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The Taxable Preferred Share Rules and the Private Corporation

2017

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Introduction

This paper will focus on the rules in the *Income Tax Act* (Canada)[1] relating to taxable preferred shares[2] ("TPS") and short-term preferred shares[3] ("STPS") as they might apply in the private corporation context. There is detailed discussion of the particular exemptions relied upon for private corporation share structures and planning. Other categories of preferred shares – term preferred shares and guaranteed preferred shares – are not discussed herein as their related rules generally require a "specified financial institution".

Other writers have commented on these rules and references are provided for the interested reader.[4] Particular inspiration for this paper has been taken from a paper that was presented at the 1997 Annual Conference of the Canadian Tax Foundation - "The Preferred Share Rules: Yes, They Can Apply to You!"[5] - much of which still resonates today.

Purpose of the Rules

The taxable preferred share rules were introduced as part of the 1987 tax reform. *The White Paper on Tax Reform* was replete with references to preferred shares as a form of after-tax financing and the proposals, as announced, were intended to reduce this tax advantage. It is instructive to understand the policy rationale as this informs the consideration of whether these rules should apply to normal course private corporation arrangements. The following are illustrative extracts from the White Paper:[6]

> The tax on preferred shares has been designed to reduce the advantages for non-taxpaying corporations associated with preferred share financings …
>
> The advantage derived from the use of preferred share as a form of after-tax financing arises because of the different tax treatment of dividends and interest. Where a corporation issues debt it may deduct the interest it pays and the recipient is subject to tax on this interest. Dividends on the other hand, are presumed to be paid out of earnings that have been subject to tax.

> Where the issuing corporation is tax paying these two forms of financing have the same after-tax consequence and so the choice of one or the other has no impact on government revenues. However, a non-tax paying corporation can take advantage of the dividend relief by issuing preferred shares even though the income out of which the dividend has been paid has not borne tax and therefore reduce its after-tax cost of capital as compared with debt. The consequence of substituting a dividend-paying instrument for an interest-bearing one in such circumstances is that government revenue are reduced. The new tax is designed to ensure that tax has been paid with respect to dividends on preferred shares when relief is given at the shareholder level. As such it will affect dividends paid by non-taxpaying corporations and will have no impact on a taxpaying corporation issuing preferred shares.

The White Paper listed the following as situations where the tax would not apply:[7]

- the new tax will not be applied to dividends on common shares as common shareholders participate fully in the risks facing the corporation;
- an exemption of up to $500,000 of preferred share dividends for any group of corporations will allow small corporations and venture capital start-up companies to continue to use preferred shares as an integral part of financing arrangements;
- no tax will be payable on dividends to individual or corporate shareholders with a significant interest in the payer corporation to ensure a free flow of funds within commonly owned entities;
- the previous two provisions will allow preferred shares to be used in private financing arrangements and joint ventures where the shares may be necessary to recognize different ownership interests among shareholders;
- no tax will be payable by intermediary type companies, such as mutual funds and certain private holding companies which are structured to hold portfolio investments to allow continued use of such flow-through vehicles.

While acknowledging that the above were intended as general statements, the rules can apply to common shares and ownership arrangements in private structures that do not necessarily fit the legislated exemptions to permit funds to flow among commonly-owned entities. A private corporation may issue shares not to raise capital and not with a view to after-tax financing, yet such shares may fall within the TPS definition. The rules can become a trap and be costly in what are likely unintended situations.

It is interesting to note that the taxable preferred share rules and related definitions have not been subject to any significant amendments since enactment.[8]

General Overview

Commentary on this topic often refers to corporations potentially subject to Part VI.1 tax as the issuer, e.g., the issuer of TPS. It is acknowledged that for securities law purposes, an issuer is simply a corporation that issues securities. Securities law applies to private corporations. However, the focus of this paper is the ordinary share structure and arrangements of a private corporation and not private corporations that are engaged in financing and issuing securities to raise capital. Accordingly, the writer has deliberately chosen not to use the term “issuer” (as that may have financing and securities connotations) but rather simply refers to the dividend payor corporation.

Pursuant to subsection 191.1(1), tax is imposed on the dividend payor corporation upon the payment of a taxable dividend on TPS or STPS (referred to herein as “Part VI.1 tax”) unless certain exceptions apply. The tax is recoverable by way of deduction (as explained below) and is imposed as a percentage of the dividend. The percentage or rate differs for TPS dividends versus STPS dividends. Pursuant to subparagraph 191.1(1)(a)(iii), where a corporation pays a taxable dividend on TPS, tax is imposed at a rate of 25% of the amount of the dividend and pursuant to subparagraph 191.1(1)(a)(i). Where a corporation pays a taxable dividend on STPS, tax is imposed at a rate of 40% of the amount of the dividend.

Part VI.1 applies only to a taxable Canadian corporation. Corporations that are not resident in Canada or not incorporated in Canada are not subject to Part VI.1 tax.

There is a corresponding tax applicable to a corporate dividend recipient. A corporation that receives a taxable dividend on TPS[9] may be subject to a tax at a rate of 10% of the amount of the dividend pursuant to section 187.2 (referred to herein as “Part IV.1 tax”) unless it is an “excepted dividend”.[10] A dividend received by a private corporation is an “excepted dividend”. As a result, given the private corporation focus of this paper, Part IV.1 tax should not be a concern.

A $500,000 threshold referred to as a “dividend allowance” is provided for in subsection 191.1(2). Only taxable dividends on TPS in excess of a corporation’s dividend allowance for its particular taxation year are subject to Part VI.1 tax. In each taxation year, the corporation’s dividend allowance must be reviewed because it may be “ground” by the amount of a prior year’s dividend. Specifically, the amount of the dividend allowance is reduced dollar-for-dollar by dividends on TPS (which are not excluded dividends) in excess of $1 million paid in the calendar year immediately preceding the calendar year in which the corporation’s taxation year ends. The dividend allowance must be allocated among associated corporations and is pro-rated for short taxation years.

In light of the dividend allowance (the amount of which has remained unchanged since enactment), Part VI.1 tax would most likely become of concern to a private corporation where sizable dividends are paid. For example, shares could be redeemed either post-mortem or in a reorganization resulting in a substantial dividend. A sizable dividend (which is not an excluded dividend) effectively has a two-year impact – in the year of payment, such dividend may itself exceed the dividend allowance for the particular taxation year and in the subsequent year, the prior year’s dividend may grind the corporation’s dividend allowance.

If a dividend paid on TPS constitutes an "excluded dividend" as defined,[11] it is not subject to Part VI.1 tax and, as noted above, it is also not included in the computation of the dividend allowance grind. In the private corporation context, the portion of the "excluded dividend" definition that is particularly relevant is paragraph (a) which states that a dividend paid by a corporation to a shareholder who had a substantial interest in the corporation at the time the dividend was paid is an excluded dividend. There is also a particular exclusion available to certain deemed dividends upon a share redemption. Both of these exclusions are discussed further below.

Recovery of Part VI.1 Tax

Where the dividend payor corporation is subject to Part VI.1 tax, the tax may effectively be recovered by means of a paragraph 110(1)(k) deduction in the computation of taxable income. The deduction is supposed to offset the Part VI.1 tax. At present, paragraph 110(1)(k) permits a deduction equal to 3.5 times the Part VI.1 tax. This ratio assumes that the taxpayer is subject to a combined federal–provincial corporate tax rate of 1/3.5 or 28.5%. Where the taxpayer is subject to a lower combined rate, paragraph 110(1)(k) does not operate as a full offset and Part VI.1 tax becomes a cost. In Ontario, the combined federal-provincial rate is 26.5%. Therefore an Ontario corporate taxpayer subject to tax at the combined rate of 26.5% which pays a dividend subject to Part VI.1 tax effectively bears a cost of approximately 1.8%. Clearly, the cost is greater for a Canadian-controlled private corporation claiming the small business deduction and subject to tax at the combined rate of 15%.

The TPS Definition

Characterization Triggers in Paragraph (b)

TPS characterization may result from the terms or conditions of the share or any agreement to which the dividend payor corporation or a "specified person" in relation to the corporation is a party. The term "specified person" is defined in paragraph (h) of the TPS definition as any non-arm's-length person. A partnership or trust of which the corporation is a partner or beneficiary, as the case may be, is also a specified person. Because a corporation is typically a party to a shareholders' agreement or unanimous shareholder agreement entered into by its shareholders, the terms of such an agreement could contain the characterization triggers.

Although it is sometimes thought that TPS characterization requires a fixed dividend right, this is an understatement. Subparagraph (b)(i) of the TPS definition refers to the "dividend entitlement". The mantra in the TPS definition to describe the characteristics of the amount are the words: fixed, limited to a maximum, or established to be not less than a minimum. With respect to the latter, i.e., established to be not less than a minimum, there must be a preference over any other class of shares. Clearly, shares that have a set percentage dividend rate or a rate of "up to" a specified percentage will meet the requirement of "fixed" or "limited to a maximum". Shares whose dividend tracks a particular asset or branch or subsidiary will likely meet this requirement, too.[12] If the corporation establishes a dividend policy (which might be set out in a shareholders' agreement), the terms of this policy may be such that it may reasonably be considered that the amount of dividends paid on a particular class of shares is

established to be not less than a minimum. These could be the common shares of the corporation. It seems implicit in the decision to document in a dividend policy that there is an intended preference over any other class of shares and, if so, such shares may have a dividend entitlement triggering TPS characterization.[13]

Subparagraph (b)(ii) of the TPS definition refers to the "liquidation entitlement" and describes the characteristics of the amount received using the same mantra of fixed, limited to a maximum, or established to be not less than a minimum. Clearly, fixed value preferred shares, such as the typical redeemable retractable preferred shares issued in connection with section 85, 86 or 51 transactions, will be caught. Such shares commonly have a dividend rate that is fixed as a percentage of the redemption amount and, in any event, are redeemable and retractable. In addition, upon liquidation or dissolution of the corporation, such shares typically are entitled to a return of an amount per share equal to the redemption amount. The foregoing attributes fit within the characterization triggers in both the subparagraph (b)(i) dividend entitlement and subparagraph (b)(ii) liquidation entitlement.

Notwithstanding the use of the term "liquidation entitlement", subparagraph (b)(ii) is not limited to the amount received upon liquidation, dissolution, or winding up of the corporation. It also applies to the amount received upon redemption, acquisition, or cancellation of the share or on a reduction of the paid-up capital of the share by the corporation or a specified person in relation to the corporation. This means that any shareholders' agreement which provides for a corporate repurchase of shares, or a purchase by a controlling shareholder, or other person non-arm's-length with the corporation may cause the shares in question to be characterized as TPS (even though these may be designated as common shares) provided that the price is fixed, limited to a maximum, or established to be not less than a minimum. In the case of a shareholders' agreement, the common procedures for the determination of price include: (1) a price that is supposed to be determined at the time the shareholders' agreement is entered into and updated periodically; (2) a price determined by a formula set out in the shareholders' agreement; or (3) a price determined at the relevant time by an independent third party such as the corporation's accountants or a certified business valuator. If the first two of the above procedures are used, the amount could be considered to be fixed, limited to a maximum, or established to be not less than a minimum.

Subparagraph (b)(ii) expressly excludes the situation where the requirement to redeem, acquire, or cancel arises only in the event of the death of the shareholder.[14] The limited utility of this express exclusion is caused by the word "only", i.e., "only in the event of the death." A shareholders' agreement may provide for compulsory acquisition of shares by the corporation in other situations. For example, a compulsory acquisition event may be triggered by disability (permanent or possibly shorter term) of a shareholder (or the principal of a corporate shareholder); resignation, retirement or other termination of employment in the case of a shareholder who is also an employee; a shareholder declaring a bankruptcy or making a proposal in bankruptcy; the date that a spouse of a shareholder brings an application under applicable family law legislation that he/she is entitled to the shares; or a shareholder being in breach of certain covenants in the shareholders' agreement, such as a failure to capitalize as required. Other than death, it is never certain that any of the typical compulsory acquisition events in a shareholders' agreement outlined above will occur. Subparagraph (b)(ii) of the TPS definition asks not

about the certainty of receipt of the amount but rather, whether it may reasonably be considered that the amount which the shareholder is entitled to receive is fixed, limited to a maximum, or established to be not less than a minimum. If a shareholders' agreement fixes a price in an amount or by formula for compulsory acquisition events, then notwithstanding that the occurrence of such events may be uncertain, the amount which the shareholder is entitled to receive in respect of the share on redemption, acquisition, or cancellation of the share is certain.

In some planning situations, it may be desirable to have multiple classes of common shares. To the extent that it is regarded as necessary for tax or other reasons to have a differentiating characteristic rather than identical terms, care must be exercised for TPS reasons. A differentiating characteristic such as a priority $1 return on dissolution may be a TPS characterization trigger pursuant to subparagraph (b)(ii) of the TPS definition.[15]

Subparagraph (b)(iv) of the TPS definition refers to a guarantee agreement and should be considered in the context of exit or buy-sell clauses of a shareholders' agreement. Subparagraph (b)(iv) applies if a person (other than the dividend payor corporation) is obligated, either absolutely or contingently and either immediately or in the future, to effect an undertaking including a covenant or agreement to purchase the share, which ensures that any loss that the shareholder may sustain by virtue of ownership of the share is limited or ensures that the shareholder will derive earnings by reason of the ownership of the share. There is limited marketability for shares of a private corporation if the shareholder has a minority interest. It could be argued that the buy-sell clauses of a shareholders' agreement operate to provide some degree of liquidity and if so, this could be considered protection against loss thereby triggering subparagraph (b)(iv).[16]

Paragraph (f) fair market value exception

The exception in paragraph (f) of the TPS definition may provide relief where the exit clauses of a shareholders' agreement appear to be TPS characterization triggers.

Paragraph (f) of the TPS definition provides that for purposes of the TPS definition, an agreement in respect of a share is to be read without reference to that part of the agreement where a person agrees to acquire a share in the circumstances set out in subparagraphs (i) and (ii) therein. The exception in paragraph (f) is important because subparagraph (b)(ii) of the TPS definition essentially causes any share that is subject to a purchase agreement to which the dividend payor corporation or a "specified person" in relation to the dividend payor corporation is a party to constitute a TPS, provided that the price is fixed, limited to a maximum, or established to be not less than a minimum.

Reading the agreement without reference to the part where a person agrees to acquire the share should exclude the name of the purchaser, price, number, and description of the subject shares and the covenant to purchase as these are the essential components of a narrow purchase clause. If the agreement is read in this manner (i.e., without reference to the part where a person agrees to acquire the share), then the amount which a shareholder is entitled to receive on the redemption, acquisition, or cancellation of the share is not fixed, limited to a maximum, or established to be not less than a minimum because there is no clause in the agreement to redeem, acquire or cancel the share. This

results in subparagraph (b)(ii) of the TPS definition not being met. It should be noted that it is only the section relating to the agreement to acquire the share that is ignored; all other parts of the agreement must nonetheless be considered for TPS analysis.

The Technical Notes state that paragraph (f) was intended to be a relieving provision and specific reference was made to a shareholders' agreement.[17]

Timing considerations

TPS characterization is relevant at the time of payment of a dividend. As mentioned above, a shareholders' agreement to which the dividend payor corporation or a specified person in relation to the corporation as a party may provide for the acquisition, redemption, or cancellation of the share in certain circumstances which would trigger a subsection 84(3) deemed dividend, but other dividends may be paid on such share. The paragraph (f) exception may assist with respect to the former but not necessarily the latter.

Subparagraph (i) of paragraph (f) of the TPS definition applies where the agreement provides for closing within 60 days after the agreement is entered into and the acquisition price does not exceed the greater of fair market value of the share at the time of the agreement or fair market value of the share at the time of acquisition, in both cases determined without reference to the agreement.

Subparagraph (ii) of paragraph (f) of the TPS definition is two-pronged. Either the purchase price does not exceed fair market value at the time of acquisition (the "Acquisition Time Value Test") or the purchase price is an amount determined "by reference to the assets or earnings of the corporation where that determination may reasonably be considered to be used to determine an amount that does not exceed the fair market value of the share" at the time of acquisition (the "Assets or Earnings Reference Test")", in both cases determined without reference to the agreement.

As indicated above, the paragraph (f) exception requires comparison to the fair market value of the share at the time of acquisition. The timing of any compulsory acquisition event in a shareholders' agreement is unknown. Until the event occurs, the fair market value of the share at that time is also unknown. Therefore the paragraph (f) exception can be of no assistance until the event triggers the compulsory acquisition. Until that time, shares subject to a shareholders' agreement with compulsory acquisition events may be TPS by virtue of subparagraph (b)(ii). The result is that dividends declared on such shares from time to time may be subject to Part VI.1 tax, unless other exceptions apply.

When the event triggering the compulsory acquisition occurs, it is then possible to determine the fair market value of the subject shares at the time of acquisition. If the price does not exceed fair market value of the share at the time of the compulsory acquisition by the corporation, determined without reference to the agreement, then the paragraph (f) exception applies and the share is not a TPS. If so, Part VI.1 tax cannot apply to the deemed dividend resulting from the compulsory reacquisition by the corporation.

Valuation issues with paragraph (f)

Where the compulsory acquisition clauses of a shareholders' agreement provide for a fixed price with periodic updates, the problem is that periodic updates often do not occur in practice, causing the initial price in the agreement to become an out of date figure. If the figure is dated, the figure's relationship with fair market value at the time of acquisition may become suspect. Formula pricing requires updating too, or the formula will be out of date as the business of the particular corporation matures and as the industry changes. Again, this raises questions about comparison with fair market value at the time of acquisition. A shareholders' agreement may be entered into early in the relationship and may thereafter be put aside.

Where the compulsory acquisition clauses of a shareholders' agreement direct an independent third party to determine a price, the shareholders' agreement may provide direction regarding assumptions and valuation approaches including the following:[18]

- Use of minority discount and/or marketability discount in contrast to assigning a rateable value to each share;
- The treatment of latent or embedded taxes in corporate assets or investments;
- Whether value should be assigned to tax accounts, such as GRIP, RDTOH, or CDA;
- The effect of such shareholder's departure (if a key person) on the business of the corporation; and
- The effect of any special restrictions, including transfer restrictions in the shareholders' agreement.

It may be difficult to find comfort in the paragraph (f) exception due to the many issues with a fair market value benchmark and the possibility of CRA challenge.[19] Recent cases such as *Zeller Estate v. The Queen*[20] and *Grimes v. The Queen*[21] have applied both a minority discount and a marketability discount in the determination of fair market value of private corporation shares, the latter for purposes of the 21-year deemed disposition rule in subsection 104(4) and the former for purposes of the deemed disposition immediately before death in subsection 70(5). This suggests that a price under a shareholders' agreement that is fixed or determined without reference to a minority and marketability discount may be an amount greater than fair market value. In the context of transactions among the shareholders *inter se*, the parties may not consider the use of such discounts to be appropriate; however, if they are not used, the paragraph (f) exception may not apply.

Further, a valuation may provide a range of value rather than a pinpoint figure. Since the paragraph (f) exception requires the amount to be not greater than fair market value at the times noted in subparagraphs (i) or (ii), conservativism means that the price must be less than the lower end of the valuation range.

Subparagraph (ii) of the paragraph (f) exception

Both the Acquisition Time Value Test and the Assets or Earnings Reference Test in subparagraph (ii) of paragraph (f) are considered without reference to the agreement.

In the Acquisition Time Value Test, because fair market value is determined without reference to the agreement, the pricing in the agreement itself cannot be used as an arbiter of value, notwithstanding that the parties may be arm's length. Rather, the valuation principles referred to above must apply. It should be noted that in the Acquisition Time Value Test, the price in the agreement can be less than fair market value determined without reference to the agreement, but cannot be greater. Thus, if appropriate valuation principles (e.g., marketability discount) would decrease the amount, reliance on the exception is problematic if the shareholders did not apply these principles in setting the terms of their agreement.

In the Assets or Earnings Reference Test, the amount must be determined by reference to the assets or earnings of the corporation and it is necessary that the determination may reasonably be considered to be used to determine an amount that does not exceed fair market value at the time of acquisition. Determination by reference suggests a formula which might be an earnings multiple or specifically driven by revenue of certain assets or licenses. The use of the phrase "may reasonably be considered" suggests that the formula must be appropriate at the time, i.e., the time of acquisition. As stated above, a formula price in a shareholders' agreement may not be updated as circumstances change in the business of the corporation or the industry. The formula in the agreement may cease being representative of a fair market value determination. Similar to the Acquisition Time Value Test, the Assets or Earning Reference Test only requires a formula resulting in an amount that does not exceed fair market value at the time of acquisition. While pinpoint accuracy is not required, the fair market value benchmark puts pressure on the ability to rely on subparagraph (ii) of the paragraph (f) exception.

Subparagraph (i) of the paragraph (f) exception

Subparagraph (i) of the paragraph (f) exception has two components. First, the acquisition must close within a maximum of 60 days of the entering into the agreement. Second, the price cannot exceed the greater of the fair market value of the share on the day on which the agreement was entered into and the fair market value of the share at the time of acquisition, both determined without reference to the agreement.

The prerequisite of a maximum 60-day closing requirement cannot be satisfied when considering the compulsory acquisition clauses of a shareholders' agreement. The 60-day period runs from the entering into of the agreement, rather than the occurrence of a triggering event. In the typical shareholders' agreement, the agreement to sell upon the compulsory acquisition event is made from the outset, although the time of closing may be delayed. Upon notice of such triggering event, the purchase by the corporation or other shareholder(s) at the price set out in the agreement is compulsory and timing depends on the closing mechanics in the agreement. Obviously, this will be a stipulated number of days following the triggering event. Therefore subparagraph (i) of the paragraph (f) exception will not be of assistance where a compulsory acquisition clause in a shareholders' agreement is the TPS characterization trigger, ignoring the fair market value issues.

The 60 days closing requirement may be satisfied in the case of other exit provisions in a shareholders' agreement which contemplate offer and acceptance. For example, a right of first refusal or a shotgun

requires one shareholder (the "offeror shareholder") to make an offer to the remaining shareholders or corporation (the "offeree"). In the case of a right of first refusal, it is an offer to sell on the same terms and conditions as a third party offer which the offeror shareholder has received. In the case of a shotgun, it is an offer to sell all of the shares of the offeror shareholder to the offeree. In both cases, a price is contained in the offer and the offeree can accept. Thus, in contrast to the compulsory acquisition events, there is no agreement to sell unless and until the offeree accepts. If the offeree is the corporation, then the acquisition will result in a deemed dividend pursuant to subsection 84(3) thus causing TPS characterization and the application of the exemption in subparagraph (f) to be relevant. In this case, if closing occurs within 60 days of acceptance of the offer, subparagraph (i) of the paragraph (f) exception may apply provided that the second prerequisite is satisfied, i.e., the price does not exceed the greater of the fair market value at the time the offer is accepted and the fair market value at the of time of closing.

The STPS Definition

The critical defining characteristic of STPS is that the corporation may be required to redeem such shares or a specified person in relation to the corporation may be required to acquire such shares within five years after the date of issue. This can arise from the terms and conditions of the share or an agreement in respect of the share. The simple example is a retraction right in the terms and conditions of the share. A shareholders' agreement might contain a put right. There is a fair market value purchase agreement exception similar to the paragraph (f) exception in the TPS definition and therefore reference should be made to the above discussion.

Substantial Interest Exemption

An "excluded dividend" is not subject to Part VI.1 tax. A dividend paid by a corporation to a shareholder that had a substantial interest in the corporation at the time the dividend was paid falls within paragraph (a) of the definition of "excluded dividend" in subsection 191(1). The prerequisites for a shareholder to have a substantial interest are set out in subsection 191(2). Paragraphs (a) and (b) therein are alternates and are discussed separately below.

Paragraphs 191(2)(a) and (b) are based on a related person connection and share ownership, respectively. Accordingly, the number of shares owned at the particular time is relevant. Where shares are redeemed or purchased for cancellation, it has been the CRA's administrative position that the shareholder's substantial interest in the corporation is tested prior to the redemption or purchase for cancellation of shares.[22] This is similar to the CRA's position in relation to connected corporation status and Part IV tax.[23]

Paragraph 191(2)(a)

Paragraph 191(2)(a) requires that the dividend recipient shareholder be related to the corporation otherwise than by reason of paragraph 251(5)(b).

The concept of "related persons" is set out in subsection 251(2) and has been the subject of much writing.[24] The question of whether any particular shareholder is related to the corporation is dependent on the particular facts including the share structure at the particular time. The following are two examples of private corporation shareholder situations where Part VI.1 tax may become a potential concern.

- Employee shareholders and "friends and family" investor shareholders may acquire shares which provide for a return that trips into TPS characterization. Such individuals may not be related to the dividend payor corporation.
- The founder or owner-manager of the corporation implements an estate freeze exchanging his/her common shares for redeemable retractable preferred shares. An *inter vivos* trust becomes a common shareholder. Later, the founder passes away and his/her estate becomes a shareholder. Upon the freezor's death, his/her estate may seek to redeem the shares to implement certain post-mortem planning pursuant to subsection 164(6). The share redemption may result in a significant deemed dividend pursuant to subsection 84(3).

In the second example above, if the shares owned by the trust or estate represent *de jure* control of the corporation, then clearly, the trust or estate and the corporation are related persons. If this is not the case, the related person analysis requires consideration of the identity of the trustees and relationship of the group of trustees who exercise the decisions (as determined by the trust document or will, i.e., unanimously or otherwise) with the person(s) who has *de jure* control of the corporation.[25] Questions arise where there are multiple trustees.[26] Most examples contemplate only a sole trustee. Where there are two trustees, one of whom is not related to the person who controls the dividend payor corporation, it seems that the trust or estate would not be related to the corporation. Where there are three trustees with majority decisionmaking prevailing but one trustee is not related to the person who controls the dividend payor corporation, the application of subsection 104(1) and subsection 251(2) seems unclear.[27] The presence of an unrelated trustee causes concern with the availability of paragraph (a) of the substantial interest exemption.

In the case of an estate, it is quite possible that one or more "non-family" estate trustees may be named, thereby causing the above concern. The "non-family" estate trustee(s) could resign to permit the appointment of related family trustee(s) prior to a post-mortem share redemption, but consideration must be given to the anti-avoidance rule in subsection 191(3)(b). A more cautious approach would be that the "non-family" person refuses the appointment as estate trustee rather than resigning.

Paragraph 191(2)(b)

Paragraph 191(2)(b) requires the dividend recipient shareholder to have sufficient share ownership to meet the benchmarks set out below. For this purpose, shares otherwise owned by a related person (other than a person related by reason of paragraph 251(5)(b)) are deemed to be owned by the dividend recipient shareholder in question.

(i) The shares owned or deemed owned by the dividend recipient shareholder must represent more than 25% of the votes that could be cast under all circumstances at an annual meeting of shareholders of the corporation.

(ii) The shares owned or deemed owned by the dividend recipient shareholder must represent more than 25% of the fair market value of all issued shares of the corporation.

And either (iii) or (iv) below

(iii) Such shares must represent more than 25% of the fair market value of all shares of the corporation that are not TPS,[28] or

(iv) Such shares must represent more than 25% of the fair market value of the issued shares of each class of shares of the corporation.

The reference to voting "under all circumstances at an annual meeting of shareholders" in subparagraph 191(2)(b)(i) is presumably intended to exclude circumstances where otherwise non-voting shares have a right to vote or where the consent of a particular class of shares might be required by corporate law.[29] This should be analogous to the phrase "full voting rights under all circumstances" which appears in the subsection 186(4) connected corporation test. However, it is useful to contrast the requirements. The analogous "10% votes" requirement for connected corporations in subparagraph 186(4)(b)(i) refers to owning more than a specified percentage of the shares having full voting rights, whereas subparagraph 191(2)(b)(i) refers to owning shares which carry the right to more than a specified percentage of the votes. The latter gives full recognition to a share which carries multiple voting rights.[30]

While the particular shareholder must hold at least one share (or a fraction thereof) else it would not be a dividend recipient shareholder triggering a potential Part VI.1 tax concern, the balance of the ownership needed to satisfy the tests above may be that of related persons but deemed to the particular shareholder. In the CRA's view, a corporate beneficiary of a trust cannot meet the substantial interest exemption requirements because it does not own the property held by the trust. The trust owns shares of the dividend payor corporation and the trust pays the dividend to a beneficiary and makes the necessary subsection 104(19) designation such that the amount is deemed to be a taxable dividend received by the beneficiary. However, the beneficiary is not a shareholder as required by the preamble to the substantial interest exemption in subsection 191(2).[31]

Override rule

Notwithstanding all of the above, there is an override rule in paragraph 191(3)(d) applicable to a trust or a partnership.

- A partnership is deemed not to have a substantial interest in a corporation unless all of the members are related to each other (otherwise than by reason of paragraph 251(5)(b)).

- A trust is deemed not to have a substantial interest in a corporation unless:
  - It is a trust in which each person beneficially interested is related to each other person beneficially interested, excluding registered charities. For this purpose, an individual is deemed to be related to his/her aunt, uncle, niece, or nephew, and the individual's child or descendant is deemed related to the individual's aunt, uncle, niece, or nephew or that person's child or other descendant. But for this deeming provision, an individual and his/her aunt, uncle, niece, or nephew would not be related based on the rules in subsection 251(2).
  - It is a trust in which each person beneficially interested is a registered charity.
  - It is a trust in which only one person (other than a registered charity) is beneficially interested.

The effect of the override rule is that even if the trust or estate is related to the dividend payor corporation (e.g., *de jure* control of the corporation), the trust or estate will not have a substantial interest if any single person beneficially interested is not related to each other person who is beneficially interested.[32] A problem may arise where there is a second marriage. The beneficiaries under the estate could be the surviving second spouse and children of the first marriage. If the estate holds TPS and seeks to redeem same, it would not have a substantial interest in the corporation. In the case of an estate, it is also possible that there may be legacies to persons who are not related to other beneficiaries. While such legatees may be considered beneficially interested in the estate at the outset, presumably legacies are paid in full and legatees will have executed releases before the significant post-mortem share redemptions are implemented.

If the substantial interest exemption is not available, a shareholder may next look to the exception provided by subsection 191(4).

Subsection 191(4) and the Specified Amount

Where subsection 191(4) applies, the particular dividend is deemed to be an excluded dividend and therefore excluded from Part VI.1 tax. The application of subsection 191(4) is often considered to turn on whether there is what has sometimes been colloquially referred to as a “specified amount”. In general terms, the “specified amount” effectively limits the portion of the deemed dividend which is not subject to Part VI.1 tax.

Deemed Dividend

Subsection 191(4) contemplates a dividend deemed to be paid on a redemption, acquisition or cancellation of a share to which subsection 84(2) or (3) applies. The words “redeemed, acquired or cancelled” are used in subsection 84(3) but not in subsection 84(2). Pursuant to subsection 84(3), a dividend is deemed to have been paid by a corporation resident in Canada on the redemption, acquisition, or cancellation of any of the shares of any class equal to the amount paid by the corporation on such redemption, acquisition, or cancellation in excess of the paid-up capital of the shares immediately before that time. Thus, it seems apparent that a redemption of shares in

accordance with their attributes or a corporation's purchase for cancellation of its issued shares[33] is corporate action triggering subsection 84(3).

It is not the case that a subsection 84(2) deemed dividend necessarily involves a redemption, acquisition, or cancellation of a share. Pursuant to subsection 84(2), a dividend is deemed to have been paid by a corporation resident in Canada where property of the corporation is distributed or otherwise appropriated in any manner whatever to or for the benefit of the shareholders of any class of shares on the winding up, discontinuance, or reorganization of its business. The winding up, discontinuance, or reorganization of a corporation's business will not necessarily involve the redemption, acquisition, or cancellation of issued shares of the corporation absent the winding up of the corporation. It has long been the CRA's administrative position that the winding up of a corporation ends its business and its existence and in the CRA's view, a corporation has wound up where the formal procedures for dissolution are followed.[34] Given the reference in subsection 191(4) to a redemption, acquisition, or cancellation of a share, the particular subsection 84(2) deemed dividend must be tied to a winding up and dissolution of the corporation. Where the corporation dissolves under corporate law, its issued shares are necessarily cancelled. As subsection 84(2) does not apply to the parent in a winding up to which subsection 88(1) applies,[35] the relevant subsection 84(2) deemed dividend to which subsection 191(4) may apply is that deemed paid to shareholders on a subsection 88(2) wind-up or to shareholders other than the parent in a subsection 88(1) wind-up, assuming that the formal dissolution of the corporation follows.

The Component Parts of subsection 191(4)

It is instructive to break down subsection 191(4) into its component parts to understand its parameters and the CRA's interpretation.

Opening Conditions

The opening conditions to subsection 191(4) require one of the three actions below.

(a) A share is issued;

(b) The terms or conditions of a share are changed; or

(c) An agreement in respect of a share is changed or entered into.

In the following discussion, each of the above actions is referred to as an "Opening Condition" and with reference to the particular paragraph shown.

With respect to Opening Condition (a), it is trite to say that a share is issued in accordance with the requirements of the applicable corporate statute, at such time, to such persons and for such consideration as the directors may determine.[36]

With respect to Opening Condition (b), corporate statutes in Canada do not typically use the phrase "terms or conditions" of a share although this phrase is used in a number of sections of the Act.[37] The predominant language used in Canadian corporate statutes to describe the attributes of shares that

are set out in the articles is “rights, privileges, restrictions, and conditions”.[38] Where steps are taken in accordance with the applicable corporate statute to amend the articles of the corporation to add, change or remove any rights, privileges, restrictions, and conditions, such action should fall within Opening Condition (b). It may be arguable that “terms or conditions” of a share are not limited to the words in the articles which set out the “rights, privileges, restrictions, and conditions”.

In some corporate reorganization steps, it is unclear whether Opening Condition (a) or (b) is met. For example, under the OBCA, it is also possible to “change” the shares of any class into the same or different number of shares of another class by filing articles of amendment.[39] This could be a means of effecting a section 86 reorganization without the need for an exchange contract between shareholder and corporation. However, it is unclear whether shares are issued in this case (to fit within Opening Condition (a)); rather, shares of one class are merely “changed” into shares of another class. It is also unclear that Opening Condition (b) is met. Although shares of one class may have “morphed” into shares of the second class, the attributes of neither class changed. Rather, the particular shares held by the shareholder changed. An amalgamation may be another example of this uncertainty. Under the CBCA, each corporation proposing to amalgamate enters into an amalgamation agreement which sets out the terms and means of effecting the amalgamation including “the manner in which the shares of each amalgamating corporation are to be converted into shares or other securities of the amalgamated corporation.”[40] Given the use of the word “converted” instead of “issued” (the latter most certainly being used elsewhere in the CBCA), it is unclear whether shares are “issued” upon an amalgamation.[41] There is also inconsistency in the Act with reference to this matter upon an amalgamation,[42] which highlights the uncertainty that Opening Condition (a) or (b) is met.

Opening Condition (c) is clearly broad. There are no particular requirements regarding the agreement and how it affects the share. The reference is simply to an agreement “in respect of the share” being entered into. In other words, any shareholders’ agreement could be such an agreement. Also given the uncertainty with respect to Opening Condition (a) or (b) in the case of an amalgamation, perhaps the amalgamation agreement fits within Opening Condition (c).

The Specified Amount

The “specified amount” concept appears in the mid-amble of subsection 191(4). Either the terms and conditions of the shares must specify an amount or the agreement in respect of the shares must specify an amount. Where Opening Condition (a) applies, the specified amount cannot exceed the fair market value of the consideration for which the share was issued and the share cannot be issued for consideration that included a TPS. Where Opening Condition (b) or (c) applies, the specified amount cannot exceed the fair market value of the share immediately before the particular time (being the time the terms or conditions of the share are changed or the time an agreement in respect of the share is entered into or changed) and further, the share cannot have been a TPS immediately before the particular time.

It is curious to note that the specified amount may not necessarily be the redemption or purchase amount. Subsection 191(4) requires that the terms or conditions of the share or the agreement in

respect of the share specify an amount "including an amount for which the share is to be redeemed, acquired, or cancelled". Context is provided by subsection 191(5) which states that subsection (4) does not apply to the extent that the total of the amount paid on the redemption and all amounts paid on a reduction of the paid-up capital in respect of the share exceeds the specified amount. The effect of subsection 191(5) is that the specified amount should align with the redemption amount, else any "excess" deemed dividend (i.e., the amount paid on the redemption in excess of the specified amount) will not be an excluded dividend under subsection 191(4).

It is fairly typical that shares issued in a section 85, 86, or 51 transaction are drafted to refer to the redemption amount of such shares in a formulaic or definitive fashion. For example, a corporation's authorized capital may include Class X shares where the redemption amount per share is as set out below and a certain number of Class X shares may be issued on the section 85, 86, or 51 transaction.

> Class X Redemption Amount means the fair market value of the property received in consideration of the first issuance of Class X shares divided by the number of Class X shares first issued, such amount to be confirmed and determined by resolution of the board of directors of the corporation.

In this case, there is no dollar amount expressly set out in the attributes of the shares as the redemption amount. Rather, there will be a directors' resolution confirming the arithmetic result of the foregoing based on a determination of value. The directors' resolution may be contemporaneous with the share issuance, or possibly some time thereafter (perhaps when valuation work is completed or an election form or other tax compliance is completed). The alternative would be preferred shares which have been drafted with an actual dollar redemption amount of $1, $100, or $1000 per share, for example. In the latter case, there can be no question there is a specified amount. Use of preferred shares thus drafted presumes valuation decisions are made prior to implementation of the reorganization step because it will be necessary to decide the number of such preferred shares to issue (i.e., number of preferred shares multiplied by the actual dollar redemption amount per share equals the particular valuation).

Formulaic redemption amount preferred shares (such as the Class X shares described above) are often preferred for the section 85, 86, or 51 transaction because the value of the transferred property/shares may not yet be determined. This necessarily means that the redemption amount is confirmed sometime after share issuance. It is not clear, in the writer's view, that subsection 191(4) requires the amount to be specified at the particular time referred to in subsection 191(4). The term "particular time" appears in the preamble: "Where, at any particular time" a share is issued, the terms or conditions of a share are changed or an agreement in respect of a share is entered into. In other words, the particular time is the time when Opening Condition (a), (b), or (c) is met. The term next appears in the mid-amble of subsection 191(4) to modify the time of determination of fair market value where Opening Condition (b) or (c) is met, i.e., the specified amount cannot exceed the fair market value of the share immediately before the terms of the share are changed or the agreement is entered into. The term also appears in subparagraph 191(4)(d)(ii) to provide that subsection 191(4) does not apply in the case of Opening Condition (b) or (c) if the share was a TPS immediately before such opening condition was met (i.e., the particular time). It is submitted that subsection 191(4) does not expressly state "when" as opposed

to "where" the amount must be specified (the "where" being the terms or conditions of the share or the agreement in respect of the share). On the basis that subsection 191(4) does not expressly state "when" the amount must be specified, it is suggested that in the case of formulaic redemption amount preferred shares, a directors' resolution confirming the redemption amount following the time of share issuance should not, in and of itself, be problematic.

It is recognized that the above contradicts a CRA administrative position out in 1990 as follows: [43]

> If the redemption amount is set at a later date it would not be a specified amount referred to in subsection 191(4), since, for the purposes of that subsection, the amount must be specified at the particular time referred to in paragraph 191(4)(a), i.e., when the shares are issued.

With respect, the foregoing conflates the "particular time" reference in subsection 191(4) with the requirement that the terms or conditions of the share or agreement in respect of the share specify an amount. While the particular time is the time when one of the opening conditions is met, subsection 191(4) only requires that the terms or conditions of the share or agreement, in respect of the share, specify the amount. The more specific question may be whether an amount is specified in the terms or conditions of a share or agreement in respect of a share in these circumstances.

Is an amount specified? This requires interpretation of the word "specify" and the word "amount".

The word "specify" is defined in the *Oxford English Dictionary* as "to identify something clearly and definitely". The *Meriam-Webster Dictionary* defines "specify" as "to name or state explicitly or in detail."

The word "amount" is defined in subsection 248(1) as follows:

> "amount" means money, rights, or things expressed in terms of the amount of money or the value in terms of money of the right or thing.

The CRA has stated that the specified amount must be an actual dollar amount[44] and cannot be based on a formula relating to some other share.[45] This ties in with the definition of "amount". At first blush, this may suggest that formulaic redemption amount preferred shares are problematic but the writer submits that this is not the case.

If the redemption amount of shares is defined as noted above, i.e., by formulaic description to the transferred property, it can be said that something is identified clearly and with the context provided by the resolution issuing the shares, the property will be explicitly identified. Therefore, the particular transferred property is specified and indeed, specified at the time of share issuance. But subsection 191(4) requires an amount and there is no expression in terms of money as contemplated by the definition of "amount". As noted above, typically, a formulaic description of redemption amount provides for confirmation by written resolution of the board of directors of the corporation. It is suggested that the attributes of the shares should also expressly provide that the amount determined or confirmed by resolution of the board of directors shall be the specified amount for purposes of subsection 191(4). Since this action is provided for in the rights, privileges, conditions and restrictions of the particular

class of shares in the articles of the corporation, it can reasonably be said that the subsequent resolution merely completes or is indeed part of the terms or conditions.[46] Indeed, the different language of the corporate statute (i.e., rights, privileges, conditions, and restrictions) suggests that terms or conditions may be found outside of the articles themselves.

In private corporation reorganizations and estate freezes, redeemable retractable preferred shares are often used. Such shares are clearly TPS. It is desirable to be able to rely on an exempting provision so that the deemed dividend upon the redemption of such shares does not trigger Part VI.1 tax. It is unclear why an actual dollar redemption amount at the time of share issuance should be required when the shares are considered validly issued under corporate law and further, there is no after-tax financing involved (being the stated purpose for these rules). Some have suggested a cautious approach of using two classes of preferred shares. One class could have an actual dollar redemption amount and a sufficient number of shares of this class could be issued to reach a conservative low point of the value of the transferred property. The second class could be formulaic redemption amount preferred shares which would "soak up" the balance of the value. The use of two classes, however, reduces the risk because the second class with the formulaic redemption amount necessarily represents less than the total value in question.

Effect of a Price Adjustment Clause

In 1989, the CRA stated that a price adjustment clause cannot adjust the specified amount as that "would defeat the purpose of having the specified amount restriction."[47]

The CRA has recently clarified its position with respect to the interaction of a price adjustment clause and the specified amount. In CRA document no. 2016-0634551E5,[48] the terms and conditions of the shares included a price adjustment clause applicable to the redemption amount of shares. The terms and conditions of the shares specified an amount for which the shares are to be redeemed, acquired, or cancelled for purposes of subsection 191(4). There was a separate price adjustment clause relating to the redemption amount. The CRA stated that shares being subject to the potential operation of a price adjustment clause would not, in and of itself, negate the specified amount. If the shares are redeemed, triggering a deemed dividend, subsequently, the price adjustment clause became operative:

- To increase the redemption amount, then the excess or additional redemption amount would not be part of the excluded dividend pursuant to subsection 191(4).
- To decrease the redemption amount, the entire deemed dividend upon the prior redemption would not be an excluded dividend pursuant to subsection 191(4) because the redemption amount would thereby presumably be greater than the fair market value of the consideration transferred in consideration for which the shares were issued.

The underlying assumption in CRA document no. 2016-0634551E5 is that there was a specified amount which was the initial redemption amount of the shares. Although the operation of the price adjustment clause may have either increased or decreased the redemption amount, this did not "negate the amount that was specified for the purposes of subsection 191(4)." There was no information regarding the drafting, i.e., how the amount was specified. Although the usual redemption clause which

includes a redemption price per share may suffice, it is suggested that the attributes of shares should include a clause which expressly refers to subsection 191(4) and assuming that the specified amount is the redemption amount, excludes the application of the price adjustment clause for this purpose.[49]

Examples

The following are additional examples of private corporation situations with TPS potentially subjecting the dividend payor corporation to Part VI.1 tax.

The Refreeze

Sometimes an owner-manager may implement an estate freeze and later, determine that the fair market value of the "frozen asset" has declined. In such a situation, consideration may be given to refreezing, i.e., freezing again to the "new" lower value. This means that the preferred shares issued in connection with the original freeze, whose aggregate redemption and retraction amount is equal to the original freeze value, must be exchanged for new redeemable retractable preferred shares whose aggregate redemption and retraction amount is equal to the new lower freeze value.

The preferred shares issued in connection with the original freeze would be TPS. While the original preferred shares may have had a "specified amount" satisfying the parameters of subsection 191(4), the new redeemable retractable preferred shares cannot meet the parameters of subsection 191(4). Specifically, pursuant to subparagraph 191(4)(d)(i), because the new shares will be issued in consideration for TPS, there cannot be an excluded dividend. Therefore, in the event of the redemption of the new shares (assumed to be in excess of the dividend allowance), it is necessary to consider whether the resultant dividend may be excluded from Part VI.1 tax for other reasons, i.e., by virtue of the substantial interest exemption.

If the underlying corporation was a two-family company, (i.e., there were originally two owner-managers who were 50:50 shareholders), each owner-manager may hold a separate class of redeemable retractable preferred shares and two different classes of post-freeze common shares may have been used to permit future flexibility among the two families. There may be a shareholders' agreement. The agreement would have to be reviewed to determine if the common shares might be characterized as TPS because of compulsory acquisition events. If so, then all shares (both redeemable retractable preferred shares and both classes of common shares) may be TPS. As a result, it would not be possible to fit within the substantial interest exemption because of the paragraph 191(2)(b) requirement to either hold 25% of the fair market value of shares that are not TPS or 25% of each class of shares.

The Second Marriage

A second marriage creates potentially unrelated persons following the death of the spouse who is the biological parent of the children. For various reasons, the stepchildren of the second marriage spouse may not be adopted following the second marriage. Notwithstanding a good relationship, following the death of the second marriage spouse, the stepchildren are not related to the stepparent. When the stepparent dies and provides in his/her will for both children of the first marriage (i.e., biological

children) and the unadopted stepchildren of the second marriage, there will be persons beneficially interested in the estate who are not related to others beneficially interested in the estate. The paragraph 191(3)(d) override rule will deem such estate not to have a substantial interest in the corporation.

If the owner-manager (being the stepparent above) had implemented an estate freeze and died holding redeemable retractable preferred shares (which are TPS), it becomes necessary to consider whether there is a specified amount satisfying the parameters of subsection 191(4).

Incentivizing an Employee

To incentivize a key executive-level employee, the owner-manager and sole shareholder of a corporation may give an equity interest (common shares) to the employee. A shareholders' agreement is entered into. Among other things, the agreement provides for a mandatory repurchase of the individual's shares upon cessation of employment. In order to be equitable, the agreement specifically provides for pricing using an annually-reviewed valuation but on a pro-rated basis without minority or marketability discount. The compulsory acquisition clause in the shareholders' agreement causes the common shares to be characterized as TPS and the paragraph (f) exception in the TPS definition cannot assist because of the lack of minority and marketability discount. As a result, dividends paid on the common shares to the employee (both any declared periodic dividend and the deemed dividend upon share repurchase triggered by cessation of employment) may constitute TPS dividends such that it is necessary to consider the dividend allowance in the year. The dividend paid on the common shares held by the owner-manager should be an excluded dividend because of the substantial interest exemption pursuant to paragraph 191(2)(a).

Concluding Comments

The taxable preferred share rules are complex. As illustrated by the examples given above, TPS characterization may arise in the private corporation context where there was no after-tax financing involved (being the stated purpose in the White Paper for the introduction of these rules). A shareholders' agreement may cause a "garden variety" common share to be characterized as TPS and redeemable retractable preferred shares used in common planning structures for the owner-manager are by definition TPS. While the available exemptions ("specified amount" or substantial interest) can assist, they too have unexpected nuances and the paragraph 110(1)(k) deduction is not a perfect offset (without taking into account the historic slow pace of change in the multiple therein to more adequately reflect existing corporate rates). From a policy perspective, it is suggested, at a minimum, that the dividend allowance should be increased and further, a broader reorganization based exemption should be considered without the nuanced use of a "specified amount" to facilitate private corporation planning.

The simple conclusion is that it cannot be assumed that the taxable preferred share rules do not apply to a private corporation and its shareholders.

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Endnotes

1 R.S.C. 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this paper are to the Act.

2 As defined in subsection 248(1) (such shares being referred to herein as "TPS" and the definition being herein referred to as the "TPS definition"). This paper assumes that shares are not "grandfathered shares" as defined in subsection 248(1).

3 As defined in subsection 248(1) (such shares being referred to herein as "STPS" and the definition being herein referred to as the "STPS definition").

4 See, for example, Donald M. Sugg, "Preferred Share Review: Anomalies and Traps for the Unwary," *Report of Proceedings of Forty-Fourth Tax Conference*, 1992 Conference Report (Toronto: Canadian Tax Foundation, 1993), 22:1-31; David Downie and Tony Martin, "The Preferred Share Rules: An Introduction," *Report of Proceedings of Fifty-Fifth Tax Conference*, 2003 Conference Report (Toronto: Canadian Tax Foundation, 2004), 52:1-28; Michelle Chang and David Christian, "Shares Attributes," in *2016 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 2016), 4:1-17 at p.12/13 – p.16/17; Evelyn R. Schusheim, "Shareholders' Agreements," in *2012 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 2012), 12:1-23 at p. 8/9/10-p.13; Nancy Diep, "Preferred Share Rules: The Expected, Unexpected and Unintended," in *2017 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2017), 13:1-29.

5 Evelyn P. Moskowitz, "The Preferred Share Rules: Yes, They Can Apply to You!," *Report of Proceedings of Forty-Ninth Tax Conference*, 1997 Conference Report (Toronto: Canadian Tax Foundation, 1998), 9:1-47.

6 White Paper on Tax Reform, June 18, 1987 (herein the "White Paper"), "Taxation of Preferred Shares, General Notes on Proposed Regime". See page 245 of the commercially published version of the White Paper by CCH Canadian Limited Special Report 9994.

7 White Paper. See page 246 of the commercially published version of the White Paper by CCH Canadian Limited Special Report 9994.

8 Largely enacted with the Phase One tax reform bill, Bill C-139, S.C. 1988, c.55.

9 The corporate recipient of a taxable dividend received on a STPS is generally not subject to Part IV.1 tax (see paragraph (d) of the definition of "excepted dividend" in subsection 187.1). The dividend payor corporation is subject to Part VI.1 tax on a STPS dividend at the rate of 40% of the amount of the dividend. Where a dividend payor corporation elects to pay the higher 40% rate on TPS dividends under Part VI.1 , then the corresponding Part IV.1 tax on the corporate dividend recipient is eliminated.

10 See paragraph 187.1(c).

11 See definition in subsection 191(1).

12 See CRA document no. 2012-0443471E5, March 15, 2013 where in CRA's view, shares entitled to 75% of the profit resulting from an adventure in the nature of trade were TPS because the amount of dividend was fixed by formula notwithstanding the existence of variables. This is discussed in Marc Richardson Arnould, "Interpretation of Fixed Dividend Entitlement Ends Questions on Taxable Preferred Share Status" (2013) 18:4 *Corporate Finance (Federated Press)*

13 But see CRA document no. 2003-0034073, 2003. This was a ruling where the board of directors of a public company established a dividend policy which was not documented in an agreement. The company had two classes of shares, Class A and Class B which participated equally in dividends provided that no dividend could be paid on the Class A shares until a dividend of [redacted] was paid on the Class B shares. The board of directors adopted a policy and proposed to pay dividends aggregating [redacted] on the Class A shares and Class B shares annually. The dividend policy was ruled not to cause the Class B shares to be TPS.

14 For this purpose, this also includes a shareholder of a shareholder.

15 See CRA document no. 3-2558, September 28, 1989 and Larry Nevsky, "Corporate Law Considerations for the Tax Practitioner," in *2016 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 2016), 3:1-30 at p.11/12. See also Douglas S. Ewens, "The New Preferred Share Dividend Tax Regime," *Report of Proceedings of the Fortieth Tax Conference*, 1988 Conference Report (Toronto: Canadian Tax Foundation, 1989), 21:1-18 at p. 21:16/17.

16 Consideration should be given to *Howe v. The Queen* 2004 TCC719. This case involved a limited partner's at-risk amount pursuant to paragraph 96(2.2)(d). A covenant which provided liquidity in respect of limited partnership units was held to not have been given "for the purpose of reducing the impact, in whole or in part, of any loss that the taxpayer may sustain because the taxpayer is a member of the partnership" (as those words are used in paragraph 96(2.2)(d)). By analogy, reference may also be made to *Citibank Canada v. The Queen* 2002 FCA 128 for interpretation of the words "guarantee, security or similar indemnity or covenant" in the definition of "term preferred share" in subsection 248(1), and to *C.S. Esplen v. The Queen* 96 DTC 1272 (TCC) for interpretation of the words "guarantee, security or similar indemnity" in Regulation 6202(1)(b).

17 Technical Notes to Bill C-139 with reference to the TPS definition:

> Paragraph (f) is a relieving provision that provides that the liquidation entitlement of a shareholder shall not be considered to be fixed, limited to a maximum or established to be not less than a minimum, solely as a result of an agreement to which the corporation or a specified person with respect to the corporation is a party, such as a shareholders' agreement, under which a purchaser agrees to acquire the share for an amount that is not greater than its fair market value at the time of the acquisition.

18 See Amanda Salvatori and Steven Hacker, "Shareholder Buy/Sell Agreements: A Valuator's Perspective", (October 2016) 4:2 Connection, STEP Toronto Branch Newsletter 6-8; and Samantha Horn, "Annotated Shareholder Agreement Buy-Sell Provisions", *Annotated Shareholder Agreement 2016*, (Law Society of Upper Canada: 2016).

19 See Amanda Salvatori and Steven Hacker, "Shareholder Buy/Sell Agreements: A Valuator's Perspective", (October 2016) 4:2 Connection, STEP Toronto Branch Newsletter 6-8; and Samantha Horn, "Annotated Shareholder Agreement Buy-Sell Provisions", Annotated Shareholder Agreement 2016, (Law Society of Upper Canada: 2016).

20 2008 TCC 426.

21 2016 TCC 280.

22 1988 Revenue Canada Round Table Question 38, *Report of Proceedings of the Fortieth Tax Conference*, 1988 Conference Report (Toronto: Canadian Tax Foundation, 1989), 53E:1-90 at p. 53E:51.

23 *See Interpretation Bulletin* IT-269R4 (Archived), "Part IV Tax on Taxable Dividends Received by a Private Corporation or a Subject Corporation", April 24, 2006, paragraph 17.

24 See, for example, Michael Friedman and Todd Miller, "Navigating the Minefield: The Implications of being Associated, Affiliated, or Related under the *Income Tax Act* (Canada)," in *2015 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 2015), 12:1-75; and Ron Dueck and Stephanie Daniels, "Update and Review of the Related, Affiliated, and Associated Rules: Overlaps, Differences, and Their Significance," in *2014 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 2014), 10:1-82 ("Dueck and Daniels").

25 As explained in Dueck and Daniels, ibid, at p.28, subsection 104(1) states that a reference to a trust is read as a reference to the trustees and further, *MNR v. Consolidated Holding Company Limited* [1972] CTC 18 (SCC) validated review of the trust instrument to ascertain whether one or more of the trustees can control the voting rights of shares held by the trust.

26 See *Income Tax Folio* S1-F5-C1, "Related Persons and Dealing at Arm's Length", June 9, 2015, paragraphs 1.47 – 1.49.

27 Subsection 104(1) states that a reference to a trust or estate shall be read to include a reference to the trustee "having ownership or control of the trust property". If there are three trustees (X and Y are related and Z is unrelated) and the trust instrument provides for majority decision making, does subsection 104(1) mean that references to the trust shall be read as a reference to X and Y? Does "control of the trust property" equate to the possibility of two trustees joining together for decision making? But this seems to ignore some of the words of subsection 104(1) – "having ownership or control of the trust property" (emphasis added). From a trust law perspective, all trustees together have ownership of the trust property. From an income tax perspective, CRA has expressed different views – each trustee owns all (CRA document no. 2005-0111731E5, July 4, 2006); each trustee owns pro rata (CRA document no. 2008-0285021C6, October 10, 2008); all trustees own jointly (CRA document no. 2009-0330271C6, October 9, 2009). The foregoing were associated corporation questions deriving from common trustees. It is acknowledged that subsection 104(1) uses the conjunction "or", i.e., "ownership or control". Query whether the above may lead to different group of trustees being the reference trustee for subsection 104(1).

28 Excluding for this purpose the guarantee arrangements in subparagraph (b)(iv) of the TPS definition.

29 See, for example, subsection 170(1), *Business Corporations Act*, R.S.O. 1990, c. 16 as amended ("OBCA") relating to certain amendments to the articles of the corporation. See also CRA document no.2006-0204901E5, November 16, 2006.

30 Compare the result in CRA document no. 2014-0538081C6, October 10, 2014.

31 1991 Revenue Canada Round Table, Question 7, *Report of Proceedings of the Forty-Third Tax Conference*, 1991 Conference Report (Toronto: Canadian Tax Foundation, 1992), 50:1-40 at p.50E:4/5.

32 An interesting analogy is subparagraph 55(5)(e)(ii) which refers to a beneficiary (rather than persons beneficially interested) and also excludes the contingent beneficiary who succeeds to the interest of a deceased beneficiary.

33 A corporation is permitted to purchase or otherwise acquire any of its issued shares, subject to its articles. See, for example, sections 30 and 36, OBCA and sections 34 and 40, *Canada Business Corporations Act*, R.S.C. 1985, c. C-44 as amended ("CBCA").

34 *Interpretation Bulletin* IT-126R2 (Archived), "Meaning of Winding-up", March 20, 1995, at paragraphs 2-3.

35 See paragraph 88(1)(d.1).

36 See, for example, section 23, OBCA and section 25, CBCA.

37 See, for example, the definition of "specified class" in subsection 55(1); definition of "specified share" in subsection 212(3.8); and the definition of 'specified class" in subsection 256(1.1).

38 See, for example, paragraph 22(4)(a), OBCA and paragraph 6(1)(c), CBCA. Similar language is used in the corporate statutes of Saskatchewan, Manitoba, New Brunswick and Newfoundland. The corporate statutes of other provinces have minor variations, such as adding the word "special" or omitting one of the four words, such as "rights and restrictions" rather than "rights, privileges, restrictions and conditions".

39 See paragraph 168(1)(h), OBCA and also paragraph 173(1)(h), CBCA. See also CRA document no. 2007-0243101C6, October 5, 2007 where CRA was asked whether shares are issued when articles of amendment modify the description of the outstanding Class A preferred shares to Class B preferred shares having the same terms and conditions. The answer was that this is a matter of corporate law. However the question seemed to relate to a redesignation of a class of shares rather than a change of shares into shares of another class.

40 See paragraph 182(1)(c), CBCA.

41 Paragraph 175(1)(b), OBCA is the analogous provision in the OBCA. While paragraph 175(1)(b), OBCA does not use the word “convert”, it also does not use the word “issue” but rather simply provides that the amalgamation agreement must provide “the basis upon which and the manner in which” the holder of issued shares of an amalgamating corporation is to receive shares/securities of the amalgamated corporation. Context is provided by subsection 175(2), OBCA which applies where one amalgamating corporation holds shares of another amalgamating corporation and states: “…no provision shall be made in the agreement [i.e., amalgamation agreement] for the conversion of such shares into shares of the amalgamated corporation” (emphasis added). See also *Koch Transport Ltd. v. Class Freight Lines Ltd.* (1982), 37 OR (2d) 566 (HCJ).

42 See paragraph 87(3.1)(c) which refers to shares converted on the amalgamation in contrast to subsections 87(4.2) and (4.4) which refer to shares issued on the amalgamation.

43 CRA document no. rrrr349, May 15, 1990.

44 CRA document no. 9309585, April 16, 1993.

45 1989 Revenue Canada Round Table, Question 20, *Report of Proceedings of the Forty-First Tax Conference*, 1989 Conference Report (Toronto: Canadian Tax Foundation, 1990), 45E:1-29 at p.45E:13.

46 There is no equivalent to an “entire agreement” clause in the articles.

47 *Supra*, note 45.

48 May 4, 2016. See also Marlene Cepparo, “TPS Price Reduction May Eliminate Excluded Dividend” (2016) 24:11 *Canadian Tax Highlights* 7-8.

49 Such a clause could be as follows: “For purposes of subsection 191(4) of the Income Tax Act (Canada), an amount equal to the Class X Redemption Amount as first confirmed by resolution of the board of directors of the corporation and without giving effect to any subsequent adjustments contemplated in the price adjustment clause, is hereby specified in respect of each Class X share.”

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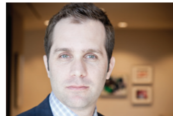

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