# SOME ASPECTS OF SURPLUS STRIPPING OF INTEREST TO PRACTITIONERS*

J. Ian M. Whitcomb‡

## Introduction

There seem to be two reasons why surplus stripping (or dividend stripping as it is often called) is a subject of importance under the present Canadian income tax law. In the first place, surplus stripping is a matter that lies close to the heart of the system whereby corporations and their shareholders are taxed. It is largely because of surplus stripping that this system has fallen into disrepute in some quarters, and drastic changes in it have been suggested in recent years. A second reason for considering surplus stripping as a subject of importance is the enactment of anti-surplus stripping legislation, the consequences of which make it imperative that legal practitioners have a grasp of the subject. This paper will examine these two aspects of surplus stripping.

## Part I

### The Corporation-Shareholder Relationship

Under the present method of taxing corporations and their shareholders, income earned through the medium of a corporation is taxed immediately at a flat rate, and may then be accumulated within the corporation for an indefinite period without attracting personal tax.[1] In the absence of a tax on capital gains on the sale of shares, many shareholders have found it possible and profitable to realize on their portions of the corporation's undistributed income without being taxed. By selling their ownership in the corporation at prices which reflect its undistributed income, they escape tax at the personal rates.[2] The personal rate structure is a corner-stone of our taxing system; by it, according to tax

---

* A paper delivered as part of a series of lectures arranged by the Faculty of Law of the University of New Brunswick at the Mid-Winter Meeting of the New Brunswick Section of the Canadian Bar Association, held at Fredericton, N.B., February 13-15, 1965.

‡ J. Ian M. Whitcomb, B.A. (U.N.B.), B.C.L. (U.N.B.), LL.M. (Michigan) of the law firm of McKelvey, Macaulay, Machum and Fairweather, Saint John, N.B., Lecturer in the Faculty of Law, University of New Brunswick.

1 *Income Tax Act*, s. 39(1).

2 *Supra*, s. 32(1).

theorists, expression is given to a sacrosanct ideology of taxation: taxation is based on ability to pay. The loopholes that permit surplus stripping offend this principle.

Because surplus stripping is predicated on the ability of a shareholder to realize on a corporation's undistributed income as a tax free capital gain, it is part of a larger problem that brings into focus the whole question of how best to tax the income earned by corporations and their shareholders. On this basis alone comment on surplus stripping can probably be justified. However, it seems appropriate to turn to an examination of more practical problems raised by the recently enacted anti-surplus stripping legislation.

## Part II

### Some Effects of the 1963 Surplus-Stripping Legislation

Prior to June 13, 1963, surplus stripping may have been of special interest to a select group only of Canadian tax experts. Up to that time surplus stripping was a tax avoidance device that was scarcely regarded as being within the sphere of interest or responsibility of lawyers engaged in general practice. As a result of an amendment to the Income Tax Act in 1963,[3] however, surplus stripping became one of the most controversial and widely discussed of the tax avoidance schemes. The 1963 amendment is feared by some to have implications that extend far beyond the limits of what was previously regarded as surplus stripping. If these fears are warranted, the amendment may have repercussions that will influence customary practices the tax consequences of which had been regarded as well established. These practices may now have to be reconsidered. Illustrations of the problems will be given in a later portion of this paper.

There are a number of schemes known collectively as surplus strips. All are methods whereby the surpluses of corporations can be distributed to shareholders without the payment of tax. It should, of course, be emphasized that the tax eliminated is the shareholder's personal tax, not the corporate tax which would have been paid in the years that the constituent portions of the surplus were earned.[4] According to the Income Tax Act, the distribution of corporate surpluses to shareholders should bear tax when received by them. The purpose of surplus stripping is to eliminate the shareholder tax.

---

3 12 Eliz. II, c. 21, s. 26(1) (1963).

4 *Income Tax Act*, s. 39(1) plus 3% Old Age Security Tax.

Certain of the most complex sections of the Income Tax Act were added by Parliament over the years as anti-surplus stripping measures. Included are:

section 8, relating to benefits received by shareholders;

section 28, relating to dividends paid out of designated surplus;

section 105B, imposing a special tax in respect of dividends paid out of designated surplus in certain circumstances;

section 105C, imposing a special tax in respect of undistributed income after a statutory amalgamation when the combined surpluses of the predecessor corporations have diminished during the amalgamation; and

section 81, relating to payments made to shareholders by corporations with undistributed income on hand on the winding up, discontinuance or reorganization of their businesses.

The original version of section 81 appeared in 1919 as an amendment to the Income War Tax Act, 1917.[5] The Income War Tax Act was Canada's first income taxing statute so obviously it did not take long for surplus stripping to become recognized as a tax avoidance device requiring anti-avoidance countermeasures. The history of the taxation of corporations and their shareholders in Canada has, in a sense, been shaped by the continuous efforts of Parliament to keep a step ahead of the surplus stripper. On the whole these efforts have been failures and, if anything, surplus stripping activities have increased in intensity over the years. This increase is probably related to higher rates of tax and a broadened tax base. Whatever the cause, Parliament reacted in 1963 with vengeance, and in a way that was believed by many at the time to be a final solution to the surplus stripping problem. This solution was the enactment of section 138A(1).

Section 138A(1), it is feared, has implications that will affect transactions and arrangements that were not traditionally regarded as surplus stripping. An attempt will now be made to illustrate these problems in three areas:

(1) incorporation

(2) estate planning; and

(3) sale of shares.

First, however, section 138A(1) as it appears in the Income Tax Act will be set out:

> Where a taxpayer has received an amount in a taxation year,
>
> (a) as consideration for the sale or other disposition of any shares of a corporation or of any interest in such shares,

5 *Income War Tax Act,* 1917, 7-8 Geo. V, c. 28.

(b) in consequence of a corporation having

(i) redeemed or acquired any of its shares or reduced its capital stock, or

(ii) converted any of its shares into shares of another class or into an obligation of the corporation, or

(c) otherwise, as a payment that would, but for this section, be exempt income,

which amount was received by the taxpayer as part of a transaction effected or to be effected after June 13, 1963 or as part of a series of transactions each of which was or is to be effected after that day, one of the purposes of which, in the opinion of the Minister, was or is to effect a substantial reduction of, or disappearance of, the assets of a corporation in such a manner that the whole or any part of any tax that might otherwise have been or become payable under this Act in consequence of any distribution of income of a corporation has been or will be avoided, the amount so received by the taxpayer or such part thereof as may be specified by the Minister shall, if the Minister so directs,

(d) be included in computing the income of the taxpayer for that taxation year, and

(e) in the case of a taxpayer who is an individual, be deemed to have been received by him as a dividend described in paragraph (a) of subsection (1) of section 38.

### (1) Corporate formation

The proprietor of a small unincorporated business may consult his lawyer about the advantages and disadvantages of incorporation. Naturally the tax consequences of continuing to do business in proprietorship or partnership form will be weighed against the advantages and disadvantages of doing business through a corporation. A point to ponder will be the feature of our tax system whereby income earned through a corporation is subject to taxation when it is earned by the corporation, and again when it is distributed to or appropriated for the benefit of the shareholders.[6] It may be explained to the client that part of the edge can be taken off the double taxation knife by capitalizing the proposed corporation with redeemable shares. Subsequent redemptions can be made and the corporate surplus or profits can flow to the shareholders with no tax barrier, perhaps even a tax saving if the corporate rate is below their personal tax rates.

Practice has shown, however, that a portion, perhaps a substantial portion, of the corporate profits will probably be retained inside the corporation for purposes of expansion of the business and possibly for tax deferment. During this interval the share-

6 *Income Tax Act,* ss. 32(1) and 6(1)(a)(i).

holders will not bother going through the motions of redeeming shares; it will be their intention to redeem in a lump sum at an appropriate future time.

Because of section 138A(1), however, such a contemplated redemption of all or a substantial part of a corporation's preferred shares issued after June 13, 1963 should start the warning lights flashing. If you compare the proposed redemption with the words of section 138A(1) you may find that the shareholder will have exposed himself to the danger of taxation. To avoid a substantial reduction or disappearance of assets in the year of redemption, caution would seem to dictate that some portion of the preferred shares should be redeemed each year during which the corporation would otherwise be accumulating its surplus. If it is essential to retain the funds within the business, the shareholder can reinvest the proceeds of the annual redemption and take back a demand note.

**(2) Estate planning**

A well-known estate planning device has been declared by the Department of National Revenue to be the subject to attack under section 138A. This is the device frequently referred to as "estate freezing". Under it, the owner of an operating corporation attempts to prevent an increase in the value of his estate to keep estate taxes to a minimum. The owner of the operating corporation exchanges his common shares for preferred shares in a holding company which is frequently owned by his son or some other member of his family. The preferred shares will never be worth more than their par value, so the value of the owner's estate, at least so far as these shares are concerned, is frozen. All increment in value will accrue to the benefit of the son or other person who owns the common shares in the new holding company. The liquidity of the owner's estate can also be improved by passing the earnings of the old corporation through the holding company to the owner by means of the payment of dividends by the operating company to its parent, the holding company, and by the holding company redeeming its preferred shares. No "designated surplus" would be encountered if dividends were paid out of current earnings only.[7]

While "estate freezing" was given as the ostensible reason for carrying out the transactions just described, the experience of the Department of National Revenue indicates that such transactions,

---

7 *Ibid.*, s. 28(2).

or variations of them, were frequently little more than schemes to strip the operating corporation of its surplus by redeeming the preferred shares in a holding company. Apparently, under present conditions, it is the intention of the Minister to treat the amount received on redemption of the preferred shares in the holding company as income. It is not clear whether the Minister would take this action unless the surplus of the operating company as it existed on the date when control was acquired by the holding company was actually stripped. It is possible however, that an actual strip is not necessary to produce the result. On the other hand, so long as the holding company is a personal corporation within the definition of section 68 of the Income Tax Act, the Minister is unlikely to exercise his discretion under section 138A(1) because no tax will be avoided.

**(3) Sale of a business**

Sales of businesses are not infrequent. Inevitably, consideration will be given to the tax implications of such transactions. Among the more important tax matters to be considered is whether the owner should sell the business and retain the shares in the corporation or whether the shares should be sold along with the business. Sale of the shares has the advantage of solving problems associated with the undistributed income of the corporation. These problems would be acquired by the purchaser along with the shares. As a result of section 138A(1) another feature has to be resolved. Assume that it was decided that the better course would be to sell the shares in the corporation. It is now necessary to ask this question: "What is the purchaser of the shares going to do with the corporation after he acquires control of it?" Will the purchaser avail himself of the opportunity to strip the surplus out of the corporation in order to defray some of the costs incurred in acquiring its shares? If so, tax liability under section 138A(1) may accrue to the vendor even though he has not knowingly participated in the surplus strip. If Parliament's solution to the surplus stripping problem is to tax the vendor of the shares, and that is what section 138A(1) amounts to, then every vendor of shares in a business will have to be certain that the purchaser isn't going to strip the surplus. Sometimes these takeovers of family type businesses are made by an agent for an anonymous purchaser, frequently a national concern. If so, the vendor may be unable to determine the purchaser's intentions. In any case it would seem prudent under the circumstances to insert a clause in the sale agreement calling for the purchaser to indemnify the vendor for any tax liability under section 138A.

## Conclusion

What is the situation now? Is surplus stripping a tax avoidance device that should be relegated to history in the face of section 138A(1) and forgotten about? Some tax advisers say no. They say that surpluses can still be stripped if the schemes are properly constructed and executed. These schemes involve the use of non-resident trusts or corporations, stock rights, or employers' payments to pension plans on account of past services. And so the battle between Parliament and the surplus stripper goes on and on.