de-designating" the designated surplus that may have existed prior to the amalgamation. In part, this result was inadvertently achieved by the fact that the amalgamated corporation was deemed under the *Act* to be a new corporation, and from the fact that designated surplus is measured by the undistributed income prior to control.[8]

One method commonly used to strip the surplus of a corporation was to effect a horizontal amalgamation of two controlled corporations. The technique proceeded in the following manner:

1. Incorporate a sister company (b), controlled by the same shareholders as the company whose surplus is being stripped. Then, amalgamate the two.

Company A				Incorporate Company	
Cash	4,000,000	Liabilities	2,000,000	Cash	1,000
Other Assets	2,000,000	Com. Stock	1,000,000	Com. Stock	1,000
	6,000,000	Surplus	3,000,000		
			6,000,000		

Amalgamated Company			
Cash	4,001,000	Liabilities	2,000,000
Other Assets	2,000,000	Bonds	3,000,000
		Com. Stock	1,001,000
	6,001,000		
			6,001,000

2. The company then redeems the bonds of the shareholders.

Amalgamated Company				Shareholders
Cash	1,001,000	Liabilities	2,000,000	3,000,000 bond redemption
Other Assets	2,000,000	Com. Stock	1,001,000	
	3,001,000		3,001,000	

Note that the bond redemption is non-taxable, thus the undistributed surplus is stripped free of tax.

[8] *Ibid.*, s. 28(6)(b)(ii).

Swiftly the minister moved to breach this gap by the 1959 Amendment 105c(1)(b). Prior to this Amendment, section 105c(1)(b) read that a 20% tax was to be paid on the aggregate amount of this surplus, calculated under section 82(1)(c), that exceed "the value of the assets of the new corporation (other than goodwill) less the liabilities of the new corporation immediately after the amalgamation ...". The wording of the Amendment permitted the non-taxable redemption of bonds, since bonds are liabilities. A specific reference to taxable liability (other than any liability for tax under this part — section 105c) is directed toward the recapitalization of undistributed surplus to debentures or bonds by amalgamated companies. Subsequent bond redemptions of this kind were taxable.

The tax specialist, however, keeping in stride with the minister, merely replaced bonds with redeemable preferred shares, and capitalized the undistributed surplus. The amalgamation then proceeded as in the previous method:

Amalgamated Company

Cash	4,001,000	Liabilities	2,000,000
Other Assets	2,000,000	Pref. Stock	3,000,000
		Com. Stock	1,001,000
	6,001,000		6,001,000

The preferred stock was then redeemed, and the shareholders received cash equal to the undistributed surplus of their original company, free of tax.

In order to prevent this capitalization technique in the stripping of surplus of amalgamating companies, the minister, under the 1960 Amendment, section 105c (1a) included classes of shares (such as preferred) to be a liability of the corporation. As a consequence, the proceeds from the redemption of the aforementioned shares would be taxable under section 105c(1).

Finally in 1963, parliament legislated the controversial section 138A in what appeared to be an admission of inability to draft legislation wide enough to prevent surplus stripping. Since this section once again introduced the concept of ministerial discretion, the *Income Tax Act* by 1963 had gone the full circle; the elimination of ministerial discretion was one of the prime objectives of the new *Act* of 1948.

One final technique, attempted and reported in 1967, D.T.C. 5334, was the Conn Smythe Case. The problem stemmed from Mr. Smythe's large holdings in his company, C. Smythe Ltd., and his wish for estate purposes, to distribute the assets of his company.

Smythe's alternative methods were three :

1. Dividends (section 38)
2. Tax Paid Undistributed Income, section 105 — a tax of 15% requiring two years and two elections, and 50% of undistributed income accumulated since 1949 to be distributed as dividends.
3. Sale to securities dealer (section 105(b) — requiring an effective tax of 16⅔% of the undistributed income).

Each of the alternatives was unattractive since the net worth of the company was:

Undistributed Surplus	$ 728,652
Capital Gains (approx.)	1,800,000 — 1,900,000

To obtain $275,000 net of taxes from the company, Smythe:

1. Incorporated C. Smythe for Sand Ltd., a new company having the same shareholders, and proportion of shares held as C. Smythe Ltd.
2. Sold all the *assets* of C. Smythe Ltd. to C. Smythe for Sand Ltd. at fair market value for a promissory note.

C. Smythe Ltd.		C. Smythe for Sand	
Assets — promissory note	2,611,769	Assets C. Smythe Ltd.	2,611,769
		Liabilities (prom. note)	2,611,769

3. Sale of the shares of C. Smythe Ltd. to stockbrokers in B.C. (for a fee of $41,433) financed through a bank loan.

Stockbrokers		C. Smythe Ltd. Shareholders	
Assets — C. Smythe Ltd. Shares	2,570,336	Cash	2,570,336
Liabilities — Bank Loan	2,570,336		

4. C. Smythe for Sand borrows $2,611,769 from a bank to repay the note to C. Smythe Ltd.

C. Smythe Ltd.		C. Smythe for Sand	
Cash	2,611,769	Assets (C. Smythe Ltd.	2,611,769
		Liabilities (Bank Loan)	2,611,769

5. Stockbrokers cause C. Smythe Ltd. to invest in their preferred shares and from cash realized, they repay their bank loan as of Step 3.

Stockbrokers		C. Smythe Ltd.	
Assets —		Assets —	
		Preferred	
C. Smythe Shares	2,570,336	Shares Stockbrokers	2,611,769
Net Cash	41,433		
Liabilities			
(Preferred Shares)	2,611,769		

6. The shareholders (Conn Smythe) with the $2,570,336 realized in Step 3, exchange their shares of C. Smythe for Sand book value $2,611,796, by buying debentures of C. Smythe for Sand Ltd., of $2,295,000; C. Smythe for Sand Ltd. used the cash from the sale of debentures and a bank overdraft to repay its bank loan.

Net Cash Positions

C. Smythe Ltd. — $2,611,769 in preferred shares issued by the stockbrokers but which are worthless.

C. Smythe for Sand Ltd. — purchased all the assets of C. Smythe Ltd., incurring a liability for debentures of $2,295,000 and a bank overdraft.

Stockbrokers — became the sole shareholders of C. Smythe Ltd. (a shell at this point) at a cost of $2,570,336 and issued their preferred to C. Smythe for $2,611,769. Thus their net cash flow was $41,433 (their fee).

Original Shareholders of C. Smythe Ltd. — exchanged C. Smythe Ltd. shares for book value $2,611,769 for cash of $275,336 and debentures of C. Smythe for Sand Ltd. worth $2,295,000. They also own the shares of C. Smythe for Sand Ltd. (which in turn, owns the assets originally owned by C. Smythe Ltd.).

The reason for this complex maneouvering was to avoid the surplus stripping amendments of the *Income Tax Act.* One will note that the transactions were not amalgamations; also the provisions of section 28 as applied via section 105(B) to brokers do not apply since no dividends were paid to the broker. Rather it was an issue of preferred shares issued by the broker bought by C. Smythe Ltd. Section 81 was not breached by the proceedings in that, as shareholders, they merely sold their shares of C. Smythe Ltd. — not a disbursement, distribution, nor dividend. Finally, and perhaps the most noteworthy feature of the attempt was that the

actual business assets of the Toronto Maple Leaf Gardens remained with the shareholders throught. This retention illustrates the purpose of surplus stripping, a purpose which is to distribute the earned surplus to the shareholders while ownership is retained in the corporation, or in the Smythe case, the assets of the corporation.

Interesting then is the success of the Tax Department in the Exchequer Court under section 137(2). Section 138A remains as a threat even though the justification for the implementation of section 138A was to stop surplus stripping such as in Smythe Case. The minister had sufficient powers under the then existing *Act* without legislation section 138A.

Because of an anomaly in the old *Income Tax Act*, designated surplus under section 28 was only created in a controlled corporation. Accordingly, if a parent company "A" controlling a subsidiary "B" was aquired by a Canadian corporation "C", dividends paid out of the undistributed income of the subsidiary company "B" could flow as a tax exempt dividend to company "A", and in turn be distributed as a tax exempt dividend to company "C", the controlling corporation. The distributions paid to the original parent company "A" became control period earnings in its hands, and consequently could flow free of tax to the purchaser "C".

The enactment of section 138A(1)(c) tended to halt this ploy of dividend stripping.

II. 1972 Income Tax Act

Under the new legislation the type of corporation which one deals with will now have a distinct tax effect. Differences between public and private corporations and between private corporations and Canadian controlled private corporations exist. This distinction between corporations constitutes a major departure from the previous tax legislation in so far as, under the old rules, all corporations were allowed the preferred rate of 21% on their first $35,000 taxable income irrespective of that incomes source.

Under the present *Act* all corporations are treated equally at the outset, only when the deductions and refunds are catagorized do the incentives isolate the "favoured corporations". One of the main thrusts of the new legislation is oriented towards a reduced tax rate for small private Canadian controlled corporations. This was as a result of a concerted public pressure following the release of the government White Paper on tax reform wherein it was proposed to abolish any reduced tax rate for small businesses. Philisophically it is obvious that the government wished to limit

any such tax favours to small Canadian corporations who needed the extra incentive in order to compete favourably with larger or international corporations. Such favour appears well founded considering the apparent reluctance of major lending institutions to advance venture capital to small business. It is suggested that under the assumption that new businesses and small business entities ought to compete with larger more established firms incentive by taxation is far more realistic than subsidization. The former sustains efficiencies and promotes viable growth, the later is little more than "make work". Subsidies are but a function of the lack of productivity.

One other concept which has partially been retained under the new legislation is that of integration. The legislation attempts to be neutral in the area of operating a business through a corporation, through a partnership or a sole proprietorship. In fact it is not completely neutral and there are some tax advantages to operating through a corporation however, not nearly so many now as under the former legislation. Capital gains, investment income and non active business income are taxed in a manner which neither benefits or penalizes those choosing to operate through a private corporation. The concept of a personal corporation has been removed from the new legislation.

a. *Small Business Incentive*

The failure of the White Paper to recognize the special status of small businesses was remedied by section 125. Whereas section 123 sets out the rates on corporate earnings, section 125 provides, in addition, for a deduction from taxable income should the company come under the definition of "Canadian controlled private corporation" and should the company's income source come from "active business". The section states that a Canadian controlled private corporation may deduct an amount equal to 25% of the least of:

1. The net profit derived from an act of business in Canada
2. The tax payable exceeding 2.5 times the foreign tax deduction claimed under section 126(1) on non business income and two times the foreign tax carry over claimed under section 126(2) on business income earned in another country by a Canadian resident.
3. The corporations "business limit" when the "cumulative deduction account" has reached an amount of $50,000.00 or less of the corporations "total business limit".[9]

[9] *Income Tax Act*, S.C. 1970-71, c. 63, s. 125(1), (2) and (3).

A Canadian controlled private corporation is defined in the *Act* as

> ...a private corporation that is a Canadian corporation other than a corporation controlled, directly or indirectly in any manner whatsoever, by one or more non resident persons, by one or more public corporations or by any combination thereof; [10]
>
> Therefore it is seen that a Canadian controlled private corporation is not a public corporation, nor a corporation controlled by a public corporation, nor a corporation controlled directly or indirectly by non residents, nor a non resident corporation, nor a company not incorporated in Canada (unless it was resident in Canada at June 18, 1971 and continued to be resident to date.

The concept of control means 51% of the issued voting shares.[11]

The idea of the legislation to apply this small business incentive only to small corporations is found in the "business limit" concept in which only $50,000 of profit per year may be eligible for the deduction and in the concept of a "cumulative deduction account" in which a maximum limit of $400,000 active business income is allowed. These concepts will be discussed at a greater length shortly. In addition to those two limiting factors there is to be an amendment to the new act deeming a private company with shareholders numbering more than 150 persons to be a public corporation. This of course would eliminate larger corporations from qualifying for the small business incentive.

To be eligible for the small business deduction a corporation must demonstrate that the income from which the deduction is claimed is generated from "active business". The definition of "business" is identical under the new act to what it was under the old.[12] In all likelihood the former jurisprudence relating to the difference between business income and income from property will appply under the new act. Any income generated from property will of course qualify for the small business deduction. Consequently passive income or income from investments will not be eligible for the deduction. The modifying word "active" is an unknown quantity. The jurisprudence which had arisen under the personal corporation concept which was present under the old *Income Tax Act* may or may not be definitive in ascertaining what constitutes "active business income". One of the criteria in the definition of a personal corporation was that the corporation "did not carry on an active financial, commercial or industrial business".[13] Many tax lawyers

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[10] *Ibid.*, s. 125(6)(a).
[11] *Ibid.*, s. 112(6)(b).
[12] *Ibid.*, s. 248(1).
[13] *Income Tax Act*, R.S.C. 1952, c. 148, s. 68(1)(c).

feel that some additional activity to the minimal amount which was apparently applicable under the personal corporation concept will be needed in order for the income to qualify as coming from "active business". Undoubtedly this will be subject to a considerable amount of litigation and guidelines formulated.

As mentioned previously there are two limitations set upon the small business incentive. In essence these constitute the governments definition of what is a small business. The first of these figures is the "business limit". A corporation may not claim the lower tax rate on more than $50,000 of active business profit in any one year. Therefore corporations whose taxable income exceeds $50,000 will not be able to claim the lower tax rate on the amount exceeding $50,000 but do not lose the lower tax rate for the $50,000 amount.

The second criteria which the legislation uses in order to define what is a small business is found in the concept of a "cumulative deduction account". Under section 125(2)(b) the *Act* uses the word "total business limit" which is a cumulative amount which, if exceeded, disqualifies the corporation for the small business incentive. This amount is set at $400,000 of active taxable business income earned subsequently to the implementation of the new act. The idea of a "cumulative deduction account" enables a corporation to delay reaching its total business limit indefinitely if the corporation is willing to declare taxable dividends. The "cumulative deduction account" is equal to the corporations active, before tax business income for that year plus four thirds of taxable dividends received from Canadian corporations, a controlled corporate resident in Canada and a non resident corporation that from June 18, 1971 has through a "permanent establishment" in Canada carried on a business throughout that year.[14]

From this amount may be deducted four thirds of the taxable dividends paid by the corporation to the shareholders,[15] and four times the amount that the corporations year end refundable dividend tax on hand [16] exceeds its dividend refund.[17] It is seen therefore that a corporation may declare a taxable dividend and reduce the cumulative deduction account by an amount equaling four thirds of the amount declared. For every three dollars of taxable dividend paid the cumulative deduction account may be reduced by four dollars.

[14] *Income Tax Act*, S.C. 1970-71, c. 63, s. 112(2).
[15] *Ibid.*, s. 125(6)(b)biii).
[16] *Ibid.*, s. 129(3).
[17] *Ibid.*, s. 129(1).

Hence, provided three quarters of the eligible corporations after tax active business earnings are annually declared as dividends, the corporation may claim its small business deduction indefinitely as it will continually keep its total business limit below $400,000. This is consistent with the government policy evidenced in the new *Act* of promoting taxable dividends to be declared out of corporations and not having the corporation build up very large surpluses.

Small business incentives applied as deduction are a major shift in Canadian tax policy. Under the old rules, all companies were allowed a reduced rate of taxation for the first $35,000 of taxable income irrespective of source.

The provisions respecting associated companies remained. Should the company be associated with one or more Canadian controlled private corporations, or be deemed by the Minister to be associated [18] (and no allocation has been made either by election or by the Minister) the corporations business limit for the year is nil. Only $50,000 of the associated compagnies earnings may be eligible for the small business deduction and the total business limit will be determined for the group as a whole. The only departure from the old policy of determining whether companies are associated is the concern with the degree of interlocking shareholders held by different related groups before the corporations are considered to be associated. Under section 39(4)(c) of the old *Act*, if only one voting or non voting share was held in the other corporation by a controlling member, the two companies may be deemed to have been associated. The extent of ownership has been expanded now to 10% of issued shares held directly or indirectly by one of the controlling persons.[19]

b. *Refundable Tax on Ineligible Investments*

As stated previously one of the major tenents in the new *Act* is to give the small business incentive only to businesses which in fact are going to use it in the business enterprise itself or as one departmental official has put it to limit it to those companies which really need it. Therefore, if the tax saving involved due to the reduction of the tax rate is not employed in the companies active business or disbursed as taxable dividends to the shareholders the effect of the tax saving is lost. Should the corporation for instance invest the savings resulting from the lower tax rate in stocks and bonds the concept of an "ineligible investment" arises and a special tax will be payable on the amount of the ineligible investment.

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[18] *Ibid.*, s. 247(2).
[19] *Ibid.*, s. 256(1)(c).

Ineligible investment is defined in section 189(4)(b) as "property that was not acquired for the purpose of gaining or producing income from an active business of the particular corporation" with certain exceptions relating to cash, government bonds maturing within one year, controlling shares of another Canadian controlled private corporation and bonds or debentures of certain other Canadian controlled private corporations which are dealing with the tax payer at arms length.

A refundable tax is levied on Canadian controlled private corporations to the extent that the source of the funds used to acquire ineligible investments has had the benefit of the small business deduction. For this reason section 188(1) specifies that the tax of 25% is payable on the lesser of two derivitives. The first[20] is equal to two times the cost of ineligible investments acquired after 1971 less the cost of ineligible investments acquired in prior years in respect of which the refundable tax had been paid. The second[21] is equal to the sum of the corporations "preferred rate amount" for that year which exceeds the cost of ineligible investments acquired in prior years (after 1971) in respect of which the refundable tax had been paid. The "preferred rate" amount is computed in section 189(4)(c) and may be said to equal the total income in respect of which the company has obtained the small business deduction, plus four thirds of taxable dividend received by a controlling corporation from its subsidiary. The effect of this section is to prevent a subsidiary which benefits from the small business deduction from dividending the after tax funds to the parent and having the parent make the ineligible investment to escape the tax. The effect of this section is that ineligible investments will be deemed to have been first acquired from "preferred rate" income. When the cost of the ineligible investment exceeds the corporations preferred rate amount and is not subject to the refundable tax in a given year, the excess is carried forward to be taxed in a year when no taxable dividends are distributed to the shareholders.

Should a corporation have a portfolio of investments at the end of 1961 any subsequent changes in the portfolio may revert the portfolio into ineligible investments subject to tax. Extreme caution should be exercised in relation to existing portfolios to keep it untainted and intact so as to avoid all probability of this tax.

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[20] *Ibid.*, s. 188(1)(a).
[21] *Ibid.*, s. 188(1)(b).

c. *Intercorporate Dividends*

The general rule under the new *Act* is to provide for a tax free intercorporate dividend when dividends flow from one tax paying Canadian controlled corporation to another or to a resident Canadian controlled corporation to another or to a resident Canadian corporation from its subsidiary. The dividends flowing may be deducted from the income of the receiving corporation[22] notwithstanding this deduction however, private corporations are subject to a special refundable tax of 33⅓% on some dividends received and deducted under sections 112 and 113. Among the dividends subject to this special tax are those from Canadian and foreign affiliate corporations not controlled by the receiving corporation. The imposition of this special tax on income received from corporations not controlled by the receiving corporation reflects the governments wish that an individual no longer may defer by accumulating dividend investment income in a holding company. Part of the dividend income received from a controlled corporation is also taxed at 33⅓% under section 186(1)(b). The amount taxed indicates the dividend refund received by the payor corporation in respect to the dividend paid to the controlling corporation.

The receiving corporation may elect to reduce the special tax payable by deducting any part of the corporations net operating loss for the year[23] or any residual loss carry over which may have been claimed against its own income.[24]

d. *Refundable Dividend Tax to Private Corporations*

Keeping with the governments objective of promoting the distribution of corporate profits, and the attempts at integrating corporate and individual income tax the *Act* provides that part of the tax payable on investment income in the hands of the private company, will be refunded to the company when the income is distributed as a taxable dividend to the shareholders.[25] This refundable tax is considered to be temporary; when the investment income is in the hands of the shareholders as taxable dividends the tax has served its purpose. The company has an inducement to pay out this income and claim the refund and the individual,

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[22] *Ibid.*, s. 112(1) and 113.
[23] *Ibid.*, s. 186(1)(c).
[24] *Ibid.*, s. 186(1)(d).
[25] *Ibid.*, s. 129(1).

while taxed at his marginal rate may claim a dividend tax credit on the amount of the dividend received.

The amount to be refunded to private corporations includes one half of the tax paid on investment income and all of the special 33⅓% tax paid under section 186 on portfolio dividends. The refund which need not be applied for is equal to the lesser at 33⅓% of the taxable dividends paid that year or the refundable tax dividend on hand at the end of the year.[26] "Refundable dividend tax on hand" is defined in section 129(3). This amount incorporates all taxes previously paid under section 186. In addition, there are some specific calculations relating to foreign investment income received.

The terms "Canadian investment income" and "foreign investment income" are defined in section 129(4)(a) and (b) respectively. In general, all the corporations non active business sources of income and losses are accounted for when computing the investment income for the year.

e. *Acquisition of Canadian Controlled Small Business by Non Resident*

A non resident may not claim the small business deduction; indeed when the control of a company which has had benefit of the deduction is acquired by a non resident the tax saving accumulated by the corporation over the years must be repaid.[27] The obvious purpose of these sections are to make small Canadian controlled business less desirable from the standpoint of foreign take overs.

Similarily the treatment of capital losses incurred before the change of control applies to this heading. No part of any capital loss may be carried forward as a deduction from a capital gain realized after the change in control.[28]

No repayment is required if any eligible corporation becomes a public corporation. Should control of the public corporation then fall into the hands of non residents the company would be required to repay the tax saving previously derived from the small business deduction.

[26] *Ibid.*, s. 129.
[27] *Ibid.*, 190 and 191.
[28] *Ibid.*, s. 111(4).

f. *Amalgamations*

Statutory amalgamations are defined in section 87(1) as "a merger of two or more corporations, each of which was, immediately before the merger, a Canadian corporation to form one corporate entity". The first taxation year of the new corporation is deemed to have commenced at the date of the amalgamation.[29] For the purposes of the small business deduction special rules apply; otherwise, by amalgamating, companies whose cumulative deduction account had reached its total business limit would merely have to amalgamate to once again qualify for the small business deduction. The impact of section 87(2)(y) serves to aggregate cumulative deduction accounts of the amalgamating companies. Should the aggregate be under the total business limit, the new company so formed by the amalgamation may claim a deduction to the extent of the business limit for that year. However, the aggregate of the companies refundable dividend tax on hand may be carried forward to the amalgamated corporation.[30]

III. Corporate Surpluses

Under the new *Act* many streams of after tax income are grouped under the heading "surplus". Each class of surplus requires separate tax treatment prior to the distribution to the shareholders. It is obvious therefore that the accounting requirements under the new act will be much more detailed and the source of the surplus will be of extreme importance. This is a fundamental shift from what was the case previously under the old *Act.*

a. *Distribution by Resident Corporations to Individual Shareholders*

(i) Distribution of pre 1972 Corporate Surpluses to Residents

As mentioned previously under the provisions of the old *Income Tax Act* extremely large surpluses were built up over the years in private companies. The new *Act* permits a corporation to pay a special 15% tax on the undistributed income accumulated between the corporations taxation years 1950-1971.[31] Upon payment of this tax "tax paid undistributed surplus on hand" is created.[32] Dividends

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29 *Ibid.*, s. 82(2)(a).
30 *Ibid.*, s. 87(2)(aa).
31 *Ibid.*, s. 196(1).
32 *Ibid.*, s. 89(1)(k).

paid from a corporation to the shareholders out of tax paid undistributed surplus on hand attract no further tax to either the corporation or the individual. "Tax paid undistributed surplus on hand" is merely the new wording for what was formerly "tax paid undistributed income" under the old *Act.* Should a corporation hold any accumulated tax paid undistributed income this becomes tax paid undistributed surplus under the new *Act* and dividends may be declared which are free of tax. All that is required in order for these tax free dividends to be declared is a directors' resolution indicating that the devidends are paid from this account. Such a distribution simplifies the procedure previously required whereby the tax paid undistributed income had to be paid out by way of redeemable preferred shares later to be redeemed by the corporation for cash. Once the "1971 tax paid undistributed surplus" has been wholly distributed the corporation may elect to declare a tax free dividend from its "1971 capital surplus".[33] In this manner the new *Act* avoids any retroactivity of capital gains accumulated by the corporation prior to the implementation of the new system.

"1971 capital surplus on hand" is defined in section 89(1)(1) and represents the corporations book surplus less its 1971 undistributed income on hand (updated to include any capital gains or losses having been realized by the end of the company's fiscal period and or December 31, 1971). Pre 1950 undistributed income is treated in a similar manner to 1971 capital surplus.

When a corporation elects to pay out a larger tax free disbursement then the amount to which it is entitled under section 83(1) the company becomes subject to a special tax on the excess. The tax equals the amount of the excess or 100%.[34] When it is considered that a corporations tax paid undistributed surplus on hand could be changed by virture of a reassessment sometime in the future which would then result in an excess amount having been paid which then becomes subject to a 100% penalty tax it is obvious that some frightening possibilities can occur from this penalty provision. Quite aside from a change to an assessment process it is extremely difficult to calculate with precise accuracy the 1971 tax paid undistributed surplus. It is understood however, that under certain conditions the Department of National Revenue will confirm a figure arrived at by the firms accountants as being the amount acceptable to the Department and certainly such steps

[33] *Ibid.*, c. 82(1)(1).
[34] *Ibid.*, s. 184(1).

should be taken prior to any further distribution which could be subject to the 100% penalty tax.

b. *Adjusted Cost Base*

The concept of "adjusted cost base" is a creature of the capital gains tax. A capital gain is calculated from the increment of appreciation from a base value or cost base of property set at valuation day. Should a corporation pay out tax exempt (section 83) distributions, any future capital gains realized of that capital stock would be artificially low without the subsequent adjustment of the shares cost base. As a result section 83(1)(d) and section 53(2)(a)(i) demand that any distribution "other than a taxable dividend or capital dividend"[35] must be accompanied by an equal deduction from the adjusted cost base of the corporations capital stock.

It is seen therefore, that if tax fee dividends referred to previously are paid the potential taxable gain is increased due to the fact that the adjusted cost base has been reduced by the amount of the tax free dividend paid. Where a company's worth is valued on assets alone this would not have a significant consequence due to the fact that if the surplus is taken out via the tax free dividend route the worth of the company will be reduced any hence the potential capital gains are roughly the same. If however a corporation is valued ont its earnings and a surplus is taken out via the tax free route it would not have a substantial effect on the value of the shares and yet the adjusted cost base of the shares would be reduced and upon disposition an increased taxable capital gain would arise.

Another consideration ties into the difficulty of small business gaining dependable low cost source of venture capital. Due to the "liquidity squeeze" that many small corporations find themselves in, it may be unlikely that they will pay out any 1971 undistributed income. Most of a company's surplus is usually bound up in working capital which dictates that the only way a company can pay out its earned surplus is either to liquidate the company's current assets or to borrow the amount intended to be distributed (thereby replacing surplus account as a means of financing with long or short term debt). These alternatives are uniattractive. Since the 1971 capital T.P.U.S. must be paid out fully before any 1971 capital surplus can be distributed a small company which remains a going concern probably will not take advantage of the section 83 election.

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[35] *Ibid.*, s. 53(2)(a)(i).

The personal corporation provisions under sections 67 and 68 of the old *Act* have not counterpart in the 1972 *Income Tax Act.* Corporations formerly qualifying as personal corporations will now be taxed as private corporations with one exception. Should a personal corporations fiscal year stradle the 1972 taxation year the company will retain its personal corporation status until the year end of its 1971-1972 taxation year as long as the company remains a personal corporation as defined under section 68(1) of the old *Act* during the period.[36]

With respect to 1971 undistributed income, section 57(8) allows the same section 83 election as private corporations. If the 1971 tax paid undistributed surplus is disbursed the company may then declare any of its 1971 capital surplus as a non taxable distribution. Since the personal corporations income is deemed as a taxable dividend to the shareholder the corporation's 1971 undistributed income would consist of tax paid undistributed income and be paid out as a non taxable distribution to the shareholders.

Dividends in the new *Act* include any distribution deemed or actually paid out of corporate surplus. Included are stock dividends and deemed dividends arising out of corporate reorganizations or by virtue of stock redemptions.

In place of the old section 105(2) election (enabling the corporation to pay out undistributed income tax free to the shareholders upon payment of a 15% tax — to the extent that dividends previously were declared and paid), the new *Act* states that shareholders receiving dividends paid from post 1971 surplus are to be granted a larger dividend tax credit (now 33⅓%). This however, is somewhat illusionary in that they have changed the method by which the amount of dividend tax credit is to be calculated. Under the old *Act* the dividend tax credit was deducted from the income tax payable. Under the new system there is a gross up and credit concept in which not only the dividend paid but the dividend credit is initially included as income and the credit taken from that increased amount. The arithmetic works out to the effect that shareholders who have a personal marginal rate of under 40% gain a greater benefit under the new *Act*, shareholders in the 40% bracket get the same benefit as under the old *Act*, shareholders whose personal marginal rate is over 40% get a reduced benefit under the new *Act*.

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[36] Section 57 Income Tax Application Rules 1971.

c. *Distributions by Non Resident Corporations to Individual Shareholders*

Under the old *Act* any disbursement received or deemed to have been received by a resident, non corporate shareholder was fully included in the tax payer's income. In return a full foreign tax credit was allowed in respect of any foreign withholding tax levied on the dividend. Under the new *Act* the rules are roughly the same with one major exception that is the equivalent of section 81 of the old *Act* (section 84) is applicable only to corporate residents in Canada. After 1975 by the combined effect of section 20(11) and 126(7)(c) non business income tax *i.e.* foreign withholding tax may be deducted from tax payable for that year only to a maximum of 15%. Any additional amount paid as a foreign tax may be deducted from income alone. The apparent purpose of this limitation is to make Canadian investments more attractive. For purposes of adjustments to the cost base of shares of non resident corporations, the amount to be deducted is determined as if the non resident corporation were an "affiliate" of the shareholder.[37]

A foreign affiliate is defined in section 95(1)(b) as a foreign corporation "controlled directly or indirectly in any manner whatsoever by the tax payer or the tax payer and other tax payers with whom the tax payer was not dealing at arms length". Control in this instance refers to a minimum 25% voting participation not less than 50% equity participation or a 10% minimum voting participation if the tax payer elects to have the corporation regarded as a foreign affiliate.[38]

d. *Distributions by Corporate Residents to Corporate Shareholders*

(i) Transfer of Special Surplus Between Corporations

Provided a company which is paying a special dividend is not a controlled subsidiary of the receiving corporate shareholder the recipient may incorporate the amount of the special dividend in its own 1971 tax paid undistributed income account.

Of more difficulty is the treatment accorded the payment of special dividends between parent corporations and its subsidiary, or where a corporation controls more than 50% of the voting shares of another corporation. Upon receipt of a special dividend the

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[37] *Income Tax Act*, S.C. 1970-71, c. 63, s. 53(2)(b).
[38] *Ibid.*, s. 95(1)(b)(ii)(iii) and (iv).

controlling corporation by application in writing to the minister within two years from the end of the calendar year in which the dividend was paid shall receive a refund in respect of the 15% special tax paid by the controlled corporation. The refund equals 15/85ths of the special dividend paid.[39] Unless that special dividend exceeded the ccontrolled corporation's controlled period earnings or unless the extent of the undistributed income on which the 15% tax paid by the subsidiary represents pre 1972 designated surplus. Should the corporate parent be structured in a way as to control a chain of subsidiaries each controlling other subsidiaries in turn the transfers along the corporate chain require individual payment and refund of the section 83 special tax. The amount finally received by the parent company is included in the parent's 1971 undistributed income on hand whereupon payment of the special 15% tax under section 196(1) the undistributed income on hand may be disbursed free of tax to the individual shareholder.

Should the special dividend be paid out of designated surplus that consists partly of 1971 undistributed income the recipient controlling corporation may elect to pay 15% tax under section 196(1) and distribute the 1971 tax paid undistributed income as a non taxable distribution by way of the section 83 election.

Adjustments to the cost base of corporate shares in respect of dividends received or deemed to be received are calculated in the same manner as adjustments made to the cost base of shares held by individual shareholders.

(ii) Taxable Dividends Between Resident Corporations

The amount to be included in a resident corporations income from dividends received from another resident corporation is determined as if the shareholder were an individual. The corporation may deduct an amount equal to the dividend for the purpose of computing its taxable income. The new *Act* has no similar provisions as contained in section 28(2) of the old *Act*.

e. *Distributions by Non Resident Corporations to Corporate Shareholders*

The deemed dividend provisions of section 84 pertaining to the issuing of stock dividends or the revaluation upward or downward of existing capital stock is only applicable to resident corporations. Now to be assessed as income however, are stock dividends.[40]

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[39] *Ibid.*, s. 196(2)(a).
[40] *Ibid.*, s. 248(1).

This provision is a major departure from the old act in which a stock dividend was expressly excluded from income.

With respect to distributions from foreign affiliates all dividends actually received from the affiliate are naturally considered as the company's income. In addition, section 91 includes the resident corporations participating percentage of foreign accrual property income and "any amount received by a foreign affiliate... as on account or in lieu of payment of or unsatisfaction of a dividend from another foreign affiliate of the tax payer during the taxation year". Participating percentage refers to the extent of participating equity of the affiliate held by the corporate resident; foreign accrual property income includes the new income from property (other than from another foreign affiliate of the tax payer) and net taxable capital gains. The company may claim a reserve respecting the deemed income provisions of section 91(1) if monetary restrictions or exchange controls imposed by a foreign country would result in undue hardship to the Canadian corporation. But, this reserve must be carried forward in the following year as income.[41]

The concept of "designated surplus" which was first introduced in the 1948 *Income Tax Act* has been retained and indeed expanded under the new act. Designated surplus has been defined as a controlled corporation's undistributed income on hand at the end of its last complete taxation year before control was acquired.[42] The meaning of control is extended under the new *Act* to embrace ownership by the controlling corporation of more than 50% of issued voting share capital. It incorporates the concept of non arms length dealings between the controlled corporation and other individuals or corporations.[43] The actual calculation of designated surplus involves several steps depending upon the year that control is to be acquired. When a company has been acquired before the end of its 1972 taxation year designated surplus is calculated using the old rules set out in section 192(13)(a)(i) of the new *Act*. When control is acquired in the company's 1972 taxation year section 192(10), the new subsection dealing with the national designation of surpluses through a chain of Canadian corporations, becomes operative; dividends from the subsidiary of the controlled corporation become incorporated into the parent's designated surplus.[44] From the amounts calculated in section 192(13)(a)(i) and (ii) the

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[41] *Ibid.*, s. 91(3) and 91(4).
[42] *Income Tax Act*, S.C. 1970, c. 43, s. 28(2).
[43] *Income Tax Act*, S.C. 1970-71, c. 63, s. 192(4).
[44] *Ibid.*, s. 192(13)(a)(ii).

amount elected to be dispersed under section 196(1) by the payment of a special tax of 15% may be deducted. When control is acquired in 1973 and subsequent taxation years designated surplus is the aggregate of the corporation's 1971 undistributed income on hand, the post-1971 undistributed surplus at the end of its last taxation year before control was acquired and all taxable dividends received by the controlled corporation's subsidiaries either from designated surplus or from tax paid undistributed surplus.[45] Excluded from this amount are losses experienced, investment income subject to refundable tax as well as the controlled period earnings of the controlled corporation.[46]

All dividends, even those dispersed from designated surplus, will be deductable in computing taxable income of the recipient Canadian corporation (except a trader or dealer in securities). Should the dividend be paid from designated surplus the recipient controlling corporation is liable for the payment of a 25% tax on the amount, should the controlled corporation's designated surplus consist in part of 1971 undistributed income on hand or 1971 capital surplus via appropriate elections under section 83(1) the controlled company may make a non taxable distribution to the controlling corporation with respect to these amounts.

Section 194 is the counterpart of section 105(8) of the old *Act*. Unlike section 105(B), section 194 stipulates that tax is payable only on dividends from designated surplus. The tax payable is only effected should the dividend be paid to a controlling non resident corporation (whereupon a tax of 15% is payable) or a controlling tax exempt person as defined in section 149 whereupon a tax of 33⅓% is payable. The payor corporation is required to pay the necessary tax.

Under the old *Act* an amalgamation of two or more companies got rid of any designated surplus on the books of one or more of the predecessor corporations. The designated surplus did not flow to the amalgamated company. This de-designation of the designated surplus did not have further tax consequences provided the net asset value of the combined companies was not exceeded by the combined undistributed incomes of the amalgamating companies. Otherwise section 105(C)(1) of the old *Act* demanded a tax of 20% be paid on the excess.

The new *Act* has made the designated surplus provisions extremely effective to the extent that whenever one Canadian corpo-

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[45] *Ibid.*, s. 192(13)(b)(i)(ii)(iii).
[46] *Ibid.*, s. 192(13)(b)(iv)(vi).

ration acquires control over another the two cannot amalgamate without incurring a 25% tax on the controlled corporations designated surplus. Prior to amalgamation designated surplus is effected by the parents control of the subsidiary. Once the two corporations amalgamate, section 87(2)(gg) (i) insures that where the predecessor corporation was immediately before the amalgamation controlled by a corporation that immediately after the amalgamation controlled the new corporation, the controlled ccorporation's designated surplus will be included in the amalgamated corporation's designated surplus.

With respect to vertical amalgamations section 192(3) provides that "when one or more of the corporations were controlled by another or others of those corporations... each controlling corporation shall be deemed to have received a taxable dividend immediately before the amalgamation of each corporation controlled by it at that time". This dividend is judged to have been paid out of designated surplus of the controlled corporation and is consequently subject to a 25% tax under the general rule contained in section 192(1). The amount deemed to be dividend to each controlling corporation is the greater of: the amount made payable on a hypothetical winding-up after the subscribed capital has been repaid or the amount realized by the shareholders if the corporation has declared and paid out a dividend from the designated surplus.[47]

Therefore extreme caution must now be exercised with respect to amalgamations and the old practice must be thoroughly reexamined in the light of the new tax legislation.

Section 182 is the successor of section 105A of the old *Act*. The effect of both these sections is to impose a special 20% or 30% tax on premiums paid upon the redemption or acquisition of a company's own capital stock. The dealings with common shares are expressly excluded. Under the new *Act* there is no equivalent to section 105A(3) of the old *Act*. Section 105A(3) permitted a corporation to deduct the premium paid from a tax paid undistributed income if any to thereby avoid tax consequences. The new *Act* demands tax on premiums paid irrespective of the company's tax paid undistributed income position.

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[47] *Ibid.*, s. 192(3)(c)(i)(ii).

f. Corporate Distributions on the Winding-Up, Discontinuance or Re-organization of Business

Corresponding with section 81 of the old *Act*, section 84 continues the policy that a dividend is deemed to be paid to the shareholders when the corporation undertakes one of the following events:

(a) increases the paid up capital without increasing the net assets
(b) distributes or appropriates benefits to the shareholders on the winding-up, discontinuance or re-organization of business
(c) redeems, acquires or cancels any class of shares
(d) reduces its paid up capital in any class of shares comprising its capital stock.[48]

The old *Act* stated that when a corporation undertook one of the aforementioned events the undistributed income of the corporation was to be paid out first. Under the new *Act* the shareholder in similar circumstances is first allowed the return of his investment in the company. The return of capital is limited to the "paid up capital limit" defined in section 89(1)(e) as "the amount if any, by which the paid up capital of the corporation at that time in respect of all the shares of its capital stock exceeds the corporations paid up capital deficiency at that time". Paid up capital deficiency has been termed the negative equivalent of the 1971 capital surplus on hand.[49] To arrive at either of the two terms the tax equity of the corporation must be defined and calculated.

Tax equity of a corporation at the end of its 1971 taxation year may be summarized as the aggregate of a company's;

(a) undepreciated capital cost of depreciable property
(b) other capital property (other than depreciable property) minus pre 1972 income deductions respecting that property
(c) inventory at 1971 closing tax value
(d) accounts receivable less bad debts
(e) cash on hand
(f) property not described above which under the old rules were not deductable in computing income

Less:

(a) liabilities of the company
(b) reserves deducted for the 1971 taxation year

Good will is not included in the computation of tax equity. Neither are other intangibles such as exploration rights. Conse-

[48] *Ibid.*, s. 84.
[49] Canadian Tax Reports, No. 84 Extra Edition, at p. 127.

quently tax equity can be broadly described as the company's book or balance sheet net work less good will and other nothings.

Paid up capital deficiency arises when paid up capital plus 1971 undistributed income exceeds the company's "tax equity". The dividends declared under section 84 to be paid and received are the amounts distributed or capitalized minus the lesser of the company's paid up capital as well as paid up capital deficiency. Because of this limitation the company may return tax free only the paid up capital allowed on the above rules.

IV. Conclusion

From the above it is seen that in order to advise corporate clients lawyers must have a working knowledge of what are essentially accounting concepts with respect to various corporate accounts. Under the new *Act* the source of income is extremely important and an analysis must be made in any given situation as to the corporations position in relation to each of the accounts mentioned above. These are difficult areas and ones in which lawyers have traditionally not involved themselves. It is to be hoped that efforts will be made by the profession as a whole to acquaint themselves with these new concepts and not to let another facit of legal practice go by default. Indeed it is imperative that extra efforts be made if sound legal advice is to be given corporate clients with respect to almost all facits of their corporate existence.