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12 October 2015

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Re: Section 55, Legislative Proposals

Dear Ms. MacLean:

On April 21, 2015 the Department of Finance released draft legislation, revised on July 31, 2015, to implement proposals announced in the April 21, 2015 federal budget relating to section 55 of the Income Tax Act (the "Legislative Proposals"). Tax Executives Institute, Inc. ("TEI") is writing to provide our comments and concerns about these Legislative Proposals.

Our fundamental concern is the Legislative Proposals as written significantly expand the scope of subsection 55(2), which is currently aimed at tax-avoidance transactions. The Legislative Proposals have a much broader scope than targeting the concerns expressed in the federal budget regarding the type of planning undertaken in *D&D Livestock v. The Queen*, 2013 TCC 318 ("*D&D Livestock*"), and would create serious uncertainty in the tax treatment of routine, non-abusive transactions. This uncertainty

would significantly impede taxpayers' abilities to make ordinary and necessary cash movements within Canadian corporate groups. We have read the submission by the Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada dated May 27, 2015 (the "Joint Committee Submission"), which aptly sets forth the technical issues presented by the Legislative Proposals. This letter highlights additional practical concerns raised by the Legislative Proposals and provides examples of common, non-abusive transactions that the Legislative Proposals are likely to impede if enacted as proposed.

About Tax Executives Institute

TEI is the preeminent international association of business tax executives. The Institute's approximately 7,000 professionals manage the tax affairs of more than 2,800 of the leading companies in North and South America, Europe, and Asia. Canadians constitute nearly 15 percent of TEI's membership, with our Canadian members belonging to chapters in Calgary, Montreal, Toronto, and Vancouver. TEI members must contend daily with the planning and compliance aspects of Canada's business tax laws. Many of our non-Canadian members (including those in Europe and Asia) work for companies with substantial activities and investments in Canada. These comments reflect the views of TEI as a whole, but more particularly those of our Canadian constituency.

TEI gets involved in important issues of tax policy and administration, and is dedicated to working with government agencies to reduce the costs and burdens of tax compliance and administration to our common benefit. In furtherance of this goal, TEI supports efforts to improve Canadian tax laws and their administration at all levels of government. The diversity, professional training, and global viewpoint of our members enable us to bring a balanced and practical perspective to the issues raised by the draft legislation discussed herein.

Subsection 55(2) and the Legislative Proposals

Subsection 55(2) is an anti-avoidance provision. It is intended to prevent capital-gains stripping, achieved through inappropriate distributions of tax-free intercorporate dividends that unduly reduce capital gains on corporate shares. Subsection 55(2) currently applies where, among other instances, a corporation pays a dividend for the purpose of significantly reducing, or that otherwise results in the reduction of, the value of the corporation's shares, thus reducing a capital gain that a selling shareholder would have realized on the sale of those shares to an unrelated buyer immediately after the dividend payment. Generally, subsection 55(2) denies deductions for such dividends and treats them as either proceeds from the sale of the underlying shares or

as a gain on the underlying shares. The existing rules in subsection 55(3)(a) are such that dividends paid to related corporate parties are excluded from the rule in subsection 55(2) ("related-party exception").

The Legislative Proposals would amend subsection 55(2) in two key respects:

1. They would expand the "purpose test" (*i.e.*, the test for determining whether the purpose of the dividend was to strip capital gains) to capture instances in which dividends are paid on a share, not to reduce a capital gain, but instead to (i) significantly decrease the fair-market value of any share, or (ii) significantly increase the total property costs to the dividend recipient.[1]

2. The Legislative Proposals would also restrict the related-party exception in subsection 55(3)(a) only to deemed dividends of a corporation redeeming, acquiring, or cancelling its shares under subsections 84(2) or 84(3). Thus, the related-party exception would no longer exclude cash dividends, ordinary-course dividends, and dividends paid in-kind (collectively "Ordinary Dividends").

We understand Finance designed the Legislative Proposals to prevent the type of tax planning undertaken by taxpayers in *D&D Livestock*. We respect and acknowledge Finance's desire to address this type of inappropriate tax-avoidance planning. However, the Legislative Proposals, particularly the amendments listed above, are overly broad and create too much uncertainty for otherwise routine and non-abusive transactions that Finance likely does not intend to stifle with subsection 55(2) or any other provision of the ITA.

Removing Ordinary Dividends from the related-party exception of subsection 55(3)(a) represents a significant policy change in the Canadian tax treatment of related-party dividends and would likely result in significant limitations on payments of Ordinary Dividends. The related-party exception has historically provided meaningful certainty that Ordinary Dividends would not be recharacterized as a capital gain. Without such clear statutory guidance, a taxpayer must determine the treatment of Ordinary Dividends under subsection's 55(2) purpose test, a far more ambiguous effort.

We acknowledge that the "safe-income" exception of subsection 55(2) would continue to exclude dividends paid from a corporation's retained earnings. The computation of safe income,

[1] Amendment would be added by proposed subparagraph 55(2.1)(b)(ii).

however, is complex and generally uncertain, in large part because of the lengthy history of many Canadian subsidiaries, as well as case-law and enforcement-policy ambiguities surrounding the calculation of safe income. Canadian corporations typically have not needed to and therefore have not incurred the excessive time and expense required to determine a safe-income balance to support an Ordinary Dividend.

We recommend the Legislative Proposals be revised to reinsert Ordinary Dividends into the related-party exception provided in paragraph 55(3)(a). Alternatively, we recommend Ordinary Dividends be excluded from the application of the expanded purpose test in proposed subparagraph 55(2.1)(b)(ii).

Furthermore, we believe Finance could prevent the type of tax planning addressed in *D&D Livestock* by adopting the "Loss Share" rule set out in the Joint Committee Submission. This rule would reduce a shareholder's adjusted cost base in the shares by an amount equal to a value-reducing dividend. This would preserve a pre-dividend unrealized capital gain in the shares without taxing the actual dividend. Generally, the "Loss Share" rule would apply where: (i) as a result of the payment and receipt of a dividend, the fair-market value of a share is reduced; (ii) immediately after the payment of the dividend, the fair-market value of the share is less than the adjusted cost base to the holder of the share; and (iii) one of the purposes of the dividend is to significantly decrease the fair-market value of the share or significantly increase the total property costs to the dividend recipient with a view to using an accrued loss in order to eliminate or reduce a gain that would otherwise be realized on the disposition of property.

Impact of the Legislative Proposals on Routine, Non-Abusive Transactions

The Legislative Proposals as currently drafted would create significant uncertainty for routine, non-abusive transactions and fundamental cash movements within corporate groups. This uncertainty is illustrated by the following examples:

1. **Ordinary Cash Management**

A common and prudent cash-management practice is to move and manage cash within a corporate group by paying intercorporate Ordinary Dividends. Such normal-course cash transfers include paying dividends up a corporate chain to:

i. fund general corporate purposes such as servicing debt, funding growth, repurchasing shares, or meeting regulatory requirements; and

ii. settle intragroup indebtedness resulting from centralized banking systems or interim-group funding arrangements.

Some TEI members are curtailing proper dividend-based cash transfers because of concerns over the expanded purpose test in subsection 55(2), notwithstanding that such transfers are and always have been imbued with a business purpose and made in the ordinary course of business. Even in a basic corporate structure involving a holding company ("Holdco") and its subsidiary operating company ("Opco"), taxpayers must now consider whether a purpose of a routine payment of an Ordinary Dividend between the two might be viewed to significantly increase the cost of property held by Holdco or significantly decrease the fair-market value of Opco shares. The Legislative Proposals should not stifle this sort of internal, ordinary-course transaction.

2. Internal Reorganizations

Canadian companies routinely undertake internal reorganizations that move assets between and among subsidiaries within a corporate group. For example, a corporate group might include Holdco and two subsidiaries, Subco1 and Subco2, both of which are wholly owned by Holdco. The group in this example intends to transfer assets from Subco1 to Subco2 to simplify the corporate structure so that Holdco is the only owner of shares or debt for both Subco1 and Subco2. The transaction would have these steps:

i. Subco1 transfers assets to Subco2 on a tax-deferred basis pursuant to subsection 85(1) in exchange for preferred shares of Subco2.

ii. Subco2 redeems the preferred shares in exchange for a promissory note.

iii. Subco1 declares a dividend in-kind to Holdco consisting of the promissory note, which preserves Holdco's adjusted cost base of the Subco1 shares.

This series of transactions does not include any of the triggering events listed in existing paragraph 55(3)(a) involving an unrelated person or partnership. Furthermore, it is intended as an internal reorganization, not tax avoidance. Under the Legislative Proposals, however, this series of transactions could trigger subsection 55(2) because the dividend in kind declared by Subco1 is not clearly covered by any exception.

Under the Legislative Proposals, if the purpose test in proposed subparagraph 55(2.1)(b)(ii) is met, the dividend of the promissory note from Subco1 to Holdco would be recharacterized as Holdco's capital gain under proposed 55(2)(b) even though the series of transactions is not

motivated by tax avoidance. We believe this result is inappropriate where no unrelated party acquires property or is otherwise involved in the series of transactions.[2]

3. Loss Consolidation Structures

The Legislative Proposals also create uncertainty for conventional loss consolidation structures. As noted in the Joint Committee Submission, without the ability for corporate taxpayers to consolidate for tax purposes, corporate groups need to be able to move funds within the groups on a tax-free basis to conduct day-to-day operations. This is a critical issue for ensuring that Canadian corporate groups are placed on an even footing and remain competitive with their peers in countries that recognize tax consolidation, as tax consolidation is not likely to be available to Canadian taxpayers in the foreseeable future.

To transfer losses from one affiliated corporation to another, the corporations generally arrange their affairs so that the corporation in the loss position lends money at a stated rate of interest to the profitable corporation, which in turn uses the borrowed funds to invest in preferred shares of the loss corporation. The profitable corporation deducts the interest expense and receives fully deductible intercorporate dividends while the loss corporation receives interest income that is offset by its accumulated losses.

Taxpayers have historically relied on the related-party exception in paragraph 55(3)(a) for intercorporate dividends paid in connection with such loss consolidation transactions and other similar transactions. Without the use of such loss consolidation structures, Canadian corporate groups would be at a disadvantage to international corporations from tax jurisdictions that recognize tax consolidation.

Recommendation

These examples are just a few of the routine, non-abusive transactions that have historically been implemented with a high degree of certainty in their tax treatment. We respectfully submit that the Legislative Proposals would create unnecessary ambiguity in the tax treatment of these and other nonabusive transactions involving Ordinary Dividends. Moreover, enactment of the

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[2] We acknowledge and agree that a reduction in the adjusted cost base of Subco1's shares is an appropriate result if the shares are sold to an unrelated person as part of the series of transactions. Furthermore, it may be possible for taxpayers to restructure their transactions to take advantage of the redemption exemption in proposed paragraph 55(3)(a). However, such restructuring may not be possible in all circumstances, and taxpayers should not have to bear the cost, risk, and expense of undertaking otherwise unnecessary transactions to avoid the unintended application of an anti-avoidance provision.

Legislative Proposals would create serious tax uncertainty in the treatment of intragroup dividends, which could harm Canadian corporations in the global marketplace when competing with taxpayers from other countries. Tax certainty and predictability are fundamental principles of Canadian tax law, and the Legislative Proposals should be amended to promote such principles and to ensure Canadian companies are not placed at a competitive disadvantage. We recommend the Legislative Proposals be revised to reinsert Ordinary Dividends into the related-party exception provided in paragraph 55(3)(a). Alternatively, we recommend Ordinary Dividends be excluded from the application of the expanded purpose test in proposed subparagraph 55(2.1)(b)(ii).

TEI's comments herein were prepared by its Canadian Income Tax Committee, whose chair is Grant Lee of HSBC Bank Canada. Should you have any questions about TEI's comments, please feel free to contact Mr. Lee at 604.641.2502 (or grant_lee@hsbc.ca) or Lynn Moen, TEI's Vice President for Canadian Affairs, at 403.750.2278 (or lmoen@walton.com).

Respectfully submitted,

Tax Executives Institute, Inc.

C.N. (Sandy) Macfarlane
International President

cc: Grant Lee, 2015-2016 Chair, TEI's Canadian Income Tax Committee