

Chapter 2 — Basic Corporate Finance

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Important Provisions

<i>Income Tax Act (ITA)</i>	
20(1)	Deductions permitted in computing income from business or property
21	Cost of borrowed money
51	Convertible property
84	Deemed dividend
88	Winding up [of subsidiary]
Part IV.1	Tax on dividends on certain preferred shares received by corporations
Part VI.1	Tax on corporations paying dividends on taxable preferred shares
191.1	Tax on taxable dividends
Reg. 1100	Capital cost allowances
<i>Canada Business Corporations Act (CBCA)</i>	
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35	Amount deducted from account upon purchase, etc. of shares

I. — General Comment

Corporations are the most common form of business structure, as they offer many, and varied, advantages. Depending upon the particular type, corporations have many advantages over other forms of business structures. For tax purposes, subsection 248(1) of the *Income Tax Act* states that a “corporation” includes an incorporated company.

Subsection 248(1) defines a “taxpayer” to include a “person”. A person includes a corporation. Provincial law governs the legal relationship of entities to which the *Income Tax Act* applies. Under provincial laws, corporations are separate entities and, therefore, taxpayers in their own right.

The CRA advised in IT-343 R (since archived and not to be updated) that it would recognize as a corporation an entity created by law that has a legal personality and existence separate and distinct, from the personality and existence of those who created or own it. Thus, as long as an entity has separate identity and existence, the CRA considers such an entity to be a corporation.

Canada does not recognize consolidated financial reporting of corporate income for tax purposes. Thus, each entity must file its own income tax returns and report its income separate and apart from its affiliated corporations. Hence, it is not easy to transfer the losses of one corporation to another related corporation that has profits. There is a distinction between the shareholder or member of a corporation and the corporate entity. A shareholder has an economic interest in the corporation, but he or she is not the beneficial owner of any property of the corporation. Thus, he or she has no legal or equitable claim to the corporate property.

A shareholder has an inchoate right to receive distributions of corporate property in the form of dividends, but only at the discretion of the board of directors. Subject to the incorporating documents, a shareholder can share in the capital of the corporation when it is dissolved.¹

¹ See, for example, *Sommerer v. R.*, [2011] 4 C.T.C. 2068, 2011 D.T.C. 1162 (Eng.) (T.C.C. [General Procedure]); additional reasons 2011 CarswellNat 6998 (T.C.C. [General Procedure]); affirmed 2012 D.T.C. 5126 (F.C.A.). See also: CRA’s Views Doc No 2008-0266251I7, Christopher Falk and Stefanie Morand, “Foreign Entity Characterization, Treaty Interpretation and Income Attribution”, *International Tax Newsletter* (Carswell), Marc Darmo, “Characterization of Foreign Business Associations”, (2005) 53(2) Can. Tax J. 481, and *Canadian Tax Highlights*, Volume 6, No 1, November 2008, under “Entity Classification Evolves” (available on *Taxnet Pro*).

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When conducting a business through a corporation, the principal corporate advantages are:

- Limited liability of shareholders for corporate debts;
- Perpetual existence;
- Versatile vehicles for funding; and
- Access to public capital markets.

In addition, there are several tax advantages, such as:

- Low tax rates;
- Opportunities to defer tax;
- Use of tax incentives, such as:
 - Small business deduction,
 - Income splitting,
 - Special industry credits,
 - Investment tax credits, and
 - Capital gains exemption on the sale of qualifying shares.

However, there are also some disadvantages to incorporation, such as:

- Corporate taxation can result in double taxation of income, once in the corporation and again to the shareholder.
- Also, as a corporation is a separate legal entity, its losses can be trapped within the entity.

The specific tax advantages and disadvantages of corporations depend upon the nature of the corporate entity. The following are some of the more common forms of corporations:

1. Public;
2. Private;
3. Canadian-controlled private (CCPC);
4. Personal Service Business (PSB);
5. Nova Scotia Unlimited Liability; and
6. Non-Profit.

II. — Capital Structures

There are three principal factors that determine the financial structure of a corporation:

1. access to funds,
2. cost of capital, and
3. tax considerations.

The conventional sources of corporate capital are:

- Share capital,
- Debt capital,
- Retained cash earnings,
- Off-balance-sheet financial instruments (warrants, options, leases, etc.), and
- Government subsidies.

The method used to finance a corporation will depend upon the type of corporation, its size, access to financial institutions and capital markets, the residence of its shareholders, and income tax considerations.

Small businesses generally use debt capital, share capital, retained earnings, and government grants. Public corporations may go to sophisticated capital markets, issue equity capital, derivatives, such as rights and warrants, and bonds and debentures.

A family business will typically structure as a CCPC in order to benefit from the low tax rate on active business income, the opportunities for splitting income, and estate planning.

The most common capital structure of corporations comprises two elements: equity capital and debt. Tax rules play an important role in determining the balance between these two forms of capital.

Market and tax considerations influence the cost of corporate capital. Where a corporation has a choice between alternative sources of funding, income tax considerations have an important role in the corporation's decision to opt for one source of capital over another.

For example, a corporation may consider its debt to share capital ratio when issuing debt to non-resident shareholders, which may trigger the thin capitalization rules and affect withholding tax rates,² which, in turn, may determine the deductibility of the corporation's interest expense.

² Subs. 18(4).

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A. — Equity Capital

There are three forms of equity capital:

- (a) share capital,
- (b) contributed surplus, and
- (c) retained earnings.

Collectively, these three forms represent the economic interest of shareholders on the corporate balance sheet. In accounting terms, the basic balance sheet equation is:

$$A = L + E$$

Where:

A = assets

L = liabilities

E = equity

It can also be understood as:

$$E = A - L$$

A business will attempt to maximize its return on equity (ROE) in most circumstances for the benefit of its shareholders. “Equity” is sometimes referred to as “net worth”, which is a misleading term, as it does not represent the worth or value of an enterprise in its financial statements.

1. — Share Capital

Share capital represents ownership interest in the corporation. The rights, restrictions, terms, and conditions attached to the shares determine the nature of the interest. In the absence of any special provisions, all shares of a corporation are presumed to be equal.³ There are two fundamental tax characteristics of share capital:

1. A corporation can return its paid-up capital (PUC) to shareholders on a tax-free basis; and
2. Dividends on shares are not deductible from the corporation’s income, but are paid with after-tax dollars.

³ *Canada Business Corporations Act*, R.S.C. 1985, c. C-44 (“CBCA”), subs. 24(3); *Ontario Business Corporations Act*, R.S.O. 1990, c. B.16 (“OBCA”), subs. 22(3).

These two characteristics influence how we finance corporations on a tax efficient basis with equity capital.

2. — Contributed Surplus

“Contributed Surplus” refers to the surplus that shareholders, or others, may contribute over the par value of shares. For example, contributed surplus is the premium that shareholders pay above the par value of shares, where the governing corporate statute permits the issuance of par value shares.⁴

3. — Retained Earnings

Retained earnings are, in effect, the residual book value that remains in the corporation after the deduction of all liabilities and share capital from the corporation’s assets. It generally represents the accumulated income retained in the business, net of any losses and dividend payments.

B. — Debt Capital

Debt is the obligation to pay a sum of money due by agreement (whether express or implied) that gives the lender the right to receive and enforce payment. Debt generally arises from a contractual obligation, whereby one person lends money to another on terms and conditions that the parties negotiate.

The quintessential characteristics of corporate debt are as follows:

- Debt does not represent ownership in a corporation, but merely creates a relationship of debtor and creditor between the corporation and the lender;
- Corporate creditors generally rank ahead of shareholders in any claims to the corporation’s assets;
- Debt may be secured by corporate assets; and
- Interest on debt used for the purposes of earning income is generally deductible for tax purposes.

⁴ British Columbia, Nova Scotia, Prince Edward Island, and New Brunswick all have corporate statutes that permit the payment of premiums above par value of shares.

C. — Hybrid Financing

Hybrid financial instruments are crafted to have characteristics of both debt and share capital. Owing to the significant tax differences in the treatment of debt and equity capital, corporations have an incentive to devise hybrid instruments that allow them to utilize the best of both worlds. For example, although interest payments on debt are generally deductible for tax purposes, the payments can be made discretionary, and, therefore, resemble dividends on share capital. Thus, from the corporation's perspective, it may be attractive to issue a hybrid instrument that has all the corporate characteristics of share capital, but that can be classified as debt for tax purposes. If it is classified as debt, the interest payments may be deductible, while dividends are non-deductible.

The tax authorities are understandably concerned about such instruments, and there are complex rules to minimize their use. These rules circumscribe the use of hybrids, such as "taxable preferred shares", "term preferred shares", and "income bonds".⁵

III. — Corporate Aspects of Equity Financing

A. — General Comment

Tax law relies on corporate law and accounting concepts to measure income and control corporate transactions.

A corporation's stated capital is a cumulative amount that is determined in respect of each class of shares that the corporation issues. For example, where a corporation issues 100 Class A shares at \$1 each, the stated capital of the class is \$100. If the corporation later issues an additional 300 Class A shares at \$1.50 per share, the stated capital of the class becomes \$550.

The concept of corporate capital in tax law initially derives from the corporate law concept of stated capital. At the outset, a corporation's share capital for tax purposes (technically, its "paid-up capital" ("PUC") in the *Income Tax Act*) is its "stated capital" for the purposes of corporate law. PUC is determined in respect of each share, and is an attribute of the particular share. In the above example, the PUC of each share would initially be \$1, and the PUC for the entire class would be \$100. Upon the subsequent issuance of 300 Class A shares, the PUC per share would be \$1.38.

In corporate law, "stated capital" has two distinct purposes:

1. Protection of creditors, and
2. Protection of shareholders.

⁵ See, generally, ITA, Part IV.1.

First, creditors look to a corporation's stated capital as a measure of security or buffer — the residual pool from which the corporation will pay its debts. Hence, creditors are interested in the capital structure of the corporation to which they loan money. Creditors want to ensure that the corporation does not dissipate its capital through unauthorized capital distributions that might endanger its solvency.⁶

Second, stated capital measures the limits of the shareholders' exposure to the corporation's debts. Most corporate statutes limit a shareholder's maximum exposure for corporate liabilities to his or her contribution to the corporation's stated capital. For example, subsection 25(2) of the *Canada Business Corporations Act* ("CBCA") states that the "shares issued by a corporation are non-assessable and the holders are not liable to the corporation or to its creditors in respect thereof. However, the CBCA does not define "capital". Generally, "capital" refers to proceeds from the sale of capital stock and represents money that the shareholder pays for an undivided interest in the assets of a corporation.⁷ Thus, in corporate law, the term "capital" means the share capital of a corporation. This is a narrower meaning than "equity capital", which means corporate share capital and retained earnings — the total nominal equity interest of shareholders. The term "capital" also has other meanings depending upon the context in which one uses it, and the adjective that describes it. For example, in accounting "working capital" denotes the excess of current assets over current liabilities; and "liquid capital" describes cash and marketable securities.

B. — Share Capital

1. — Nature of Shares

A corporate share is the proportional financial interest of a shareholder in the corporation. It measures the liability of the shareholder to outside interests, and the size of her financial interest in the corporate undertaking.

A share is not a sum of money: it is an interest measured by money. A share is a chose in action that forms a separate right of personal property.⁸ It represents a fractional interest in the capital of the corporation and represents the bundle of rights contained in the share con-

⁶ *Re Inrig Shoe Co.* (1924), 27 O.W.N. 110 (S.C.); see *J.M.P.M. Ent. Ltd. v. Danforth Fabrics (Humbertown) Ltd.*, [1969] 1 O.R. 785 (H.C.) (issuance of additional shares to affect a change in control being "sale or other disposition" of control).

⁷ *Toronto v. Consumers' Gas Co.*, [1927] 4 D.L.R. 102 (P.C. [Ont.]).

⁸ OBCA, s. 41; *Bradbury v. English Sewing Cotton Co.*, [1923] A.C. 744. The term "chose in action" only means that a share does not confer a right to possession of a physical thing; instead, it gives a personal right of property claimable by legal action.

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tract.⁹ Thus, a share is that fraction of the capital of a corporation that confers on its owner a proportional proprietary interest in the corporation. Shareholders do not own the assets of the undertaking.¹⁰ They merely share certain rights — such as, the right to vote at shareholders' meetings, the right to participate in profits through dividends, and the right to a return of capital if the corporation is dissolved.

2. — Shareholder Rights

Where there is only one class of shares, typically they have the right to:

1. Vote,
2. Participate in profits by way of dividends, and
3. Share in the property upon dissolution of the corporation.

Under the CBCA, where there is only one class of shares, these three rights automatically attach to each share.

A corporation may issue more than one class of shares. In such circumstances, the articles of incorporation must describe the rights, privileges, restrictions, and conditions that attach to each class of shares.¹¹ If a corporation issues more than one class of shares, each of these fundamental rights — the right to vote, the right to receive dividends, and the right to share in property — should attach to at least one of the classes of its shares.¹²

⁹ *Borlands Trustee v. Steel Bros. & Co.*, [1901] 1 Ch. 279 at 288 *per* Farwell J.; see also *Re Paulin*, [1935] 1 K.B. 26 (C.A.); *I.R.C. v. Crossman*, [1937] A.C. 26 (H.L.).

¹⁰ *Short v. Treasury Commrs.*, [1948] 1 K.B. 116. The term “shareholder” merely describes a person who is a holder of shares; it does not mean that that person shares property in common with another.

¹¹ CBCA, subs. 24(4); OBCA, subs. 22(4).

¹² CBCA, para. 24(4)(b).

C. — Issuing Shares

1. — No Par Value

Modern corporate statutes require that a corporation issue its shares in registered form, and without nominal or par value.¹³ A corporation is considered to have issued its shares when it satisfies all the statutory formalities in respect of their issuance.¹⁴

Under federal corporate legislation (CBCA), and legislation in Ontario, Manitoba, Saskatchewan, Newfoundland, the Northwest Territories, and the Yukon, shares must be issued without par value. Prior to the enactment of corporate statutes in the above jurisdictions, companies were allowed to issue shares with nominal or par value. Such shares are now *deemed to be shares without nominal or par value*.¹⁵

British Columbia, Nova Scotia, Prince Edward Island, and New Brunswick allow corporations to issue shares at more than their par value. Any premium above the par value of the shares is added to the contributed surplus account.

Contributed surplus is an equity account that also includes:

- Proceeds of sale of donated shares;
- Profit on forfeited shares;
- Capital donations made from other than shareholders.

A share is in registered form if it:¹⁶

- names a person who is entitled to the share such that its transfer may be recorded on a securities register; or
- bears a statement that it is in registered form.

2. — Number of Shares

In the absence of a specific restriction in its articles of incorporation, a corporation can issue an unlimited number of shares of each class provided for in its articles. A corporation can,

¹³ CBCA, subs. 24(1); OBCA, subs. 22(1).

¹⁴ See: *Dale v. R.*, [1997] 2 C.T.C. 286, 97 D.T.C. 5252 (Fed. C.A.); *National Westminster Bank v. I.R.C.*, [1994] S.T.C. 184 (C.A.).

¹⁵ CBCA, subs. 24(2); OBCA, subs. 22(2).

¹⁶ CBCA, subs. 48(4); OBCA, subs. 53(1) “registered form”.

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however, set an upper limit on the number of shares it will issue, even if the articles do not specify any limit.¹⁷

A corporation that restricts the number of shares it may issue may, at any time, by special resolution, amend its articles of incorporation to remove or amend the restriction.¹⁸ However, shareholders may dissent where a corporation amends its authorized capital. In such circumstances, and subject to procedural details, the shareholder is entitled to be paid the fair value of his or her shares.¹⁹

3. — *Limited Liability*

Corporate shares are non-assessable against the shareholders. Thus, neither the corporation nor its creditors can call upon its shareholders to pay additional amounts.²⁰ Shareholders are not, *qua shareholders*, liable for the acts or default of the corporation.²¹

4. — *Consideration for Shares*

A corporation may not issue any shares until it receives full consideration in the form of money, property, or past services, in return for the shares. If past services constitute the consideration for issued shares, the fair value of those services must not be less than the money the corporation would have received had it issued the shares for cash.²²

A corporation may also issue shares for non-cash property. The value of the property cannot be less than the cash consideration the corporation would have received had it issued its shares for money.²³

¹⁷ CBCA, para. 6(1)(c).

¹⁸ CBCA, para. 173(1)(d); OBCA, clause 168(1)(d). “Special resolution” is a defined term and, in effect, means a two-thirds majority; *Trans-Prairie Pipelines Ltd. v. M.N.R.*, [1970] C.T.C. 537, 70 D.T.C. 6351 (Ex. Ct.) (interest on money borrowed used to redeem preferred shares deductible).

¹⁹ CBCA, s. 190; OBCA, s. 185.

²⁰ CBCA, subs. 25(2); OBCA, subs. 23(2).

²¹ CBCA, subs. 45(1); OBCA, subs. 92(1).

²² CBCA, subs. 25(3); OBCA, subs. 23(3).

²³ CBCA, subs. 25(3); OBCA subs. 23(3).

5. — *Liability of Directors*

The directors of a corporation must determine the value of consideration — whether in the form of property or past services — that the corporation receives for its shares. They must ensure that the amount of consideration received by the corporation is not less than the cash equivalent consideration that it would have received otherwise.²⁴ The CBCA does not specifically require directors to act on the determination of equivalent fair value. The power of determining share consideration is, however, an incident of the directors' powers and their duty to manage the affairs of the corporation.

In determining what constitutes a fair equivalent value for property or past services, directors may take into account reasonable charges, and any expenses of organization, that are expected to benefit the corporation.²⁵ Directors can be held liable for any shortfall of consideration.²⁶

D. — *Stated Capital Account*

Stated capital is the amount of money that a shareholder “commits” to the corporation in exchange for shares, and, in most cases, represents the shareholder's maximum liability to corporate creditors. Thus, in a sense, stated capital is the financial measure of the limited liability of shareholders, and represents to creditors the amount of funds or assets that shareholders have invested in the corporation. Subsection CBCA 25(5) effectively prohibits the issuance of shares for debt.

1. — *Separate Accounts for Each Class*

A corporation must maintain a separate stated capital account for each class and each series of shares that it issues.²⁷ Generally, one credits the stated capital account with the *full* amount of any consideration that the corporation receives in respect of the particular shares that the corporation issues.²⁸ Subsection 26(3) provides some exceptions to this rule in respect of non-arm's length transactions issued for tax purposes.²⁹

²⁴ CBCA, subs. 25(3); OBCA, subs. 23(4).

²⁵ CBCA, subs. 25(4); OBCA, subss. 23(4) and 23(5).

²⁶ See, for example, CBCA, subs. 118(1) and OBCA, 130(1). Also, CBCA, subs. 25(5) and OBCA, subs. 23(6) generally do not allow a company to issue shares for debt.

²⁷ CBCA, subs. 26(1); OBCA, subs. 24(1).

²⁸ CBCA, subs. 26(2); OBCA, subss. 24(2), (8) (stated capital account may be maintained in foreign currency).

²⁹ See, for example, section 85 ITA.

2. — Shares Issued for Property

A corporation may not issue shares in exchange for any property (or past service) that is valued at less than the amount the corporation would have received had it issued the shares for money.³⁰ It can, however, issue shares for consideration of greater value than the cash equivalent of property or past services.

(a) — Credit Full Consideration

Generally, a corporation must credit the *full* amount of consideration that it receives to the stated capital account. The corporation must not credit an amount that is greater than the amount of the consideration that it receives for its shares to its stated capital account.³¹ This rule is particularly important in tax law because a corporation can distribute its PUC tax free to its shareholders.³²

(b) — Non-Arm's Length Transactions

There are several exceptions to the general rule that a corporation must credit the full amount of consideration that it receives to its stated capital account. The exceptions are intended to facilitate various corporate reorganizations under the *Income Tax Act*. For example, subsection 26(3) CBCA allows a corporation to add to its stated capital account in non-arm's length transactions and pursuant to certain amalgamation agreements. This allows corporations to issue "high-low" shares, which have a low paid-up capital and high redemption amount. Since any amount paid above PUC is deemed to be a dividend, a corporation can use high-low shares to trigger dividends, which will generally flow tax free between Canadian corporations.

A corporation may add an amount to its stated capital account that is less than the consideration that it receives for its shares, if the corporation issues the shares:³³

- In exchange for property of a person who, immediately before the exchange, does not deal with the corporation at arm's length;
- In exchange for shares of a body corporate that immediately before the exchange, or because of the exchange, does not deal with the issuing corporation at arm's length;

³⁰ CBCA, subs. 25(3); OBCA, subs. 23(3).

³¹ CBCA, subs. 26(4); OBCA, subs. 24(4).

³² "Paid-up capital" for tax purposes.

³³ CBCA, subs. 26(3); OBCA, subs. 24(3). These exceptions all cater to income tax transactions and are intended to facilitate various rollovers under the *Income Tax Act*.

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- Pursuant to an amalgamation with another corporation; or
- Pursuant to an “arrangement” that, in effect, is an amalgamation of the issuing corporation with another corporation.

A corporation may also add an amount less than the fair market value of property to its stated capital account in respect of arm’s length transactions if the corporation, and all of its shareholders, of the particular class consent.³⁴

In each of the above circumstances, the corporation may add either all or *some lesser part of* the consideration that it receives for its shares to the appropriate stated capital account.

3. — *Stock Dividends*

Where a corporation pays a stock dividend, it must add to the stated capital account of the class of shares on which it pays the dividend, the full financial equivalent of the declared amount of the dividend.³⁵ Thus, the amount that it capitalizes from retained earnings to share capital for accounting purposes is also the amount that it must credit to the share capital account for corporate law purposes.

4. — *Continuances*

A corporation that continues under the CBCA may add to its stated capital accounts any consideration that it receives for shares issued prior to its continuance. Also, it may, at any time, add to its stated capital account any amount credited to its retained earnings or other surplus accounts.³⁶

5. — *Resolutions*

Where a corporation has more than one class of shares outstanding, it must approve by special resolution any addition to the stated capital account of a class or series of shares if it did not receive the amount to be added as consideration for the issue of shares.³⁷ An Ontario

³⁴ See, for example, CBCA, subpara. 26(3)(a)(iii).

³⁵ A stock dividend is a dividend paid by issuing additional fully paid shares of the corporation to existing shareholders; see CBCA, subs. 43(2); OBCA, subs. 38(2).

³⁶ CBCA, subs. 26(6); OBCA, subs. 24(5).

³⁷ CBCA, subs. 26(5); OBCA, subs. 24(6). Under the CBCA, a special resolution is not required if there are only two classes of shares and all of the issued shares are convertible from one class into the other.

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corporation does not need to pass a special resolution if the amount that it credits to the stated capital account arises by virtue of the payment of a stock dividend.

E. — Reduction of Stated Capital

The general rule is that a corporation may not reduce its stated capital³⁸ unless it satisfies two financial tests: the reduction must not impair either the solvency or the liquidity of the corporation. Thus, a corporation may reduce its stated capital only if it is able to pay its obligations as they fall due, and if it is solvent. The stringency of the two tests varies with the method for reducing capital, and the potential harm that the reduction may cause investors.

A corporation can reduce its stated capital to:

- Acquire the corporation's own shares;
- Satisfy a court order;
- Settle or compromise debts asserted by or against the corporation;
- Eliminate fractional shares;
- Fulfill the terms of a non-assignable agreement under which the corporation has an option or is obligated to purchase shares;
- Redeem its shares;
- Adjust its capital accounts upon special resolution;
- Convert or exchange shares of one class into another.

The financial tests vary in each of these circumstances.

1. — Acquisition of Corporation's Own Shares

At common law, a corporation could not reduce its capital except with judicial approval, because purchasing its own shares would be tantamount to a reduction of capital.³⁹ A reduction of capital might prejudice the rights of creditors.

³⁸ CBCA, subs. 26(10); OBCA, subs. 24(9). This prohibition does not apply to mutual funds.

³⁹ *Trevor v. Whitworth* (1887), L.R. 12 App. Cas. 409 (H.L.).

The CBCA adopted the common law rule, but with some exceptions,⁴⁰ which permit a corporation to reduce its capital provided that it does not prejudice the financial interests of its investors and creditors.

(a) — Financial Tests

Subject to any restrictions in its articles, a corporation can reduce its stated capital. However, before purchasing its own shares, the directors must have reasonable grounds for believing that the purchase will not:⁴¹

- Render the corporation unable to pay its liabilities as they come due; or
- Cause the realizable value of its assets to be less than the aggregate of its liabilities and the stated capital of all of its classes of shares.

The corporation must satisfy two financial tests: the corporation must remain both liquid *and* solvent after it purchases its shares.

Determining corporate liquidity is fairly clear-cut in most cases. One can ascertain liquidity from corporate financial statements stated in terms of current market values. Long-term solvency is more difficult to measure, and requires professional valuations.

Directors of a corporation who authorize the purchase of its shares without satisfying the solvency and liquidity tests are jointly and severally liable to the corporation for the amount of the unauthorized disbursement of funds.⁴²

However, the CBCA absolves a director from liability if he dissents from the resolution authorizing the purchase of shares, provided that he records his dissent at the meeting. If the director is not present at the meeting, he must notify the secretary of the corporation and record the dissent in the minutes of the meeting.⁴³

A director can rely upon professionals who are qualified to comment on matters requiring technical expertise. As such, a director who relies upon the report of an accountant, ap-

⁴⁰ CBCA, s. 30; OBCA, s. 28.

⁴¹ CBCA, s. 34; OBCA, s. 30. Note that an Ontario corporation may also purchase its warrants. The financial tests are somewhat less stringent if the purchase of shares is to settle a claim against the corporation, eliminate fractional shares, or fulfil the terms of a non-assignable agreement under which the corporation is obliged to purchase the shares.

⁴² CBCA, subs. 118(2); OBCA, subs. 130(2).

⁴³ CBCA, s. 123; OBCA, subs. 135(3).

praiser, or other qualified professional to make valuation judgments is not liable if the purchase of shares subsequently proves to contravene the statutory financial tests.⁴⁴

(b) — Dissenting Shareholders

A corporation that purchases its own shares to satisfy a dissenting shareholder's claim pursuant to the appraisal remedy faces a less stringent financial test.⁴⁵ For example, under a buy-out pursuant to the appraisal remedy, a corporation cannot purchase its own shares from a dissenting shareholder if the purchase would render the corporation unable to pay its obligations as they fall due (the liquidity test), or if the purchase reduces the realizable value of its assets to less than the value of its outstanding liabilities.⁴⁶ However, in these circumstances, the corporation's stated capital is not taken into account in the second prong of the two tests. In other words, a corporation may reduce its stated capital to purchase its own shares if it does not impair its liquidity and solvency insofar as its creditors are concerned.

(c) — Court Order

A corporation may also purchase its own shares to comply with a court order.⁴⁷ In complying with the court order, the corporation does not have to satisfy the liquidity and solvency tests applicable to other purchases.⁴⁸ The corporation need only satisfy two tests: (1) that it will be able to pay its liabilities as they become due (the liquidity test); and (2) that the realizable value of its assets after the purchase does not fall below the aggregate of its liabilities.⁴⁹

⁴⁴ CBCA, subs. 123(4); OBCA, subs. 135(4).

⁴⁵ CBCA, para. 35(2)(a); OBCA, cl. 31(2)(a).

⁴⁶ CBCA, subs. 190(26); OBCA, subs. 185(30).

⁴⁷ CBCA, s. 241; OBCA, s. 248.

⁴⁸ CBCA, para. 35(2)(b); OBCA, cl. 31(2)(b).

⁴⁹ CBCA, subs. 241(6); OBCA, s. 248(6).

2. — *Alternative Acquisition of Corporation's Own Shares*

There are three additional circumstances in which a corporation may acquire its own shares by satisfying a somewhat less stringent financial test than those generally applicable. Subject to its articles, a corporation may purchase its own shares to:⁵⁰

1. Settle or compromise debts asserted by or against the corporation;
2. Eliminate fractional shares; or
3. Fulfill the terms of a non-assignable agreement under which the corporation has an option or is obligated to purchase shares owned by a director, officer, or employee of the corporation.

In any of these situations, the corporation may purchase its own shares *unless*:⁵¹

- There are reasonable grounds for believing that the purchase will render the corporation unable to pay its obligations as they fall due; or
- The realizable value of the corporation's assets after the purchase will be less than the aggregate of its liabilities and the amount required to redeem all of its shares the holders of which have the right to be paid *prior* to the holders of the shares to be purchased.

The second prong of the financial tests ensures that a corporation that purchases its own shares does not prejudice the rights of "senior" shareholders who have a higher ranking claim to the assets of the corporation than the holders of the shares purchased. The corporation cannot prejudice the rights of preferred shareholders by purchasing shares that rank lower in corporate rights.

3. — *Redemption of Shares*

A "redeemable share" is a share that is redeemable at the option of either the corporation or the shareholder.⁵² A corporation can redeem its redeemable shares, but it cannot pay an amount that exceeds the redemption price stipulated in its articles of incorporation.⁵³

A corporation may not redeem its shares unless it satisfies two financial tests. First, a corporation may redeem its shares only if there are reasonable grounds for believing that the re-

⁵⁰ CBCA, subs. 35(1); OBCA, subs. 31(1).

⁵¹ CBCA, subs. 35(3); OBCA, subs. 31(3).

⁵² CBCA, subs. 2(1) "redeemable share"; OBCA, subs. 1(1) "redeemable share". In financial jargon, a share that is redeemable at the option of the shareholder is referred to as a "retractable share".

⁵³ CBCA, subs. 36(1); OBCA, subs. 32(1).

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demption will not render the corporation unable to pay its obligations as they fall due.⁵⁴ Thus, the corporation must be liquid enough to pay its debts as they mature.

Second, the realizable value of the corporation's assets after the redemption must not be less than the aggregate of its liabilities and the amount required to pay other shareholders who rate equally with or have a higher claim than the holders of the redeemed shares.⁵⁵ The concern here is to protect only those who have a claim equal to or higher than the shares redeemed. The financial tests are less stringent because the shares would have been issued on the basis that they were redeemable and this information is available to the public.

4. — *Other Reductions of Stated Capital*

A corporation may, by special resolution, reduce its stated capital account at any time and for *any* purpose if it satisfies certain financial tests.⁵⁶ Under this general, broad-based power the corporation can proceed only by way of a special resolution of its shareholders. The resolution must identify the particular stated capital accounts that are to be reduced.⁵⁷

(a) — Financial Tests

In addition to the special resolution, the corporation must satisfy two financial tests: liquidity and solvency. These tests are similar, though not identical, to the tests applicable to a purchase or redemption of corporate shares. A corporation may not reduce its stated capital if there are reasonable grounds for believing that the reduction will render the corporation unable to pay its obligations as they fall due.⁵⁸

Second, the stated capital account may not be reduced if there are reasonable grounds for believing that the reduction will cause the realizable value of the corporation's assets to be less than the aggregate of its liabilities.⁵⁹

⁵⁴ CBCA, para. 36(2)(a); OBCA, cl. 32(2)(a).

⁵⁵ CBCA, para. 36(2)(b); OBCA, cl. 32(2)(b).

⁵⁶ CBCA, subs. 38(1); OBCA, subs. 34(1).

⁵⁷ CBCA, subs. 38(2); OBCA, subs. 34(3). A "special resolution" is a resolution passed by a majority of two-thirds of votes cast, or one signed by all of the shareholders entitled to vote on the resolution; see, CBCA, subs. 2(1) "special resolution", OBCA, subs. 1(1) "special resolution".

⁵⁸ CBCA, para. 38(3)(a); OBCA, cl. 34(4)(a). A corporation reducing its stated capital must *always* satisfy the liquidity test so that the rights of creditors are not prejudiced. It is only the solvency test which is more or less stringent depending upon the circumstances surrounding the reduction.

⁵⁹ CBCA, para. 38(3)(b); OBCA, cl. 34(4)(b).

Where an Ontario corporation plans to reduce its capital in circumstances in which the reduction will have a different effect on different classes of shares, it must allow a separate class vote for the purposes of obtaining the special resolution from each of the affected classes. The right to a separate class vote does not depend upon whether or not the shares affected would otherwise be entitled to vote.⁶⁰

(b) — Creditor's Rights

A creditor of a corporation that reduces its stated capital in contravention of either the CBCA or OBCA can apply to a court for relief. The court may order the shareholder *or other recipient* who has benefited from the reduction to:⁶¹

- pay to the corporation an amount equal to any liability of the shareholder that was either extinguished or reduced contrary to the statutory provisions; or
- deliver to the corporation any money or property paid or distributed to the shareholder or other recipient as a consequence of the improper reduction of capital.

This remedy is in addition to any other remedies that the creditor may have against the directors of the corporation who have authorized an unlawful reduction of capital.⁶² There is, however, a limitation period: the creditor must commence action within two years of the alleged unlawful reduction of capital.⁶³ Shareholders of Ontario corporations are entitled to apply to bring the suit as a class action.⁶⁴

A shareholder who holds shares as a trustee (or other fiduciary) is not personally liable on an improper reduction of stated capital. Rather, it is the beneficial owner of the shares who assumes all the liabilities flowing from an infringement of the statutory provisions.⁶⁵

⁶⁰ OBCA, subs. 34(2).

⁶¹ CBCA, subs. 38(4); OBCA, subs. 34(5).

⁶² OBCA, subs. 34(9).

⁶³ CBCA, subs. 38(5); see also: Ontario *Limitations Act, 2002*, S.O. 2002, c. 24, Sched. B, s. 4.

⁶⁴ OBCA, subs. 34(7).

⁶⁵ OBCA, subs. 34(8), subs. 1(1) “personal representative”.

F. — Adjustments of Stated Capital Accounts

A corporation must maintain a separate stated capital account for each class and series of shares that it issues.⁶⁶ Generally, the corporation must credit the full amount of any consideration that it receives upon issuing shares to the appropriate stated capital account.⁶⁷

1. — Reduction

When a corporation reduces its share capital, it must adjust the amount shown in its stated capital account. The amount of the adjustment depends upon the manner in which the corporation acquires its own shares. Where the reduction in the share capital of a corporation is:

- An acquisition of the corporation's own shares;⁶⁸
- A settlement or compromise of a claim asserted against the corporation;⁶⁹
- A plan to eliminate fractional shares;⁷⁰
- The terms of a non-assignable agreement under which the corporation was obliged to purchase shares owned by its directors, officers, or employees;⁷¹
- A redemption of its shares;⁷²
- The enforcement of a lien against its shares;⁷³

⁶⁶ CBCA, subs. 26(1); OBCA, subs. 24(1).

⁶⁷ CBCA, subs. 26(2); OBCA, subs. 24(2). A lesser amount may be credited to the stated capital account where the shares are issued in exchange for property in a non-arm's length transaction: CBCA, subs. 26(3); OBCA, subs. 24(3). The rationale of this exception is to accommodate income tax planning, particularly under s. 84.1 of the *Income Tax Act*. CBCA, subpara. 26(3)(a)(iii) also permits a corporation to add less than the FMV of property to its stated capital if the corporation and all the shareholders of the particular class consent.

⁶⁸ CBCA, s. 34; OBCA, s. 30.

⁶⁹ CBCA, para. 35(1)(a); OBCA, cl. 31(1)(a).

⁷⁰ CBCA, para. 35(1)(b); OBCA, cl. 31(1)(b).

⁷¹ CBCA, para. 35(1)(c); OBCA, cl. 31(1)(c).

⁷² CBCA, s. 36; OBCA, s. 32.

⁷³ CBCA, subs. 45(3); OBCA, subs. 40(3).

- A transaction whereby a dissenting shareholder of the corporation exercised appraisal rights,⁷⁴ or
- A court order relieving a shareholder from oppression by the corporation,⁷⁵

the amount to be deducted from the stated capital account is calculated according to a formula that reduces the stated capital account by the *average* issue price of all of the shares of the particular class or series.⁷⁶

The formula used reduces the stated capital account of the shares in proportion to the amount that was credited to the account when the shares were issued. The premium paid to a shareholder on the redemption of shares in any of the above listed circumstances is not deducted from the stated capital account.⁷⁷

In contrast, if a corporation is required to compensate a shareholder for the purchase price of the shares because of its oppressive conduct, the reduction in the stated capital account is the full amount paid to the shareholder.⁷⁸ This amount will not necessarily coincide with the amount credited to the corporation's stated capital account when the shares were initially issued, as the shareholder may have purchased the shares from another shareholder at a later date.

Where a corporation reduces its stated capital account pursuant to a special resolution, the amount specified in the resolution is the amount that the corporation deducts from the appropriate stated capital account.⁷⁹ The determination of this amount depends entirely upon the particular circumstances calling for the reduction.

2. — *Conversion or Change of Shares*

Where a corporation converts shares from one class into another class, it must adjust the stated capital accounts of both of the classes to reflect the conversion. Similarly, when a corporation changes shares from one class or series into shares of another class or series, it must adjust the stated capital account of the classes or series.⁸⁰ In either of these situa-

⁷⁴ CBCA, s. 190; OBCA, s. 185.

⁷⁵ CBCA, s. 241; OBCA, s. 248.

⁷⁶ CBCA, subs. 39(1); OBCA, subs. 35(1).

⁷⁷ *Ibid.*

⁷⁸ CBCA, subs. 39(2); OBCA, subs. 35(2).

⁷⁹ CBCA, subs. 39(3); OBCA, subs. 35(3).

⁸⁰ CBCA, subs. 39(4); OBCA, subs. 35(4). A "conversion" of shares from one class into another occurs pursuant to the terms and conditions of the shares as described in the articles of incorporation.

tions — conversion or change — the corporation must reduce the stated capital account of the class from which the shares are converted by an amount derived from a prescribed formula.

The stated capital account of the shares into which the shares are converted or changed is increased by an equivalent amount, *plus* any additional consideration payable on the conversion or change of shares.⁸¹

Where a corporation has two classes of shares with rights of conversion from one class into the other — inter-convertible shares — the adjustment to the stated capital account upon the conversion of a share from one class to the other is equal to the weighted average of the stated capital accounts of both classes of shares.⁸²

When shares of one class or series are converted or changed into shares of another class or series, the CBCA considers the old shares (that is, the converted or changed shares) to be issued shares of the class or series into which the shares have been converted or changed.⁸³ Thus, to the extent of the number of shares converted, the issued capital of the old class or series *automatically* becomes issued shares of the new class or series. The automatic conversion of shares from one class into another applies only to the *issued* shares and does not apply to any *unissued* shares. The articles must be amended to convert the unissued shares of the old class into unissued shares of the new class.

G. — Effect of Change of Shares on Authorized Capital

There are circumstances where a corporation may wish to restrict the amount of share capital that it issues.⁸⁴ Where a corporation limits the number of shares that it may issue by stipulating a maximum authorized capital, a conversion of shares from one class into another will have the effect of increasing the unissued but authorized shares of the old class by the number of shares converted or changed into shares of the new class. In other words, the number of shares converted or changed into the new class restores the authorized share capital of the old class.⁸⁵

A “change” of shares from one class into another is usually pursuant to a subsequent amendment to the terms and conditions attached to the shares.

⁸¹ CBCA, para. 39(4)(b); OBCA, cl. 35(4)(b).

⁸² CBCA, subs. 39(5); OBCA, subs. 35(5).

⁸³ CBCA, subs. 39(9); OBCA, subs. 35(8).

⁸⁴ CBCA, para. 6(1)(c).

⁸⁵ CBCA, subs. 39(10); OBCA, subs. 35(8).

H. — Cancellation of Shares

If its articles of incorporation do not limit the number of shares that a corporation may issue, any shares (or fractions of shares) that the corporation issues and later acquires are automatically cancelled. Where, however, the authorized share capital of a corporation is limited, any of its shares acquired by the corporation are restored to the status of authorized but unissued shares of the particular class.⁸⁶ The rationale of these provisions is to prevent the corporation and its senior officials from manipulating the market in the corporation's shares or using corporate assets to acquire, or enhance, voting power.

I. — Corporation Holding Its Own Shares

The common law rule against corporations "trafficking" in their own shares also prohibited a corporation from holding its own shares: the retention of cancelled shares would be tantamount to a reduction of capital.⁸⁷

The common law rule is entrenched in the CBCA.⁸⁸ The general rule is that a corporation may not hold its own shares or the shares of its parent corporation. A parent corporation is specifically prohibited from issuing its shares to any of its subsidiaries.⁸⁹ Although there are exceptions to these rules, each exception is circumscribed by financial tests that protect the interests of investors and creditors.

IV. — Tax Aspects of Equity Financing

A. — General Comment

A corporation's share capital represents its permanent capital base and, in theory, acts as a buffer for creditors. A corporation is generally under no legal obligation to re-purchase its

⁸⁶ CBCA, subs. 39(6); OBCA, subs. 35(6).

⁸⁷ *Trevor v. Whitworth* (1887), L.R. 12 App. Cas. 409 at 423 (H.L.):

Paid-up capital may be diminished or lost in the company's trading; that is a result which no legislation can prevent; but persons who deal with, and give credit to a limited company, naturally rely upon the fact that the company is trading with a certain amount of capital already paid, as well as upon the responsibility of its members for the capital remaining at call; and they are entitled to assume that no part of the capital which has been paid into the coffers of the company has been subsequently paid out, except in the legitimate course of its business.

⁸⁸ CBCA, subs. 30(1); OBCA, subs. 28(1).

⁸⁹ CBCA, subs. 30(2); OBCA, subs. 28(2) (a corporation acquiring a subsidiary that holds its shares must cause the subsidiary to dispose of those shares within five years of its becoming a subsidiary).

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shares and return capital to shareholders. Since, in most cases, the payment of dividends is within the discretion of the board of directors, a corporation need not pay dividends when it is not financially secure. Indeed, as already noted, a corporation is prohibited from paying dividends if the payment would impair its financial ability to repay its debts.

We measure a shareholder's proportional ownership of a corporation by the number of shares that he or she owns. The PUC of a class of shares is equal to its stated capital, as adjusted for tax purposes.⁹⁰ The PUC of each share of the class is equal to the total PUC for the class divided by the number of shares. The adjustments to stated capital are designed to prevent a corporation using tax-deferred transactions to increase its PUC, which it can then distribute tax-free to its shareholders. Hence, PUC adjustments are, in effect, specific anti-avoidance provisions.

There are three fundamental aspects of corporate share capital that influence corporate tax structures and tax planning:

- a) Dividends are paid from after-tax dollars;
- b) Dividends are not deductible from income; and
- c) PUC can be returned to shareholders on a tax-free.

These characteristics influence the structure of the corporate tax system, and we see their effect in many anti-avoidance rules in the *Income Tax Act*.

B. — Types of Shares

Unless otherwise stated or provided for in the articles of incorporation, all shares are presumed to be equal in respect of their fundamental rights:

- the right to vote;
- the right to participate in dividends; and
- the right to share in any proceeds on liquidation of the corporation.

However, these fundamental rights can be modified to suit the needs of the corporation and its investors. For example, shares can be voting or non-voting, and voting shares can be differently weighted. Similarly, we can grant shares priority in respect of the timing and amount of dividends payable on them. Shares can be redeemable at the option of the corporation and retractable at the option of the shareholder. Shares can be given priority in respect of the return of capital upon liquidation, and so on. These variable attributes permit a large number of combinations and permutations of share characteristics. Thus, we craft share conditions to suit the particular purposes for which they are to be used.

⁹⁰ Subsection 89(1) "paid-up capital".

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The old terminology of common and preferred shares are no longer the terminology of the CBCA. However, as noted above, we can attach such terms and conditions to shares to meet the needs of investors and, in effect, achieve the same results as under previous corporate statutes.

The particular terms, conditions, rights and restrictions attached to shares have a significant effect upon their fair market value, and this can be important for the purposes of determining capital gains and losses. For example, the types of share conditions used in an estate freeze are quite different from share conditions used in a public offering. In the former case, the objective is to freeze the fair market value of shares so that they do not increase in value; in the latter case, the objective is to facilitate growth in the value of the shares in the public market to enhance capital gains.

For income tax purposes, however, there are only two classes of shares: common and preferred. Subsection 248(1) defines a common share as one where, upon the redemption of capital, the holder of the share is *not* precluded from participating in the assets of the corporation beyond the amount paid up on the share. All other shares are preferred shares. Even shares designated as “preferred” will be considered to be common shares if they have the characteristics of common shares as defined above.⁹¹

C. — Paid-up Capital (PUC)

The first fundamental principle of income tax law is that the levy is a tax on income, and not on capital. Thus, in corporate taxation, we must distinguish between a corporation’s income and its capital, which is known as paid-up capital (PUC) for tax purposes. PUC in tax law is initially analogous to the concept of “stated capital” in corporate law — it is the amount that a shareholder contributes, or is deemed to contribute, to the corporate capital.

The second basic principle of corporate-shareholder taxation, is that dividends from earnings of a corporation resident in Canada, and repayments of capital in excess of its PUC, are taxable to shareholders. Thus, PUC is the amount of capital that a resident corporation can return to shareholders on a tax-free basis. The Act deems payments to shareholders in excess of the PUC of their shares to be income.⁹²

One initially determines the PUC of a class of shares under the applicable corporate statute.⁹³ Hence, the concept of paid-up capital can vary between different corporate jurisdictions in Canada. The PUC of a share is a characteristic of, and specific to, *the share* — it does not attach to the shareholder. It does not change when one sells the share. PUC, which

⁹¹ *Terminal Dock & Warehouse Co. v. M.N.R.* (1959), 23 Tax A.B.C. 40, 1959 CarswellNat 212; Views 2004-0088521E5.

⁹² See, e.g., *Income Tax Act*, s. 84.

⁹³ Subs. 89(1) “paid-up capital”.

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is initially equal to the corporation's stated capital, is a point in time calculation, and is affected by numerous corporate transactions.

The PUC of a class is computed without reference to the provisions of the Act. Subsection 89(1) provides that the PUC of a share equals the PUC of the class divided by the number of shares. Thus, we start with corporate stated capital, and then adjust the stated capital for tax purposes.⁹⁴ The PUC of a class is shared pro rata between all shareholders of the class. The PUC of a corporation equals the aggregate of the PUC of all classes of shares.

In contrast, the cost base of a share is unique to the shareholder, and does not affect the corporation. An adjustment to a shareholder's cost base or basis (known as adjusted cost base — "ACB") of a share has no effect whatsoever on the corporation's books.

Example

Assume that in Year 1, Susan subscribes for 100 Class A shares of a corporation for \$100. Then the PUC of the Class A shares is \$100, and the stated capital of each share is \$1.

If in year 4, the corporation issues an additional 200 Class A shares to Jack for \$20,000, the total stated capital and PUC of Class A increases to \$20,100. The PUC of each Class A share is now \$67.

Thus, the original 100 investor (Susan) would see the PUC of her shares increase by \$66, which she can extract tax-free, leaving the other shareholder (Jack) with a PUC reduced from \$100 (his original investment) to \$67 for each share. Jack loses \$33 of tax-free basis per Class A share.

In these circumstances, a private corporation should use another class (say, Class B) to issue the additional 200 shares, so that each class has its own PUC, which reflects each shareholder's invested amount.

D. — Adjustments to Paid-up Capital

The PUC of a share starts off equal to its stated capital for corporate purposes. However, as noted above, the two measures of capital can diverge because of adjustments that may have to be made for tax purposes. For example, the following are some of the provisions of the *Income Tax Act* that may require adjustments to a corporation's PUC:

- Subsections 66.3(2) and (4) (flow-through shares);
- Subsection 84(1) (increases in PUC);
- Subsection 84(2) (distribution on winding-up);
- Subsection 84(3) (redemption of shares);

⁹⁴ See subpara. 89(1)(b)(iii).

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- Subsection 84(4) (reduction of PUC);
- Sections 84.1 and 84.2 (non-arm's length sales);
- Section 85 (transfer of property to a corporation);
- Subsections 87(3) and (9) (amalgamation);
- Subsection 192(4.1) (designation by corporation); and
- Section 212.1 (non-arm's length purchase of shares from non-resident).

The difference between PUC and stated capital can be a trap for anyone who relies solely on the corporation's financial statements to determine the PUC of shares. For example, where a corporation redeems its shares, any amount paid over PUC is a dividend to the shareholder.⁹⁵ Since PUC for tax purposes may be lower than stated capital for accounting purposes, what appears on the financial statements to be a tax-free return of stated capital, may, for tax purposes, actually be a taxable dividend in the hands of the shareholder.

To avoid the risk of unexpected deemed dividends, corporate counsel should reduce a corporation's stated capital for corporate purposes to accord with its PUC for income tax purposes. This reduces the risk of inadvertently triggering income tax consequences on the basis of corporate share transactions.

Example

Where shares are transferred in a section 85 rollover, paragraph 85(2.1)(a) of the Act requires that any increase in PUC from the issuance of the shares must be reduced where the increase in PUC exceeds the "agreed amount" under the rollover transaction. This adjustment, known as the "PUC grind", prevents the withdrawal of an excessive amount of PUC on a tax-free basis.

In these circumstances, stated capital on the corporation's balance sheet will be different from its PUC for tax purposes. The variation between stated capital and PUC should be recorded in a note to the financial statements so that readers of the statements are not misled. Further, where the corporation is sold, corporate counsel for the purchaser should obtain an undertaking from the vendor, and its accountants, on the respective stated capital and PUC amounts.

1. — Return of Capital

A return of capital by a corporation resident in Canada is a capital receipt. Since returns of PUC are tax-free, the Act contains a series of deeming rules, which circumscribe improper

⁹⁵ Subs. 84(3).

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withdrawals of corporate capital. The purpose of the dividend rules is to curtail dividend stripping by deeming payments in excess of the PUC of shares to be taxable dividends.

Broadly speaking, the deeming rules apply to corporate distributions that are not a distribution of profits as a matter of corporate law. Under these rules, a distribution is deemed to be a dividend to the extent that the amount of the distribution exceeds the PUC in respect of the subject shares. Generally, the paid-up capital in respect of a class of shares can be returned tax-free to shareholders as capital.

The purpose of subsection 84(1) is to prevent a corporation from converting its retained earnings into PUC, as a preliminary step, and then returning the PUC to shareholders tax-free. Thus, subsection 84(1) provides that every increase in PUC, other than certain enumerated exceptions, results in a deemed dividend to the shareholder. PUC increases resulting from the issuance of shares for fair market value consideration equal to the PUC increase are excluded from the deemed dividend rule because the transaction does not undermine the purpose of the rule.

The PUC of a share is different from its ACB. PUC is an attribute of the share; ACB is an attribute of the shareholder. Over time, the two will vary as shares are bought and sold, or the corporation issues new share capital.

Example

Assume that in Year 1, a corporation issues 100 Class A shares for \$100. Then the PUC and the stated capital of each share is \$1. If a shareholder sells one of the Class A shares for \$150, the ACB of the share to the purchaser becomes \$150, whereas its PUC of \$100 stays with the share. Thus, the initial shareholder derives a gain of \$50 because he sells for more than his cost, but the PUC (and stated capital) of the share remains constant. The new purchaser can extract only \$100 tax-free even though he paid \$150 for the share.

2. — High-Low Shares

The term “high-low shares” describes shares that have a low stated capital, but a high redemption amount for tax purposes, which lawyers use in corporate reorganizations, and in estate planning.

Example

Mr. S transfers property with a cost base of \$100 and value of \$1000 to his corporation, S Ltd., in exchange for 100 shares with a stated capital of \$100. The transfer is organized as a section 85 rollover to avoid any immediate tax consequences. Mr. S would take back shares with a stated capital (and PUC) of \$100, but which might be redeemed at \$1000, the economic value of the property transferred. Subject to sections 85(2.1), 84.1 and 212.1, the amount added to the stated capital of shares is added to PUC.

3. — Increase Paid-up Capital

A corporation can increase its PUC by special resolution.⁹⁶ However, to prevent tax abuse of the tax-free status of PUC, subsection 84(1) deems a dividend to the shareholder to the extent of the increase, unless one of the exceptions applies. For example, “dividend” includes a stock dividend. Stock dividends are taxed as dividends.⁹⁷ The amount of the dividend is equal to the increase in PUC. Hence, there is no need to apply subsection 84(1) as the dividend is already taxable.

To prevent double taxation on the same economic gain, the amount of a deemed dividend under subsection 84(1) increases the adjusted cost base to the shareholder of the shares on which he or she receives the dividend.⁹⁸ There is no adjustment to the ACB of the shares if the deemed dividend is deductible under subsection 112(1) because there is no risk of double taxation of the same amount.

4. — Redemption of Shares

Similarly, where a corporation redeems its shares, subsection 84(3) requires that the PUC of the class be reduced pro rata for the number of shares redeemed. There is a deemed dividend to the extent that the redemption proceeds exceed the PUC of the shares.

Example

Assume that in the example above, S redeems 50% of his high low shares in S Ltd. for \$500. S will realize a dividend of \$450, that is, \$500 (proceeds) minus the \$50 PUC of 50 shares.

Example

Assume that the aggregate PUC in respect of Class A shares of corporation X Ltd. is \$100,000, and their aggregate redemption amount is \$1,000,000. If X Ltd. redeems the shares, there is a deemed dividend of \$900,000 for the Class A shareholders.⁹⁹

However, the redemption triggers a disposition of the shares for proceeds of \$1,000,000 at the same time as the triggering of the deemed dividend. To avoid double taxation of the same amount, the proceeds are reduced by the amount of the deemed dividend of \$900,000 to a net value of \$100,000. The net proceeds of disposition may give rise to a capital gain or loss depending upon the ACB of the shares.

⁹⁶ Section 84(1).

⁹⁷ Subsection 248(1) “dividend” and “stock dividend”.

⁹⁸ Para. 53(1)(b).

⁹⁹ Subsection 84(3).

5. — *Winding-up, Discontinuance or Reorganization of Business*

The Act refers to “winding-up” to describe both winding-up of a business, and the winding-up of a corporation’s existence. While a business that a corporation conducts may be wound up without affecting the corporation’s existence, the winding-up of a corporation brings to an end both the existence of the corporation and that of its business.

Section 88 applies only to winding-up a corporation’s existence, made pursuant to the appropriate corporate procedures. Corporate statutes prescribe the procedures and requirements for winding-up a corporation. The corporation must show that it has discharged its debts, obligations, and or liabilities, or the creditors have consented to the dissolution. After the interests of creditors are satisfied, all remaining property of the corporation can be distributed among its shareholders.

Subsection 84(2) is broader in scope and applies to both the winding-up of a business or the winding-up of a corporation. The provision taxes as a dividend all distributions that a Canadian resident corporation makes on the winding-up, discontinuance or reorganization of its business, except to the extent that the distribution represents a return of PUC. Thus, a corporation may generally return its PUC to shareholders as a tax-free return of capital.

Special rules under subsections 88(2) to (2.3) may apply in respect of the deemed dividend that arises on the winding up of a Canadian corporation.¹⁰⁰

6. — *Other Tax Consequences of Subsections 84(2) and 84(3)*

Some additional tax consequences to consider are as follows:

- Withholding tax on deemed dividends to non-resident shareholders under subsection 212(2) (subject to tax treaties);
- Potential application of subsection 116(5) if the redeemed or cancelled shares are taxable Canadian property;
- Denial of capital loss under subsection 40(3.6) if taxpayer continues to be affiliated with the corporation after the disposition of shares.

E. — *Classes of Shares*

Corporate statutes presume all shares to be equal and hold the same rights unless they expressly state otherwise. In order for shares to be considered to belong to different classes,

¹⁰⁰ IT-126R2 discusses the meaning of “winding-up”.

they must, *in substance*, have different rights, conditions, privileges, or restrictions. As Dickson C.J., said in *McClurg*:¹⁰¹

In my view, a precondition to the derogation from the presumption of equality, both with respect to entitlement to dividends and other shareholder entitlements, is the division of shares into different “classes”. The rationale for this rule can be traced to the principle that shareholder rights attach to the shares themselves and not to shareholders. The division of shares into separate classes, then, is the means by which shares (as opposed to shareholders) are distinguished, and in turn allows for the derogation from the presumption of equality. . . .

One determines the stated capital and paid-up capital of shares of inter-convertible classes as if they were combined in one class.¹⁰²

F. — Capitalizing Retained Earnings

The amount of retained earnings that a corporation capitalizes affects the stated capital and the PUC of its shares, and may also trigger a deemed dividend.¹⁰³

Example

Assume:

Holdco capitalizes \$50 of its retained earnings to its Class A shares.

Then:

Stated capital (Class A shares):	
Before capitalization	\$ 100
Capitalization	50
After capitalization	<u>\$ 150</u>
Paid-up capital (Class A shares):	
Stated capital	\$ 150
Adjustment	<u>0</u>
Paid-up capital	<u>\$ 150</u>

¹⁰¹ *McClurg v. Minister of National Revenue* (1990), (sub nom. *McClurg v. Canada*) [1990] 3 S.C.R. 1020, [1991] 1 C.T.C. 169, (sub nom. *R. v. McClurg*) 91 D.T.C. 5001 (S.C.C.) at 5007 [D.T.C.]; see also *Int. Power Co. v. McMaster Univ.*, [1946] S.C.R. 178 (S.C.C.) [Que.].

¹⁰² CBCA, subs. 39(5); OBCA, subs. 35(5).

¹⁰³ *Income Tax Act*, subs. 84(1).

G. — Stock Dividends

Section 248(1) ITA defines a stock dividend as payment in shares. The corporation issues shares to existing shareholders, but without any additional consideration. Stock dividends are taxable as regular cash dividends to the shareholder.¹⁰⁴ Typically, distributions of stock dividends are prompted by a desire to ostensibly allocate retained earnings to shareholders, but without distributing cash. Subsection 43(2) CBCA requires the “declared amount” of a stock dividend to be added to the stated capital of the class of shares on which the corporation pays the dividend.¹⁰⁵ The “declared amount” of a dividend is the amount *declared* by the directors in the corporation’s resolutions.

Example

Assume:

Holdco declares and pays a dividend in the amount of \$10 on its Class A share payable by the issue of one Class B share that has a fair market value of \$100.

Then:

<u>Stated capital (Class B shares):</u>	
Before stock dividend	\$ 0
Stock dividend	<u>10</u>
After stock dividend	\$ 10
<u>Paid-up capital (Class B shares):</u>	
Stated capital	\$ 10
Adjustment	<u>0</u>
Paid-up capital	\$ 10

Alternatively, and perhaps preferably, pursuant to subsection 26(2) CBCA, the “full amount” of the consideration for the stock dividend is the fair value of the dividend — here, \$100 per Class B share. This amount is added to the stated capital and PUC of the shares. This view better accords with the policy of the corporate and tax statutes. It is also in keeping with general commercial and accounting practices. For example, as the American Institute of Certified Public Accountants said:¹⁰⁶

... a stock dividend does not, in fact, give rise to any change whatsoever in either the corporation’s assets or its respective shareholders’ proportionate interests therein. However, it cannot fail to be recognized that, merely as a consequence of the expressed purpose of the transaction

¹⁰⁴ Subsection 248(1).

¹⁰⁵ See also OBCA, subs. 38(2).

¹⁰⁶ ARB 43, c. 7 (1953).

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and its characterization as a *dividend* in related notices to shareholders and the public at large, many recipients of stock dividends look upon them as distributions of corporate earnings and usually in an amount equivalent to the fair value of the additional shares received. Furthermore, it is to be presumed that such views of recipients are materially strengthened in those instances, which are by far the most numerous, where the issuances are so small in comparison with the shares previously outstanding that they do not have any apparent effect upon the share market price and, consequently, the market value of the shares previously held remains substantially unchanged. The committee, therefore, believes that where these circumstances exist the corporation should, in the public interest, account for the transaction by transferring from earned surplus to the category of permanent capitalization (represented by the capital stock and capital surplus accounts) an amount equal to the fair value of the additional shares issued.

H. — Conversion of Shares

Subsection 39(4) CBCA requires stated capital adjustments to be made on a conversion of shares from one class into another class.¹⁰⁷ The stated capital of the class from which one converts the shares is reduced by the appropriate percentage. The stated capital of the class into which the shares are converted is increased by a corresponding amount.

Example

Holdco's shareholder elects to convert its Class B share into a Class D share.

Stated capital (Class B shares):

Before conversion	\$ 10
Deduction on conversion	(10)
After conversion	\$ 0

Paid-up capital (Class B shares):

Stated capital	\$ 0
Adjustment	0
Paid-up capital	\$ 0

Stated capital (Class D shares):

Before conversion	\$ 0
Increase on conversion	10
After conversion	\$ 10

¹⁰⁷ See also OBCA, subs. 35(4).

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Paid-up capital (Class D shares):	
Stated capital	\$ 10
Adjustment	0
Paid-up capital	<u>\$ 10</u>

1. — Cost of Issuing Shares

1. — General Comment

The general rules on expense deductions prohibits a corporation from deducting the cost of issuing equity capital.¹⁰⁸ However, the Act permits the deduction of certain financing charges, but only according to a specific amortization formula.¹⁰⁹

2. — Commissions to Agents

A corporation may deduct certain types of financing expenses associated with the issuance of its shares. Deductible expenses include any commissions, fees, or other amounts payable to salespersons, agents, or securities dealers in the course of issuing shares. The deduction is available only to the taxpayer who issues the shares, and not to any other person. For example, a parent corporation may not deduct expenses incurred in respect of shares that its subsidiary issues. The subsidiary may, however, be able to deduct fees that it pays to its parent corporation in respect of the shares that the subsidiary issues.

3. — Commissions to Purchaser

A commission, fee, or bonus paid to the person to whom the shares are sold is not deductible as part of the cost of issuing equity. Such expenses are considered to be a discount of the share price rather than an expense of issuing the shares.

¹⁰⁸ Paras. 18(1)(a) and (b).

¹⁰⁹ Para. 20(1)(e).

4. — *Deductible Expenses*

A corporation may deduct the following expenses when it issues shares:¹¹⁰

- Legal fees in connection with the preparation and approval of a prospectus related to the issuance of shares;
- Accounting or auditing fees in connection with the preparation of financial statements, and related data, for inclusion with the prospectus;
- Printing costs for the prospectus, share certificates, etc.;
- Registrars' and transfer agents' fees; and
- Filing fees payable to any regulatory authorities with whom the prospectus must be filed.

Incorporation expenses, which include legal and accounting fees, are not part of the cost of issuing shares and are not deductible expenses for tax purposes. However, such expenses qualify as eligible capital expenditures.¹¹¹

5. — *Amortization of Issuance Expenses*

Expenses of issuing securities are deductible in equal portions over a period of five years.¹¹² Corporations with short taxation years must prorate the deduction for the short year. Where a corporation with a balance of financing expenses is wound up into, or amalgamated with, another corporation, the parent or new corporation may continue to deduct the expenses over the remainder of the five-year period.

J. — *Adjusted Cost Base (ACB)*

The adjusted cost base ("ACB") of property refers to the cost or "basis" of capital property for tax purposes. The concept is used to determine the capital gain or loss when one disposes of capital property. Section 54 defines ACB as the capital cost to the taxpayer with respect to depreciable property, and in any other case as the cost to the taxpayer as adjusted by section 53.

¹¹⁰ See also: *International Colin Energy Corp. v. R.* (2002), [2003] 1 C.T.C. 2406, 2002 D.T.C. 2185 (T.C.C. [General Procedure]); *BJ Services Co. Canada v. R.* (2003), [2004] 2 C.T.C. 2169, 2004 D.T.C. 2032 (T.C.C. [General Procedure]) [reviews the meaning of expense "in the course of an issuance or sale of shares of the capital stock of the taxpayer"].

¹¹¹ Subs. 14(5) "eligible capital expenditure".

¹¹² Subpara. 20(1)(e)(iii).

“Capital cost” refers to the actual or historical cost of depreciable property when the taxpayer acquired it.¹¹³ Cost includes all legal, accounting, and engineering costs incurred in acquiring the property. It also includes interest expenses incurred during construction of depreciable property¹¹⁴ but not interest expenses incurred for holding the asset after its acquisition. In *R. v. Stirling*,¹¹⁵ for example, the Federal Court of Appeal did not allow the taxpayer to deduct interest expense on holding gold bullion for resale. The interest expense was for holding the bullion and not for acquiring it.

K. — Share Redemptions and Adjusted Cost Base

Where a corporation redeems shares for an amount that exceeds their PUC, the excess is deemed to be a dividend.¹¹⁶ For example, assume that the stated capital and PUC of a share are \$100 each, and the shareholder’s ACB is \$150. If the corporation redeems the share for \$180, the shareholder is deemed to receive a dividend of \$80.

Cash paid on redemption	\$	180
Paid-up capital		100
Deemed dividend	\$	80

At the same time, the Act deems the shareholder to dispose of his or her share and to derive proceeds of disposition, which may trigger a capital gain. However in order to prevent double taxation, the Act reduces the shareholder’s proceeds of disposition by the amount of the previously taxable deemed dividend — in the above example, \$80.

Cash paid on redemption	\$	180
Less: deemed dividend		(80)
Proceeds of disposition	\$	100
Less: adjusted cost base		(150)
Capital loss	\$	50

Thus, the shareholder is deemed to receive a dividend of \$80, and, at the same time, suffers a capital loss of \$50. His net economic gain is \$30, which equals the difference between his selling price and the ACB of the shares. However, the tax treatment of the dividend and

¹¹³ *Cockshutt Farm Equipment Ltd. of Canada v. M.N.R.*, 66 D.T.C. 544 (Can. Tax App. Bd.), at para. 28.

¹¹⁴ Section 21 and *Sherritt Gordon Mines Ltd. v. M.N.R.*, [1968] C.T.C. 262, 68 D.T.C. 5180 (Exch. Ct.).

¹¹⁵ [1985] 1 C.T.C. 275, 85 D.T.C. 5199 (Fed. C.A.).

¹¹⁶ Subs. 84(3).

capital loss is quite different from the economic gain on the sale. The shareholder obtains a tax credit on the dividend if the corporation that redeems the share is a Canadian corporation.¹¹⁷ Only 50% of the capital loss of \$50 is deductible for tax purposes, and then only against the shareholder's capital gains. If the shareholder does not have any capital gains, the tax bite can exceed the economic gain.

The Act deems the capital loss of \$50 to be nil if the taxpayer is affiliated with the corporation immediately after the redemption. In such a case, we add the amount of the denied loss proportionately (based on relative FMV) to the ACB of any other shares that the shareholder owns. The purpose of this stop-loss rule is to prevent the shareholder from recognizing his loss in circumstances where he remains a part of an economic group of affiliated persons.¹¹⁸

L. — Taxable Preferred Shares

1. — Background

A fundamental structural characteristic of the corporate tax system is that corporations pay dividends to shareholders with after-tax earnings. In contrast, interest expense is generally deductible for tax purposes and comes out of pre-tax earnings.

On the other side of the coin, subsection 112(1) generally permits dividends to flow on a tax-free basis between taxable Canadian corporations. In contrast, interest income is taxable. Thus, the system has a built-in structural bias. A taxable corporation prefers to receive tax-free dividend income, rather than interest income. However, a taxable corporation will generally prefer paying interest expense, instead of dividends, on its debt so that it can deduct the expense.

In most situations in arm's length relationships, the opposing economic interests of the lending and the borrowing corporations will result in the parties arriving at the market-efficient solution for corporate financing needs. Typically, because of the disparate tax treatment, there is a rate differential in financial markets between interest charged on debt, and the dividend rate on shares.

We justify the tax-free flows of inter-corporate dividends on two bases:

- (1) dividends are paid out of previously taxed profits; and
- (2) dividends will be taxed again when paid out to individual shareholders.

Thus, the different tax treatment of dividend and interest income is intended to prevent double taxation of the same income within an economic unit of corporations.

¹¹⁷ S. 121.

¹¹⁸ Subs. 40(3.6) and para. 53(2)(f.2).

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However, the market model breaks down, if one of the parties to the financing transaction is not a taxable entity, or has large accumulated losses. “After-tax financing” refers to the substitution of shares for debt in a manner that lowers the after-tax cost of financing for an issuer.

Example

Assume that X Ltd. is not taxable because it has excess loss carryovers. A deduction of interest expense is of little value to X Ltd. because it is not taxable. Hence, the after-tax cost of debt financing for X Ltd. is essentially equal to its before-tax interest expense.

Now assume that Bank Ltd., a taxable financial institution, is prepared to lend money to X Ltd. Bank Ltd. will be taxable on its interest income from the loan, which will reduce its after-tax return on equity.

X Ltd. and Bank Ltd, which are at arm’s length with each other, will want to reduce the cost of financing for the issuer and increase the after-tax return for the lender. They can do so by having X Ltd. issue preferred shares to Bank Ltd. instead of borrowing and paying interest. Because of the deduction for inter-corporate dividends, Bank Ltd. will receive the dividends on the preferred shares tax-free. Because of the mutual tax advantage to both parties, the dividend rate on the preferred shares can be set at a lower rate than the interest rate that would be chargeable on debt, but slightly higher than the after-tax return on interest for the lender.

The non-deductibility of dividends on the preferred shares is not a problem for X Ltd because it is in a non-taxpaying position. At the same time, Bank Ltd improves its after-tax return on equity.

Finally, to ensure that Bank Ltd is secure in the arrangements and its investment is protected, the preferred shares will have rights and obligations closely associated with debt, such as a fixed and pre-determined life, supported by guarantees. Hence, they are known as “term preferred shares”.

In effect, the borrower and the lender would arbitrage the tax benefits of the deduction of interest expense for mutual advantage. The arrangement would be a “win-win” for both taxpayer corporations. In economic substance, term preferred shares are equity instruments with preferences that one usually finds in preferred shares. The only loser is the government, which loses on its taxes.

Similarly, even if both the lender and the borrower are taxable entities, there can be a tax advantage if the borrower’s tax rate is lower than that of the lending institution. The net result of this tax-driven financial arbitrage is that otherwise profitable enterprises (but without taxable income because of available tax write-offs) can transform what are, in effect, payments on debt-type instruments into tax-free dividends in exchange for a lower borrowing cost.

Financial institutions are frequently the beneficiaries of these arrangements, and were able to increase their income through tax-free dividends. In 1978, for example, the annual cost to

federal and provincial governments of this form of after-tax financing was approximately \$500,000,000.¹¹⁹ In that year, the government introduced new rules to curb the use of after-tax financing. These rules (known as the “term preferred share” rules) are complex provisions intended to disallow the manipulation of the inter-corporate dividend deduction by financial institutions. They are also intended to ensure that a corporation pays its dividends on preferred shares out of its taxed earnings, and with after-tax dollars.

2. — Taxable Preferred Shares

(a) — General Scheme

Part VI.1 of the Act levies a special tax on dividends paid on “taxable preferred shares”. The tax, together with the special tax in Part IV.1, attempts to control after-tax financing through the use of term preferred shares. These provisions are intended to make the tax system more neutral as between debt and preferred share financing.

The tax on dividends on taxable preferred shares is, in effect, a refundable tax. The tax is structured to prevent taxable corporations that do not have taxable income from using after-tax financial instruments to pay tax-free dividends to taxable lending institutions.

A corporation pays the tax on its taxable dividends on taxable preferred shares, but can claim a refund of the tax paid in certain circumstances. The refund is in the form of a deduction from income in an amount equal to three times the tax paid.¹²⁰ The tax is fully refundable only if the corporation that pays the dividend has sufficient income against which it can use the deduction. Thus, the payer corporation cannot use its Part VI.1 tax to reduce income if it does not have any income that is subject to tax.

The rationale of the tax is that “taxable preferred shares” are the equivalent of debt substitutes that could be used to after-tax finance. However, the definition of “taxable preferred share” in subsection 248(1) is extremely broad and is not limited to preferred shares.

The broad definition of “taxable preferred share” ensures that Part VI.1 tax applies to dividends on almost any type of preferred share, as well as some common shares. Part VI.1 ensures that non-taxpaying issuers pay some tax to compensate for the inter-corporate dividend deduction and the dividend tax credit for resident individuals. Because of the deduction from taxable income in paragraph 110(1)(k), the amount of the Part VI.1 tax is effectively offset against any Part I tax payable on the underlying income from which the corporation pays the dividend. Thus, Part VI.1 tax represents an “advance” payment of Part I tax on

¹¹⁹ See Budget Papers, *Notice of Ways and Means Motions and Supplementary Information*, November 16, 1978.

¹²⁰ Para. 110(1)(k).

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taxable income for taxpaying issuers. For non-taxpaying issuers, Part VI.1 tax is a liability that substitutes for Part I tax.

The Part VI.1 tax is equal to a basic rate of 25% of dividends that a taxable Canadian corporation pays on taxable preferred shares, other than short-term preferred shares. Where the basic rate applies, Part IV.1 imposes a tax on certain corporate recipients equal to 10% of the dividends received. Where a payor elects, the basic Part VI.1 rate is increased to 40%. In these circumstances, there is no tax payable under Part IV.1.

Thus, the tax under Part VI.1 is, in effect, a refundable tax on large corporations that use after-tax financing.

There are several exemptions from Part VI.1 tax that depend on the status of the corporate payor, the interest of a shareholder and the type of dividend paid. Deemed dividends arising under subsection 84(2) or (3) are also exempted where certain tests regarding the calculation of the redemption or acquisition price are satisfied. Further, all corporations are entitled to a basic dividend allowance, which exempts a maximum of \$500,000 (shareable by associated corporations) of dividends paid.

(b) — Rates of Tax

The tax is imposed at three different rates.¹²¹ The basic rate under Part VI.1 is equal to 25% of taxable dividends paid on taxable preferred shares other than short-term preferred shares.¹²² This rate attempts to ensure that a taxable Canadian corporation pays an amount of tax on its underlying income sufficient to support the provision of the dividend tax credit for resident individuals who receive dividends on taxable preferred shares.

Where a corporation elects under section 191.2, the basic rate increases to 40%.¹²³ This election eliminates the 10% Part IV.1 tax otherwise imposed on public corporations under section 187.2.

The 40% Part VI.1 tax attempts to ensure that a taxable Canadian corporation pays some tax on its underlying income in support of the provision of the deduction of inter-corporate dividends under subsection 112(1).

In most cases, a corporation will elect to pay this 40% tax where the holders of a class of its taxable preferred shares are primarily public corporations subject to Part IV.1 tax. In other cases, the lesser 25% tax is preferable, and an election under section 191.2 will not be filed.

¹²¹ Subs. 191.1(1)(a) effective from 2003.

¹²² Subpara 191.1(1)(a)(iii).

¹²³ Subpara 191.1(1)(a)(ii).

(c) — Meaning of “Taxable Preferred Shares”

The Part VI.1 tax is built around the concept of “taxable preferred shares”. Generally, a “taxable preferred share” is a share with a special liquidation or dividend entitlement, or has a guarantee in respect of its proceeds of sale or return of income. In effect, the definition likely encompasses all preferred and special shares issued after June 18, 1987.

Thus, a share is a taxable preferred share if:

- The shareholder is entitled to a fixed annual dividend, as and when declared by the directors of the issuing corporation,
- The shareholder is entitled to a fixed entitlement on a winding-up or a redemption of the share,
- It has any preference to dividends in relation to any other share, or
- It is convertible into a share that would be a taxable preferred share.

More specifically, a “taxable preferred share” includes a share that can be described in any of the following ways:¹²⁴

- It is a “short-term preferred share” issued after December 15, 1987;
- It may reasonably be considered that the amount of any dividends payable on the share is fixed, limited to a maximum, or established to be not less than a minimum;
- It may reasonably be considered that the amount that a shareholder is entitled to receive for the share upon the dissolution, liquidation, or winding-up of the issuing corporation is fixed, limited to a maximum, or established to be not less than a minimum amount;
- It may reasonably be considered that the amount that a shareholder is entitled to receive upon a redemption, acquisition or cancellation of the share or on a reduction of the paid-up capital of the share is fixed, limited to a maximum, or established not to be less than a minimum amount;
- The share is convertible or exchangeable, unless the share is convertible or exchangeable into something that would not be a taxable preferred share; or
- The share is one the shareholder’s investment in which any person (other than the issuing corporation) has undertaken to guarantee.

A “taxable preferred share” does not include prescribed shares or shares issued by a corporation in financial difficulty.¹²⁵

¹²⁴ Subs. 248(1) “taxable preferred share”.

¹²⁵ The concept of “financial difficulty” is itself defined in paragraph (e) of the definition of “term preferred share” in subsection 248(1).

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The definition of “taxable preferred shares” is comprehensive enough to include shares that are considered “common shares” in most other circumstances. Given the broad definition of “taxable preferred share”, the term encompasses ordinary “common shares” that have rights, conditions, privileges, or restrictions attached to them that fall within that definition. For example, it is not unusual to see so-called “common shares” that may be redeemable at a pre-determined (“fixed”) amount. Such a share is caught within the definition of “taxable preferred share” for the purposes of the special taxes.

3. — *Exemptions*

There are several exemptions from the special tax on “taxable preferred shares”.

(a) — “Substantial Interest”

There are exemptions in respect of substantial interest shareholdings that are, essentially, dividends received by a related party or dividends received by a shareholder who owns at least 25% of the votes and value of the capital stock of the paying corporation.¹²⁶ A dividend paid to a shareholder with a substantial interest in the corporation is an “excluded dividend” for the purposes of the tax.¹²⁷

(b) — “Dividend Allowance”

The Part VI.1 tax applies only to dividends paid in excess of the corporation’s dividend allowance. The dividend allowance is set at \$500,000, which must be shared among associated corporations.¹²⁸ The allowance is reduced on a dollar-for-dollar basis by preferred share dividends paid in the preceding year in excess of \$1,000,000.¹²⁹ Thus, small corporations may issue taxable preferred shares without getting caught by the tax.

¹²⁶ Subss. 191(1) and (2).

¹²⁷ Subss. 191(1) and 191.1(1).

¹²⁸ Subs. 191.1(3); s. 256(1) “associated corporations”.

¹²⁹ Subs. 191.1(2).

(c) — Financial Intermediaries

There are also some special exemptions in respect of dividends that financial intermediary corporations pay and receive and certain deemed dividends that arise on corporate reorganizations.¹³⁰

(d) — Short-Term Preferred Shares

The tax rate on short-term preferred shares is 50%. This rate reflects the basic 33.3% tax rate plus the effect of the denial of the inter-corporate dividend deduction to the recipient. In effect, this rate combines the two taxes into one rate and levies it on the issuer of the share, subject to a full refund if the issuer is a taxable corporation. In a sense the tax on taxable preferred shares is the equivalent of an advance corporation tax.

Generally, a short-term preferred share is a share issued after December 15, 1987 that is retractable within five years of its issue, or that is potentially subject to a guarantee of proceeds of disposition that may be effective within five years of the issuance of the shares.¹³¹

V. — Tax Aspects of Debt Financing

Debt is often the primary source of capitalization of a small business corporation in the early stages of its life. There are advantages to using debt capital to capitalize a small business corporation. If one structures the loan properly, interest on the debt is deductible for tax purposes. The owner of the business can also secure the debt and rank ahead of other creditors to the extent of the security.¹³²

Thus, an individual can start an enterprise with a small amount of share capital and contribute the balance of the capital by way of a secured shareholder loan. External lenders (for example, banks) will, however, usually require the owner/shareholder to provide a personal guarantee for borrowed funds.

There are several factors to be taken into account in selecting an appropriate method of debt financing. One must consider, for example, the cost of capital, its availability, and the risk exposure of the enterprise. No single formula applies to every corporation. Each corporation must take into account the terms and conditions attached to its debt financing in the context of the economic climate at the particular time.

¹³⁰ Subs. 191(1).

¹³¹ Subs. 248(1) “short-term preferred share”.

¹³² Except against banks and lending institutions.

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Debt financing falls into one of two broad categories: long-term or short-term debt. One uses long-term debt, typically with a maturity of 15 to 20 years, to finance the purchase of assets that have a long life. Shorter term debt financing is appropriate only for short-term needs.

A. — Discounts and Premiums

Corporations can issue debt obligations at face value, at a discount, or at a premium from their face value. A discount or premium generally reflects an economic adjustment to the nominal rate of interest to bring it in line with the effective market rate at the time that the corporation issues the obligation.

A bond's premium or discount may be on account of interest or capital. Then what is the "true nature" of the discount or premium? The answer depends upon several elements: Does the debt have a commercial rate of interest? Does the bonus or discount vary with the length of time that the loan funds are outstanding, the extent of capital at risk, and the nature of the financial operation? For example, discounts on financial market instruments, such as treasury bills, bankers' acceptances, and call loans, are, in economic substance, interest. The discount is the economic reward for holding the principal sum of the instrument for a period of time. A treasury bill that is issued at 95 and matures at par (100) in one year has an effective interest rate of 5.3%.¹³³

Discounts on debt obligations are deductible from income.¹³⁴ Where an obligation is issued at a price that is equal to at least 97% of its principal amount, and it does not yield an amount in excess of 4/3 of the nominal interest rate, the entire amount of the discount is deductible in computing income.

Where, however, a bond is issued for a deep discount that is less than 97% of its face amount, and for a yield in excess of 4/3 of its nominal interest rate, the difference is considered to be on account of capital, and only one-half of the discount is deductible in computing income for tax purposes.

B. — Interest

The Act does not define the term "interest". "Interest" is the return, or consideration for, the use or retention by one person of a sum of money belonging to or owed to another.¹³⁵ In effect, interest is a form of rental payment for the use of another person's money.

¹³³ $5/95 \times 100$.

¹³⁴ Para. 20(1)(f).

¹³⁵ *Ref. re s. 6 of Farm Security Act, 1944 of Sask.*, [1947] S.C.R. 394 at 411 (S.C.C.); *affd.* [1949] A.C. 110, (sub nom. *A.G. Sask. v. A.G. Can.*) (P.C.); *Riches v. Westminster Bank Ltd.*, [1947] A.C. 390 (U.K.H.L.).

1. — *Source of Income*

Interest is deductible only if the source of income to which the expense relates to exists.¹³⁶ For example, a taxpayer who finances the purchase of investment securities may claim any directly related interest expense as a deduction. The deduction is available so long as the taxpayer continues to hold the original investment or substituted securities. This is so even if the security declines in value or becomes worthless.

In certain circumstances, a taxpayer may claim the deduction if the investment is sold, and then uses the funds for another eligible purpose.

Interest on money used to acquire income earning property may be deductible even if one disposes of the property. There are two conditions for continued deductibility:¹³⁷

- The borrowed money must have been used for the purpose of earning income from capital property (other than real or immovable property or depreciable property); and
- The property must have been disposed of at its fair market value.

2. — *Accrued Interest*

A taxpayer who purchases a debt obligation (other than an income bond, income debenture, small business development bond, or small business bond) can deduct interest accrued on the debt to the date of the purchase. The deduction is restricted to the extent that the amount is included as interest in computing income for the year. The accrued interest paid to the vendor of the debt obligation is included in computing the vendor's income.¹³⁸ Alternatively, the purchasing taxpayer may choose to capitalize the interest.

¹³⁶ *Emerson v. The Queen*, [1986] 1 C.T.C. 422, 86 D.T.C. 6184 (F.C.A.); leave to appeal to S.C.C. refused 70 N.R. 160 (taxpayer not allowed to deduct interest on money used to purchase shares after shares sold at loss); *Bronfman Trust v. R.*, [1987] 1 S.C.R. 32, [1987] 1 C.T.C. 117, 87 D.T.C. 5059 (S.C.C.) (interest not deductible where principal borrowed to make capital distribution to trust beneficiary).

¹³⁷ Subs. 20.1(1).

¹³⁸ Subs. 20(14); IT-410R, "Debt Obligations — Accrued Interest on Transfer" (April 23, 1993) archived by CRA. This rule only operates where there has been an assignment or transfer of title. Evidence of registration of title would likely be necessary; see *Hill v. M.N.R.*, [1981] C.T.C. 2120, 81 D.T.C. 167 (T.R.B.); *Smye v. M.N.R.*, [1980] C.T.C. 2372, 80 D.T.C. 1326 (T.R.B.); *Antosko v. Minister of National Revenue*, (sub nom. *Canada v. Antosko*) [1994] 2 S.C.R. 312, (sub nom. *Antosko v. R.*) [1994] 2 C.T.C. 25, 94 D.T.C. 6314 (S.C.C.).

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3. — *Expenses of Issuing Debt*

A taxpayer can deduct expenses incurred in borrowing money for the purpose of earning income from a business or property.¹³⁹ In the absence of specific authorization, financing expenses (which typically include legal and accounting fees, printing costs, commissions, etc.) would be caught by the prohibition against deducting expenses not directly related to the income-earning process.¹⁴⁰ Financing expenses are deductible on a ratable basis over a five-year period.

4. — *Lump Sum Payments*

Interest may be paid lump sum at the end of the term of a loan.¹⁴¹

C. — *Capitalizing Interest*

1. — *General Comment*

A taxpayer may prefer not to write-off his interest expense against current operations. For example, there may be little advantage in taking a deduction for interest expense on money borrowed to construct an asset, if the asset is not currently producing income. The deduction of interest would merely create a loss that the taxpayer may not be able to use within the time limits allowed for carryover of losses.¹⁴² In such circumstances, the taxpayer may prefer to treat the interest expense as part of the capital cost of the asset and write-off the total cost of the asset at a later time when it begins to produce income. In other words, a taxpayer may treat interest costs as a capital expenditure, rather than as a current expense.

2. — *Depreciable Property*

A taxpayer who acquires depreciable property with borrowed money can elect to capitalize related interest charges.¹⁴³ However, the taxpayer can capitalize only those costs that would

¹³⁹ Para. 20(1)(e).

¹⁴⁰ *Montreal Light, Heat & Power Consol. v. M.N.R.*, [1944] C.T.C. 94, 2 D.T.C. 654 (P.C.); see *The Queen v. Royal Trust Corp. of Can.*, [1983] C.T.C. 159, 83 D.T.C. 5172 (F.C.A.) (payment was commission for services rendered therefore qualified as an eligible capital expenditure).

¹⁴¹ *Lomax v. Dixon*, [1943] 1 K.B. 671 (C.A.).

¹⁴² See para. 111(1)(a) (limitation period in respect of non-capital losses). This concern has become less significant now that the carry forward of losses has been extended.

¹⁴³ S. 21. Special restrictions on “soft costs” are discussed below; see subs. 18(3.1).

otherwise have been deductible as interest expense or as an expense of borrowing money. Interest expense to earn exempt income is not deductible and may not be capitalized.

The election is available in respect of costs incurred in the year in which one acquires the asset, and also in respect of costs that one incurred in the three immediately preceding taxation years. The extension of the election to the three preceding years recognizes that large undertakings extend over many years, and that a taxpayer may incur interest on money borrowed prior to the period in which he actually uses the money for its intended purpose.

3. — Election

(a) — Timing

The taxpayer must make the election for the taxation year in which he or she:

- *Acquires* the depreciable property,¹⁴⁴ or
- Uses the money borrowed for exploration, development, or acquisition of property.¹⁴⁵

A taxpayer may not elect to capitalize interest in anticipation of the acquisition of depreciable property or in anticipation of the use of borrowed money for exploration or development. The taxpayer may only elect *after* he or she acquires the property or expends the funds. However, once the election is made, it is effective for borrowing costs and interest incurred in the election year and in the three preceding years.

A taxpayer may elect under subsection 21(1) only for the taxation year in which he acquires the depreciable property. Where the taxpayer is erecting a building or other structure, he is considered to have “acquired” the asset at any time to the extent of the construction costs up to that time. Hence, a taxpayer must file a separate election for each taxation year in respect of the interest expense related to that year.

(b) — Amount Capitalized

The election to capitalize interest does not have to be in respect of the full amount of the costs of borrowing. A taxpayer may elect to capitalize only part of the interest charges and deduct the remainder as a current expense.

The portion of any capitalized interest is added to the capital cost of the depreciable property acquired. Thus, any capitalized interest can be written off through capital cost allowance

¹⁴⁴ Subs. 21(1).

¹⁴⁵ Subs. 21(2).

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charges in the future. The adjusted cost base of the property is also increased for the purpose of determining capital gains upon disposition of the property.¹⁴⁶

4. — *Reassessment*

Where a taxpayer elects to capitalize interest charges in respect of prior years, the Minister must reassess the taxpayer's preceding taxation years if the interest would have been otherwise deductible in those years. Having made the election, the taxpayer may continue to capitalize interest in succeeding years if, in each of those succeeding years, the taxpayer capitalizes the *entire* amount of the interest on the property.

5. — *Compound Interest*

A taxpayer may also capitalize compound interest and the expense of raising money. For example, a taxpayer may pay a commitment fee to a financier before funds are advanced. The taxpayer can capitalize the commitment fee, or standby interest, as part of the cost of borrowed money.¹⁴⁷

VI. — Hybrid Debt

Just as a corporation can issue hybrid share capital (that is, share capital with substantial debt characteristics), it can also issue hybrid debt — debt capital with all of the characteristics of share equity.

There are two advantages of hybrid debt:

- (1) payments on debt are generally deductible for tax purposes; and
- (2) payments can be made discretionary and, in this sense, resemble dividends on share capital.

Thus, there are special rules that control the deductibility of interest on hybrid debt capital.

¹⁴⁶ Para. 54 “adjusted cost base”.

¹⁴⁷ *Sherritt Gordon Mines Ltd. v. M.N.R.*, [1968] C.T.C. 262, 68 D.T.C. 5180 (Ex. Ct.).

A. — Income Bonds and Debentures

1. — General Rule

An income bond or debenture is a hybrid that pays interest or dividends only when, and to the extent that, the issuing corporation makes a profit.¹⁴⁸ This allows its issuer the flexibility of making interest or dividend payments only if it is in a profitable position and able to do so. Thus, an income bond or debenture resembles share capital.

The Act defines an “income bond” or “income debenture” as an instrument that does not, in any circumstances, exceed a term of five years, and is issued:¹⁴⁹

- As part of a proposal or arrangement with creditors that is approved under the *Bankruptcy Act* and *Insolvency Act*;
- At a time when all or substantially all of its assets were under the control of a receiver, or similar person; or
- At a time when the issuing corporation or a resident non-arm’s length corporation was in default, or reasonably expected to be in default, on a debt obligation,

The proceeds of the issue must be used in a business that is carried on immediately before its issued by the issuing corporation, or by a corporation with which it does not deal at arm’s length. The Act deems interest or dividends paid by a resident corporation on an income bond or debenture to be dividends¹⁵⁰ and, therefore, not deductible from income for tax purposes.

2. — Financial Difficulty

Interest on income bonds that a resident corporation issues to afford relief from financial difficulty, is deductible and is not deemed to be a dividend.¹⁵¹

3. — Taxable as Dividends

Payments on income bonds or debentures that are deemed to be dividends are taxable as such in the recipient’s hands. In the case of individuals, the dividend is treated as a taxable

¹⁴⁸ Subs. 248(1) “income bond”.

¹⁴⁹ *Ibid.*

¹⁵⁰ Subs.15(3).

¹⁵¹ Para. 18(1)(g).

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dividend subject to the usual gross-up and dividend tax credit rules.¹⁵² Where the recipient is a corporation, the dividend may be deductible as an inter-corporate dividend under section 112 of the Act. The dividend may also be subject to the refundable tax under Part IV if the recipient is a private corporation.

B. — Convertible Debt

Convertible debt is debt that is convertible into equity. Convertible debt allows the lender the best of two worlds: the security of debt capital, and the growth potential of share capital. The corporation that issues convertible debt also benefits since it can deduct interest payments on the debt. As a trade-off for the convertibility feature, interest on convertible debt is usually lower than that on conventional debt.

1. — Rollover into Shares

A holder of convertible debt can roll over the debt into share capital of the issuing corporation without triggering a disposition.¹⁵³ Thus, the lender can defer recognizing any accrued capital gain on the conversion of the debt instrument into share capital. This rollover is not elective: it applies automatically if the taxpayer satisfies all of the conditions of the provision.

The rollover is available only if:¹⁵⁴

- The convertible debt constitutes capital property to the taxpayer;
- The capital property is exchanged for shares in the same corporation; and
- The taxpayer receives no additional consideration for the conversion other than the shares of the corporation.

In these circumstances, the Act deems the taxpayer not to have disposed of the convertible debt and he can rollover the cost of the debt into the cost of the newly acquired shares. Hence, there are no immediate income tax consequences of the conversion.

The rollover is available only in respect of certain types of convertible properties: bonds, debentures, notes, and shares. It does not extend to other debt instruments such as mortgages. The rollover is available only in respect of “capital property” and does not extend to any property, a gain or loss from the disposition of which would constitute a capital gain or loss.

¹⁵² Para. 82(1)(b), s. 121.

¹⁵³ Para. 51(1)(c).

¹⁵⁴ Subs. 51(1).

2. — *Indirect Gifts*

The rollover is not available where the fair market value of the convertible debt before the exchange exceeds the fair market value of the shares immediately after the exchange *and* it is reasonable to regard the excess of the value of the debt over the value of the shares as a benefit that the taxpayer desires to confer on a related person.¹⁵⁵ Thus, a taxpayer cannot dispose of high valued debt in exchange for lower value shares and have the difference accrue to the benefit of a person related to the taxpayer. In the absence of such a rule, a taxpayer could divest capital property without triggering a capital gain or loss.

It is not always clear what constitutes a “gift” or benefit in these circumstances. It is not enough that a related taxpayer benefits from the conversion: subsection 51(2) applies only if the taxpayer who converts a debt actually desires to have the benefit conferred on a person related to him or her. The test is objective. The taxpayer must have at least some minimum threshold level of intention to benefit a related person.

Subsection 51(2) deems the taxpayer to receive proceeds of disposition for the convertible property equal to the lesser of its fair market value immediately prior to the exchange and the aggregate of its adjusted cost base and the “gift” portion. Thus, the taxpayer defers the capital gain on the conversion, except to the extent that the gain is decreased (or loss increased) as a result of the indirect gift. The Act deems the taxpayer’s capital loss from the disposition to be nil.

VII. — **Leases**

A lease is a contractual arrangement whereby one of the parties (the “lessor”) grants to another party (“the lessee”) the use, possession and enjoyment of an asset for a period of time in consideration of rental payments. A lease payment represents rental for the use of property. The terms and conditions of a lease can be tailored to meet the financial needs of the lessor and the lessee. Almost any asset that can be purchased can be structured as a lease. However, the most common forms of leases in business, deal with automobiles, furniture, equipment, and real property.

Leasing is “off-balance sheet” financing. The popularity of leasing assets is attributable to the financial advantage of keeping debt off the balance sheet, which allows the corporation to maintain a more favourable debt to equity ratio. Also, leasing does not drain the cash flow of an enterprise in the same way as a purchase of assets.

¹⁵⁵ Subs. 51(2).

A. — Advantages

The financial advantages of leasing are as follows:

- Since leasing is an “off-balance sheet” form of financing, it does not affect debt/equity ratios, which are often covenants in debt instruments that an enterprise issues.
- Since leases are not reported as liabilities on the balance sheet, they do not reflect adversely on the enterprise’s access to the credit markets.
- Small businesses do not usually have easy access to the capital markets in order to purchase substantial amounts of tangible assets. A lease is an alternative to long-term financing to purchase equipment.
- Leasing terms and conditions are flexible and, therefore, can be readily adapted to the particular needs of the business. Lease payments can be linked to the enterprise’s profits.

B. — Disadvantages

There are also certain disadvantages associated with leases:

- Since the leased asset belongs to the lessor, any appreciation in the value of the asset belongs to the lessor, not to the lessee. This is a significant financial consideration in leases involving real property.
- Leases are fixed term contracts (*albeit* often with options to renew), and during the term of the contract the lessee is committed to the contract. It is not usually easy to exit from the contract without paying a penalty or premium. Thus, unlike the owner of an asset who may be able to dispose of it if circumstances change, a lessee is contractually locked in even when economic circumstances change or become unattractive.

C. — Tax Treatment

Leasing brings to the fore the entire form versus economic substance debate in tax law. This in turn raises difficult issues of whether we should look at legal versus economic substance in determining the character of a “lease”. Consider the following situations:

1. X agrees to lease a small office for 55 years. In exchange for the long lease, the landlord gives X a fixed rental price of \$10,000 per year. The agreement is clearly a rental for the use of the office for 55 years.
2. Y buys an office for \$123,860 (the present value of \$10,000 annually over 55 years at 8%) and finances the purchase through a 10-year mortgage at 8%. The agreement is clearly the purchase of real property. Y can claim capital cost allowance on the property, and can deduct the mortgage interest for business purposes.

3. Z leases an office for \$10,000 per year (as in case 1 above), but also negotiates an option to purchase the property at the end of 55 years for \$1. Until that time, the landlord retains full legal title to the property, but Z pays all of the maintenance, taxes, and utilities for the office. The form of the transaction is clearly hybrid. Z does not have title but has all the costs of ownership. The agreement looks like a lease, but, in economic substance, it resembles an outright purchase.

The income tax considerations of leasing depend upon three principal factors:

1. The nature of the agreement;
2. The tax status of the lessee and the lessor; and
3. The type of property leased.

1. — Nature of Lease

What is a “lease” for tax purposes? The answer to this question is crucial in the context of property acquisitions. The leasing rules apply only to property leases. The capital cost allowance rules apply to purchases of property. Thus, the distinction between a lease and purchase is critical.

In the absence of specific tax rules, the characterization of a contractual arrangement depends upon the law of the jurisdiction that regulates the contract. One determines the nature of an acquisition by reference to the normal incidents of ownership of property: title (actual or constructive), possession, use and risk. In Quebec, the matter is determined by reference to the *Civil Code*.

2. — Rentals or Installments

Payments for the use of leased property may represent rental payments or installments on account of its purchase price. Payments on account of rent are deductible as a current expense in the computation of income.¹⁵⁶ Payments on account of the purchase of depreciable property are capital costs and eligible for capital cost allowance.¹⁵⁷ The distinction between these two types of payments is blurred, however, where the contract provides for a lease with an option to purchase the property. In such cases, one must determine the true nature of the contract: is it, in substance, a lease or an installment purchase?

¹⁵⁶ S. 9.

¹⁵⁷ Para. 20(1)(a).

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There are two different types of lease agreements: operating leases (pure leases with no option to purchase) and financing leases with options to purchase. Financing leases can be characterized into two types:

1. A financing arrangement for the purchase of an asset that one will acquire at a later date pursuant to a determinable option price; or
2. A rental agreement for the use of an asset, but with an option to purchase the asset at a later date.

A lease option agreement that is a pure financing arrangement, is, in effect, a transaction that is a purchase of an asset: the lease is merely the vehicle to finance the purchase. In contrast, a “genuine” lease-option agreement is, in substance and form, a rental agreement, but one that allows the lessee the privilege of changing his or her mind and purchasing the asset at a later date.

There is no bright line test to distinguish between these two types of agreements. Obviously, they both involve the same arrangements, namely, periodic payments with an option to purchase the asset at a later date. However the two arrangements have substantially different legal and tax results.

The CRA’s administrative position is that the following factors point toward a sale, rather than a lease:¹⁵⁸

- The lessee *automatically* acquires title to the property after payment of a specified amount in the form of rental payments;
- The lessee *must* buy the property from the lessor during, or at the termination of, the lease;
- The lessee has the right, during or at the expiration of the lease, to acquire the property at a price which, *at the inception* of the lease, is substantially less than what the probable fair market value of the property will be at the time that the lessee *can* acquire the property; or
- The lessee has the right, during or at the expiration of the lease, to acquire the property at a price, or under terms and conditions which, *at the inception* of the lease, are such that no reasonable person would fail to exercise the option.

The above criteria indicate that the determination of whether a contract is a lease or a purchase of property is almost always a question of fact. One determines the issue by examining the conduct of the parties, the nature of the legal obligation, and, where relevant, past dealings between the parties in similar transactions.

¹⁵⁸ IT-233R, “Lease-option Agreements; Sale-leaseback Agreements” (February 11, 1983), para. 3 (IT-233R has been cancelled by Technical News No. 21 (June 14, 2001)).

The examination requires more than a superficial enumeration of the relevant criteria. For example, in a “financial lease”, it is quite usual for the lessee to assume the responsibility for paying the expenses of the leased property, such as taxes, insurance, maintenance, etc. The obligation to pay these expenses, which are normally associated with the ownership rather than the rental of property, does not, in and by itself, necessarily imply that the transaction is, in substance, a purchase. Such an obligation is only one factor that one evaluates to determine the character of a particular contract. The fact that the lessee assumes the expenses does not necessarily render the contract something other than a true lease.

(a) — Option to Purchase at Fair Market Value

An option agreement that is, in substance, a purchase agreement is not a genuine “lease”. The so-called “lessee” cannot deduct lease payments. However, where the lease-option agreement is a genuine lease, the taxpayer can deduct lease payments during the tenure of the lease.

(b) — Option to Purchase at Less than Fair Market Value

A special rule applies to options to purchase property at less than its fair market value. Where a taxpayer purchases an asset at less than its fair market value pursuant to an option, any amounts that had been paid previously to use the property (for example, rent) are considered as amounts previously claimed as capital cost allowance in respect of the property.¹⁵⁹ The effect of this rule is that a subsequent disposition of the property may trigger a recapture of capital cost allowance.

More specifically, this rule applies where a taxpayer acquires a depreciable property or real or immovable property in respect of which:

- The taxpayer (or a person with whom the taxpayer was not dealing at arm’s length) was entitled to a deduction from income for use (for example, rent) of the property; and
- The capital cost of acquisition is less than the fair market value of the property, determined without reference to the option price.

This rule prevents the taxpayer from receiving the best of both worlds: current deductions of lease payments and capital gains treatment on any gains that the taxpayer realizes when he or she eventually sells the asset. This rule applies only in circumstances in which, *even though the lease-option agreement is a genuine lease*, the option allows the taxpayer to acquire the property at less than its fair market value. The rule does not apply to installment purchases whereby the purchaser is not, in any event, entitled to a rental deduction.

¹⁵⁹ Subs. 13(5.2).

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Subsection 13(5.2) deems a taxpayer who exercises an option to acquire property at less than its fair market value to acquire the property at the *lesser* of:

- Its fair market value at the time that the taxpayer exercises the option; and
- Its actual cost at that time *plus* all payments that the taxpayer previously paid on account of rent for its use.

If the actual cost of the property to the taxpayer is less than its deemed cost, the Act deems the taxpayer to have previously claimed the difference as capital cost allowance on the property. Thus, the taxpayer may be subject to recapture of capital cost allowance at a later date if he or she sells the property at a profit.

Example

Assume:		
In 1998, X Ltd. leased some land from T Ltd. at an annual rental of \$20,000. The lease allows X Ltd. to purchase the land at the end of five years at an agreed upon price of \$80,000, which is a reasonable estimate of its fair market value at that time. In 2003 X Ltd. exercised its option to purchase the land at its fair market value, which is \$120,000. In 2017, X Ltd. sells the land for \$200,000.		
<i>Upon exercise of the option in 2003</i>		
Exercise of option (A)		\$ 80,000
Lesser of:		
FMV of land	\$ 120,000	
Cost of land plus rental payments	\$ 180,000	
Lesser amount is deemed cost of land (B)		\$ 120,000
Depreciation deemed claimed (B) minus (A)		\$ 40,000
<i>Upon sale of land in 2017</i>		
Proceeds of disposition	\$ 200,000	
ACB of land	\$ 120,000	
Capital gain		\$ 80,000
Recapture of depreciation deemed claimed		\$ 40,000

Subsection 13(5.2) applies to all capital property that is depreciable property or real or immovable property, including land. Thus, in the above example, the Act deems the land to be depreciable property of a separate prescribed class and, therefore, the rental payments (or a portion thereof) on the land are subject to “recapture,” and are taxable as income.

To prevent a taxpayer from circumventing this rule by disposing of, instead of exercising, the option to acquire the property, subsection 13(5.3) deems that any difference between the proceeds of disposition of the option and its cost, is taxable as “recaptured” income.

D. — Restrictions on After-Tax Financing

We have seen that leasing can be used as an alternative to the more usual methods of financing. The tax advantages of leasing arise because capital cost allowance (“CCA”) for leased property often exceeds its actual depreciation, particularly in the early years of a lease. This allows non-taxable lessees to trade off accelerated CCA against reduced rental payments. The Act restricts the use of leases as a form of after-tax financing for tax-exempt entities and taxpayers who are not currently taxable. It does this through the capital cost allowance rules.

1. — The Lessor’s Position

A taxpayer (“the lessor”) who leases specified leasing property (other than exempt property) with a fair market value of more than \$25,000 to another person for more than one year is restricted in the amount that may be claimed for capital cost allowance on the property.¹⁶⁰ The CCA claimable is limited to the amount that would have been a repayment of principal if the lease had been a loan and the rental payments were considered blended payments that represented principal and interest.¹⁶¹ Thus, the entire regime depends upon the concept of notional loans and repayments.

The lessor is regarded as having made a loan to the lessee in an amount equal to the fair market value of the leased property, and the rental payments on the lease are considered to be a blend of principal and interest. Generally, the capital cost allowance that may be claimed by the lessor on each property is restricted to the difference between rental income and a notional value for interest.

Regulation 1100(1.1) restricts the capital cost allowance that is deductible by the lessor in respect of such property to the *lesser* of:

- The amount that would be received by the lessor in the year as a return of principal had the lessor made a loan to the lessee at a prescribed rate of interest in an amount equal to the fair market value of the leased property; and
- The amount by which the total capital cost allowance that the lessor could have claimed in respect of the property in the absence of any special leasing rules, over the amount of any capital cost allowance previously claimed by the lessor in respect of the property.

A rate of interest is prescribed for each month.

¹⁶⁰ Reg. 1100(1.11).

¹⁶¹ Reg. 1100(1.1).

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“Specified leasing property” is depreciable property (other than exempt property) that is used principally to earn leasing revenue from a lease that has a term of more than one year.¹⁶²

“Exempt property” includes automobiles, light trucks and trailers, buildings, home furnishings, appliances, office furniture, office equipment, computers and general-purpose electronic data-processing equipment included in Class 45. The exemption in respect of office furniture, office equipment, and electronic data processing equipment does not apply to individual assets that have a capital cost in excess of \$1,000,000.¹⁶³

2. — *The Lessee's Position*

Lessees are generally entitled to claim the full amount of lease payments that relate to the use of the property in the year in the normal manner.

A lessee may, however, jointly elect with the lessor to have the lease considered as money borrowed to purchase the asset leased.¹⁶⁴ The lessee is entitled to claim capital cost allowance and deduct the interest portion of the deemed blended payments of principal and interest. Thus, *both* the lessee and the lessor may be able to claim capital cost allowance in certain circumstances.

Where the lessor and lessee *jointly* elect, in prescribed form, and agree upon the fair market value of the leased property, the lessee is considered to have borrowed an amount equal to the fair market value of the property and to have acquired the property. In these circumstances, rental payments made under the lease are not considered to be rent, but are treated as blended payments of principal and interest on the loan.

To the extent that the property is used to earn income, the lessee is able to claim capital cost allowance in respect of the property, and to deduct the interest portion of each rental payment. This rule applies only in computing the income of a lessee who leases property (other than prescribed property) for a term of more than one year from an arm's-length person who is resident in Canada, or who carries on business in Canada through a permanent establishment.

¹⁶² Reg. 1100(1.11).

¹⁶³ Reg. 1100(1.13).

¹⁶⁴ Subs. 16.1(1).

Example

Assume:

A taxpayer leases an asset with a fair market value of \$10,000 in an arm's length transaction. The lease is for a period of five years at an annual rental rate of \$1,314. The capital cost allowance rate applicable in respect of the property is 25% (diminishing balance basis) subject to the half-year rule. Both the lessor and the lessee jointly elect to treat the lease as a loan and purchase for the term of the lease. The prescribed rate in effect at the time of the lease is 10%.

Then:

The lessee may deduct interest expense and capital cost allowance as follows:

Year	Lease Payments	Principal	Interest	CCA	UCC
					\$ 10,000
1	\$ 1,314	\$ 314	\$ 1,000	\$ 1,250	8,750
2	1,314	345	969	2,188	6,562
3	1,314	380	934	1,641	4,921
4	1,314	418	896	1,230	3,691
5	1,314	460	854	923	2,768
TOTAL	\$ 6,570	\$ 1,917	\$ 4,653	\$ 7,232	

At the end of the five-year lease period, the lessee is deemed to have disposed of the property for the remaining principal amount of the deemed loan, that is, \$8,083. Assuming that the property was the only property in that class of assets, the lessee is subject to recapture of capital cost allowance of \$5,315:

Principal amount of loan	\$ 10,000
Loan (principal) payments	1,917
Principal balance outstanding	8,083
Undepreciated capital cost (UCC)	2,768
Recapture of CCA	\$ 5,315

Thus, the total deductions allowed to the lessee with respect to the property over the term of the lease is \$6,570, that is, interest expense of \$4,653 and capital cost allowance of \$7,232 less the recapture of capital cost allowance of \$5,315.

3. — Anti-Avoidance Rule

An anti-avoidance rule applies to leases made for less than one year that are extended later. The Act deems property that is the subject of a lease for less than one year to be a lease longer than one year if it is reasonable to conclude that the lessor knew, or ought to have known, that the lessee would lease the property for more

than one year. The burden is on the lessor to establish that he or she could not have known that the lessee would extend the term of the lease beyond one year.¹⁶⁵

Where a taxpayer acquires a lease that has a remaining term of more than one year, the taxpayer is generally considered to have entered into a new lease of the property at that time for a term of more than one year.¹⁶⁶ There is an exception for acquisitions from a non-arm's length person or in the course of certain rollover transactions, for example, an amalgamation of corporations.¹⁶⁷ Apart from these exceptions, however, the acquiring taxpayer steps into the shoes of the vendor in respect of the property covered by the lease.

4. — *Financing a U.S. Subsidiary*

Canadian corporations funding their U.S. subsidiaries must determine whether to advance funds through equity, debt, or both. Each form has tax consequences.

Equity funding can be returned to the Canadian parent by way of a distribution from the U.S. subsidiary. The distribution will be considered to be a dividend for U.S. purposes to the extent of the U.S. subsidiary's current or accumulated earnings and profits. Under the *Canada-U.S. Tax Treaty*, dividends are subject to U.S. withholding tax of 5% in the case of a Canadian corporation that owns at least 10% of the voting stock of the U.S. subsidiary. The U.S. subsidiary does not receive an income tax deduction for this dividend payment.

Where funds are loaned to the U.S. subsidiary, the subsidiary is entitled, subject to various limitations, to an income tax deduction for interest paid on the loan. The interest payment is not subject to U.S. withholding tax under the *Canada-U.S. Tax Treaty*. Repayments of loan principal are not deductible by the borrower.

5. — *Meaning of Debt*

The *Income Tax Act* does not define "debt." Indebtedness generally requires an intention to create the debt, accompanied by an enforceable, provable, and unconditional obligation to legally repay it.

The following are some of the salient features to look at in determining the existence of debt:

1. the intent of the parties;
2. the existence of a written document evidencing the indebtedness;

¹⁶⁵ Reg. 1100(1.13)(b).

¹⁶⁶ Reg. 1100(1.15).

¹⁶⁷ Reg. 1100(1.16).

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3. the presence or absence of a fixed maturity date;
4. the presence or absence of a stated interest rate;
5. the right to enforce payment of principal and interest; and
6. the expected ability of the borrower to satisfy the loan in accordance with terms at the inception of the loan.

No single factor is conclusive, and it is necessary to look at all the features to determine the character of the instrument under review.

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