Safe Income May Vary Within Shares of the Same Class

The anti-surplus-stripping provision in subsection 55(2), which can recharacterize a dividend as a capital gain, is not of concern if the corporate group has sufficient safe income (retained earnings with certain adjustments). However, one peculiarity of the calculation of safe income is that safe income on hand is calculated on a share-by-share basis, based on the length of time that the shareholder has owned that particular share. Nevertheless, the CRA will permit averaging across a class of shares as an administrative convenience. (See John R. Robertson, "Capital Gains Strips: A Revenue Canada Perspective on the Provisions of Section 55," 1981 CTF Conference Report, question 8(b).)

Robertson's Rules (named for John R. Robertson, a former director general of the Corporate Rulings Directorate) represent the CRA's longstanding policy on the calculation of safe income: simply put, if a company has different classes of shares held by different corporate shareholders, the dividend entitlement of each class of shares is considered in allocating safe income. Assume, for example, that a company has fixed preferred shares with an entitlement of 10 percent on a redemption amount of $500, and common shares that receive dividends at the discretion of the directors. If the operating company has safe income on hand of $400, then $50 (10% × $500) of safe income will be attributed to the preferred shareholder, and the remaining $350 will be attributed to the common shareholder. (If all classes of shares have discretionary dividends, this method breaks down; I understand that the CRA is currently conducting a study of this issue.)

It is implicit in the calculation above that safe income is a flow concept and depends on the holding period, which can vary from share to share. Thus, it is not enough to simply separate safe income by the different classes of shares. If the dividend recipient has held shares of the same class for different amounts of time, safe income may differ within the same class of shares. *Gestion Jean-Paul Champagne Inc. v. MNR* (97 DTC 155 (TCC)) and *Canada v. Nassau Walnut Investments Inc.* (1996 CanLII 4097 (FCA)) established that all safe income should be allocated equally and pro rata within the same class of shares. However, those cases do not address situations in which the shares may be owned for different lengths of time.

Assume that Holdco purchases 100 shares of Opco for $10 ("the old shares"). These shares earn $1 per share of safe income per year. Therefore, at the end of year 1, Holdco has $100 of safe income on hand. At the beginning of year 2, Holdco purchases another 100 shares of Opco ("the new shares") for $10. These shares also earn $1 per share of safe income per year. Therefore, at the end of year 2, Holdco should have $300 of safe income on hand in total ($100 of safe income earned in year 1 plus $200 of safe income earned in year 2).

Opco then proceeds to pay an intercorporate dividend of $1.25 per share, for a total dividend of $250 (200 × $1.25). It might seem that subsection 55(2) will not apply because the dividends are less than the safe income ($250 < $300), but this is not the case. For the old shares, Holdco has $200 of safe income (100 × ($1 + $1)) and $125 of dividends (100 × $1.25). On the new shares, however, Holdco has the same $125 (100 × $1.25) of dividends, but only $100 of safe income (100 × $1). Therefore, subsection 55(2) applies to recharacterize $25 of the dividends on the new shares.

It is possible that one could still escape the application of subsection 55(2) by relying on the "reasonable regular dividends" exemption rule (see CRA document no. 2015-0613821C6, November 17, 2015). Another way to avoid the application of subsection 55(2) is to ensure that the intercorporate dividends do not reduce the value of any share or increase the cost base of properties. (The CRA gave some indication of when it thinks that this may be the case in question 8 of "Canada Revenue Agency Round Table" in the 2015 CTF Conference Report.) In both of these circumstances, the calculation and allocation of safe income will not be required.

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