The Joint Committee on Taxation of The Canadian Bar Association and The Canadian Institute of Chartered Accountants

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September 29, 2006

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Dear Mr. Ernewein:

June 29, 2006 Draft Legislation on Taxation of Dividends

The enclosed submission sets out the concerns and suggestions of the Joint Committee with respect to the draft legislative measures regarding the taxation of dividends released by the Minister of Finance on June 29, 2006. We appreciate the opportunity to provide input on this important legislative initiative.

We would like to observe that we found the Explanatory Notes to be of considerable assistance in understanding the new rules, and thank the drafter of the Notes for this.

We trust that you will find our comments and recommendations helpful. If you and your colleagues think it worthwhile, we would be pleased to meet with you to discuss the submission.

Yours truly,

Bruce Harris, CA
Chair, Taxation Committee
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William R. Holmes
Chair, Taxation Section
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cc: Gerard Lalonde – Department of Finance
Lawrence Purdy – Department of Finance

Submission of the
CICA-CBA Joint Committee on Taxation
Regarding the June 29, 2006 Draft Legislation on the Taxation of Dividends

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Submission of the
CICA-CBA Joint Committee on Taxation
Regarding the June 29, 2006 Draft Legislation on the Taxation of Dividends

A. INTRODUCTION

This submission identifies technical issues and other concerns relating to the draft legislation on the taxation of dividends (the "Draft Legislation") that was released by the Minister of Finance for public consultation on June 29, 2006.

The following abbreviations are used throughout this submission:

Act	*Income Tax Act* (Canada)
CCPC	Canadian-controlled private corporation
GRIP	General rate income pool
LRIP	Low rate income pool
Opening GRIP	The amount included in a CCPC's GRIP in respect of taxation years ending before 2006

References to subsections, paragraphs, etc. are to provisions of the Act. References to provisions that would be added to the Act by the Draft Legislation are not prefaced by the word "proposed".

In the examples in this submission, taxation years are assumed to be calendar years except as otherwise indicated.

B. DESIGNATION OF ELIGIBLE DIVIDENDS

1. Eligible Dividends Paid by a Non-CCPC

A dividend is an eligible dividend only if it is designated as such by the payer corporation in accordance with subsection 89(14). Since most dividends paid by non-CCPCs to Canadian residents will be eligible dividends, such corporations would face less of a compliance burden if they could make a blanket election to have all dividends paid by them to Canadian residents treated as eligible dividends, other than dividends they designate not to be eligible dividends. Corporations making the election would be required provide some form of public notification that they have done so.

Recommendation

We recommend that a mechanism be introduced whereby non-CCPCs can elect to have their dividends automatically treated as eligible dividends. This election would apply to all dividends, other than dividends that a non-CCPC designates not to be eligible dividends.

2. Method for Designating Dividends

Subsection 89(14) provides that the designation of a dividend as an eligible dividend is made by the corporation notifying in writing each person or partnership to whom it pays all or any part of the dividend that the dividend is an eligible dividend. This notification must occur when the dividend is paid. Depending on how the obligation to notify dividend recipients is intended to apply, it could impose an extremely onerous compliance burden in many cases. We expect that the Department of Finance has received submissions on this point from public corporations and the securities industry, which are in a better position than we are to describe in detail the difficulties created by a literal compliance with the notification obligation.

Recommendation

We recommend that consideration be given to permitting alternative methods of notification that will be less onerous for dividend payers.

3. Designation of Portion of Dividend

It is unclear whether a designation under subsection 89(14) must be made in respect of the full amount of a dividend paid on a class of shares, or whether a designation can be limited to the portion of the dividend paid to particular shareholders. Subsection 89(14) appears to contemplate the designation being made in respect of the full amount of a dividend. The definition of "eligible dividend", on the other hand, seems to contemplate designations that are shareholder specific.

We submit that a corporation should have the flexibility to make a designation under subsection 89(14) with respect to the portion of a full dividend paid to some shareholders without having to designate the remainder of the dividend. This would enable the corporation to achieve the same result as it could achieve by having different classes of shares.

We also submit that it would be appropriate to allow a corporation to make a designation in respect of a fraction of a dividend. For example, a corporation could designate 80% of the amount of a dividend paid to each shareholder as an eligible dividend. The ability to designate a fraction of a dividend would save a corporation from having to pay two dividends when it wishes to pay both an eligible dividend and a non-eligible dividend at the same time.

There is a consequential issue that also needs consideration. If a dividend is treated in part as an eligible dividend and in part as a non-eligible dividend, the non-eligible dividend will not reduce the corporation's LRIP for purposes of determining if the corporation has made an excessive eligible dividend designation (as defined in subsection 89(1)) in respect of the eligible dividend. Whether there is an excessive eligible dividend designation is determined by reference to the corporation's LRIP at the time the eligible dividend is paid, whereas the non-eligible dividend will not reduce LRIP until immediately after it has been paid. It would be appropriate in our view for a non-eligible dividend that is paid at the same time as an eligible dividend to be taken into account in determining if an excessive eligible dividend designation has been made in respect of the eligible dividend.

Recommendation

We recommend that corporations be permitted to designate portions of dividends as eligible dividends. This flexibility would encompass both the shareholders in respect of whom a designation is made, and the proportion of a dividend to which a designation applies. In addition, we recommend that a non-eligible dividend paid by a non-CCPC at the same time as it pays an eligible dividend be taken into account in determining if the non-CCPC has made an "excessive eligible dividend designation" in respect of the eligible dividend.

If, as we recommend above, dividends paid by electing non-CCPCs are automatically treated as eligible dividends unless designated not to be eligible dividends, the flexibility we are recommending should also apply to designations of non-eligible dividends.

4. Designation after Payment of Dividend

The Draft Legislation does not permit a dividend to be designated as an eligible dividend after the dividend has been paid. This appears to be a deliberate decision, given the statement in the Explanatory Notes to the Draft Legislation that the designation under subsection 89(14) will not be prescribed for the purposes of section 600 of the *Income Tax Regulations*. We request that this decision be reconsidered. There can be circumstances where the GRIP of a CCPC turns out to be larger than it was thought to be at the time a dividend was paid. For example, if a CCPC reports its gain on the sale of property on capital account, and the CRA later successfully challenges this with the result that the gain is on income account, an additional amount will be added to the CCPC's GRIP at the end of the year of sale. The CCPC should be permitted to designate any dividends it has paid subsequent to the sale as eligible dividends. In particular, the CCPC may have paid an excess capital dividend that it should be allowed to designate as an eligible dividend. In addition, each recipient of a dividend that is designated to be an eligible dividend after it has been paid should have the right to be reassessed to give effect to the status of the dividend as an eligible dividend, even if the year in which the dividend was received is statute-barred.

Recommendations

We recommend that there be a right for a CCPC to designate a dividend as an eligible dividend subsequent to the payment of the dividend. This right could be limited to situations where a CCPC's GRIP has increased as a result of certain events, such as a reassessment or the amendment of an amount reported in a tax return, and should be exercisable for a reasonable period of time (e.g., 90 days) after the event. In the case of a reassessment, this period would run from the expiry of the appeal period on respect of the final determination.

In addition, we recommend that the recipients of a dividend that is subsequently designated to be an eligible dividend have the right to be reassessed on the basis that the dividend is an eligible dividend, regardless of whether the year in which the dividend was received is statute-barred.

C. OPENING GRIP

1. Inclusion of Opening GRIP in Formula for GRIP

It is unclear how opening GRIP determined under subsection 89(7) is included in the formula in subsection 89(1) for GRIP.

Subsection 89(7) states that "there may be included in computing [a CCPC's] general rate income pool at the end of its immediately preceding taxation year the amount determined by the formula …". Since the only taxation year referred to before this in subsection 89(7) is the CCPC's taxation year that includes January 1, 2006, we understand the "immediately preceding taxation year" to be the CCPC's last taxation year ending before 2006. Thus, it appears that the opening GRIP addition is treated as GRIP at the end of the CCPC's last taxation year ending before 2006, and hence is included in GRIP at the end of the CCPC's first taxation year ending after 2005 through quantity C in the formula for GRIP.

On the other hand, quantity H in the GRIP formula expressly includes, in the computation of GRIP at the end of a taxation year, the amount determined under subsection 89(7) for the year. The only taxation year of a CCPC for which an amount can be considered to be determined under subsection 89(7) is the last taxation year of the CCPC ending before 2006. However, the definition of GRIP applies only to taxation years that end after 2005, so there appears to be a mismatch between the years. It appears to us that quantity H should not refer to subsection 89(7).

Subsection 89(8) reinforces our impression that it is intended to treat a CCPC's opening GRIP as its GRIP at the end of its 2005 taxation year. In determining a corporation's opening LRIP under this provision where the corporation was a CCPC in its 2005 taxation year and is not a CCPC in its 2006 taxation year, the corporation's GRIP at the end of its 2005 taxation year is included in the formula through quantity H. The corporation's GRIP at the end of its 2005 taxation year must be the amount determined under subsection 89(7). We can't see what else it would be.

Assuming that we are correct in our conclusion that it is intended that the amount determined under subsection 89(7) be treated as a CCPC's GRIP at the end of its 2005 taxation year, then it is not clear why subsection 89(7) *includes* the amount in computing GRIP at that time instead of *deeming* the amount to be the GRIP at that time. No other amounts would be included in computing the CCPC's GRIP at the end of its 2005 taxation year.

Recommendation

We recommend that it be clarified how the amount determined under subsection 89(7) is included in the formula in subsection 89(1) for GRIP, and that if subsection 89(7) is intended to establish a corporation's GRIP at the end of its 2005 taxation year, it be revised to be a deeming rule rather than an inclusion rule.

2. Inclusion of Dividends in Opening GRIP

The opening GRIP of a CCPC determined under subsection 89(7) is equal to 63% of the CCPC's aggregate full rate taxable income (as defined in subsection 123.4(1)) for its 2001 to 2005

taxation years less the total of all taxable dividends paid by the CCPC in those taxation years. Where a CCPC paid a dividend to another CCPC during those taxation years, the dividend is subtracted in determining the payer corporation's opening GRIP, but is not included in determining the recipient corporation's opening GRIP (since it is not included in full rate taxable income). There does not appear to be any tax policy reason for excluding such dividends in determining the recipient corporation's opening GRIP.

Consider the following example. Aco is a CCPC owned by Ms. A. Bco is a CCPC owned by Holdco B, which in turn is owned by Mr. B. Both Aco and Bco had aggregate full rate taxable income for their 2001 to 2005 taxation years of $1 million. Aco did not pay any taxable dividends in those years, and so has opening GRIP of $630,000. Bco paid taxable dividends of $630,000 to Holdco B, and so has no opening GRIP. Holdco B did not pay any dividends. Since the dividends that Bco paid to Holdco B are not taken into account in determining Holdco B's opening GRIP, the result is that opening GRIP has been lost. We submit that this is not an appropriate result, given that the full rate taxable income remains in a CCPC (Holdco B).

Recommendation

We recommend that a taxable dividend received by one CCPC from another in the 2001 to 2005 taxation years (the "pre-system years") be included in determining the recipient CCPC's opening GRIP, to the extent that the dividend reduced the payer corporation's opening GRIP. Where the aggregate amount of dividends paid by a CCPC in the pre-system years does not exceed the CCPC's opening GRIP determined without taking the dividends into account, the full amount of each dividend would be considered to have reduced the CCPC's opening GRIP. In other situations, it may be necessary to require the payer CCPC to designate the dividends (or portions of dividends) to which this treatment applies. As a special case, where a dividend is paid in the payer's 2005 taxation year but received in the recipient's 2006 taxation year (because the taxation years of the CCPCs do not coincide), the dividend should be treated as an eligible dividend.

3. Dividends Giving Rise to Dividend Refunds

In determining the opening GRIP of a CCPC under subsection 89(7), all taxable dividends paid by the CCPC in its 2001 to 2005 taxation years are subtracted. To the extent that these dividends give rise to dividend refunds under subsection 129(1), we submit that they should not be subtracted. Such dividends can be considered to be distributions of aggregate investment income or of taxable dividends that were subject to Part IV tax, neither of which is included in full rate taxable income used to determine opening GRIP.

Recommendation

We recommend that an amount of dividends paid by a CCPC equal to three times its dividend refunds under subsection 129(1) for its 2001 to 2005 taxation years not be subtracted in determining the CCPC's opening GRIP.

4. M&P Income for Taxation Years Prior to 2006

Taxable income qualifying for the manufacturing and processing ("M&P") deduction is excluded from full rate taxable income, and hence is excluded in determining opening GRIP under subsection 89(7). We submit that such taxable income should not be excluded. The federal M&P tax rate for the 2001 to 2005 taxation years was 22.12%, which is the same as the general federal corporate tax rate since 2004, and is higher than the 19% federal rate that is the basis for the enhanced dividend credit. Thus, M&P income for the 2001 to 2005 taxation years was taxed at a rate that is consistent with the 45% gross-up and corresponding credit.

Recommendation

We recommend that taxable income that qualified for the M&P deduction be included in computing opening GRIP.

5. Double Counting of Loss Carrybacks

Non-capital losses for 2006 and subsequent taxation years that are carried back to taxation years ending before 2006 are taken into account in determining quantity B in the formula for GRIP in subsection 89(1), and hence give rise to GRIP reductions through this route. They may also reduce GRIP by entering into the determination of opening GRIP under subsection 89(7). It is unclear whether, and to what extent, opening GRIP is affected by the losses carried back from 2006 and subsequent taxation years. Specifically, it is unclear whether full rate taxable income referred to in subsection 89(7) is to be determined with regard to such loss carrybacks. One interpretation is that all such loss carrybacks are to be taken into account, and furthermore that opening GRIP – and hence GRIP at the end of taxation years before the year in which a loss arises – can change over time as such losses are carried back. This is to be contrasted with the GRIP formula, which states that quantity A is to be determined without regard to specified future tax consequences.

Clearly, it is inappropriate for losses for 2006 and subsequent taxation years to be applied twice to reduce GRIP. We submit that the appropriate way to take such loss carrybacks into account is through quantity B in the formula for GRIP. The alternative approach of redetermining opening GRIP, and also GRIP at the end of each past year, could retroactively result in excessive eligible dividend designations.

Recommendation

It should be clarified that non-capital losses for 2006 and subsequent taxation years are not to be taken into account in determining opening GRIP under subsection 89(7).

6. Percentage Applied to Loss Carrybacks

Subsection 89(7) includes 63% of a CCPC's full rate taxable income for each relevant year in computing opening GRIP. If a non-capital loss for 2006 or a subsequent year is carried back to a pre-2006 taxation year, quantity B in the formula for GRIP in subsection 89(1) reduces GRIP at the end of the loss year by 68% of the amount of loss carried back. The result is that GRIP is

reduced by more than the amount originally included in computing opening GRIP. For example, if a CCPC has full rate taxable income of $1,000 for 2005, $630 will be included in opening GRIP in respect of this income. If the CCPC subsequently has a $1,000 non-capital loss for 2007 that it carries back to 2005, quantity B will produce a reduction in GRIP at the end of 2007 of $680 in respect of the loss carryback. Clearly, the reduction should be only $630.

Recommendation

The percentage used with respect to pre-2006 taxation years in quantity B in the formula for GRIP in subsection 89(1) should be 63%.

7. Loss Carryback Reductions in Excess of Opening GRIP

The reductions in GRIP in respect of losses carried back to pre-2006 taxation years may exceed the opening GRIP determined under subsection 89(7) (even if the percentage used in determining quantity B in the formula for GRIP in subsection 89(1) is reduced to 63%, as discussed above). The reason is that quantity B does not take into account the subtraction of dividends in computing opening GRIP. It is inappropriate to reduce GRIP in respect of losses carried back to pre-2006 taxation years by more than the amount included in GRIP in respect of those years.

The problem can be seen from the following example. A CCPC has full rate taxable income of $1,000 for 2005, and no full rate taxable income for 2001 to 2004. The CCPC paid a dividend of $630 in 2005. Consequently, the CCPC's opening GRIP under subsection 89(7) is nil. The CCPC subsequently has a $1,000 non-capital loss for 2007 that is carried back to 2005. In this situation, there should be no reduction in GRIP as a result of the loss carryback, since no amount is included in GRIP in respect of the CCPC's full rate taxable income for 2005, and the dividend does not benefit from the favourable tax treatment for eligible dividends. However, quantity B will produce a reduction in GRIP at the end of 2007 of $680 ($630 if the percentage is reduced) in respect of the loss carryback.

Recommendation

The aggregate reduction in GRIP as a result of the carryback of losses to pre-2006 taxation years should be limited to the amount of opening GRIP determined under subsection 89(7).

This solution would need to be modified if, as we propose above, certain inter-corporate dividends paid by a CCPC before its 2006 taxation year are included in determining the recipient corporation's opening GRIP. In this case, the dividends would serve to shift GRIP to the recipient corporation, and so the cap on the aggregate reduction in GRIP as a result of the carryback of losses should equal opening GRIP computed without deducting such dividends.

8. Loss Carrybacks that Reduce Taxable Income Qualifying for M&P Deduction

The following comment is relevant only if it is decided not to implement our recommendation that taxable income that qualified for the manufacturing and processing ("M&P") deduction be included in computing opening GRIP.

There is an inconsistency between the computation of opening GRIP under subsection 89(7) and the reduction in GRIP in respect of loss carrybacks, as these relate to taxable income that qualifies for the M&P deduction. As noted above, taxable income that qualified for the M&P deduction is excluded in computing opening GRIP. However, where a loss that is carried back to a pre-2006 taxation year reduces taxable income that qualified for the M&P deduction, there is a reduction in GRIP. The reduction occurs because quantity B in the formula for GRIP in subsection 89(1) is based on full rate taxable income determined by reading the definition of "full rate taxable income" in subsection 123.4(1) without reference to subparagraphs (a)(i) to (iii). This reduction in GRIP is inappropriate, given that the taxable income was not included in determining opening GRIP.

For example, assume that a CCPC has taxable income for 2005 of $500,000, of which $300,000 qualified for the small business deduction and $200,000 qualified for the M&P deduction. Hence, the CCPC had no full rate taxable income for 2005, and so in computing its opening GRIP under subsection 89(7), no amount is included in respect of its 2005 taxable income. Assume that the CCPC has a non-capital loss of $50,000 for 2006 which it carries back to 2005. The $50,000 reduction in taxable income for 2005 will be included in determining quantity B in the formula for GRIP, and will result in a reduction of the CCPC's GRIP at the end of 2006 of 68% (63%, if the percentage is reduced) of $50,000. The result is a reduction in the CCPC's GRIP that pertains to taxable income that was not included in computing its opening GRIP.

Recommendation

We recommend that there be no reduction in GRIP in respect of non-capital losses carried back to pre-2006 taxation years, to the extent that the losses reduce taxable income that was not included in determining opening GRIP under subsection 89(7).

D. OTHER GRIP AND LRIP ISSUES

1. Part VI.1 Tax and GRIP

A corporation that is subject to Part VI.1 tax on dividends it has paid in a taxation year on taxable preferred shares is entitled to deduct an amount under paragraph 110(1)(k) in computing its taxable income for the year. In the case of a CCPC, this deduction may result in a reduced amount being added to the corporation's GRIP at the end of the year. We submit that this is an inappropriate result, since the amount deductible under paragraph 110(1)(k) can be regarded as taxable income on which tax has been paid at a rate of 33-1/3%. A CCPC's GRIP should not depend on whether tax is paid under Part I or under Part VI.1.

Consider the following example. A CCPC earns $100 of business income that does not qualify for the small business deduction and has no other income in the year. In the same year, the CCPC pays an $80 dividend on taxable preferred shares. Part VI.1 tax is applicable in respect of the dividend at the rate of 25%, resulting in tax of $20. The CCPC therefore deducts $60 under paragraph 110(1)(k) (based on the proposed factor of 3), reducing its taxable income to $40. In this situation, only the $40 of taxable income gives rise to GRIP, even though the CCPC has, in effect, paid tax on the other $60 of earnings at a rate of 33-1/3%.

The payment of Part VI.1 tax can also have an adverse effect on a CCPC's GRIP through the carryover of non-capital losses. The amount deductible by a CCPC under paragraph 110(1)(k) in a particular taxation year is included in computing the CCPC's non-capital loss for the year. Where the non-capital loss is deducted in computing taxable income for a subsequent taxation year, it reduces the amount added to the CCPC's GRIP at the end of that subsequent year by virtue of reducing quantity D in the formula for GRIP in subsection 89(1). Where the non-capital loss is carried back to a preceding taxation year, the reduction in GRIP occurs in the particular year through quantity B in the formula for GRIP. In either case, to the extent that the non-capital loss that is carried over is attributable to the paragraph 110(1)(k) amount, the result is that GRIP is lower on account of this amount. We submit that this is inappropriate, for the same reason as stated above in connection with the deduction of amounts under paragraph 110(1)(k).

Recommendations

We recommend that a corporation's GRIP be determined using taxable income computed without any deduction under paragraph 110(1)(k), and without the deduction of any non-capital loss to the extent that the non-capital loss is attributable to an amount deductible under paragraph 110(1)(k). Furthermore, quantity B in the formula for GRIP should be determined without regard for the portion of each non-capital loss that is attributable to an amount deductible under paragraph 110(1)(k). We recognize that this will require a determination, each time all or part of a non-capital loss is applied, of the portion of the applied amount that is attributable to an amount deductible under paragraph 110(1)(k). However, a similar determination with respect to the business loss component of non-capital losses is already required for purposes of the loss-streaming rule in subsection 111(5).

2. GRIP and LRIP Additions – Contributed Surplus

Several provisions in the Draft Legislation – subsections 89(4) to (6) and (8) to (10) – provide for the determination of an amount to be added to a corporation's GRIP or LRIP on the occurrence of various events. Each of these subsections uses a "tax balance sheet" approach to determining the amount to be added to GRIP or LRIP. In computing the amount of the GRIP or LRIP addition, the paid-up capital ("PUC") of all the shares of a corporation is subtracted, but the corporation's contributed surplus is not. We submit that contributed surplus should be taken into account on the same basis as PUC, to the extent that the contributed surplus could be converted into PUC without a deemed dividend arising, i.e., to the extent that the contributed surplus is described in paragraph 84(1)(c.3). From a tax balance sheet point of view, there is no difference between such contributed surplus and PUC.

Recommendation

We recommend that, in the formulae in subsections 89(4) to (6) and (8) to (10), there be a deduction for a corporation's contributed surplus to the extent that the contributed surplus is described in paragraph 84(1)(c.3).

3. LRIP Addition on Ceasing to be a CCPC

Where a corporation ceases to be a CCPC, subsection 89(8) adds an amount to its LRIP for its first taxation year as a non-CCPC. This is the initial LRIP of the corporation as a non-CCPC. In

very general terms, the LRIP addition can, we think, be described as the sum of – (a) income for taxation years before 2001, (b) income for the 2001 and subsequent taxation years that benefited from the small business deduction, (c) income for the 2001 to 2005 taxation years that benefited from the manufacturing and processing deduction, (d) aggregate investment income for all taxation years, and (e) the portion of aggregate net capital gains not included in income – to the extent that this sum has been retained by the corporation as determined by reference to its "tax balance sheet".

We submit that this method of determining the LRIP addition will be unfair to many corporations that cease to be CCPCs. Large corporations that have had little or no income qualifying for the small business deduction could nonetheless have substantial initial LRIPs – in particular, by virtue of retained earnings from taxation years before 2001 – thereby disadvantaging them relative to other non-CCPCs. Furthermore, where a CCPC ceases to be a private corporation, it will no longer be able to claim tax refunds under subsection 129(1) or to pay capital dividends. Hence, it seems inappropriate to treat investment income and capital gains as if they were tax-favoured amounts.

The LRIP addition determined in the proposed manner will deter some corporations from electing under subsection 89(11) not to be CCPCs for the specified purposes.

A further concern is that there is a substantial discontinuity in the treatment of corporations. The requirement to determine an initial LRIP applies only to corporations that cease to be CCPCs after their 2005 taxation year. Corporations that ceased to be CCPCs before their 2006 taxation year do not have an initial LRIP. For example, a corporation with a January 31 year-end that ceased to be a CCPC in February 2005 has an initial LRIP, whereas a corporation with a calendar year-end that ceased to be a CCPC in December 2005 does not.

These concerns also apply with respect to LRIP additions determined under paragraph 89(9)(b), in the case of an amalgamation, and paragraph 89(10)(b), in the case of a winding-up.

Recommendations

We recommend that the LRIP additions in subsections 89(8) to (10) be revised to address the concerns identified above. One approach would be to allow corporations to establish on a factual basis the amount of tax-favoured income on hand, or an upper bound for this amount, when they cease to be CCPCs. This would be somewhat analogous to the determination of safe income on hand for the purposes of subsection 55(2). An alternative approach would be to limit the amount determined in respect of a corporation under subsection 89(8) or paragraph 89(9)(b) or (10)(b) to the aggregate amount of its tax-favoured income for its 2001 to 2005 taxation years. While this approach would allow some tax-favoured income to be distributed as eligible dividends, we submit that this is preferable to denying eligible dividend treatment to distributions of income that has been taxed at the high rate. If an approximation of tax-favoured income must be used, we submit that it should not be detrimental to taxpayers.

For the reason given above in our comments on opening GRIP, income that has benefited from the manufacturing and processing deduction should not be regarded as tax-favoured income. Furthermore, where a corporation has ceased to be both a CCPC and a private corporation, its

accumulated investment income should not be regarded as tax-favoured income for the purpose of either of these approaches, since the distribution of the income will not result in a tax refund. Similarly, the amount in the corporation's capital dividend account should be treated as if it were income taxed at the high rate, since the corporation will not be able to distribute this amount as tax-free dividends.

4. GRIP Addition on Becoming a CCPC

Where a corporation becomes a CCPC, subsection 89(4) adds an amount to its GRIP at the end of its first taxation year as a CCPC. This GRIP addition is determined by reference to the "tax balance sheet" of the corporation. In some cases, the "tax balance sheet" will not provide an appropriate basis for determining the addition. For example, assume that the corporation ("Amalco") was formed by the amalgamation of a parent corporation and a subsidiary corporation and that the parent acquired the subsidiary in a leveraged takeover transaction. Assume also that the principal amount of the debt incurred by the parent for purposes of the acquisition of the subsidiary substantially exceeded the tax cost of the assets of the subsidiary that became assets of Amalco, and that the parent had a nominal amount of assets before the takeover. In this situation, there would have been a substantial deficit in the "tax balance sheet" of Amalco immediately after the amalgamation. Income earned by Amalco, to the extent of this deficit, would not be reflected in the GRIP addition, and nor would any income earned by its predecessor corporations.

The concern described above could also arise with the application of paragraphs 89(5)(b) and (6)(b). These paragraphs provide for similar GRIP additions in connection with amalgamations and windings-up where the amalgamated corporation or the parent corporation is a CCPC.

Recommendation

We recommend that a corporation that becomes a CCPC be permitted to determine its GRIP addition by reference to the corporation's historic taxable earnings and the dividends paid by the corporation. This would be similar to the approach for determining opening GRIP in subsection 89(7), but without a limit on the number of past years that could be taken into account. Continuity rules would apply for this purpose with respect to amalgamations and windings-up.

An alternative, narrower solution that would address the problem in those situations where it is most likely to occur would be to allow debt to be excluded from the "tax balance sheet" to the extent that the debt exceeds the tax cost of the assets corresponding to the debt.

Whatever change is made for corporations that become CCPCs should also be made with respect to the GRIP additions in paragraphs 89(5)(b) and (6)(b).

5. Deemed Dividends in Butterfly Reorganization

In a butterfly reorganization – i.e., a divisive reorganization of a corporation structured to rely on the paragraph 55(3)(b) exemption from subsection 55(2) – both the distributing corporation and the transferee corporation (or a subsidiary of the transferee corporation) will be deemed to pay a dividend on the redemption of their shares. If the distributing corporation is a CCPC and the transferee corporation is not, there could be an inappropriate addition to the transferee

corporation's LRIP as a result of the dividend that is deemed to have been paid by the distributing corporation. In general, this deemed dividend will represent not only a share of the distributing company's retained earnings, but also a share of its goodwill and of the unrealized appreciation in the value of its assets. Consequently, the addition to LRIP will be wholly or partly inappropriate. In some cases, it should be possible to structure the divisive reorganization so as to avoid an addition to the transferee corporation's LRIP or to have an offsetting reduction. Even so, it would be preferable if it were not necessary to have to take this issue into account in structuring the reorganization.

Recommendation

We recommend that a deemed dividend to which paragraph 55(3)(b) applies be excluded in the computation of the LRIP or GRIP of the corporations deemed to pay and receive the dividend. It may also be appropriate to exclude dividends to which paragraph 55(3)(a) applies.

E. MISCELLANEOUS ISSUES

1. Purchase and Sale Agreements

When a public corporation or a non-resident person enters into a purchase and sale agreement to acquire the shares of a corporation that is a CCPC, the corporation will thereupon cease to be a CCPC. This result will occur because of the application of paragraph 251(5)(b) with respect to the right under the agreement to acquire the shares of the corporation. Consequently, subsection 249(4.1) will deem the corporation to have a year-end immediately before the agreement is entered into. Furthermore, subsection 89(8) will apply to require the determination of an opening LRIP for the corporation, and the corporation may lose its ability to pay eligible dividends before the completion of the sale.

We submit that it is inappropriate for these consequences to occur as a result of a purchase and sale agreement. If the purchase of the shares completes, there will be a deemed year-end pursuant to subsection 249(4) because of the acquisition of control. This would be the appropriate time for the corporation to cease to be a CCPC for purposes of the dividend rules. In particular, it would avoid two deemed year-ends within a short time of each other. If the purchase does not complete, then we do not see any reason to treat the corporation as having ceased to be a CCPC, and then having become a CCPC again.

These comments also apply with respect to direct and indirect subsidiaries of the target corporation that are CCPCs.

Recommendation

We recommend that, for the purposes of the new rules in section 82 and the deemed year-end rule in subsection 249(4.1), the determination of whether a corporation is a CCPC be made without regard to a right referred to in paragraph 251(5)(b), where the right is contained in a purchase and sale agreement and relates to shares of the corporation or another corporation. We note that there is a similar provision for purposes of the capital gains exemption in paragraph 110.6(14)(b).

2. Distribution of Eligible Dividends by Trust

Subsection 104(19) deems a taxable dividend received by a resident trust from a taxable Canadian corporation to be a taxable dividend received by a beneficiary of the trust, to the extent that the dividend has been included in computing the beneficiary's income and has been designated by the trust in respect of the beneficiary. It is unclear whether an eligible dividend to which subsection 104(19) applies will be considered an eligible dividend in the hands of the beneficiary. The uncertainty arises because subsection 104(19) specifies the character of the amount that it deems the beneficiary to have received: it states that the amount deemed to be received by the beneficiary is a taxable dividend on the share on which the actual dividend was paid. Given this express statement of the character of the amount, it is likely that a dividend will not be considered an eligible dividend in the hands of a beneficiary unless it is stated to be such. This would not be necessary if subsection 104(19) merely deemed the beneficiary to have received all or a portion of the dividend that was received by the trust.

Recommendation

We recommend that subsection 104(19) be amended, or a new rule be added, to provide that a taxable dividend deemed to have been received by a beneficiary is an eligible dividend if the dividend received by the trust is an eligible dividend.

3. Dividends Received by Partnership

(a) *Residency Requirement in Definition of "Eligible Dividend"*

To qualify as an eligible dividend, a dividend must be received by a resident of Canada. In the case of a dividend received by a partnership, it is unclear whether this residency requirement applies to the partnership itself, or to each partner with respect to the partner's share of the dividend. The former appears to be what is intended, given that the dividend designation rule in subsection 89(14) refers to a dividend paid to a person or partnership. This suggests that a dividend paid to a partnership is not considered to be paid to the partners. To the best of our knowledge, the concept of the residence of a partnership is not currently used in the Act. We submit that it would be more appropriate to determine the status of a dividend as an eligible dividend by looking through to the partners. A particular partner's share of a dividend received by the partnership would be an eligible dividend received by the partner if the partner is resident in Canada and the other conditions for the dividend to be an eligible dividend are satisfied.

If a dividend's status as an eligible dividend is to be based on the residence of a partnership, then we suggest that this be clarified by adding a reference to a partnership in the definition of "eligible dividend".

(b) *Receipt of Partnership Dividends by Partners*

Regardless of which of the approaches described above is used to determine whether dividends received by a partnership are eligible dividends, partners must be considered to receive dividends received by a partnership in order for the eligible dividend rules to work properly. It appears that paragraph 96(1)(f) does not produce this result. Paragraph 96(1)(f) provides that the income of a partnership from any source is to be considered the income of a particular partner from that

source, to the extent of the partner's share of the income from the source, but does not provide that each partner is considered to have received a portion of each amount that is included in determining the income from the source.

Even if paragraph 96(1)(f) were considered to treat partners as having received dividends received by the partnership to the extent of each partner's share of the dividends, this would only be for the purposes set out in the preamble to subsection 96(1). Those purposes are the computation of a partner's income, non-capital loss, net capital loss, restricted farm loss and farm loss, or a non-resident partner's taxable income earned in Canada. The determination of the GRIP of a CCPC is not one of these purposes.

Partners might be considered under general legal principles to have received dividends received by a partnership, to the extent of each partner's share of the dividends. However, there is an indication in the Act that such a general principle is not intended to apply. Paragraph 186(6)(a) expressly deems each member of a partnership to have received the member's share of taxable dividends received by the partnership. This deeming is for the purpose of Part IV. Paragraph 186(6)(a) would be superfluous if this were the result under general legal principles.

We note that certain areas of uncertainty relating to dividends received by partnerships have been addressed by administrative positions of the CRA. In particular, there is uncertainty regarding the application of the inter-corporate dividend deduction in subsection 112(1) when a corporation is a member of a partnership that has received a taxable dividend. In Technical Interpretation 2003-0027745, the CRA states that corporate partners can claim a deduction under subsection 112(1) with respect to dividends allocated from a partnership. The reason given is "administrative practice".

Recommendations

We recommend that, in the case of a dividend that is paid to a partnership, the definition of "eligible dividend" be applied separately to each partner's share of the dividend, so that a particular partner's residency status is used to determine whether the partner's share of the dividend is an eligible dividend. In addition, we think that a rule is required to deem each partner of a partnership to have received dividends received by the partnership to the extent of the partner's share of the dividends. This rule, which would be analogous to paragraph 186(6)(a), would apply for the purposes of the provisions relating to eligible dividends.

4. Securities Lending Arrangements

Subsection 260(5) deems certain compensation payments made to taxpayers in connection with securities lending arrangements to be taxable dividends received on shares. Where a compensation payment to which subsection 260(5) applies is made in respect of a dividend that is an eligible dividend, we submit that it would be appropriate for the compensation payment to be deemed to be an eligible dividend. This comment also applies to proposed subsection 260(5.1), which is contained in the draft legislation released on July 18, 2005.

Recommendation

We recommend that subsection 260(5) be amended to deem a compensation payment in respect of an eligible dividend to be an eligible dividend. This change should also be made to proposed subsection 260(5.1) for payments to which paragraph 260(5.1)(a) applies.

5. Negative GRIP and Excessive Eligible Dividend Designations

If a CCPC pays an eligible dividend in a year at the end of which its GRIP is a negative amount, the absolute value of the amount of the GRIP will be included in computing the amount of the "excessive eligible dividend designation" made by the CCPC in respect of the dividend (as defined in subsection 89(1)). This will occur because the formula for the amount of an excessive eligible dividend designation involves the subtraction of GRIP, and the subtraction of a negative number is equivalent to the addition of the absolute value of the number. Consequently, the CCPC's excessive eligible dividend designation will exceed the actual amount of the dividend.

For example, assume that a CCPC's GRIP is -$1,000 at the end of a taxation year, and that the CCPC pays a single eligible dividend in the year of $100. The amount of the excessive eligible dividend designation in respect of the dividend will equal $100 - (-$1,000) = $1,100.

We submit that it is not appropriate for the excessive eligible dividend designation in respect of a dividend to exceed the amount of the dividend. The negative GRIP will serve to reduce the eligible dividends that can be paid in the future, and should not be subject to the penalty tax under Part III.1.

Recommendation

We recommend that the definition of "excessive eligible dividend designation" in subsection 89(1) be modified to use an amount of nil for quantity B where a corporation's GRIP is a negative amount.

6. Requirement to File Part III.1 Return

Subsection 185.2(1) requires a corporation that pays a taxable dividend (other than a capital gains dividend) in a year to file a return for the year under Part III.1. This obligation applies whether or not the corporation has paid an eligible dividend in the year. This is to be contrasted with the obligation to file a return under Part VI.1, for example, which applies only if a corporation is liable to pay tax under that Part for a year. We are not aware of any reason why corporations that do not pay eligible dividends should be required to file a return under Part III.1.

Recommendation

We recommend that a corporation be required to file a return under Part III.1 for a taxation year only if it has paid an eligible dividend in the year.

7. Election re Excessive Eligible Dividend Designation

Where a corporation makes an election under subsection 185.1(2) in respect of an eligible dividend, it is deemed to have paid a smaller eligible dividend and a separate taxable dividend that is not an eligible dividend. Each shareholder who held shares of the class on which the eligible dividend was paid is deemed to have received a pro-rata portion of each of these dividends, based on the proportion of the shares of that class held by the shareholder.

We submit that the pro-rata allocation of these two dividends among all shareholders of the class is inappropriate if any of the shareholders is a non-resident person. Pursuant to the definition of "eligible dividend" in subsection 89(1), the actual dividend paid on the class of shares is not an eligible dividend to the extent it was paid to non-resident shareholders. Hence, subsection 185.1(2) applies only with respect to the portion of the dividend that was paid to resident shareholders. It follows that the consequences in paragraph 185.1(2)(c) should apply only to resident shareholders.

Recommendation

We recommend that subsection 185.1(2) be revised to exclude non-resident shareholders from its application.

In addition, if, as we have recommended above, corporations are permitted to designate portions of dividends as eligible dividends, subsection 185.1(2) would need to be revised so that it applies appropriately where only a portion of a dividend has been designated.

8. Minimum Tax

The proposed reduction in the net tax rate applicable to eligible dividends will be partially offset, in some cases, by alternative minimum tax ("AMT"). For example, assume that the only income of an inter vivos trust consists of eligible dividends, and that the dividends are taxed in the trust, i.e., they are not distributed to the beneficiaries of the trust. The net federal rate of tax on the dividends will be 14.55%, whereas the AMT rate applicable to the dividends will be 15.25% for 2006 and 15.5% for 2007 and subsequent years. We submit that it is inappropriate for AMT to apply in a situation such as this, since no tax preference has been obtained.

Recommendation

We recommend that the definition of adjusted taxable income in subsection 127.52(1) be amended so that it includes a percentage of each eligible dividend, instead of the full amount of the dividend, in order to avoid AMT being payable by virtue of the receipt of eligible dividends. The percentage should be set at a level that avoids AMT being payable in any circumstances where it would not have been payable before the change to the taxation of dividends. A similar amendment was made with respect to capital gains a few years ago, as a consequence of the reduction of the inclusion rate for capital gains from 3/4 to 1/2. Only 80% of capital gains are included in computing adjusted taxable income

9. Corporation Attribution Rule (Subsection 74.4(2))

Subsection 74.4(2) requires an individual who has transferred or lent property to a corporation (other than a small business corporation) to include an amount of interest in income each year if it is reasonable to consider that one of the main purposes for the transfer or loan was to reduce the individual's income and to benefit a person who is a designated person in respect of the individual. The amount of interest to be included in income is equal to interest at the prescribed rate on the "outstanding amount" defined in the subsection minus, inter alia, the total of any interest actually received by the individual in respect of the transfer or loan and 5/4 of any taxable dividends received by the individual on certain shares.

According to the historical explanatory notes to section 74.4, the factor of "5/4" is intended to gross up dividends to parallel the gross-up that is contained in subsection 82(1). The factor was originally "4/3", and was reduced to "5/4" consequential on the reduction of the gross-up in subsection 82(1) to 25% of the amount of a dividend. Since eligible dividends will be grossed up by 45%, it would be appropriate to use a factor in subsection 74.4(2) for such dividends that reflects this higher gross-up rate.

Recommendation

We recommend that subsection 74.4(2) be amended to apply a factor of "29/20" to eligible dividends.

10. Technical Drafting Points

(a) *Use of "Shall" and "May" in GRIP Additions*

Subsections 89(5) and (6) state that the amount determined under the subsection "shall" be included in computing a corporation's GRIP. Subsections 89(4) and (7), on the other hand, state that the amount determined under the subsection "may" be included in computing a corporation's GRIP. Unless there is a reason for the difference, either "shall" or "may" should be used in all these provisions.

(b) *LRIP – Dividends Deductible under Section 112*

The description of B in the definition of LRIP in subsection 89(1) refers to an amount deductible by a non-CCPC under section 112 in respect of a taxable dividend that *became payable* in a particular taxation year to the non-CCPC. Section 112 provides a deduction for taxable dividends *received* in a taxation year, not for dividends that became receivable. Thus, the description of B should refer to a taxable dividend that was paid to the non-CCPC (or that was received by the non-CCPC).