Tax Notes – February

Bad Dividend/Good Dividend

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In most years, the days before and after New Year are occasions for a fair amount of tax news. Although year end was less frantic than usual in this regard, there are a couple of developments – both of which relate to the taxation of dividends - that are worthy of discussion.

The first pertains to an article I wrote in October in this newsletter about “leaky pipelines”**[1]** – that the dividend-strip provisions of subsection 84(2) may potentially apply to a post mortem “pipeline” procedure. As a reminder, a “pipeline” involves the estate swapping shares of an Opco to a Holdco for Holdco debt in order to extract corporate-level assets equivalent to the cost base on the Opco shares - which is bumped up when the shares pass on death to another generation. The application of subsection 84(2) would “transmogrify” the normally tax-free Holdco debt repayment into a taxable dividend**[2]**.

Briefly speaking, the CRA’s position has appeared to be that subsection 84(2) can override the normal results of a “pipeline” if funds or property of the corporation in question (the “Opco” in my example) have been distributed or otherwise appropriated in any manner whatever to or for the benefit of the estate on the “winding-up, discontinuance or reorganization of its business”. If so, Opco would be deemed to have paid a dividend to the estate.

A few weeks after my article appeared, the potential application of subsection 84(2) in this situation was canvassed in the December Canadian Tax Foundation CRA Round Table in Vancouver. The CRA’s slides themselves, while delineating its general views (as above), are relatively non-committal, indicating that it could not confirm that subsection 84(2) would not apply in the context of a pipeline, and that the potential application of subsection 84(2) requires a review of the facts and circumstances relating to a particular situation (i.e., focusing on the wording above).

More interesting were the verbal remarks at the session made by a senior CRA official**[3]**. They pertained to a specific question from the 2009 APFF Conference CRA Round Table,**[4]** which relates to the application of subsection 84(2) to a pipeline to extract cash balances sequestered in a corporation which seemed to have discontinued its business prior to the death of the shareholder. The remarks were to the effect that if such a corporation is now nothing but a pot of cash, this is the sort of situation to which dividend rather than capital gain taxation should be applicable, i.e., so that subsection 84(2) would apply to the apparent fact situation in the APFF question.**[5]**

Central to the application of subsection 84(2) is the issue of whether there has been a “winding-up, discontinuance or reorganization”.**[6]** This terminology refers to the business, rather than the corporation itself. As noted by the CRA in the Vancouver Round Table question, circumstances falling short of a dissolution of a corporation may still result in the application of subsection 84(2).

While the meaning of winding-up and discontinuance are fairly straightforward, “reorganization” of a business may be perceived to have a wider reach. But in Kennedy v. MNR**[7]**, the Court observed that:

. . . the word "reorganization" is used in association with the words "winding-up" and discontinuance". Both of those words contain an element of finality. The company is ended. It is therefore logical to assume that the word "reorganization" presupposes the conclusion of the conduct of the business in one form and its continuance in a different form.

Thus, cases have generally held that section 84(2) does not apply in situations where substantial business assets have been sold but the business continues on in a similar manner as prior to the transaction**[8]**. However, commentators have criticized some of these cases as having an overly narrow view of the term “reorganization”.**[9]**

Coming back to the “pipeline” itself, assuming that a ruling is not obtained, it may be prudent to ensure that if cash or other assets are to be distributed, it is not necessary to liquidate sufficient amounts of assets to fund the distribution(s) that the CRA could possibly take the position that there has been a winding-up, discontinuance or reorganization of the business. It may be prudent to withdraw funds only as needed and preferably over extended periods of time.**[10]**

The CRA remarks above have significance beyond the realm of post-mortem planning. Although at one point there was little difference between the tax rate on dividends and capital gains, the differential has increased**[11]**. The remarks are a reminder that the difference has become sufficiently large that the CRA may be motivated to take an adverse position on structures that convert tax on dividends to tax on capital gains. As discussed in my October article, the potential application of subsection 84(2) itself is not confined to post-mortem tax planning situations and pertains to a variety of structures where the proceeds of a realization of corporate-level assets end up in the hands of shareholders on a tax-efficient basis.**[12]**

TIEAs and International Business Structures

On January 4th, the first bilateral Tax Information Exchange Agreement (TIEA) – between Canada and the Netherlands Antilles – came into effect. Actually, this is the first of many such agreements. You can check out the status of the agreements at www.fin.gc.ca/treaties-conventions/tieaaerf-eng.asp. You will see that there are over a dozen TIEAs signed but not yet in force, with almost another dozen others under negotiation. For many taxpayers, the notion of exchange of tax information is not exactly a welcome idea, what with the tax haven status of most or all of the jurisdictions involved. In fact, many comments from authorities in affected jurisdictions have been crafted to ease angst about loss of confidentiality.

But the cloud has a big silver lining. When a TIEA comes into effect, companies resident and carrying on businesses in the TIEA jurisdiction will potentially be entitled to Canadian-exempt surplus treatment. This means that active business profits can be distributed as dividends to a Canadian holding company without Canadian tax. Under former rules, active business income would escape Canadian tax only to the extent that earnings were not distributed to Canada. (Note that, contrary to what some believe, qualifying active business income carried on in a non-treaty/TIEA country is not immediately taxable in Canada. However, under current tax rules, FAPI treatment will apply if Canada does not enter into a TIEA with a country within five years following the initiation of such negotiations.)

These provisions extend the favourable tax treatment which, in recent years, has been exemplified in treaties with such countries as Ireland and Cyprus, but most notably, the Canada-Barbados tax treaty.

But besides favourable tax treatment, the ability to successfully implement international tax planning structures may depend upon the infrastructure in the particular jurisdiction – including the availability of sophisticated professionals.

The “B” Words

While some of the countries currently entering into TIEAs are comparative backwaters, a number of them have quite sophisticated financial and legal advisors. One such jurisdiction is Bermuda, where the morning flight from Toronto pulls in nearly two and a half hours earlier than the flight to Bridgetown. (At time of writing the Canada-Bermuda TIEA is signed, but not yet in effect.)

A release by a major Bermuda law firm pulls no punches about the two jurisdictions:

While Canada has had a long standing relationship with Barbados pursuant to the Barbados-Canada tax treaty, as a result of the TIEAs being entered into by Canada, we expect Bermuda to play a significantly greater role in the international structuring by Canadian companies.

. . .

When the Canada-Bermuda TIEA becomes effective, Bermuda will become a "designated treaty country" as a consequence of the 2007 Canadian Budget. With this designation, income earned by a Bermuda subsidiary and distributed to its Canadian parent is not subject to certain taxes. This designation has been afforded to foreign affiliates in countries who share a double-tax treaty with Canada (including Barbados, Ireland and Cyprus). However, unlike these countries, Bermuda does not impose any corporate income tax, capital gains tax or withholding tax. Thus by establishing a Bermuda subsidiary, a Canadian corporation may benefit from the tax savings available to it. With the Canada-Bermuda TIEA, Bermuda may be even more attractive than such double taxation treaty partners, by offering Canadian groups an international financial centre with a favourable tax regime and advanced business infrastructure.**[13]**

So if "set up an IBC" is the first thing that may pop out of your mouth in an international tax planning session, bite your tongue. I don't expect that established enterprises will pull out of Barbados over its 2 1/2% tax rate, but for new international initiatives, this may be one of a number of considerations in making a choice of jurisdiction**[14]**.

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[1] "Tax Grazing: Questionnaires, Wills and Leaky Pipelines", *Tax Notes* No. 573, October, 2010.

[2] Based on amount or value of funds or property appropriated in excess of the paid-up capital of the shares in question.

[3] Mr. Wayne Adams.

[4] Doc. No. 2009–0326961C6 (2009 APFF Round Table Question 1).

[5] In this context, subsection 164(6) *post-mortem* procedures - if carried out on time - could essentially replace the terminal period gains with post mortem dividends. It should be noted that the CRA official indicated that the CRA could be in a position to reconfirm the earlier favourable rulings where the business continues and the "hard"/business assets remain.

[6] It should also be noted that the distribution or appropriation must be "on" the winding-up, discontinuance or reorganization of the business. Per paragraph 8 of Interpretation Bulletin IT-126R2, the phrase "on the winding-up", as used in subsection 88(1) for a corporation or in subsection 84(2) for a corporation's business means that period of time during which the winding-up takes place. In the 2009 APFF Round Table question referred to above, was observed that in previous rulings, the deceased individual would have ceased to be a shareholder of the particular corporation for a period of at least one year before receipt of funds or property on the winding-up, discontinuance or reorganization of its business. (During this period, the corporation would remain a separate and distinct legal entity and would continue to carry on its business in the same manner as before, after which the promissory note would be repaid on a progressive basis.) However, it was pointed out that these elements were part of the proposed transactions submitted by the taxpayer and, as such, cannot be considered to be a CRA requirement (see also Doc. No. 2006-0170641E5, June 29, 2006). In "Public Company Non-butterfly Spinouts" (2003) CR p.32:24, Suarez and Ahmed, it was suggested that a one-year rule of thumb had applied. However, this was in the context of fitting within the subsection 84(2) exception to subsection 84(4.1), so that it is desirable that the distribution occur no later than 12 months after the winding-up, discontinuance or

reorganization.

[7] 72 DTC 6357, aff'd 73 DTC 5359 (FCA).

[8] *Kennedy* involved a sale and leaseback of automotive premises to the corporation's shareholder. *Geransky* (2001 DTC 243, TCC) was an outsourcing transaction, involving the sale of a cement plant to a large cement manufacturer which entered into a supply contract with the operating company. *McMullen* (2007 DTC 286, TCC) involved a split up of a corporation whereby one of two locations was retained in the operating company, with the other acquired by the taxpayer and his wife through a corporation.

[9] Ironically, in the public company realm, it will be advantageous to fall within this provision – in order to avoid deemed dividend status on a reduction of public company's capital under subsection 84(4.1). Because of cases referenced above that tended to narrow the ambit of a reorganization of a company's business, proposals most recently brought forward in the July 16 draft legislation would amend subsection 84(4.1) to broaden the situations in which deemed dividend status would not apply.

[10] As illustrated by the APFF question, the liquidation of assets may be occasioned by events other than post mortem planning, e.g., a business liquidation due to the advanced age; there is no "series of transactions" requirement in subsection 84(2).

[11] For non-eligible dividends, at least.

[12] Subsection 84(2) itself comes from an era before 1972 tax reform in which there was no tax whatever on capital gains, so that such "anti-strip" provisions were necessary. The provision could even apply where there has been a sale of business assets and the proceeds are distributed via bonuses; however, a number of favourable rulings have been given in such situations as to the deductibility of bonuses to active shareholders/managers. In my October article, however, I cited a Technical Interpretation (Doc. No. 2004-0106951I7, May 31st, 2005) in which the CRA indicates that the provision would be applicable to bonuses paid to non-active shareholders – i.e., so as to deny the deduction for the bonus and tax the distribution as a dividend in the hands of the shareholders.

[13] "Canada signs TIEA with Bermuda", by Kathleen Moniz, Conyers, Dill & Pearman News Letter, June 2010 (www.conyersdill.com/publication-files).

[14] One such consideration is the applicability of Regulation 5907(11.2), which deems a foreign affiliate not to be resident in a treaty country. In Doc. No. 2007-0261551I7, October 19, 2010, the CRA indicated that Barbados EICs will not be subject to this regulation (i.e., so that the exempt surplus regime applies). It has been indicated that: "The interpretation provides consistency and a level playing field for the classification of active business earnings derived in either a tax treaty country or a TIEA country." (See "Exempt Earnings for Barbados Insurers", John Haag, *Canadian Tax Highlights*, December 2010.)