Sun Life
Life's brighter under the sun

SUBSECTION 55(2) ITA: AN IMPORTANT PROVISION TO KEEP ON YOUR RADAR!

Jean Turcotte, Attorney, B.B.A., LL.B., D.Fisc, Fin.Pl., TEP, Director, Insurance Tax Solutions Group

It is generally recognized in the tax community that subsection 55(2) of the *Income Tax Act* (ITA) is one of the most complex tax provisions there is. In simple terms, it is an anti-avoidance rule intended to prevent the conversion into a dividend of an amount that would normally be a taxable capital gain. The reason for this is that, unlike capital gains, intercorporate dividends are usually not taxable.

Before we go any further, it's important to note that this provision of the *Income Tax Act* contains a number of very technical rules which, for financial security advisors, are well beyond the scope of their practice. However, it's still worth taking a look at the basic rules in this provision that could potentially be applied by the tax authorities.

With that in mind, this article will provide a general overview of the relevant tax rules, and then examine two concrete situations that financial security advisors may encounter where this provision could apply.

The nature of subsection 55(2) ITA

Specifically, subsection 55(2) ITA is intended to prevent the conversion into a dividend of an amount that would normally be considered a capital gain. For example, if an operating company pays a $500,000 non-taxable dividend to its parent company (HoldCo) just before it is sold, the value of the operating company will be reduced by that amount. Additionally, this transaction would reduce the capital gain and the tax amount payable. Prior to the 2015 federal budget, the tax authorities would regularly review this type of transaction in order to determine whether the capital gain arising on the sale of the shares of the operating company (the one paying the dividend) was reduced as a result of a dividend being paid. Where that determination was made by the tax authorities based on the outcome of various tests, then the tax-free dividend would be disallowed to the recipient corporation and there would instead be a taxable capital gain to that corporation.

Despite this, there were ways to "protect" an intercorporate dividend from the application of this basic rule. This type of protected dividend is referred to, appropriately, as "safe income". While very important, the concepts around safe income are complex and are therefore beyond the scope of this article.

Simply put, safe income can be defined as the equivalent of a corporation's taxed retained earnings. In other words, safe income consists of the after-tax earnings available for payment of a dividend.

As a result, even in a situation involving a transaction that might reduce the value of the operating company's shares following payment of a dividend to the parent company, if the amount of the dividend did not exceed the corporation's safe income on hand, there would be no tax implications and subsection 55(2) ITA would not apply.

The 2015 federal budget

The 2015 federal budget introduced some significant changes to the rules for the application of subsection 55(2) ITA, which broadened its scope considerably. Consequently, as of April 21, 2015,[1] matters became much more complex and the application of this subsection became much more generalized. Without going into all the technical details, we can say that the 2015 federal budget contained new measures[2] aimed at restricting the payment of dividends between corporations. Furthermore, two new tax tests[3] were added, and some of the considerations around safe income were changed. Now, many transactions[4] between a holding company and an operating company will fall within the ambit of these new provisions.

To summarize, these new provisions are much more restrictive and are intended essentially to prevent transactions, regardless of what form they take, that would reduce the capital gains that would otherwise have been realized. As a result, many transactions will now have to be validated in advance by a tax specialist to ensure they are in compliance with the tax legislation.

[1] The new provisions were assented to on June 22, 2016. The new rules are, however, retroactive to April 22, 2015.
[2] Subsections 55(2.2) to 55(2.4) ITA.
[3] The two new purpose tests are: 1) whether a significant reduction is effected in the fair market value of a share pursuant to clause 55(2.1)(b)(ii)(A) ITA; and 2) whether a significant increase is effected in the cost amount of the property of the dividend recipient pursuant to clause 55(2.1)(b)(ii)(B) ITA.
[4] See the explanatory notes from the Canada Revenue Agency (CRA) for more details.

Subsection 55(2) ITA and your practice as a financial security advisor

Although subsection 55(2) ITA can apply in a wide variety of different transaction scenarios, there are two situations in particular that financial security advisors may encounter where its provisions could potentially come into play.

1) Transfer of a life insurance policy from an operating company to a holding company

Corporate restructuring or the sale of an operating company will often lead to a change in the ownership structure of any life insurance involved. One common arrangement is for an operating company that is owned by a holding company to transfer ownership of the policy to the holding company. In such a case, the provisions of subsection 148(7) ITA would apply to the transfer.

As a result, the proceeds of disposition for the operating company will be the highest of the following amounts: the value of the policy (i.e., the cash surrender value), the fair market value (FMV) of the consideration paid by the holding company, and the adjusted cost basis (ACB) of the policy. The new ACB to the holding company is deemed to be equal to the proceeds of disposition. Lastly, the difference between the FMV of the policy and the amount paid as consideration for the transfer will be considered a taxable benefit to the transferee (holding company) pursuant to subsection 15(1) ITA.

To reduce or eliminate the assessment of a taxable benefit, the policy transfer could be considered as a dividend payable in kind.[5] The amount of the dividend would be equal to the FMV of the life insurance policy. The dividend could then be treated as a tax-free intercorporate dividend in kind.

Since 2015, the expanded scope of subsection 55(2) ITA has made this type of transaction rather more complicated. Financial security advisors should therefore check with their clients' tax specialists before proceeding with a life insurance policy transfer by means of a dividend in kind. Specifically, to prevent the application of subsection 55(2) ITA and allow the transfer of the policy to the holding company without triggering a capital gain, it's important to determine in advance that there is sufficient safe

---

[5] In Technical Interpretation 2016-067173 dated June 7, 2017, the CRA confirmed the tax treatment of the transfer of a life insurance policy by dividend in kind.

income (taxed retained earnings) attributable to the class of the operating company's shares used to pay the dividend in kind.

2) Disability insurance and critical illness insurance as part of a shareholders' agreement

It is quite common for disability insurance or critical illness insurance to be used for funding a shareholder buyout under conditions stipulated in a shareholders' agreement.

Let's look at an example: Two shareholders each own $750,000 worth of shares in an operating company, and their respective holding companies own $250,000 worth each. To protect itself in the event of one of the shareholders becoming disabled, the operating company purchases a disability buy-sell insurance policy in an amount of $1,000,000 on each of the two shareholders. If either of the shareholders becomes disabled, the operating company will be able to collect the $750,000 disability benefit, which it can then pay in the form of a special dividend to the holding company of the active shareholder for the purpose of acquiring the shares of the disabled shareholder. The active shareholder would then redeem the shares held by the holding company of the disabled shareholder for the remaining $250,000.

While this approach may at first glance appear to be perfectly valid, it could fall under the new rules in subsection 55(2) ITA, given the payment of the $750,000 special dividend to the holding company. As a result, under the new tax measures, the tax authorities could possibly consider the payment of this dividend to have caused a reduction in the market value of the operating company's shares, meaning that they could then recharacterize the dividend as a taxable capital gain.

To prevent this undesirable outcome, the recommendation is to appoint each shareholder's holding company as the sole beneficiary and owner of the disability or critical illness insurance. In such a case, to prevent the application of new subsection 55(2) ITA, it's important to ensure that the payment of a dividend from the operating company to the holding company to fund the premiums can be considered to be a compensation policy. In light of this situation, it's a good idea to suggest that clients with this type of insurance review the terms of their shareholders' agreement and the information contained in their insurance policy.

Conclusion

Advisors should keep in mind that subsection 55(2) ITA is highly complex. There are a number of situations in which the provisions of this subsection could potentially apply. This article merely presents some of the considerations relating to these tax rules. In view of the complexity of this topic, financial security advisors should refer their clients to a tax specialist for an expert opinion.

This document/post is intended to provide general information only, and cannot be treated as legal, accounting or tax advice. All content, views, expressions, or judgments articulated herein are of the author, and are not representative of the views of Sun Life, its employees, executives, customers, or business partners. Sun Life Assurance Company of Canada does not provide legal, accounting or taxation advice to advisors or their clients. Before a client acts on any of the information contained in this document, or before you recommend any course of action, make sure that the client seeks advice from a qualified professional, including a thorough examination of their specific legal, accounting and tax situation, as required.