SHARE CAPITAL DESIGN

THE PREFERRED SHARE RULES

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THE PREFERRED SHARES RULES[*]

Generally speaking, the *Income Tax Act* (Canada) (the "**Act**")[1] recognizes the distinction between debt and equity investments in a Canadian corporation and contains different rules for dealing with interest and dividend payments, from the perspective of both the payor and the payee. Interest payments are generally deductible by the payor, assuming that the payments are reasonable in amount and have been incurred for the purpose of earning income. Dividends, on the other hand, are not deductible by the payor because, unlike interest, dividends are not expenses incurred in the income-earning process but, rather, represent a distribution of the after-tax profits of the payor. From the payee's perspective, interest payments are fully taxable whereas dividend payments, if received by a corporation, are effectively received tax-free. This tax-free treatment of dividends in the hands of a corporate shareholder reflects the fact that the income giving rise to the dividends has already been taxed at the corporate level and should therefore not bear any further tax until paid out to an individual shareholder. Dividends paid to an individual shareholder are taxed in that individual's hands but are subject to the dividend gross-up and tax credit rules under the Act which will result in the individual paying less tax on the dividends than he/she would have paid on an equivalent amount of interest. (The dividend gross-up and tax credit rules are intended to partially credit the individual shareholder with the tax paid by the corporation on the income giving rise to the dividend and so avoid full double taxation.)

Where, however, the terms of a share or any agreement relating to that share are such that the share more closely resembles debt than equity, the Act will ignore the corporate law characterization of the security and will effectively treat the equity investment as an investment in debt of the corporation. The reason for this tax treatment is to preclude a holder of what is

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[1] RSC 1985, c.1, (5th Supp.), as amended. Unless otherwise stated, all statutory references in this paper are to the Act.

economically a debt instrument from benefitting from rules specifically designed for equity investments. The foregoing concern can best be illustrated by the following example:

Assume that Company A borrows money from Company B at a rate of 12% and that both Company A and Company B are taxable at a rate of 45%. Provided that the 12% interest expense has been incurred by Company A for the purpose of earning income and that such expense is reasonable in the circumstances, Company A will be entitled to deduct this interest expense in computing income for tax purposes. The value of this tax deduction to Company A is measured in terms of the tax savings generated by the tax deduction – in this example, 5.4% (calculated by multiplying the 12% deduction by Company A's tax rate of 45%). The net result is that Company A's after-tax cost of funds is only 6.6% (calculated as the difference between the before-tax interest expense of 12% and the 5.4% tax savings generated by the 12% interest deduction). From Company B's perspective, it will include the 12% interest payment in income, will pay tax on that payment at 45% and will net, on an after-tax basis, 6.6%.

If it is now assumed that Company A is not taxable (because of loss carryforwards or other deductions that it has), it will not be able to utilize the 12% interest deduction. Accordingly, there will be no tax savings generated by the interest expense incurred, with the result that Company A's after-tax cost of financing will be the full 12%. Company B's position, however, will remain unchanged. It will still have to include the 12% interest payment in income, will still have to pay tax on that payment at 45%, and will still net, on an after-tax basis, 6.6%.

If, however, the debt to Company B were to be restructured as equity (and ignoring the preferred share rules in the Act), Company A would need only pay to Company B a 6.6% dividend in order to net to Company B the same after-tax return that it would have received under the debt structure, because the 6.6% dividend would be received by Company B on a tax-free basis. Company A, however, would be in a much better position because, even though it could not deduct the 6.6% dividend, its after-tax cost of financing would only be 6.6% instead of 12%. From Company B's perspective, since it receives the same 6.6% after-tax return in both the debt and equity structures, it would be indifferent, insofar as its rate of return is concerned, as to which of these two structures is used. Company B's security position, however, would be different under the equity structure and it would therefore wish to ensure that it retained all the rights that it had as a debt holder – for example, the right to receive back its principal on demand or on certain payment dates and the right to be secured. The shares, therefore, would typically carry a retraction right (that is, a right on the part of Company B to cause Company A to redeem Company B's shares), a right to pre-scheduled redemptions or a put right, to effectively allow Company B to receive its principal back on demand. The shares might also be guaranteed, with such guarantees being secured to give to Company B the security that it would otherwise have received as a debt holder.[2] In the end result, Company B would effectively hold debt of Company A but such debt would be formally structured as equity so as to enable Company B to receive what is essentially its interest return as a tax-free dividend.

Not surprisingly, over the years, a number of preferred share rules have been introduced into the Act in order to preclude the foregoing type of after-tax financing. These rules are of two kinds – those that deny the intercorporate dividend deduction provided for in subsections 112(1) and (2) of the Act for dividends received on debt-like shares (thereby fully taxing the corporate payee on such dividends and effectively treating such dividends as interest in the payee's hands), and those that impose a special tax on such dividends in the hands of the corporate payor and, in certain circumstances, in the hands of the corporate payee. Falling into the first category are the rules governing term preferred shares, guaranteed preferred shares and collateralized preferred shares. The second category encompasses the rules governing taxable preferred shares, short-term preferred shares and taxable RFI shares.

The collateralized preferred shares rules were introduced into the Act in 1987 and, as will be seen below, have limited application as they generally only apply where the after-tax financing in question involves the giving of security. The term preferred share and guaranteed preferred share rules, on the other hand, are broader in scope but, even so, only apply, in the case of term preferred shares, where the corporate payee is a "specified financial institution" (an "**SFI**") and, in the case of guaranteed preferred shares, where the guarantor is an SFI. Initially, the rules governing these latter two types of shares were thought to be sufficient to deal with

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2 Note that, under common law, a corporation cannot secure its own equity so that this guarantee cannot be given by Company A itself.

what was perceived to be the most egregious form of after-tax financings – those involving institutional lenders. However, as time went on and after-tax financing began increasingly to be used in situations involving lenders that were ordinary corporations or individuals, the second category of preferred share rules was introduced to preclude after-tax financing regardless of the status of the lender or the guarantor. Notwithstanding the far-reaching scope of these newer rules, however, and the fact that they apply in almost all the circumstances in which the first category of rules apply, these latter rules were retained in the Act to ensure that after-tax financings involving SFIs or the giving of security would still be precluded even in those situations to which the newer rules did not apply. The two sets of rules, however, were not made mutually exclusive in all instances with the result that there are a significant number of situations to which both sets of rules will apply.

TERM PREFERRED SHARES

As stated above, where a share is a term preferred share and is held by an SFI, the dividend deduction otherwise allowed in computing taxable income under subsection 112(1) or (2) will generally be denied unless the share is acquired outside the ordinary course of business of the SFI. The terms "specified financial institution" and "term preferred share" are defined in subsection 248(1) and the denial of the intercorporate dividend deduction is found in subsection 112(2.1).

I. SPECIFIED FINANCIAL INSTITUTION

An SFI is defined as meaning:

A. a bank;

B. a trust company licensed to carry on business in Canada;

C. a credit union;

D. an insurance corporation;

E. a corporation whose principal business is the lending of money to, or the purchasing of debt obligations issued by, arm's length persons;

F. a corporation prescribed to be a financial institution for federal capital tax purposes;

G. a corporation controlled (as defined in subsection 248(1) for this purpose) by one or more of the corporations referred to at A to F above; or

H. a corporation related to any of the corporations referred to at A to G above, other than a corporation referred to at A to G whose principal business is the factoring of related party receivables.

It should be noted that this definition is broader than the definition of "restricted financial institution" in subsection 248(1) which is relevant for purposes of the rules governing taxable RFI shares.

II. ORDINARY COURSE OF BUSINESS

The term "ordinary course of business" is not defined in the Act. The Canada Revenue Agency (the "**CRA**"), however, has often stated that whether or not a share is acquired in the ordinary course of business is a question of fact and has cited the following factors as being relevant to this determination:

- the nature of the holder's activities;
- the number or frequency of share acquisitions by the holder;
- whether the particular funds represent the initial capitalization of a new subsidiary or the provision of additional operating capital, both of which indicate permanent capitalization;
- the terms of the shares and their status as term preferred shares other than by reason of paragraph (b) of the definition of "term preferred shares" in subsection 248(1) (see discussion below); and
- whether the shares were acquired as consideration on the sale of all or part of a business

[3]

The CRA has also indicated that it would generally not consider a term preferred share issued on the incorporation of a wholly owned subsidiary to be acquired in the ordinary course of business carried on by an SFI. However, the CRA has also indicated that the exception in subsection 112(2.1) which permits an SFI to deduct dividends received by it on term preferred shares is intended to encompass only exceptional situations and the use of the phrase "in the ordinary course of business" is designed to distinguish those exceptional situations from the usual situation where dividends are not deductible. More specifically, the CRA has indicated that where an SFI invests in term preferred shares of a related corporation, the shares will generally be considered to have been acquired in the ordinary course of business, unless those shares were acquired in the course of a reorganization of the SFI and were redeemed quickly (as in the case of a butterfly reorganization) or unless those shares were issued on the incorporation of a wholly owned subsidiary where the proceeds of the sale of the shares constitute permanent capital of the subsidiary.[4]

In *Société D'Investissement Des Jardins v. MNR*,[5] the Tax Court of Canada had occasion to consider the meaning of the phrase "acquired in the ordinary course of business" for purposes of subsection 112(2.1). In that case, the appellant, which was held to be an SFI, was incorporated to invest in shares and debt of Quebec businesses. As part of a reorganization of a corporation in which the appellant had invested, the purpose of which was to grant greater employee ownership of the corporation, the appellant converted certain debentures of that corporation into a separate class of shares. A few days later, those shares were redeemed giving

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3 "Revenue Canada Round Table," in *Report of Proceedings of the Thirty-Sixth Tax Conference*, 1984 Conference Report (Toronto: Canadian Tax Foundation, 1985), 783-845, question 62. See also "Revenue Canada Round Table", in *Report of Proceedings of the Thirty-Eighth Tax Conference*, 1986 Conference Report (Toronto: Canadian Tax Foundation, 1987), 51:1-88, question 15; "Revenue Canada Perspectives," in *Income Tax and Goods and Services Tax Considerations in Corporate Financing*, Corporate Management Tax Conference, 1992 (Toronto: Canadian Tax Foundation, 1993), 5:1-41, question 12; and *Advance Tax Ruling* ATR-10, "Issue of Term Preferred Shares", July 31, 1986.

4 "Revenue Canada Round Table," in *Report of Proceedings of the Thirty-Second Tax Conference*, 1980 Conference Report (Toronto: Canadian Tax Foundation, 1981), 591-628, question 23 and Technical Interpretation 2001-0079985 – Ordinary Course of Business (November 13, 2001).

5 [1991] 1 CTC 2214.

rise to a deemed dividend in respect of which the appellant claimed a deduction under subsection 112(1). The Minister disallowed the deduction arguing that the deduction was denied by virtue of subsection 112(2.1). The appellant argued that the shares were not subject to the term preferred share rules since they were not acquired by it in the ordinary course of its business. The Tax Court of Canada accepted the appellant's argument finding, first, that, in considering all the circumstances surrounding the acquisition, the shares were not acquired in the appellant's ordinary course of business but were in response to the extraordinary circumstances relating to the desire to increase employee holdings. Second, the Court held that the extremely short period of time in which the appellant held the shares was in stark contrast to its general operating procedure of holding its investments for long-term growth.[6]

III. CHARACTERISTICS OF A TERM PREFERRED SHARE

The definition of term preferred share and the specific exemptions from the term preferred rules are extremely detailed. The comments below do not represent an exhaustive review of the relevant provisions but are intended only as a summary thereof.

A share can be a term preferred share as a result of the terms of the share or an agreement relating to the share, or because of the application of a specific anti-avoidance rule.

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6 See also the decision of the Tax Court of Canada in *Banner Pharmacaps NRO Ltd. v. The Queen*, 2003 DTC 245 (aff'd, 2003 DTC 5642). In that case, the Court had to determine whether the corporate taxpayer was a NRO and, in so doing, focused on whether the taxpayer's principal business was the making of loans. (If it was not, the taxpayer could not qualify as an NRO.) The only activity of the taxpayer was the acquisition of shares of a related company and the holding of two promissory notes from that company evidencing its indebtedness to the taxpayer in respect of a paid-up capital reduction and a declared dividend. Based on a long line of cases, the Court held that the notes receivable were "debts", not "loans", and that the taxpayer therefore did not make any loans. Its principal business could therefore not be "the making of loans" and thus the taxpayer does not qualify as an NRO. The Court, however, went on to say, in *obiter*, that even if the taxpayer had made loans, it was not in the *business* of making loans. Specifically, the Court stated:

> When trying to decide if the Appellant was in any business in 1996, I would observe that the Appellant did not initiate any transactions on its own. The Appellant was the passive recipient of two promissory notes which resulted from two transactions of Banner Canada. It is difficult to examine the number, volume or frequency of transactions where there are none to examine. *Apart from acquiring all the shares of Banner Canada which was the sole reason for its incorporation, the Appellant was totally passive in 1996. I have no hesitation in concluding that the Appellant did not engage in any business in 1996.* (emphasis added)

The Court then went on to say that since the corporation did not carry on any *business*, it could not have a *principal* business. Based on this decision, the mere acquisition of shares (and receipt of related dividends), does not amount to business and therefore the acquisition of such shares arguably cannot be in the ordinary course of any business.

A. <u>TERMS OF THE SHARE OR AN AGREEMENT RELATING TO THE SHARE</u>

The phrase "term preferred share" is defined in very broad terms. Generally, a share will be a term preferred share if the holder of the share has the right to cause, or the issuing corporation may be required to implement, the redemption, acquisition or cancellation of the share or a reduction of the paid-up capital in respect of the share, or if anyone provides a guarantee, security or similar indemnity or covenant with respect to the share. Excluded from the definition are redemptions, acquisitions or cancellations as a result of a right to convert the share so long as the converted share is not a term preferred share. The right to convert or exchange a share into a term preferred share will also cause the first-mentioned share to be a term preferred share.

As an example of the potential scope of this definition, the CRA has indicated that shares subject to an agreement of purchase and sale between arm's length parties will be term preferred shares from the time the agreement is entered into until termination of the agreement because the owner is entitled to cause the share to be acquired by reason of the agreement. In the past, the CRA has also taken the position that a right to convert a particular share into a non-term preferred share could still cause the particular share to be a term preferred share where the conversion formula is effectively designed to ensure that the shareholder receives a sufficient number of new shares so as to recoup all or part of its original investment, as would be the case, for example, where the number of new shares to be issued is not determined at the time of issue of the particular share or is based on the value of the particular share at the time of conversion. The basis for The CRA's position in this regard is that the conversion formula effectively amounts to a form of "guarantee, security, indemnity, or similar covenant". The courts have disagreed. In the *Citibank* case the Court held that the correct answer emanates from a determination of the proper rules of interpretation to be deployed. More specifically, do the words in question have an ordinary dictionary meaning or a more technical meaning derived from the law as it applies to commerce in general and public listed companies in particular. Looking at the disputed words in their entire context, the Court concluded that those words have the more technical meaning. Following the reasoning of the Supreme Court of Canada in *Notre-Dame de Bon-Secours* and in *Will-Kare Paving & Contracting* v. *Canada* the Federal Court of Appeal found that once ambiguity becomes an issue, the legislative provision should be given a strict or liberal interpretation depending on the purpose underlying the provision. That purpose must be identified in light of the context of the statute, its objective and apparent legislative intent. Here the definition of term preferred share arises from a narrow and particular context and applies to a specific and sophisticated segment of taxpayers. Therefore, the legal or commercial understandings of the disputed words are the appropriate context in which to interpret them. Where legislation applies to a narrow commercial context, Parliament must make clear its intention to apply a meaning other than that ascribed by settled commercial law.[7]

It is important to note the date on which a particular share is issued as well as the date of any amendment to the terms of the share or any agreement relating to the share. Generally, shares issued prior to November 16, 1978 are not term preferred shares. However, as a result of various amendments to the term preferred share definition subsequent to 1978, which have expanded the scope of the definition, the application of the term preferred share regime will be sensitive to the date on which any such activities occurred.

It should also be noted that there is no requirement that a term preferred share in fact be a "preferred" share. There is no magic in the nomenclature "preferred". Indeed, as a result of the broad scope of the term preferred share definition, it is possible that certain shares which would generally be viewed as common shares could fall within the definition. Specifically, paragraph (b) of the definition "term preferred share" provides that any share acquired after certain dates in 1979 by:

1. an SFI;
2. a corporation controlled by one or more SFIs;
3. a corporation related to a corporation referred to in (1) or (2); or
4. a partnership or trust of which a corporation referred to in (1) or (2) is a member or beneficiary,

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[7] "Revenue Canada Round Table," in *Report of Proceedings of the Forth-Fifth Tax Conference*, 1993 Conference Report (Toronto: Canadian Tax Foundation, 1994), 58:1-75, question 9. But see also *Citibank Canada* v. *The Queen*, 2002 FCA 128 (April 5, 2002); *Notre-Dame de Bon-Secours* v. *The City of Québec et al,* [1994] 3 S.C.R. 3; and *Will-Kare Paving & Contracting* v. *Canada,* [2000] 1 S.C.R. 915.

will qualify as a term preferred share if such corporation, either alone or together with any number of other such corporations, controls or has a right to control, or acquire control of, the issuer. It should be noted that The CRA takes the position that, in determining whether an issuer is controlled by more than one SFI, a factor to be considered is whether such SFIs have sufficient common connections or business interests.[8]

As stated above, the general intent of the term preferred share rules is to deny a dividend deduction in respect of dividends received on certain shares that bear a resemblance to debt. Thus, for example, included in the definition of term preferred share are shares issued after June 28, 1982 in circumstances where the issuing corporation would likely have a limited existence and the holder would receive a winding-up distribution in respect of the share.[9] Also included are shares where the owner could require, or it would be reasonable to expect, the redemption, acquisition, cancellation or reduction of paid-up capital by the issuer or by any person related to the issuer or by any partnership or trust of which the issuer or related person is a member or beneficiary.[10] A share will also be a term preferred share if the issuer or any person or partnership provides any form of guarantee, security or similar indemnity or covenant providing for protection with respect to the share.[11] Convertible or exchangeable shares will also be subject to the term preferred share rules unless they are not convertible or exchangeable into shares that would be term preferred shares.[12]

B. ANTI-AVOIDANCE RULE

The term preferred share rules also contain certain anti-avoidance rules. For example, where a dividend is received on the share of the capital stock of a corporation that is not

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8 "Revenue Canada Round Table," in *Report of Proceedings of the Forty-First Tax Conference*, 1989 Conference Report (Toronto: Canadian Tax Foundation, 1990), 45:1-59, question 18.

9 This rule is found in the preamble of the definition of "term preferred share" and is similar to the rule applicable to short-term preferred shares discussed at page 48 under the heading "Winding Up".

10 Paragraph (i) of the definition of "term preferred share". This rule is similar to the rule applicable to short-term preferred shares discussed at page 49, under the heading "Reasonable Expectation of Redemption".

11 Subparagraph (a)(iii) of the definition of "term preferred share".

12 Subparagraph (a)(iv) of the definition of "term preferred share".

otherwise a term preferred share but the dividend is derived from dividends received on a term preferred share (that is, the dividends are received through a conduit) and it may reasonably be considered that the purpose of the conduit corporation is to prevent the application of subsection 112(2.1), the share of the conduit corporation will be deemed to be a term preferred share which would be subject to the application of subsection 112(2.1).[13]

IV. EXCLUSIONS

A. DISTRESS PREFERRED SHARES

An important exclusion from the term preferred rules are shares issued in circumstances of financial difficulty or so-called "distress preferred shares".[14] A distress preferred share is a share that would otherwise be a term preferred share, that is issued:

1. as part of a proposal or an arrangement approved by a court under the Bankruptcy and Insolvency Act (Canada);

2. at a time when all or substantially all of the issuer's assets were under the control of a receiver, receiver-manager, sequestrator or trustee in bankruptcy; or

3. at a time when, by reason of financial difficulty, the issuer or a corporation resident in Canada with which the issuer does not deal at arm's length, was in default or could reasonably be expected to default on a debt owing to an arm's length person, and such share was issued, in whole or in substantial part, directly or indirectly, in exchange or substitution for such debt.

The exclusion for financial difficulty shares only applies for a maximum period of five years following the date of issuance of the shares. Accordingly, although the shares can remain outstanding for a period longer than five years, they will become term preferred shares (assuming that they still otherwise so qualify) after the five-year period has elapsed.

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13 For an example as to how this anti-avoidance rule would operate, see the discussion at pages 34-36 of the analogous anti-avoidance rule applicable to taxable preferred shares.

14 Paragraph (e) of the definition of "term preferred share".

B. PRESCRIBED SHARES

A further exclusion from the term preferred share rules are shares that are "prescribed shares". The definition of prescribed share differs depending on whether the shares were acquired before June 29, 1982 or after June 28, 1982.

1. Shares Acquired Before June 29, 1982

A share acquired *before* June 29, 1982 will be a prescribed share under Regulation 6201(1) if the shares are listed on a "designated stock exchange" in Canada[15] and the shareholder, either alone or together with other related parties, does not own more than 10% of the issued and outstanding shares of the class.

2. Shares Acquired After June 28, 1982

The determination as to whether a share acquired *after* June 28, 1982 is a prescribed share differs depending on whether or not:

(a) the share is also a taxable preferred share; and

(b) the investor is a restricted financial institution (an "**RFI**").

The rules are as follows:

(c) If the share is also a taxable preferred share, the share will be a prescribed share under Regulation 6201(2)(c) if:

 (i) it is listed on a designated stock exchange in Canada; and

 (ii) the shareholder, either alone or together with other non-arm's length parties, does not receive dividends in respect of more than 10% of the issued and outstanding shares of the class.

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[15] Subsection 248(1) defines a "designated stock exchange" as a stock exchange, or part thereof, for which a designation by the Minister of Finance under section 262 is in effect.

The test in (a)(ii) above should be contrasted with the test that applies to shares acquired before June 29, 1982. In the latter situation, the determination as to whether a share is a prescribed share is dependent upon the percentage of shares held by the shareholder and other persons with to which the shareholder is *related* whereas, for shares acquired after June 28, 1982, one must look to the percentage shareholdings of parties *non-arm's length* to the shareholder. As well, for shares acquired after June 28, 1982, the test does not depend on the number of shares held but, rather, on the number of shares in respect of which dividends are received.

(d) If the share is not a taxable preferred share and the shareholder is not an RFI, the same rules as in (a) will apply.

(e) If the share is not a taxable preferred share and the shareholder is an RFI that acquired the share or is deemed under certain of the term preferred share rules to have acquired the share after December 15, 1987,[16] the share will be a prescribed share, if:

  (i) it is listed on a designated stock exchange; and

  (ii) the shareholder, either alone or together with other non-arm's length RFIs, does not receive dividends in respect of more than 5% of the issued and outstanding shares of the class. (If the shares were acquired before December 16, 1987, the foregoing 5% threshold limit is 10%.)

The foregoing prescribed preferred share rules do not generally apply if the shares are listed on a designated stock exchange in Canada and the shareholder is a registered or licensed trader in securities that holds the shares for the purpose of sale in the course of the business ordinarily carried on by the shareholder.[17]

C. OTHER EXCEPTIONS

Other specific exclusions from the term preferred share rules include shares issued after

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[16] Regulation 6201(11) sets up four situations in which shares acquired after December 15, 1987 are deemed to have been acquired before that date.

[17] Regulation 6201(5).

November 16, 1978 and before 1980 pursuant to an "established agreement" so long as neither the established agreement nor the share terms have been amended after November 16, 1978. Certain shares received by way of stock dividend will not be term preferred shares if, in the case of a share issued before April 22, 1980, the share on which the dividend was paid was itself not a term preferred share or, in the case of a dividend paid after April 21, 1980, the share on which the stock dividend was paid was a share prescribed not to be a term preferred share.

It should also be noted that subsections 258(3) and (5) may deem a dividend received by an SFI from a non-resident corporation on a term preferred share to be interest.

GUARANTEED PREFERRED SHARES

In general, the rules with respect to "guaranteed preferred shares" apply where guarantees are provided by an SFI, or persons related thereto, to protect against losses which might otherwise be suffered by the shareholder or to ensure minimum earnings on those shares. It should be noted that, as in the case of term preferred shares, one should not be misled by the reference to guaranteed "preferred" shares, as these guarantee rules can also apply to common shares. The rules may apply to any corporate holder of guaranteed shares and, if applicable, serve to deny the intercorporate dividend deduction for dividends paid on the guaranteed shares.[18] These rules are currently set out in subsection 112(2.2), (2.21) and (2.22).

The guaranteed preferred share rules are found in subsection 112(2.2), (2.21) and (2.22) which generally applies to deny a corporate recipient of the dividend a deduction under

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18 One explanation offered for the enactment of the original rule in 1979 to deny the deduction of dividends on "guaranteed shares" was provided by Robert Couzin and Robert J. Dart, "The New Preferred Share Rules," in *Report of Proceedings of the Thirty-Ninth Tax Conference*, 1987 Conference Report (Toronto: Canadian Tax Foundation, 1988), 18:1-37, at 18:8:

> A specified financial institution that desired to acquire an after-tax financing instrument or loan equivalent issued by its customer might have been prevented from doing so by the new term preferred share rules. However, a relatively simple method of circumventing that restriction was devised. That would-be lender would instead proffer its guarantee to support a term preferred share issued by the customer. On the strength of such guarantee, a taxable public corporation, which was not a specified financial institution, would agree to acquire the share. In effect, the financial institution and its customer were "renting" the tax base of the corporate investor and thereby accomplishing precisely the evil that the term preferred share rules were designed to prevent.

subsection 112(1) or (2) in computing taxable income where the following requirements are satisfied:

I. the share is issued after 8:00 p.m. Eastern Daylight Saving Time on June 18, 1987 (“**Implementation Time**”);

II. a person or partnership (other than an individual that is not a trust, or the issuer of the share) that is an SFI or a “specified person” in relation to a SFI is absolutely or contingently obligated to effect any undertaking including any guarantee, covenant or agreement to purchase or repurchase the share from, or otherwise provide funds to, the holder of the share in order to ensure that:

   A. any loss which may be sustained by the holder by reason of the ownership, holding or disposition of the share or any other property is limited, or

   B. the holder will derive earnings from the ownership, holding or disposition of the share or any other property; and

III. the guarantee was given as part of a transaction or series of transactions that included the issuance of the share.[19]

Notwithstanding the above rule, a deduction in computing taxable income under subsection 112(1) or (2) will nevertheless be permitted where the share is a “distress preferred share”.

These requirements and exemptions are discussed in further detail below, along with the tax treatment of dividends received on shares of a foreign affiliate.

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19 The CRA provided the following explanation of this in the Technical Notes published in 1988 for paragraph 112(2.2):

> Subsection 112(2.2) denies the intercorporate dividend deduction for dividends on certain shares that are guaranteed by a specified financial institution. This subsection, as amended, generally applies to dividends received on shares issued, or deemed to be issued, after 8:00 p.m. EDST, June 18, 1987. It is applicable where a specified financial institution or a specified person in relation to any such institution has undertaken to protect a corporate shareholder with respect to the value or yield of a share. The amendment to paragraphs 112(2.2)(a) and (b) ensure that the intercorporate dividend deduction will not apply where a specified financial institution has provided a guarantee to the shareholder or a specified person in relation to the shareholder with respect to the share or dividend.

I. TIMING OF THE ISSUANCE OF THE SHARE

The current version of subsection 112(2.2) only applies to shares issued after Implementation Time. Paragraph 112(2.22)(a) deems a share to be reissued after that time where a guarantee agreement in respect of that share is executed after Implementation Time, unless that guarantee was provided pursuant to an earlier written agreement executed before that time. Paragraph 112(2.22) also provides that where a post-June 18, 1987 guarantee agreement results in a deemed reissuance of a share, the guarantee agreement shall be deemed to have been given as part of a series of transactions that included the issuance of the share.

A substantially similar version of subsection 112(2.2) applies to any share issued or deemed to be issued before Implementation Time. Former subsection 112(2.2) generally applies to any “guaranteed shares” acquired by the corporate shareholder after October 23, 1979 and before June 18, 1987.

II. THE GUARANTOR

The definition of SFI has already been discussed above. A “specified person” is defined in paragraph (h) of the definition of a taxable preferred share in subsection 248(1) to be a person with whom the institution does not deal at arm’s length, or any a trust or partnership of which the institution or related person is a beneficiary or member, respectively.

It should be noted that subsection 112(2.2) does not apply where the issuer of the share itself provides the guarantee. Furthermore, the subsection will be inapplicable where an individual (other than a trust) is the guarantor.

III. NATURE OF THE GUARANTEE

The language used in paragraphs 112(a)(i) and (ii) to describe the guarantee is very broad and is intended to encompass virtually any arrangement which aims to either limit the loss which might be incurred by the holder (or any specified person in relation to that holder) of the shares, or ensure that the holder (or specified person) derives earnings from the ownership, holding or disposition of such shares or “any other property”. The guarantee arrangement must be in place at or before the time that the dividend was paid in order for subsection 112(2.2) to deny the deduction under subsection 112(1).

IV. SHARES EXEMPTED FROM SUBSECTION 112(2.2)

Subsection 112(2.21) specifically exempts dividends received on several classes of shares from the application of subsection 112(2.2). As noted above, distress preferred shares are one such class, thereby providing an opportunity for corporations in severe financial difficulty to reorganize their affairs by attracting investors (typically financial institutions) to acquire newly-issued preferred shares.

A second class of exempted shares are "grandfathered shares", which are described below in the context of the taxable preferred share rules.

A third class of exempted shares are taxable preferred shares issued before December 16, 1987. (As is discussed below, the definition of taxable preferred share includes a share that is guaranteed. Accordingly, such a share can also be a guaranteed preferred share.)

Taxable preferred shares issued *after* December 15, 1987 are also exempted from the application of subsection 112(2.2) if they are listed on a designated stock exchange, the guarantee agreements on such shares are given only by the issuer or persons related to the issuer (other than persons related only by operation of paragraph 251(5)(b)) and the holder of such shares (and specified persons in relation to that holder) own less than 10% of the issued and outstanding shares to which the guarantee applies.

"Prescribed shares" are also exempted from subsection 112(2.2). To date, only certain shares of Massey-Ferguson Limited are prescribed.[20]

The last class exempted from subsection 112(2.2) are shares where (i) the shares were not acquired by the corporate shareholder in the ordinary course of its business, (ii) the guarantee agreement was not given in the ordinary course of the guarantor's business and (iii) the issuer of

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20 Regulation 6201(3).

the shares is, at the time the dividend is paid, related (other than because of a right referred to in paragraph 251(5)(b)) to both the corporate shareholder and the guarantor.

It should be noted that the exemptions included in some of the former versions of subsection 112(2.2) are quite different from those currently in place. There is an exemption for dividends received on a share owned by an SFI that acquired it in its ordinary course of business, although this was eliminated in 1986 (applicable to shares issued before May 23, 1985). Accordingly, special care should be taken in reviewing which exemptions apply when considering particular shares.[21]

V. DIVIDENDS ON SHARES OF A FOREIGN AFFILIATE

Section 113 provides a limited deduction in computing taxable income for dividends received by a corporation resident in Canada on shares of a foreign affiliate of that corporation.[22] However, paragraph 258(3)(b) and subsection 258(5) could intervene to deny the deduction for dividends on certain shares of the foreign affiliate. Paragraph 258(3)(b) applies to grandfathered shares and shares issued before Implementation Time that would be caught by former subsection 112(2.2) if the foreign affiliate paying the dividend was instead a taxable Canadian corporation. Subsection 258(5) applies to dividends on shares issued by the foreign affiliate after Implementation Time (other than if the recipient of the dividends had a "substantial interest" in the foreign affiliate)[23] where a deduction would have been denied by subsection 112(2.2) if the foreign affiliate were instead a taxable Canadian corporation. In either circumstance, the corporation receiving the dividend is deemed instead to have received interest, thereby effectively denying the subsection 113(1) dividend deduction. The foreign tax credit provisions in section 126 will apply to the deemed interest received.

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21 A good summary of the history of subsection 112(2.2) is provided by Couzin and Dart, *supra* footnote 19 at 18:9-11.

22 Note that dividends on shares of certain non-resident corporations may be otherwise deductible under subsection 112(2).

23 See discussion later in this paper under the heading "Substantial Interest".

COLLATERALIZED PREFERRED SHARES

The rules with respect to what are called “collateralized preferred shares” are essentially designed to preclude a company with losses and other deductions from using the intercorporate dividend deduction as a means of passing on the tax value of these losses and deductions to what will usually be an arm’s length profitable company.[24] In general, and subject to the saving provision in subsection 112(2.5), subsection 112(2.4) denies a deduction in computing taxable income under subsections 112(1) and (2) for a dividend received on a share (referred to as the “subject share”) where:

I. any person or partnership was obligated, either absolutely or contingently, to effect an undertaking under which the holder of the subject share would be entitled to receive an amount or benefit for the purpose of limiting any loss that the investor may sustain by virtue of the ownership, holding or disposition of the subject share (or another share or obligation that was issued as part of the same overall transaction in which the subject share was issued), and property is used to secure that undertaking; or

II. the consideration received by the issuer from the investor includes either:

   A. an obligation of that investor (other than an obligation of an investor that was related to the issuer) to make payments that will be included in the income of the issuer; or

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24 The purpose behind the enactment of the collateralized preferred share rules was explained in a government press release dated November 27, 1986:

> The Honourable Michael Wilson, Minister of Finance, today announced his intention to introduce legislation to deny the deduction of intercorporate dividends paid on what has become known as collateralized preferred shares.
>
> The Minister expressed concern with transactions that have come to his attention involving the use of preferred shares issued by corporations with accumulated losses and unutilized deductions in order to provide a means of sheltering the income of profitable corporations from tax. Under these arrangements, a profitable corporation will invest in the shares of a corporation with accumulated tax losses and deductions. The loss corporation will typically invest the share proceeds in Treasury bills or other interest-bearing securities. The resulting income less a “spread” or administrative charge to compensate the loss corporation for the use of its losses, can then be distributed to the profitable corporation as a dividend.
>
> Such intercorporate dividends are generally deductible in the hands of the recipient corporation and thus are tax-free. In addition, to ensure that the profitable corporation will realize its return, such transactions are structured to provide a guarantee for the profitable corporations’ share investment and dividend yield. As a result of this guarantee feature, the investment is more in the nature of a debt security than an equity investment, yet the return is in the form of deductible dividends rather than taxable interest.

B. any right to receive payments that are to be included in computing the income of the issuer where that right is held on condition that it or property substituted therefor may revert to the investor or a person specified by the investor;

and that obligation or right was acquired by the issuer as part of a transaction or series of transactions that included the issuance of the subject share or a share substituted therefor.[25]

As is the case in subsection 112(2.2), a corporation that is related to the issuer only by operation of paragraph 251(5)(b) is deemed not to be so related for purposes of subsection 112(2.4). Furthermore, subsection 112(2.9) deems a corporation not to be related for the purposes of subsection 112(2.4) where it may be reasonably concluded having regard to all of the circumstances that the corporation has become related for the purpose of avoiding any limitation on the deductibility of a dividend under subsections 112(1) or 112(2).

Specific aspects of the collateralized preferred share rules are discussed in greater detail below.

I. SAVING PROVISION

By virtue of subsection 112(2.5), subsection 112(2.4) only applies to a dividend paid on a share where, having regard to all of the circumstances, it may reasonably be considered that the share was issued or acquired as part of a series of transactions or events which enabled any corporation to earn investment income (or any income substituted therefor) so that the amount of taxes subsequently payable by that corporation for a taxation year would be less than the taxes that would otherwise be payable if the investment income were its only source of income for the year and all other taxation years. This saving provision is intended to restrict the application of subsection 112(2.4) to transactions involving the transfer of income-producing properties to unprofitable corporations which can offset the investment income derived therefrom with current and past losses. Subsection 112(2.5) is difficult to understand in the absence of recognizing the underlying mischief at which the provisions are aimed. However, the subsection is a long way of

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[25] The Technical Notes published in 1987 with respect to subsections 112(2.4) to (2.9) provide a thorough explanation of the purpose and operation of the restrictions applying to so-called collateralized preferred shares.

expressing the concept that the issuer corporation must have available tax losses and contemplates a comparison between two scenarios:

A. where past losses and current deductions of the unprofitable corporation are used to shelter the income earned on the transferred property; and

B. where past losses and current deductions cannot be utilized since the income from the transferred property is deemed to be the only source of income for the corporation for all relevant taxation years, thus resulting in taxes being payable in respect of such income.[26]

Profitable companies which issue secured preferred shares in exchange for property are unlikely to be caught by subsection 112(2.4) since they will not have accumulated and current losses to offset the income from the transferred property (thereby not decreasing the taxes otherwise owing).

Subsection 112(2.4) will also not apply if business income is derived from the transferred property (for example, where a group of properties which together constitute an operating unit are transferred to another corporation). As a result, a potential issue which could arise with respect to the application of subsection 112(2.4) is whether the income earned on the transferred property is investment or business income.[27]

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26 The language used in subsection 112(2.5) has been criticized by Al Meghji in his article "Collateralized Preferred Shares", (1987) 35 Canadian Tax Journal 467, at 470-71:

> Apparently, to meet the second condition, it must be established that *as a result* of earning property income, the amount of the issuer corporation's taxes payable is less than that liability would be if the property income were the issuer corporation's only source of income for that and all other taxation years. It is difficult to imagine how any reduced tax liability on the income earned by the issuer corporation can be "as a result" of the investor corporation's enabling the issuer corporation to earn income from property. It seems more cogent to state that any reduced tax liability will result from the use of losses, other deductions, and credits available to the issuer corporation. The causal test found in subsection 112(2.5) makes it hard to contemplate situations where the second condition in that subsection can be met.

27 The Supreme Court of Canada decision of *Canadian Marconi* v. *The Queen* (1986), 86 DTC 6526 accentuates this issue, as the Court there held that there is a rebuttable presumption that a corporation's income should be characterized as business income.

II. EXEMPT SHARES

Subsection 112(2.6) exempts certain shares from the application of subsection 112(2.4). These shares (which are termed "exempt shares") include distress preferred shares, prescribed shares and, subject to limited exceptions, shares issued before 5:00 p.m. Eastern Standard Time on November 27, 1986 (the time of the public announcement introducing subsection 112(2.4)). Specific rules are included in subsections 112(2.6) and (2.7) to ascertain when shares are deemed to have been issued. To date, no shares have been prescribed as exempt shares under subsection 112(2.6).

III. SECURED SHARES

Subparagraph 112(2.2)(a)(i) identifies any share (which need *not* be a preferred share) as a collateralized share (that is, a subject share) if property is used to secure any undertaking given to reduce the impact of any loss on the share. Of course, once a share is described by subparagraph 112(2.2)(a)(i), it is subject to the dividend denial rules if the saving provision does not apply.

Subsection 112(2.8) deems any losses that an investor might sustain by virtue of the ownership, holding or disposition of the subject share also to include any loss arising on an obligation or share that was issued as part of the same transaction in which that subject share was issued. Without this provision it would be possible to circumvent paragraph 112(2.4)(a) by concurrently issuing two classes of shares, with the one class being entitled to dividends and the other class being secured with an undertaking. This rule is similar to the "Tied Share" anti-avoidance rule (described below) applicable to taxable preferred shares.

IV. CONTROL OVER SUBSCRIPTION PROCEEDS BY THE INVESTING CORPORATION

Paragraph 112(2.4)(b) applies to deny a dividend deduction under subsections 112(1) and (2) where the corporation receiving the shares either is to make payments to the issuing corporation which are included in the latter's income, or has control over the subscription proceeds for the shares.[28] But for such restrictions the issuing corporation could simply re-loan the subscription proceeds to the investing corporation, resulting in no net cash actually changing hands and the investing corporation being left at the end of the day with deductible interest payments and tax-free dividends. Subparagraph 112(2.4)(b)(i) does not, however, apply where the issuing and investing corporations are related (otherwise than by paragraph 251(5)(b)), thereby permitting transfers of losses and deductions between related corporations.

V. INVESTOR AND ISSUER CORPORATIONS

Subsection 112(2.6) broadly defines an "investor" and "issuer" for the purposes of subsection 112(2.4) in order to prevent corporations from circumventing the collateralized preferred share rules by utilizing related persons, partnerships or trusts.

VI. DIVIDENDS FROM SHARES OF A FOREIGN AFFILIATE

Subsection 258(5) applies to dividends on collateralized preferred shares of a foreign affiliate in the same manner as it applies to guaranteed preferred shares so as to deem the dividends to be treated as interest in certain circumstances.

TAXABLE PREFERRED SHARES

If a share is a taxable preferred share, taxable dividends paid on that share,[29] unless they

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[28] The Technical Notes, *supra* footnote 19, describe paragraph 112(2.4)(b) as follows:

> A second approach to securing the profitable corporation's share interest is for the profitable corporation to retain control or possession of the share proceeds. New paragraph 112(2.4)(b) will apply in these circumstances. For example, rather than investing the share proceeds in a trust which provides an undertaking to protect the profitable corporation from loss, the loss corporation may simply reloan the funds either to the profitable corporation or to a person who does not deal at arm's length with the profitable corporation. It should be noted that a deduction will not be denied under new subsection 112(2.4) if the obligation referred to in new subparagraph 112(2.4)(b)(i) is issued by a corporation that is related, otherwise than by virtue of a right referred to in paragraph 251(5)(b), to the corporation which issued the subject share....
>
> New paragraph 112(2.4)(b) also applies if the proceeds of the share issue constitute an income interest which may revert to the profitable corporation at its discretion. Thus, where the profitable corporation retains control over the income source which has been transferred to the loss corporation as a means of providing security for the share investment, the intercorporate dividend deduction will be denied if the income source is acquired by the loss corporation in conjunction with the acquisition by the profitable corporation of the shares of the loss corporation.

[29] The preferred share rules only apply to taxable dividends, including taxable dividends that are paid as stock

are "excluded dividends" or "excepted dividends" (these concepts are discussed below), will be subject to the special taxes described below. The concept of the taxable preferred share rules is to ensure that, except where the share is truly an equity instrument, intercorporate dividends do not pass tax-free unless the dividend is paid out of income that has been taxed at or near the maximum rate. A share may be both a taxable preferred share as well as a term preferred share, guaranteed preferred share and/or collateralized preferred share.

I. PART VI.1 TAX

A. RATE OF TAX

A corporation paying a dividend on a taxable preferred share must pay a special tax under Part VI.1 of the Act equal to either 25% or 40% of the dividend paid. The 25% rate will apply unless the corporation elects to pay tax at the 40% rate. The 40% election is only available if the terms of the shares require that the election be made.[30]

B. DEDUCTION FOR PART VI.1 TAX

Regardless of which of the foregoing rates apply, the corporation will be entitled, under paragraph 110(1)(k) of the Act, to a grossed-up deduction in calculating its Part I tax liability equal to 9/4 of the tax payable by it under Part VI.1.[31] The net effect of this deduction is to make Part VI.1 tax a creditable tax. To the extent that the corporation cannot use the paragraph 110(1)(k) deduction (because it has no income against which to offset this deduction), the

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dividends (see *Interpretation Bulletin* IT-88-R2, "Stock Dividends", May 31, 1991, paragraph 16). (As indicated above, however, under the discussion of term preferred shares, certain stock dividends will not be subject to the term preferred share rules.) Capital dividends are not affected by the preferred share rules. It should be noted that the "amount" of a stock dividend for purposes of Part VI.1 and Part IV.1 tax is the greater of the amount by which the paid-up capital of the issuer is increased by reason of the payment of the stock dividend and the fair market value of the shares paid as a stock dividend (see definition of "amount" in subsection 248(1)). The purpose of this rule is to ensure that Part VI.1 and Part IV.1 tax are not circumvented in the case of a stock dividend, by simply adding a nominal amount to stated capital in respect of that stock dividend.

30 Subparagraphs 191.1(1)(a)(ii) and 191.1(1)(a)(iii) and Subsection 191.2(1).

31 The December 20, 2002 and February 27, 2004 Technical Bills proposes to increase this 9/4 deduction to 3 times the Part VI.1 tax payable. This change is intended to compensate for decreasing corporate tax rates under Part I.

deduction will constitute a non-capital loss of the corporation[32] which can be carried forward seven years or carried back three years to offset any Part I tax liability of the corporation in those years.[33]

To illustrate the foregoing, assume that Company A (which is taxable at the maximum rate of 45%) pays a dividend of $100, makes the 40% election and therefore pays Part VI.1 tax of $40 on the dividend. In calculating its Part I tax liability, Company A is entitled to a deduction in computing taxable income equal to 9/4 of the $40, or $90. This $90 deduction reduces Company A's Part I tax liability by approximately $40 (calculated as $90 times the corporation's 45% tax rate) which is equal to the Part VI.1 tax paid. As this example illustrates, as long as Company A is taxable at the highest possible rate, Part VI.1 tax will have no impact – that is, Company A will either pay the $40 as Part I tax or as Part VI.1 tax. However, if Company A is not taxable (which will typically be the case for the type of corporation that will prefer to utilize preferred share financing over debt financing), it would not have to pay the $40 of tax under Part I and, therefore, it will essentially be prepaying the $40 of tax because of its Part VI.1 tax liability (unless it can apply this tax, in the form of a non-capital loss, to offset its Part I tax liability in any of the previous three years). Part VI.1 tax therefore is a form of advance corporate tax that is intended to ensure that the theoretical basis for the intercorporate dividend deduction and the dividend gross-up and tax credit mechanism – that is, that dividends are paid out of earnings that have actually borne tax at the corporate level – is actually justified. (If Company A is fully taxable but at a lower rate (for example, because it is entitled to the manufacturing and processing tax credit), it will recover some but not all of its Part VI.1 tax and this represents a permanent cost to it of its preferred share financing.)

C. AGREEMENT TO TRANSFER PART VI.1 TAX LIABILITY

Rather than utilizing the paragraph 110(1)(k) deduction to create non-capital losses, a corporation that is not currently taxable may file a joint agreement with a related corporation that

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32 Item "E" in the definition of "non-capital loss" found in subsection 111(8).

33 The March 23, 2004 Budget proposes to increase the loss carry forward period to ten years.

is a taxable Canadian corporation[34] pursuant to which the related corporation agrees to pay all or part of the Part VI.1 tax liability of the non-taxable corporation.[35, 36] The effect of such an agreement (a "**Subsection 191.3 Agreement**") is that the Part VI.1 tax liability of the non-taxable corporation will be reduced by the amount specified in the agreement[37] and the Part VI.1 tax liability of the related corporation will be increased by a corresponding amount.[38] The related corporation will then be entitled to claim the paragraph 110(1)(k) deduction in respect of the Part VI.1 tax liability that has been transferred to it under the Subsection 191.3 Agreement and offset that deduction against its Part I tax payable. It should be noted that, notwithstanding the Subsection 191.3 Agreement, the non-taxable corporation remains jointly and severally liable with the related corporation to pay the amount of the Part VI.1 tax specified in the agreement.[39]

D. DIVIDEND ALLOWANCE

The amount of a corporation's Part VI.1 tax liability will be reduced by its "dividend allowance" for the year.[40] The dividend allowance of a corporation is $500,000 although this allowance is reduced to the extent that the corporation and other corporations associated with it have, in the immediately preceding calendar year, paid dividends in excess of $1,000,000 on

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34 Defined in subsection 89(1).

35 Section 191.3. Note that this joint agreement option is not limited to corporations that cannot use the paragraph 110(1)(k) deduction, but these are the types of corporations that would typically take advantage of this option. Note as well that a joint agreement can only be filed if the corporation transferring its Part VI.I liability (the "**Transferor**") is related to the transferee corporation (the "**Transferee**") both throughout the taxation year of the Transferor in respect of which the Part VI.I tax liability is incurred (the "**particular year**") and throughout the last taxation year of the Transferee that ends at or before the end of the particular year. However, the election may be filed even if the Transferor and Transferee are not related *throughout* the foregoing years if the reason for this is that either the Transferor or the Transferee has only come into existence during the relevant year.

36 Subsection 191.3(4) contains an anti-avoidance rule which effectively precludes the ability of a corporation to file a section 191.3 agreement where the main purpose for a corporation becoming related to another corporation is to transfer to the former corporation the benefit of the paragraph 110(1)(k) deduction.

37 Paragraph 191.3(1)(c) and paragraph 191.1(1)(b).

38 Paragraph 191.3(1)(d) and subparagraph 191.1(1)(a)(iv).

39 Paragraph 191.3(1)(e).

40 Subparagraphs 191.1(1)(a)(ii) and 191.1(1)(a)(iii).

their taxable preferred shares.[41] The dividend allowance must be pro-rated for short taxation years.[42]

Note that where a corporation has entered into a Subsection 191.3 Agreement to transfer all or part of its Part VI.1 tax liability to a related corporation, the related corporation is not entitled to claim the dividend allowance in respect of that Part VI.1 tax. This is so because the Subsection 191.3 Agreement only transfers to the related party the transferor's *liability* for the amount of Part VI.1 tax specified in the Subsection 191.3 Agreement. It does not deem the related corporation *to have paid the dividend* that gave rise to that liability.

Accordingly, before entering into such a Subsection 191.3 Agreement, the parties should:

- first determine the amount of the dividend allowance to which the transferor is entitled in respect of the dividends in question (the "**Available Dividend Allowance**");
- have the transferor remain liable for such portion of its Part VI.1 tax liability as is equal to its Available Dividend Allowance; and
- enter into a Subsection 191.3 Agreement pursuant to which the transferor transfers to the related corporation the remaining portion of the transferor's Part VI.1 tax liability.

II. PART IV.1 TAX

Generally, if the payor corporation pays Part VI.1 tax at the 25% rate, a payee that is a public corporation or a subsidiary of a public corporation will pay Part IV.1 tax of 10% on the dividends received.[43] If the payor elects to pay Part VI.1 tax at the 40% rate, Part IV.1 tax will not apply to the payee.

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41 Subsection 191.1(2). Note that, in calculating the $1,000,000 of dividends paid in the immediately preceding year, one must include dividends paid on shares that would be taxable preferred shares had they been issued after Implementation Time and exclude dividends paid on "excluded shares".

42 Subsection 191.1(6).

43 Section 187.2. As is discussed *infra* footnote 79, private corporations are not required to pay Part IV.1 tax.

Unlike Part VI.1 tax, Part IV.1 tax is not "creditable" against the Part I tax liability of the recipient corporation but it will reduce the amount, if any, of the corporation's Part IV tax liability.[44] Part IV.1 tax applies regardless of whether Part VI.1 tax is reduced or eliminated by reason of the dividend allowance. Part IV.1 tax does not apply if the dividends are not eligible for the intercorporate dividend deduction – for example, because the shares on which the dividends are paid are term preferred shares, guaranteed preferred share or collateralized preferred shares. Thus, unlike Part VI.1 tax, which can apply to the payor even if the intercorporate dividend deduction is denied to the payee, the denial of the intercorporate dividend deduction to the payee automatically eliminates any Part IV.1 tax liability on the dividend in question.

III. 25/10% REGIME VS. 40% REGIME

The decision as to whether a corporation should elect to pay Part VI.1 tax at the 25% or 40% rate will depend on whether the corporation (or a corporation related to it) is taxable and on the types of shareholders that the corporation wishes to attract. If the corporation (or a corporation related to it) is taxable at the maximum rate and can fully utilize the paragraph 110(1)(k) deduction, it should not mind paying Part VI.1 tax at the 40% rate because, as described above, Part VI.1 tax will have no net impact on the corporation's tax position since its Part I tax will be reduced by any Part VI.1 tax payable. A corporation paying tax under the 40% regime will therefore be able to attract, as investors, public corporations, subsidiaries of public corporations and SFIs (since these are the types of corporations that would have to pay the 10% tax under Part IV.1 if the 40% election were not made) as well as individuals and private corporations (who are not subject to Part IV.1 tax). As well, a corporation which is able to rely on the dividend allowance to eliminate Part VI.1 tax on dividends should not be affected by the requirement to pay Part VI.1 tax at the higher 40% rate.

Conversely, if a corporation (or a corporation related to it) is not taxable or cannot fully utilize the paragraph 110(1)(k) deduction, the corporation would likely prefer the 25%/10%

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44 Section 186(1.1). Since private corporations are not subject to Part IV.1 tax, this Part IV tax offset will only apply in limited circumstances -- i.e., where the recipient corporation is subject to Part IV tax because it is a corporation (other than a private corporation) that is resident in Canada and controlled by or for the benefit of any individual or a related group of individuals (see subsection 186(1)).

regime since all or part of the Part VI.1 tax payable by it will constitute a prepayment of tax that the corporation will presumably wish to minimize. Such a corporation, however, would likely only be able to attract individuals and private corporations as investors (since they are not required to pay Part IV.1 tax) unless it increases the dividend rate on its taxable preferred shares to compensate other corporations for the Part IV.1 tax that will be payable by them.

IV. CHARACTERISTICS OF A TAXABLE PREFERRED SHARE

The definition of "taxable preferred share", found in section 248 of the Act, is very broad and includes most preferred shares (and, in some instances, common shares) issued after Implementation Time. In some instances, a share issued before Implementation Time may also constitute a taxable preferred share as a result of the application to such share of one of the "deemed reissuance" rules discussed below.

A share may be a taxable preferred share because of its terms or the terms of any agreement in respect of the share or because of a specific anti-avoidance rule. A short-term preferred share (discussed below) is also a type of taxable preferred share.

A. <u>TERMS OF THE SHARE OR AN AGREEMENT RELATING TO THE SHARE</u>

A share will be a taxable preferred share if it is issued after Implementation Time and the terms of the share or the terms of any agreement in respect of the share *to which the issuer or a "specified person" in relation to the issuer is a party*, provide for any of the following:

1. a dividend entitlement;

2. a liquidation entitlement;

3. certain conversion or exchange rights; or

4. a guarantee.[45]

As indicated above, a "specified person" is a person with which the corporation does not

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[45] Paragraph (b) of the definition of "taxable preferred share".

deal at arm's length or any partnership or trust of which the corporation or non-arm's length person is a member or a beneficiary.[46]

1. Dividend Entitlement

A share will be considered to have a dividend entitlement if the amount of dividends that may be declared or paid on the share is, by way of formula or otherwise:

(a) fixed;

(b) limited to a maximum; or

(c) established to be not less than a minimum and the minimum dividend has a preference over any other shares of the corporation.[47]

Thus, for example, any share issued after Implementation Time that carries a specified dividend rate will be a taxable preferred share.

The foregoing rule does not apply if the dividend entitlement of the share is determined solely by reference to the dividend entitlement of another share of the issuer or of a corporation

46 Paragraph (h) of the definition of "taxable preferred share". Subsection 248(13) provides that for the purposes of, *inter alia*, this "specified person" definition, where a person has an interest in a trust or partnership, whether directly or indirectly through one other trusts or partnerships, the person shall be deemed to be the beneficiary or member of the trust or partnership, as the case may be.

47 Subparagraph (b)(i) of the definition of "taxable preferred share". In a Technical Interpretation of the Financial Industries Division, Rulings Directorate (see CCH Tax Windows Files [this is an online data base], document number 9615105, dated June 10, 1996) The CRA has taken the position that "alphabet shares" may be taxable preferred shares depending on how the dividend entitlement of those shares is worded. (Alphabet shares or "tracking shares" are shares, dividends on which are derived from the profits generated by specified assets or businesses of the corporation.) In the CRA's view, alphabet shares will be taxable preferred shares if their dividend entitlement is specifically limited to profits of a specific business division of the corporation because, in such circumstances, those dividends would be considered to be "limited to a maximum". If, however, the dividend entitlement is worded in a manner that states that the dividends on the share are intended to reflect the financial results of that specific business division (but are not specifically limited to those results), the share would not be a taxable preferred share because the dividend entitlement would not be "limited to a maximum" in that dividends could, at the discretion of the directors, be either greater or lesser than the results attributable to the division. (See also "Alphabet Shares - Taxable Preferred Shares", Technical Interpretation of the Financial Industries Division, Rulings Directorate in CCH Tax Window Files, document number 961064, dated April 17, 1996.)

that controls the issuer, if that other share is not a taxable preferred share.[48] Accordingly, a dividend entitlement of a share that is determined by reference to the dividends payable on the common shares of the issuer or the common shares of its parent will not cause the first-mentioned share to be a taxable preferred share.

2. Liquidation Entitlement

A share will be considered to have a liquidation entitlement if the amount that the shareholder is entitled to receive on the:

(a) dissolution, liquidation or winding-up of the issuer; or

(b) the redemption, acquisition or cancellation of the share or a reduction in the paid-up capital of the share by the issuer or specified person in relation to the issuer

is, by way of formula or otherwise:

(c) fixed;

(d) limited to a maximum; or

(e) established to be not less than a minimum.[49]

As can be seen, there is an overlap between the term preferred share rules and the taxable preferred share rules where, for example, the holder of a share has the right to require the issuer to acquire the share (a retraction right) for a specified amount determined by a formula. Accordingly, if the holder is a SFI, it will be denied the intercorporate dividend deduction in respect of any dividend it receives on the share while, at the same time, the issuer will be required to pay Part VI.1 tax on such dividend.

There are a number of exceptions to the liquidation entitlement rules:

48 Paragraph (c) of the definition of "taxable preferred share".

49 Subparagraph (b)(ii) of the definition of "taxable preferred share".

- *DEATH OF A SHAREHOLDER*: If the requirement to redeem, acquire or cancel a share of a particular shareholder arises only in the event of the death of that shareholder (or any shareholder in the corporate chain to which the particular shareholder belongs), the share is not considered to have a liquidation entitlement.[50] This exemption is intended to exempt from the taxable preferred share rules, shares that are the subject matter of a buy-sell agreement.

- *CONVERTIBLE OR EXCHANGEABLE SHARES*: A share is not considered to have a liquidation entitlement simply because of a conversion or an exchange right attached to the share or given in an agreement in respect of the share.[51] The reason for this exemption is that conversion or exchange rights are dealt with separately for purposes of the taxable preferred shares rules (see discussion below).

- *REFERENCE TO OTHER SHARES*: If the liquidation entitlement of a share is determined solely by reference to the liquidation entitlement of another share of the issuer or a corporation that controls the issuer, the liquidation entitlement of the share is deemed not to be fixed, limited to a maximum or established to be not less than a minimum, provided that other share is not a taxable preferred share.[52]

- *AGREEMENT TO ACQUIRE WITHIN SIXTY DAYS*: Where there is an agreement to acquire a share within sixty days after the agreement is entered into for a price that does not exceed the greater of the fair market value of the share as at the time of the agreement and the fair market value of the share as at the time of acquisition, such an agreement is ignored for purposes of determining whether or not the share has a liquidation entitlement (the "**Sixty Day Test**").[53] In other words, such an agreement is not considered to be an agreement in respect of the share entitling the shareholder to a fixed, maximum or minimum amount upon the acquisition of that share.

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[50] *Ibid*.

[51] *Ibid*.

[52] Paragraph (d) of the definition of "taxable preferred share".

- *ACQUISITION FOR FAIR MARKET VALUE*: Where there is an agreement to acquire the share for a price that does not exceed its fair market value at the time of acquisition (or for 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 shares at the time of acquisition), such an agreement is to be ignored for purposes of determining whether or not the share has a liquidation entitlement (the "**Fair Market Value Test**").[54]

3. Conversion or Exchange Right

A share will be a taxable preferred share if it is convertible or exchangeable into a taxable preferred share of the issuer or a corporation related to the issuer and/or a right or warrant that, if exercised, would allow the shareholder to acquire a taxable preferred share.[55] A share will also be a taxable preferred share if the consideration receivable on a conversion or exchange of that share includes something other than a non-taxable preferred share or a right or warrant to acquire a non-taxable preferred share.[56] The foregoing rules do not apply if the right to convert or exchange arises as a result of an agreement that either satisfies the Sixty Day Test or the Fair Market Value Test.[57]

As in the case of a liquidation entitlement, a right to convert or exchange a share may

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[53] Subparagraph (f)(i) of the definition of "taxable preferred share".

[54] Subparagraph (f)(ii) of the definition of "taxable preferred share".

[55] Subparagraph (b)(iii) of the definition of "taxable preferred share". Note that, in the case of a contingent conversion or exchange right, the CRA considers the share in question to be a taxable preferred share until such time as the contingency in question ceases to exist. ("Taxable Preferred Shares - Contingent Conversion Privilege", Technical Interpretation, Financial Industries Division, January 5, 1994, Window on Canadian Tax (CCH), paragraph 2927).

[56] Clause (b)(iii)(B) of the definition of "taxable preferred share". This clause, however, does allow for other consideration (such as cash) to be paid for a fractional share as long as one of the main purposes for paying such consideration is not to avoid or limit the application of Part IV.1 or Part VI.1 tax.

[57] *Supra* footnotes 53 and 54.

cause the share to be both a taxable preferred share and a term preferred share.[58]

4. Guarantees

A share will be a taxable preferred share if any person (other than the issuer) is obligated to effect any undertaking in respect of the share (a "**Guarantee Agreement**") that limits any loss that the shareholder or a specified person in relation to the shareholder may sustain by reason of the ownership, holding or disposition of the share or any other property (essentially, a guarantee of principal) or ensures that the shareholder or a specified person in relation to the shareholder will derive earnings by reason of owning, holding or disposing of the share or any other property (essentially, a guarantee of interest).[59] Included in the definition of Guarantee Agreement is any agreement to purchase the share or the lending of funds to, or putting funds on deposit with, or on behalf of, the shareholder or specified person. The Guarantee Agreement, however, must be given as part of a transaction or event or a series of transactions or events that includes the issuance of the share, before the agreement will cause the share to be a taxable preferred share. As well, if the Guarantee Agreement in question satisfies either the Sixty Day Test or the Fair Market Value Test, the Guarantee Agreement may be ignored and will therefore not cause the share to be a taxable preferred share.

It should be noted that a Guarantee Agreement will also render the share a term preferred share[60] and may, in addition, cause the share to be a guaranteed preferred share if the guarantor is an SFI.[61] Moreover, if the guarantee is secured by a property, the share may also qualify as a collateralized preferred share.[62]

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58 Subparagraph (a)(iv) of the definition of "term preferred share".

59 Subparagraph (b)(iv) of the definition of "taxable preferred share".

60 Subparagraph 248(a)(iii) of the definition of "term preferred share".

61 Subsection 112(2.2).

62 Paragraph 112(2.4)(a). Before the share would so qualify, however, the purpose test in subsection 112(2.5) would have to be met.

B. ANTI-AVOIDANCE RULE

A share that would not otherwise qualify as a taxable preferred share may nonetheless be considered to be a taxable preferred share where it may reasonably be considered that dividends paid on that share are derived primarily from dividends received on taxable preferred shares of another corporation and that the first-mentioned share was issued or acquired as part of a transaction or event or series of transactions or events the main purposes of which was to avoid or limit the application of Part IV.1 or VI.1.[63] The operation of this anti-avoidance rule is best illustrated by way of example:

Assume that Company A wishes to acquire 25% of the preferred shares of Company C, which shares qualify as taxable preferred shares. Further assume that these shares represent 25% of the votes and value of Company C. Company B, which is unrelated to Company A, also wishes to acquire 30% of the preferred shares of Company C.

As is discussed below, dividends paid on taxable preferred shares will be considered to be "excluded dividends" and "excepted dividends" and, therefore, not subject to Part VI.1 tax and Part IV.1 tax, respectively, if such dividends are paid to, or received by, a person that has a "substantial interest" in the corporation. As is also discussed below, a person will be considered to have a substantial interest in a corporation if that person is related to that corporation and a person will be considered to be related to a corporation if the person controls the corporation.[64]

If each of Company A and Company B were to separately acquire their respective 25% and 30% interests in Company C, neither Company A nor Company B would control Company C and, therefore, neither company would be related to Company C. Consequently, neither Company A nor Company B would have a substantial interest in Company C, with the result that the dividends paid on Company C's preferred shares (assuming that they do not otherwise qualify as excluded dividends or excepted dividends) would be subject to Part VI.1 tax in Company C's hands and, possibly, Part IV.1 tax in the hands of Company A and Company B.

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[63] Paragraph (g) of the definition of "taxable preferred share".

[64] Subparagraph 251(2)(b)(i).

Now assume that Company A and Company B, rather than acquiring their respective 25% and 30% interests in Company C separately, incorporate a holding company ("Holdco") to acquire their aggregate 55% preferred share interest in Company C. Holdco then issues common shares to each of Company A and Company B in proportion to each such company's underlying interest in Company C. As a result of this pooling of the preferred share interests of Company A and Company B and the consequent control of Company C by Holdco, Holdco will have a substantial interest in Company C. Accordingly, if Company C pays dividends on the taxable preferred shares issued to Holdco, these dividends will be considered to be excluded and excepted dividends. Company C, therefore, will not have to pay Part VI.1 tax on such dividends nor will Holdco have to pay Part IV.1 tax on such dividends. Moreover, when Holdco, in turn, applies the dividends it receives from Company C to pay dividends on its common shares to each of Company A and Company B, absent this anti-avoidance rule, no Part VI.1 tax or Part IV.1 tax would be exigible on those dividends because the common shares held by Company A and Company B in Holdco do not constitute taxable preferred shares.

This anti-avoidance rule, therefore, is designed to deal with this type of avoidance technique and will cause the common shares in this example to be taxable preferred shares.

V. EXCEPTIONS

There are basically four types of preferred shares that do not qualify as taxable preferred shares. They are as follows:

A. shares issued prior to Implementation Time;

B. grandfathered shares;

C. distress preferred shares; and

D. prescribed shares.[65]

[65] The first two of these exceptions are found in the preamble to paragraph (b) of the definition of "taxable preferred share" whereas the last two of these exemptions are found in the postamble to that paragraph.

A. SHARES ISSUED PRIOR TO IMPLEMENTATION TIME

As discussed above, a share that is issued prior to Implementation Time will not be a taxable preferred share unless it is deemed to have been reissued after that time. There are two "deemed reissuance" rules in the Act that will cause a share that is otherwise issued prior to Implementation Time to be deemed to have been issued after that time. The first such rule deals with Guarantee Agreements while the second rule deals with amendments to the terms or conditions of, or agreements in respect of certain matters relevant to, the share:

1. Guarantee Agreement

A Guarantee Agreement given in respect of a share at any time after Implementation Time will generally cause that share to be deemed to be issued at the time the Guarantee Agreement is given. As well, the Guarantee Agreement will be considered to be given as part of a series of transactions that includes the issuance of the share.[66] Accordingly, the share will qualify as a taxable preferred share notwithstanding its actual issuance before Implementation Time.

2. Amendments or Agreements After Implementation Time

If, at any particular time that is after Implementation Time, the terms of a share relevant to a dividend entitlement, liquidation entitlement, conversion or exchange right or a guarantee are established or modified, or any agreement in respect of any of the foregoing (to which the issuer or a specified person in relation to the issuer is a party) is changed or entered into, the share will be deemed to be issued at the particular time.[67] In these circumstances, the fact that the share was issued prior to Implementation Time will not preclude it from qualifying as a taxable preferred share if it otherwise so qualifies.

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66 This deemed reissuance provision is found in the postamble to subparagraph (b)(iv) of the definition of "taxable preferred share".

67 Paragraph (e) of definition of "taxable preferred share". See Donald M. Sugg, "Preferred Share Review: Anomalies and Traps for the Unwary," in *Report of Proceedings of the Forty-Forth Tax Conference*, 1992 Conference Report (Toronto: Canadian Tax Foundation, 1993), 22:1-29, at 22:2-5, for a discussion of the scope of this deemed reissuance rule.

B. GRANDFATHERED SHARES

A grandfathered share is a share that is issued after Implementation Time and that falls into one of the following four categories:

(1) the share was issued pursuant to an agreement in writing entered into before Implementation Time;

(2) the share was issued before 1988 pursuant to the terms of a prospectus, preliminary prospectus, registration statement, offering memorandum or notice filed before Implementation Time;

(3) the share was issued in exchange for:

  (a) a share of the issuer that was issued before Implementation Time or a grandfathered share of the issuer; or

  (b) a debt obligation of the issuer that was issued:

    (i) before Implementation Time; or

    (ii) after Implementation Time pursuant to a written agreement entered into before that time or after Implementation Time and before 1988 pursuant to the terms of a prospectus, preliminary prospectus, registration statement or notice filed before Implementation Time,

where the right to the exchange and all or substantially all the terms and conditions of the new share were established in writing before Implementation Time; and

(4) the share is a share of a Canadian corporation that is listed on a designated stock exchange and is issued upon the exercise of a right that was listed on a designated stock exchange and that was issued:

  (a) before Implementation Time;

  (b) after Implementation Time pursuant to a written agreement entered into before that time;

or

(c) after Implementation Time and before 1988 pursuant to the terms of a prospectus, preliminary prospectus, registration statement or notice filed before Implementation Time,

and all, or substantially all, the terms and conditions of the right and the share were established in writing before that time.

A share will not be a grandfathered share if it is deemed to be reissued after Implementation Time under any of the deemed reissuance rules that apply to taxable preferred shares, short-term preferred shares, guaranteed preferred shares or term preferred shares.[68] It should also be noted that there are specific grandfathering rules that apply on an amalgamation.[69]

C. DISTRESS PREFERRED SHARES

These types of shares have already been discussed in the context of the term preferred shares rules.

D. PRESCRIBED SHARES

Currently, the only prescribed shares for purposes of the taxable preferred share rules are specific shares of four named companies set out in Regulations 6201(7) and 6201(8) to the Act.

VI. EXCLUDED AND EXCEPTED DIVIDENDS

Notwithstanding the fact that a share may be a taxable preferred share, a dividend paid on that share will not be subject to Part VI.1 tax or Part IV.1 tax if the dividend qualifies respectively, as an "excluded dividend" or an "excepted dividend". The definitions of excluded dividend and excepted dividend are essentially the same although there are some important differences.

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68 See definition of "grandfathered shares" in subsection 248(1).

69 Subsections 87(4.2) and 87(4.3).

A. EXCLUDED DIVIDENDS

An excluded dividend is a dividend that is:

1. paid by a corporation to a shareholder that has a "substantial interest" in the payor;
2. paid by a corporation that is a "financial intermediary corporation" (a "**FIC**") or a "private holding corporation";
3. paid by a corporation that would be a FIC but for the Control Rule or Substantial Interest Rule (described below), unless the dividend is paid to a corporation that controls the FIC or to a specified person in relation to such a controlling corporation;
4. paid by a mortgage investment corporation; and
5. that is a capital gains dividend (this concept is relevant to mutual fund corporations).[70]

An excluded dividend also includes a deemed dividend arising on a redemption, acquisition or cancellation of a taxable preferred share if the terms of the share or an agreement in respect of the share specify an amount for which the share may be redeemed, acquired or cancelled and such specified amount does not exceed the fair market value of the consideration for which the share was issued and provided that the consideration for which the share was issued does not include a taxable preferred share.[71]

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[70] Subsection 191(1).

[71] Paragraph 191(4)(d). Note that for a dividend to qualify as an excluded dividend under this paragraph the specified amount must be contained in the terms of the share or an agreement in respect of the share and, unless such terms or agreement otherwise provide, the specified amount will be the redemption amount of the share. However, the specified amount cannot be based on a formula nor can it be subject to a price adjustment clause. It must be set at a specific amount. ("Revenue Canada Round Table", in *Report of Proceedings of the Fortieth Tax Conference*, 1988 Conference Report (Toronto: Canadian Tax Foundation, 1989), 53:1-187, question 37; "Revenue Canada Round Table", in *Report of Proceedings of the Forty-First Tax Conference*, *supra* footnote 7, question 20; and Claude Désy, ed., TAP Tax Authorities Papers, 1990, meeting with Toronto Chapter of the Institute of Chartered Accountants of Ontario, *Access to Canadian Income Tax* (1992, Dacfo Publications Inc.), paragraphs 238 and 239, *Technical Interpretation* 2007-0250831E5, "Part IV.1 and VI.1 Taxes – Subsection 55(2)").

1. Substantial Interest

A shareholder will have a substantial interest in a corporation if:

(a) the shareholder is related to the corporation (other than by reason of a right referred to in paragraph 251(5)(b)); or

(b) the shareholder:

(i) owns shares of the corporation that carry 25% or more of the votes and value of the corporation; and

(ii) also owns either 25% or more of the non-taxable preferred shares of the corporation (based on fair market value) or 25% or more of each class of shares of the corporation.[72, 73]

For purposes of the foregoing rule, a shareholder is deemed to own each share that is owned by a person to whom the shareholder is related (other than by reason of paragraph 251(5)(b)). A shareholder will generally be considered to be related to a corporation if the shareholder either alone or together with other related persons controls the corporation.[74] It should be noted that subsection 191(3) of the Act sets out certain anti-avoidance and other rules which deem a substantial interest not to exist in certain circumstances. For example, a trust or a partnership that otherwise has a substantial interest in a corporation will not be considered to

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72 Subsection 191(2). The substantial interest exclusion evidences the fact that Part VI.1 and Part IV.1 tax are intended to apply in arm's length situations only. Note that the CRA takes the position that a beneficiary of a trust will not be considered to have a substantial interest in a corporation where the trust itself has such a substantial interest. The CRA's reasoning is based on its interpretation that, to have a substantial interest in a corporation, a person must own shares of the corporation. In circumstances involving a trust, it is the trust that owns the shares, not the beneficiary. Consequently, dividends paid to the trust and flowed through to a corporate beneficiary are, according to the CRA, subject to Part IV.1 tax. ("Revenue Canada Round Table," in *Report of Proceedings of the Forty-Third Tax Conference*, 1991 Conference Report (Toronto: Canadian Tax Foundation, 1992), 50:1-82, question 7).

73 In determining whether a shareholder has a substantial interest in a corporation in the context of a redemption of such shareholder's shares, such determination is made prior to the redemption. ("Revenue Canada Round Table", in *Report of Proceedings of the Fortieth Tax Conference*, *supra* footnote 71, question 38).

74 Subsection 251(2).

have a substantial interest unless all the beneficiaries or partners, as the case may be, are related to one another (or, in the case of a trust, the beneficiary is a registered charity).[75]

2. A FIC

A FIC is essentially a conduit vehicle through which investors' funds are pooled for the purposes of acquiring various investments. Generally, a FIC is not taxed to the extent that the income of the FIC is flowed through to its investors. In keeping with this principle of non-taxation of FICs, dividends paid by a FIC are considered to be excluded dividends and are thus exempt from Part VI.1 tax. Similarly, as is discussed below, dividends received by a FIC are generally treated as excepted dividends and, accordingly, received free of Part IV.1 tax.

A FIC is defined to be:

(a) a company licensed to issue investment contracts (as more fully described in subparagraph (b)(ii) of the definition of "retirement savings plan" in subsection 146(1) of the Act);

(b) an investment corporation;

(c) a mortgage investment corporation;

(d) a mutual fund corporation;

(e) a prescribed venture capital corporation; or

(f) a prescribed labour-sponsored venture capital corporation,

but does *not* include:

(g) a prescribed corporation (no corporations have yet been prescribed for these purposes);

(h) a particular corporation that is controlled by one or more corporations (the "Control Rule")

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75 The December 20, 2002 and February 27, 2004 Technical Bills, however, proposes to add new subsection 191(6) which will expand the "excluded dividend" definition to include a partner's share of any dividend received by the partnership, to the extent that the partner otherwise has a substantial interest in the payor corporation.

unless the controlling corporation(s) is itself a FIC(s) or a private holding corporation or does not own (either alone or together with specified persons in relation to it) more than 10% of the value of the particular corporation; and

(i) any particular corporation in which another corporation has a substantial interest (the "**Substantial Interest Rule**") unless the other corporation is itself a FIC or a private holding corporation or does not own (either alone or together with specified persons in relation to it) more than 10% of the value of the particular corporation.[76]

The foregoing exclusions from the FIC definition are intended to preclude the types of arrangements that are similar to the pooling example given earlier in the context of the anti-avoidance rules. Specifically, these exclusions are designed to preclude large institutional investors from pooling their preferred share investments in a FIC (and thereby acquiring a controlling or substantial interest in the FIC). Were it not for these rules, such a controlling interest would allow the FIC to avoid Part IV.1 tax when dividends are paid to it on these preferred shares (because, absent these exclusions from the FIC definition, these dividends would be excepted dividends since they are received by a FIC) and Part VI.1 tax when these dividends are, in turn, paid by the FIC to the investors (since, absent these exclusions, dividends paid by a FIC are excluded dividends).

3. Private Holding Corporation

A private holding corporation is a private corporation the only undertaking of which is the investing of funds. A private holding corporation does not include:

(a) an SFI;

(b) a particular corporation that has a substantial interest in another corporation unless the other corporation is a FIC or a corporation that, but for (c) below, would be a private holding corporation; and

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[76] Subsection 191(1).

(c) a particular corporation in which another corporation has a substantial interest unless the other corporation would, but for (b) above, be a private holding corporation.[77]

For example, assume that Company A's only asset is 51% of the common shares of Company B. This 51% interest gives Company A voting control of Company B and, accordingly, Company A has a substantial interest in Company B. The only asset of Company B is a 10% interest in Company C. Company B, therefore, does not have a substantial interest in Company C.

Under rule (c), Company B, although it would otherwise qualify as a private holding company, does not so qualify because of Company A's substantial interest in it, unless Company A itself qualifies as a private holding company. In determining whether Company A so qualifies, rule (b) requires that one ignore Company A's substantial interest in Company B. Under these circumstances, Company A is a private holding company and, accordingly, so is Company B.

B. EXCEPTED DIVIDENDS

An excepted dividend[78] is a dividend received by a corporation:

1. on a share of a foreign affiliate of a corporation if the share was not acquired in the ordinary course of business;

2. from a corporation (other than a FIC) in which it has a substantial interest;

3. that is a private corporation[79] or a FIC;

4. on a short-term preferred share, except if such dividend is paid by a FIC, a private holding corporation or a corporation that would be a FIC but for the Control Rule or Substantial

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77 *Ibid*.

78 Defined in section 187.1.

79 This exception for dividends received by private corporations essentially recognizes the fact that most private corporations will generally pay Part IV tax on such dividends and, accordingly, there is no need to also impose Part IV.1 tax.

Interest Rule; or

5. on a share of a mutual fund corporation. This exception, however, does not apply if the share is a taxable RFI share or a taxable preferred share (other than solely by reason of the sharing being a short-term preferred share).

An excepted dividend also includes a deemed dividend arising on a redemption, acquisition or cancellation of a taxable preferred share if the terms of the share or an agreement in respect of the share specify an amount for which the share may be redeemed, acquired or cancelled and such specified amount does not exceed the fair market value of the consideration for which the share was issued provided that the share was not issued for consideration which included a taxable preferred share.

VII. DECISION CHART

As can be seen, the taxable preferred shares are somewhat complex and require an analysis of various factors. Set out below is a decision chart that summarizes this analysis:

1.	Is the share a taxable preferred share (consider taxable preferred share exceptions)?	No	STOP No Part VI.1 or IV.1 tax payable
	Yes		
2.	Is the share a short-term preferred share?	Yes	STOP See short-term preferred share rules
	No		
3.	Are dividends on the share excluded and/or excepted dividends?	Yes	STOP No Part VI.1 or IV.1 tax payable
	No		
4.	Is the payor company or a company related to the payor subject to tax and therefore able to fully utilize 9/4 deduction?	Yes	STOP Part VI.1 tax payable but no net impact on payor Payor should make 40% election (if its shareholders are subject to Part IV.1 tax), in which case there will be no Part IV.1 tax payable

No

5.	Will the dividends exceed the dividend allowance available to the payor in the year?	No	STOP No Part VI.1 tax payable Payor should make 40% election (if its shareholders are subject to Part IV.1 tax), in which case there will also be no Part IV.1 tax payable

Yes

Part VI.1 and Part IV.1 tax payable

SHORT-TERM PREFERRED SHARES

If a share is a short-term preferred share, dividends paid on that share, other than excluded dividends, will be subject to Part VI.1 tax in the hands of the payor at a rate of 66⅔%.[80] However, as indicated above, dividends paid on short-term preferred shares are considered to be excepted dividends (unless such dividends are paid by a FIC, a private holding corporation or a corporation that would be a FIC but for the Control Rule or the Substantial Interest Rule[81]) and, accordingly, no Part IV.1 tax is exigible on such dividends. A share may be both a short-term preferred share as well as a term preferred share in which case dividends paid on such share may both be subject to the 66⅔% tax in the hands of the payor and be ineligible for the intercorporate dividend deduction in the hands of the payee.

I. CHARACTERISTICS OF A SHORT-TERM PREFERRED SHARE

A "short-term preferred share" is defined in section 248 of the Act and is essentially a share with a liquidation entitlement (exerciseable at the option of the shareholder), a conversion or exchange right or a guarantee right that arises at any time within five years from the date the share is issued. A share may be a short-term preferred share because of:

A. its terms or the terms of any agreement in respect of such share;

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80 Subparagraph 191.1(1)(a)(i). The December 20, 2002 and February 27 2004 Technical Bills proposes to reduce this rate to 50%.

81 *Supra* footnote 73. Such dividends, however, would be excluded dividends and therefore would not give rise to the 66⅔% Part VI.1 tax in the hands of the payor.

B. the fact (or possibility) that the issuer will (or may be) wound up; or

C. specific anti-avoidance rules.

A. TERMS OF THE SHARE OR AN AGREEMENT RELATING TO THE SHARE

A share may be a short-term preferred share if the terms of the share, or the terms of any agreement relating to the share, provide that, at any time within five years from the date of issue of the share, the share:

1. is or may be required to be redeemed, acquired or cancelled by the corporation or a specified person in relation to the corporation or any such person may be required to reduce the paid-up capital of the share (a form of liquidation entitlement that is referred to herein as a "**Retraction/Put Right**");[82]

2. is convertible or exchangeable;[83] or

3. is guaranteed.[84]

A share that is redeemable *at the option of the issuer* within five years from the date of its issue will not be a short-term preferred share unless there is a reasonable expectation of redemption (see discussion of anti-avoidance rules below).

1. Retraction/Put Right

A share will not be considered to have a Retraction/Put Right if such right arises only in the event of the death of the holder of the share (or any shareholder in the corporate chain to which such holder belongs) or because of any right to convert or exchange the share. As well, any Retraction/Put Right that arises by virtue of any agreement that satisfies the Sixty Day Test[85]

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82 Paragraph (a) of the definition "short-term preferred share".

83 Paragraph (b) of the definition "short-term preferred share".

84 Paragraph (h) of the definition "short-term preferred share".

85 Clause (a)(i)(A) of the definition of "short-term preferred share".

or the Fair Market Value Test[86] will not cause the share to be a short-term preferred share.

2. Conversion and Exchange Rights

A share will be a short-term preferred share if the share is convertible or exchangeable into a short-term preferred share and/or a right or warrant that, if exercised, would allow the shareholder to acquire a short-term preferred share. A share will also be a short-term preferred share if the consideration receivable on a conversion or exchange includes something other than a non-short-term preferred share or right or warrant to acquire a non-short-term preferred share.[87, 88] Note that unlike the conversion/exchange rules that apply to taxable preferred shares, conversion/exchange rights that arise by virtue of an agreement that satisfies the Sixty Day Test or the Fair Market Value Test will still cause the share in question to be a short-term preferred share (assuming that such conversion/exchange rights are of the type to which the short-term preferred share rules apply).

3. Guarantees

A share will generally be a short-term preferred share if, at any time after December 15, 1987, any corporation (other than the issuer) or a trust has, under the terms or conditions of the share, or any agreement entered into by the issuer or a specified person in relation to the issuer, given a guarantee in respect of the share at any time within five years after the date on which the share was issued. As in the case of taxable preferred shares, the guarantee must be given to limit any loss that the shareholder or a specified person in relation to the shareholder may sustain by reason of the ownership, holding or disposition of the share or any other property (essentially, a guarantee of principal) and must be given as part of a transaction or event or series of transaction

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86 Clause (a)(i)(B) of the definition of "short-term preferred share".

87 Paragraph (b) of the definition of "short-term preferred share". This paragraph, however, does allow for other consideration (such as cash) to be paid for fractional shares as long as one of the main purposes for paying such consideration is not to avoid or limit the application of Part IV.1 or Part VI.1 tax.

88 A share will be considered to be convertible or exchangeable if it is convertible or exchangeable at the option of either the holder or the issuer ("Revenue Canada Round Table," in *Report of Proceedings of the Forty-Fifth Tax Conference*, *supra* footnote 6, question 10).

and events that includes the issuance of the share.[89] However, unlike Guarantee Agreements given in respect of taxable preferred shares (or guaranteed preferred shares or term preferred shares), a guarantee given in respect of earnings on the share does not cause the share to be a short-term preferred share.[90] As well, a Guarantee Agreement that causes a share to be a short-term preferred share will not be ignored (as it would in the case of the taxable preferred share rules) simply because it satisfies the Sixty Day Test or the Fair Market Value Test.

B. WINDING UP

If, at the time of the issuance of a share, the existence of the issuer was or could be limited to a period that was within five years from the date of issue, the share will be considered to be a short-term preferred share. The basis for this rule is that a pre-arranged wind-up of the corporation is simply another form of a Retraction/Put Right in that it ensures that the shareholder will receive back its "principal" invested in the share. This wind-up rule, however, does not apply if the share is a grandfathered share (see discussion above) and the arrangement to wind-up is a written arrangement entered into before December 16, 1987.[91]

C. ANTI-AVOIDANCE RULES

There are two types of anti-avoidance rules that will cause a share that would not otherwise be a short-term preferred share to be a short-term preferred share. These two anti-avoidance rules deal with the situation in which there is a reasonable expectation that the share will be redeemed and the situation in which the share is effectively "tied" to another share.

1. Reasonable Expectation of Redemption

Where the terms of a share or any agreement in respect of the share are such that the issuer or a specified person in relation to the issuer may reasonably be expected to redeem,

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89 This latter condition is deemed to be automatically satisfied if the guarantee is entered into after December 15, 1987 otherwise then pursuant to a written agreement to do so before December 16, 1987.

90 In this regard, see "Revenue Canada Round Table," in *Report of Proceedings of the Forty-First Tax Conference*, *supra* footnote 7, question 19.

91 Paragraph (f) of the definition of "short-term preferred share".

acquire or cancel the share or reduce its paid-up capital within five years from the date that such terms were established or such agreement entered into, the share will be a short-term preferred share for so long as such reasonable expectation exists.[92] The same exceptions that apply with respect to the Retraction/Put Right also apply to this rule such that if the reasonable expectation of redemption arises because of the death of the shareholder (or any shareholder in the corporate chain), a conversion or exchange right that would not cause the share to be a short-term preferred share, or an agreement that satisfies the Sixty Day Test or the Fair Market Value Test, the share will not be considered to be a short-term preferred share.

2. Tied Shares

This rule generally deals with the situation in which a particular share is issued or its terms modified in conjunction with the issuance or acquisition of another share or debt and the reason for the issuance of the particular share is to avoid the short-term preferred share rule.[93] In essence, this rule is designed to circumvent the technique pursuant to which the shareholder's return on its "principal" is separated from the "principal" itself. This anti-avoidance rule is best illustrated by way of example:

Assume that a corporation acquires Share A of an issuer and that Share A is a short-term preferred share (for example, because it has a Retraction/Put Right that is exercisable within five years from the date of issuance of the share) but that such share carries no dividend rights. The corporation also acquires Share B of the issuer which is a common share and which does carry dividend rights. Share B carries no liquidation entitlement, conversion or exchange right, or guarantee right and, accordingly, it is not otherwise a short-term preferred share. Share B will be purchased for cancellation when Share A is retracted (thus "tying" Share A to Share B). The dividend that would otherwise have been paid on Share A (and would therefore have been caught by the short-term preferred share rules) will now be paid on Share B. But for this anti-avoidance rule, Share B would not be a short-term preferred share and dividends paid on Share B would therefore be exempt from the 66% Part VI.1 tax.

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92 Paragraph (e) of the definition of "short-term preferred share".

93 Paragraph (d) of the definition of "short-term preferred share".

II. EXCEPTIONS

The exceptions to the short-term preferred rules are basically the same as those for taxable preferred shares. Specifically:

A. shares issued prior to December 16, 1987;

B. grandfathered shares;

C. distress preferred shares; and

D. prescribed shares,

will not constitute short-term preferred shares.[94]

A. SHARES ISSUED PRIOR TO DECEMBER 16, 1987

A share issued prior to December 16, 1987 ("**Implementation Date**"), will not be considered to be a short-term preferred share unless it is deemed to have been reissued after that date. A deemed reissuance of a share, for purposes of the short-term preferred share rules, will generally occur if, after December 15, 1987, the terms or conditions of the share that are relevant to a Retraction/Put Right, a conversion or exchange right, a guarantee right or the winding-up or potential winding-up of the issuer, are established or modified, or any agreement in respect of any such matter to which the corporation or a specified person in relation to the corporation is a party, is changed or entered into.[95]

A share will also be deemed to have been reissued after Implementation Date if it is acquired by the issuer or a specified person in relation to the issuer after the Implementation Date and the share is at any time after that time acquired by a person with whom the issuer or the specified person is dealing at arm's length, from the issuer or the specified person.[96] This latter

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94 The first two of these exceptions are found in the preamble to the definition of "short-term preferred share" while the last two of these exceptions are found in paragraph (i) of the definition of "short-term preferred share".

95 Paragraphs (c) and (h) of the definition of "short-term preferred share".

96 Paragraph (g) of the definition of "short-term preferred share".

"deemed reissuance" rule is, in fact, an anti-avoidance rule designed to deal with the situation in which short-term preferred shares are warehoused. For example, assume that a retractable share is issued by a corporation to a related corporation that holds the share for five years. Since the related corporation has a substantial interest in the issuer, Part VI.1 tax will not be exigible on any dividends paid to the corporation during that five-year period. At the end of the period, the share is then sold by the corporation to an arm's length purchaser who, absent this rule, could retract the share at any time without having the share qualify as a short-term preferred share since the share is not retractable within five years from the date of its issue. By deeming the share to be reissued at the time of its acquisition by the purchaser, the Act precludes this type of anti-avoidance technique.

B. PRESCRIBED SHARES

Regulation 6201(8) prescribes the shares that are excepted from the short-term preferred share rules. Currently, the only prescribed shares for these purposes are the specific shares of two named corporations.

TAXABLE RFI SHARES

The taxable RFI share rules only apply to RFIs. Dividends paid on shares that are taxable RFI shares will be subject to Part IV.1 tax in the hands of the recipient RFI.

I. PART IV.1 TAX

Under subsection 187.3(1), RFIs must pay a 10% tax in respect of dividends (other than excepted dividends) received on taxable RFI shares acquired after Implementation Time to the extent that such dividends are eligible for the intercorporate dividend deduction. In other words, the intercorporate dividend deduction is not denied (as is the case with term preferred shares) but the recipient is liable for tax under Part IV.1. In circumstances where there is a Part IV.1 liability, the tax under subsection 187.3(1) must be paid on or before the last day of the second month following the end of the corporation's taxation year.

For purposes of subsection 187.3(1), subsection 187.3(2) provides that, in certain circumstances, a share acquired after Implementation Time will be treated as being acquired before Implementation Time. This treatment will be available where:

A. the share was acquired pursuant to an agreement in writing entered into before Implementation Time;

B. the share was acquired after Implementation Time and before 1988 as part of a public offering provided that the offering documentation was filed before Implementation Time; or

C. the share was acquired after Implementation Time in exchange for:

1. a share issued before Implementation Time or a grandfathered share; or

2. a debt issued before Implementation Time or issued after Implementation Time pursuant to an agreement in writing entered into before Implementation Time,

provided that the rights to the exchange for the new share and all or substantially all the terms and conditions of the new share were established in writing before Implementation Time;

D. the share was acquired after Implementation Time on the exercise of a right that was issued before Implementation Time and listed on a designated stock exchange; and the terms of which at that time included the right to acquire the share where all or substantially all of the terms and conditions of the share were established in writing before Implementation Time;

E. the share was transferred among related RFIs; or

F. the share was acquired as a result of an amalgamation of RFIs that were related at all times throughout the period from Implementation Time to the time of amalgamation and each of the predecessor corporations was an RFI at all relevant times.

II. RFIS

An RFI is defined in subsection 248(1) as generally meaning:

A. a bank;

B. a trust company licensed to carry on business in Canada;

C. a credit union;

D. an insurance corporation;

E. a corporation whose principal business is the loaning of money to, and/or purchasing of debt obligations issued by, arm's length persons;

F. a corporation prescribed to be a financial institution for capital tax purposes; or

G. a corporation controlled by one or more corporations described at A to F above.

It should be noted that this definition is narrower than the definition of SFI which, as stated above, essentially includes all RFIs as well as any corporation related to an RFI.

III. CHARACTERISTICS

Generally, the intent of the taxable RFI share rules is to discourage certain financial institutions from trading in preferred shares that would otherwise be grandfathered for purposes of the taxable preferred share rules. Accordingly, the definition of taxable RFI shares is similar to the definition of taxable preferred share but only applies to shares issued before Implementation Time that would have been taxable preferred shares if issued after Implementation Time, as well as to grandfathered shares.

A. TERMS OF THE SHARE OR AN AGREEMENT RELATING TO THE SHARE

"Taxable RFI share" is defined in subsection 248(1) as meaning a share issued before Implementation Time or a grandfathered share where, at the particular time, either under the terms or conditions of the share or any agreement in respect of the share, it may reasonably be considered having regard to all the circumstances that the dividend entitlement or the liquidation entitlement of the share is, by way of a formula or otherwise,

1. Fixed;

2. limited to a maximum; or

3. established to be not less than a minimum.

Specifically excluded from the definition of taxable RFI shares are:

1. prescribed shares (discussed below);

2. term preferred shares;

3. distress preferred shares; and

4. taxable preferred shares.

The dividend entitlement and the liquidation entitlement of a share will be deemed not to be fixed, limited to a maximum or established to be not less than a minimum where the liquidation entitlement or dividend entitlement is determined by reference to the liquidation entitlement or dividend entitlement of another share of the capital stock of the particular corporation or of another corporation that controls the corporation provided that the other share would not be a taxable preferred share if:

1. the definition of taxable preferred share were read without reference to the Sixty Day Rule;

2. the other share was issued after Implementation Time; and

3. the other share was not a grandfathered share, a prescribed share or a distress preferred share.

B. ANTI-AVOIDANCE RULE

A share may also be a taxable RFI share if an intermediary corporation paid dividends on common shares held by an RFI where those dividends may reasonably be considered to be derived from dividends received on taxable RFI shares and it may reasonably be considered that the transaction or event or series of transactions or events are intended to avoid or limit the application of Part IV.1. In such circumstances, the share of the intermediary corporation will be deemed to be a taxable RFI share. Thus rule is analogous to the anti-avoidance rule described above in the context of the taxable preferred share rules.

IV. EXCEPTIONS

A. PRESCRIBED SHARES

Prescribed shares, which are not taxable RFI shares, are shares listed on a designated stock exchange in Canada unless the total holdings of the particular RFI and other non-arm's length RFIs exceed certain ownership thresholds.[97] Under Regulation 6201(4), applicable to dividends received after December 20, 1991, the RFI's percentage holding of a particular class of shares is measured based upon the number of shares of that class outstanding at the time that the particular RFI or a member of the related corporate group last acquired any such shares (as opposed to the time at which the dividend is paid). The relevant percentage is 10% if none of the shares was acquired after December 15, 1987 and 5% if any of the shares were acquired after that date. For purposes of determining the date on which a share was acquired, shares are deemed to have been disposed of on a last in-first out basis. Accordingly, it is possible to move from the 5% test to the 10% test by disposing of the appropriate number of shares.

In determining when a particular share was acquired for purposes of the 10% or 5% test, the Regulation also allows for the grandfathering of shares acquired after December 15, 1987 if the share:

1. was acquired pursuant to an agreement in writing entered into before December 16, 1987;

2. was acquired before July, 1988 as part of a public offering where the offering documentation was filed before December 15, 1987; or

3. the share was owned by a related RFI before December 16, 1987 and subsequently transferred.

Shares acquired by an RFI by virtue of an amalgamation will be deemed to have been acquired at the time that the predecessor corporation acquired the particular share provided the

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97 A prescribed share for these purposes also includes a share listed on a designated stock exchange in Canada, where the shareholder is a registered or licensed trader in securities and holds the share for the purpose of sale in the course of the business ordinarily carried on by the shareholder.

corporations were related throughout the period from December 16, 1987 to the date of amalgamation.

The Regulations provide for a look-through rule with respect to dividends deemed to have been received by the RFI as a result of being a beneficiary under a trust or a member of a partnership.

B. EXCEPTED DIVIDENDS

Part IV.1 tax is not payable in respect of a dividend received on a taxable RFI share held by an RFI if the dividend is an "excepted dividend" (as defined above in the context of the taxable preferred share rules).

CONCLUSION

The preferred share rules are not the type of rules that one generally uses as a planning tool. Rather, they are the type of rules that are to be avoided, if possible. At the very least, one should be aware of these rules and their potential adverse tax impact on certain transactions. The types of transactions to which these rules might apply include corporate reorganizations such as butterflies, corporate acquisitions, changes in terms of shares or agreements relating to shares, transactions which may result in a non-SFI becoming an SFI, public offerings, distress preferred shares and de-listing of shares.

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