INTRODUCTION TO TAX ATTRIBUTES

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BASIC ACCOUNTING CONCEPTS

Shareholders' Equity

The "shareholders' equity" account on a corporation's balance sheet represents the value of assets less liabilities. Shareholders' equity consists of three accounts - share capital, contributed surplus (if any) and retained earnings.

Retained Earnings (Earned Surplus)

Retained Earnings represent accumulated undistributed income net of any losses, miscellaneous charges and dividend payments.

Contributed Surplus

Where contributions are made to a corporation and these contributions are not added to a particular stated capital account, such amount is generally added to contributed surplus. The CICA defines contributed surplus as:

1. *Surplus contributed by shareholders, being the premium received on the issue of par value shares, the portion of proceeds of issue of no par value shares that has been allocated to surplus, the proceeds of sale of donated shares, profit on forfeited shares, credits resulting from redemption or conversion of shares at less than the amount set up as share capital or any other contributions in excess of stated value of shares made by shareholders as such.*

2. *Capital donations from sources other than shareholders.*

STATED CAPITAL

Definition

The term "stated capital" relates to the amount of consideration that a corporation receives for the issuance of its shares. The composition of share capital under corporate law depends on the jurisdiction of incorporation. Where par value shares (i.e.: a fixed value per share that a company has chosen in its incorporating documents) are permitted, the stated capital of a class will be its aggregate par value. Par value shares are permitted under provincial legislation in British Columbia, Nova Scotia, Prince Edward Island, New Brunswick and Quebec. A par value share may not be issued for less than its par value, but may be issued for more. Any amount received on the issue of par value shares in excess of par value is not included in stated capital but is added to contributed surplus.

Under the *Canada Business Corporations Act* ("CBCA") and legislation under Alberta, Ontario, Manitoba, Saskatchewan, Newfoundland, the Northwest Territories and the Yukon, shares are to be issued without nominal or par value. The stated capital of shares issued without par value is the amount of consideration that the corporation receives for the issue of such shares, subject to the adjustments described below. The CBCA provides that a corporation must maintain a separate stated capital account for each class and series of shares that it issues (subsection 26(1)). Shares are not to be issued until full consideration is received for the share in money, property or past service that is not less in value than the fair market value of the share (subsection 25(3)). Where property or past services are paid as consideration for shares, the dollar value of the property or services is added to the stated capital account.

Adjustments to Stated Capital

Adjustments

A corporation under the CBCA (subsection 26(3)) is permitted, in certain non-arm's length transactions and pursuant to certain amalgamation agreements, to add to stated capital an amount that is less than the consideration received for the shares issued pursuant to the transaction. This provision under the CBCA allows for the issuance of "high-low shares" which have a low paid-up capital and high redemption amount. High-low shares are often used for tax purposes to convert what would have been a capital gain into a deemed dividend, as dividends are generally received tax-free between Canadian corporations.

Any changes to stated capital should take into account corporate solvency tests in the applicable provincial legislation.

Reductions

Stated capital may be reduced under subsection 38(1) of the CBCA for the purpose of (i) reducing or extinguishing liabilities in respect of an amount unpaid on any share, (ii) making a distribution to a shareholder; and (iii) reducing stated capital by an amount that is not represented by realizable assets.

When a corporation purchases or redeems its own shares, the corporation (under subsection 39(1) of the CBCA) must reduce its stated capital for the particular class or series of shares being redeemed on a pro-rata basis.

Additions

Share capital of a corporation may be increased under subsection 26(4) of the CBCA by adding the amount of consideration received by it for the issued shares (as discussed above). Share capital may also be increased by special resolution to add an amount that the corporation credited to retained earnings or other surplus accounts (subsection 26(5)).

PAID-UP CAPITAL

Definition

Paid-up capital ("PUC") is the expression used by the *Income Tax Act* (Canada) (the "Act") to refer to the capital concept. In general, PUC may be returned to shareholders of a corporation, including non-resident shareholders, free of tax. All other corporate distributions are either dividends or taxable shareholder benefits. PUC is therefore relevant in determining the tax consequences of corporate reorganizations, distributions and dissolutions.

Where a private corporation[1] returns cash to its shareholders other than by way of redemption, the directors may choose to pay the shareholders by way of a dividend or a tax-free return of capital. Tax law in the U.S., by contrast, generally provides that any distribution (however characterized) will be treated as a dividend to the extent the corporation has undistributed earnings or profits at the time of the distribution.

The starting point for the computation of the PUC of a class of shares is the stated capital of the class for corporate law purposes.[2] The PUC of a class of shares is equal to its stated capital, plus or minus certain adjustments specified in the Act. The adjustments are generally designed to prevent a corporation from using tax-deferred transactions to increase the stated capital of the corporation and thereby obtain an increased PUC.

While stated capital is a cumulative amount calculated in relation to a class or series of shares, the value of PUC must be determined for a particular share. The PUC of a share of a particular class is calculated by dividing the PUC for the particular class by the number of issued shares in the class. All the shares of a particular class will have the same PUC per share. Consequently, as a corporation issues new shares (of the same class), the PUC of the existing shareholders will vary unless the shares are always issued for the same price. For example, if a corporation issues its initial 100 common shares for $100 (a fairly common practice) the PUC of each share will be $1. If the corporation subsequently increases in value and issues a further 200 shares to new investors for $20,000, the PUC per share will be $67.00 ($20,100 ÷ 300). The original investors who started with a PUC of $100 for 100 shares, without any additional investment, would then have a total PUC of $6,700. The new investors after purchasing 200 shares for $20,000 will have a total PUC of only $13,400. To avoid this problem, private corporations will utilize a new class of shares similar to the existing class for new share issuances, so that the PUC's of different share issues are not averaged.

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[1] Subsection 84(4.1) deems a return of capital by a public corporation to be the payment of a dividend except when it occurs by way of the purchase, cancellation or redemption of shares, a transaction described in subsection 84(2) or section 86 or the reduction arises from the distribution of proceeds realized by the corporation from a transaction that occurred outside the ordinary course of business within the previous 24 months.

[2] Definition of "PUC", subsection 89(1). See also IT-463R2. The Act and the bulletin refer to the PUC of a corporation determined without reference to the Act (except the specified provisions). However, most corporate statutes do not refer to the concept of PUC and it is generally accepted that the reference to PUC determined without reference to the Act means "stated capital" or the equivalent term used in the relevant corporate statute.

A corporation's balance sheet generally reflects the amount of stated capital in the corporation. While a corporation's stated capital may equal its PUC, there are certain situations where the two amounts could be different. For example, on the transfer of assets in exchange for shares under section 85 of the Act, paragraph 85(2.1)(a) of the Act requires that the increase in PUC from the issue of the shares be reduced where the amount added to PUC exceeds the agreed amount under the subsection 85(1) election (such reduction is generally referred to as a "PUC grind"). In that case, the amount added to stated capital would exceed the amount added to PUC as determined under the Act. In these circumstances, it is often advisable for corporate counsel to utilize subsection 26(3) of the CBCA to add a lesser amount to the stated capital account of the corporation to keep the stated capital and PUC equal.

Deemed Dividends

In general, any amount received by a shareholder from the corporation in excess of PUC will be taxed in the shareholder's hands as a deemed dividend. Section 84 provides rules that deem a dividend to have been paid by a corporation and received by a shareholder when the corporation increases PUC without correspondingly increasing its net asset value (subject to certain exceptions).

Subsection 84(1) provides exceptions to the deemed dividend provisions arising upon an increase in PUC where (i) stock dividends are issued (paragraph 84(1)(a)); (ii) the increase in PUC in one class of shares is offset by a decrease in PUC in another class of shares (paragraph 84(1)(c)); and (iii) on a capitalization of contributed surplus (paragraph 84(1)(c.3)).

Stock Dividends

A stock dividend is defined in subsection 248(1) of the Act to include any dividend paid by a corporation by the issuance of shares of any class of its capital stock. A corporation may increase its stated capital by issuing stock dividends which are taxable as regular dividends in the shareholders' hands. CBCA subsection 43(2) provides that a corporation is to add to stated capital the amount of dividend declared (as opposed to fair market value) in respect of shares issued on a stock dividend. In general, the "amount" (as defined in subsection 248(1) of the Act) of the dividend to be taxed on the issuance of a stock dividend is the amount by which PUC increased by reason of the dividend payment.

Capitalization of Surplus

A corporation may convert contributed surplus of a class of shares without triggering a deemed dividend if the contributed surplus arose <u>after March 31, 1977</u> (i) on the issuance of shares where the stated capital of the issued shares was less than the consideration received excluding contributed surplus arising from transactions described in sections 51, 66.3, 84.1, 85, 85.2, 86, 87, 192(4.1), 194(4.1) or 212.1 (which are provisions which specifically mandate a PUC which may be less than the stated capital of the shares); (ii) on the acquisition of property by the corporation from a shareholder of that class for no consideration or for consideration that did not include shares of the corporation; or (iii) on a prior reduction of PUC on that class of shares.

WHERE PUC DEPARTS FROM STATED CAPITAL

The situations in which the Act requires that PUC be computed differently from stated capital can be broken down into four categories; (i) rollover transactions, (ii) tax benefit adjustments, (iii) anti-surplus stripping provisions,[3] and (iv) historical adjustments.

(i) Rollover Transactions

The Act contains a number of provisions that allow for the exchange of shares (sections 51, 85.1, 86, 87) or the transfer of property (section 85) without triggering immediate tax consequences. The quid pro quo of utilizing these provisions to avoid gains on the disposition of shares or property is that the taxpayer does not obtain an increase in the tax attributes of such shares or property.

The provisions of subsections 51(3), 85.1(2.1), 86(2.1), 87(3), and 87(9) generally provide that if the increase in the PUC of the new shares received as a result of the rollover transaction exceed the PUC of the old shares disposed of as part of the rollover transaction, the PUC of the new shares is reduced by the amount of such excess on a pro rata basis. Simply put, the PUC of the new shares cannot exceed the PUC of the old shares.[4]

A similar principle applies to section 85 rollover transactions, although the rule is slightly different because section 85 deals with the transfer of property generally (which may include, but is not restricted to shares) on a tax deferred basis in exchange for at least one share of the transferee corporation, together with other non-share considerations if desired by the parties. Since the property transferred under section 85 is not necessarily shares, the PUC of the shares received on the transfer cannot be based upon the PUC of the transferred shares but is instead based on an “elected amount”. Section 85 allows the transferor and the transferee to elect, for tax purposes, the price (the “elected amount”) at which the property is transferred to the transferee. Under subsection 85(2.1), the PUC of the shares received in consideration for the transferred property may not exceed the elected amount less the amount of any non-share considerations.

If a share for share exchange is conducted under section 85, the rules for determining the PUC of the shares received is different than exchanges conducted under sections 51, 85.1, 86 and 87. As noted above, the PUC of the shares received on the exchange will be based on the elected amount, less other non-share considerations received, not on the PUC of the exchanged shares.[5]

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[3]There is such a close nexus between the rollover transaction category and the anti-surplus stripping category that one might consider combining these two categories.

[4]Section 86 allows a shareholder to exchange shares of a corporation (old shares”) in return for new shares of the same corporation and, if desired, other non-share consideration. If such non-share consideration is received, the PUC of the new shares cannot exceed the PUC of the old shares less the amount of the non-share consideration.

[5]If the exchange of shares takes place between parties not dealing at arm’s length, section 84.1 may have application to prevent the shares received on the exchange from having a PUC greater than the shares transferred. See the discussion of section 84.1 below.

(ii) Tax Benefit Adjustments (Subsections 66.3(4), 192(4.1) and 194(4.1))

Some incentive provisions of the Act allow a corporation to flow out to its shareholders either expense deductions or tax credits which in the absence of the transfer to the shareholders would have been available to the corporation. The Act treats the flow out of such benefits very much like a return of capital to the shareholder and therefore reduces the PUC of the class of shares through which such benefits are provided.

Consequently, the PUC of a class of flow through shares which allows the holder to deduct from his or her income exploration expenses incurred by the issuing corporation and renounced to its shareholders, is reduced under subsection 66.3(4) by 50% of the amount of the renounced expenses. Assuming that the shareholder is subject to tax at a marginal rate of 50%, the amount of PUC reduction equals the tax savings realized by the holders as a result of the flow out of the exploration expense deductions.

Similarly, subsections 192(4.1) and 194(4.1) reduce the PUC of a class of shares with respect to the amount of investment tax credits and scientific research tax credits that were designated by the corporation and effectively transferred to the shareholder under these incentive provisions.

The ability of a corporation to designate amounts on account of tax credits does not extend to shares issued after 1986 for investment tax credits or to shares issued after May 22, 1985[6] for scientific research and experimental development tax credits. However, the PUC adjustments continue to be relevant because classes of shares in respect of which such credits were designated may still be outstanding.

As the full amount designated on account of investment tax credits and 50% of the amount designated on account of scientific research and experimental development tax credits was deductible against taxes payable by the shareholder (which is more advantageous than a simple deduction from income), the full amount of the designation in respect of investment tax credits, and 50% of the amount designated in respect of scientific research and experimental development tax credits were deducted from the PUC of the class of the shares in respect of which the designations were made.

(iii) Anti-Surplus Stripping Provisions

Sections 84.1 and 212.1 are designed to prevent a shareholder from converting distributions that would otherwise be taxable dividends into gains which may be exempt from tax by virtue of the section 110.6 capital gains exemption, the V-day value tax free zone or an income tax treaty provision.

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[6] Subject to certain grandfathering provisions for shares which were issued under written agreements made before that time.

Section 84.1 applies if a taxpayer (other than a corporation) transfers shares of a Canadian Corporation (the "subject corporation") to another corporation with which the taxpayer does not deal at arm's length (the "purchaser corporation") and, after the transfer, the subject corporation is connected to the purchaser corporation. The subject corporation would be connected to the purchaser corporation if the purchaser corporation (or the purchaser corporation and persons with whom it does not deal at arm's length) controls the subject corporation, or if the purchaser corporation owns shares of the subject corporation representing more than 10% of the voting rights and fair market value of all the shares of the subject corporation.

If section 84.1 applies, the PUC of any shares of the purchaser corporation received as consideration for the transfer of the shares in the subject corporation cannot exceed the greater of (i) the PUC of the shares in the subject corporation and (ii) the arm's length adjusted cost base of the subject shares less, in each case, the value of any non-share consideration received on the transfer.

The "arm's length adjusted cost base" is the term coined by the Canada Customs and Revenue Agency (the "CCRA") to refer to the adjusted cost base of the shares less:

(i) for shares outstanding prior to December 31, 1971 ("V day") or substitutes for such shares, the amount of the V-day tax free zone; and

(ii) the amount of any capital gains exemption that was claimed on the disposition of the shares by the taxpayer or an individual with whom the taxpayer did not deal at arm's length.

Section 84.1 was designed to stop the following type of transaction. Parent owns shares of Opco which were acquired in 1967 for a cost of $1000 and which had a PUC of $10. On December 31, 1971 the shares were worth $10,000 and at the time of transfer the shares are worth $100,000. If Opco purchased the shares for cancellation, Parent would have a deemed dividend of $99,990. Absent section 84.1, Parent might sell the shares to Child for a $100,000 promissory note which would trigger a capital gain of $90,000 ($100,000 proceeds - $10,000 V-day value). Parent then claims the capital gains exemption to avoid tax on this gain.

Child would then transfer the Opco shares to Holdco for $100,000 payable in redeemable shares of Holdco. Child has no gain on this transaction as the proceeds of disposition are equal to Child's adjusted cost base of the Opco shares. If section 84.1 did not reduce the PUC of the Holdco shares, Child could have Holdco redeem the shares for $100,000, and Child would use the $100,000 to pay out the promissory note to Parent, effectively stripping $100,000 from the corporation tax free.

However, section 84.1 reduces the PUC of the Holdco shares so that it does not exceed the greater of the PUC of the Opco shares of $10 and the arm's length adjusted cost base of the shares of $1,000 (normal adjusted cost base $100,000 - less $90,000 capital gains exemption less $9,000 pre-V-day increase in value). The end result is that section 84.1 allows the taxpayer to strip out earnings in excess of PUC but not exceeding the original arm's length purchase cost of the shares. If the taxpayer receives non-share considerations in excess of the greater of the PUC and the arm's length adjusted cost base of the shares, the amount of such excess would be deemed to be a dividend and the PUC of any share considerations received would be nil.

Section 212.1 operates in a similar manner to 84.1, but is designed to prevent non-residents from stripping earnings from corporations resident in Canada by converting them into treaty exempt taxable capital gains.

Section 212.1 applies where a non-resident person, designated partnership (defined as a partnership where either a majority interest partner or every member of a majority interest group of partners is a non-resident person) or a non-resident-owned investment corporation ("NRO") disposes of shares in a corporation resident in Canada (the "subject shares") to another corporation resident in Canada (the "purchaser corporation") with which the non-resident, designated partnership or NRO does not deal at arm's length and immediately after the disposition, the subject corporation is connected to the purchaser corporation.

If section 212.1 applies, the PUC of the shares of the purchaser corporation received in consideration for the transfer of the shares of the subject corporation may not exceed the PUC of the transferred shares less the amount of any non-share consideration received on the transfer. If the non-resident receives non-share considerations in excess of the PUC of the shares, the amount of such excess would be deemed to be a dividend and the PUC of any share consideration received would be nil.

Section 212.1 was enacted to prevent a non-resident from transferring shares of a Canadian Opco with an accrued gain to a Canadian Holdco, taking back shares in Holdco with a PUC equal to the value of the Opco shares, and claiming an exemption from Canadian taxation on the capital gain arising on this transfer under an Income Tax Convention and then redeeming the shares or returning the full amount of the PUC free of Canadian tax.

Unfortunately section 212.1 is indiscriminate in its application as it also applies when no treaty exemption is available and could result in double (or even triple) taxation to the unwary. The 1998 Federal Budget proposed that section 212.1 not apply to shares that were taxable Canadian property where Canada had the right to tax any gains arising from the disposition of the shares and such gains were not exempt from tax under a tax treaty. However, according to a Finance Canada News Release in October 1998, it was decided that legislation to implement these proposals would be delayed for further study.

New proposed section 212.2 is designed to prevent surplus stripping on the demutualization of a Canadian insurance company. Finance was concerned that in circumstances where an insurance corporation ("Insurco") was in the process of being demutualized and was controlled by a Canadian corporation ("Holdco"), the following technique would be used to avoid Part XIII withholding tax:

> *Insurco issues shares to a non-resident policyholder on a demutualization. Rather than Insurco redeeming the share, Holdco buys the shares and several days later uses dividends received from Insurco to fund the purchase price.*

> *If Insurco had redeemed the share, there would have been a deemed dividend equal to the amount of the proceeds of redemption. By having Holdco buy the shares, the deemed dividend rules are avoided. Dividends received from Insurco in the example would be received on a tax-free basis because of the intercorporate dividend deduction.*

As the draft legislation is not of general application, but only applies to dispositions forming part of a series of transactions or events that includes the issue of a shares on the demutualization of an insurance corporation, the rules governing its application are not reviewed here. If the provision is applicable, the proceeds of disposition of the share in excess of its PUC will be deemed to be a dividend.

(iv) Historical Adjustments

Prior to April 1, 1977, there were complex provisions in the Act for computing PUC, "PUC deficiencies" and "PUC limits" which dealt with the difference between V-day value and the PUC of shares. In general terms, subsection 84.2(1) states that if a corporation's PUC, as determined on April 1, 1977, exceeds the corporation's PUC limit as determined on March 3l, 1977, then this excess reduces the corporation's PUC after March 31, 1977 to the extent that this excess was attributable to a paid-up capital deficiency (under former paragraph 89(1)(d)). The total PUC reduction calculated under subsection 84.2(1) is pro-rated among the class of issued shares of the corporation. PUC may also be increased by any amount of deemed dividend that resulted under subsections 84(3) and 84(4) from this PUC reduction.

ADJUSTED COST BASE

Definition

Adjusted cost base ("ACB") is the term used by the Act to refer to the cost of property. The adjusted cost base of property is relevant in determining the capital gain or capital loss arising from the disposition of capital property. It is defined in section 54 of the Act as "the capital cost to the taxpayer" with respect to depreciable property and in any other case as "the cost to the taxpayer of the property adjusted, as of that time, in accordance with section 53".

The terms "cost" and "capital cost" are generally considered to be synonymous with respect to capital property[7] and "capital cost" has been held to mean:

> *the actual factual or historical cost to the appellant of depreciable property when acquired.*[8]

The CCRA, in IT-285R2, defines "capital cost" as the full cost to the taxpayer of acquiring the depreciable property including legal, accounting and engineering costs, and in the

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[7] Ottawa Valley Power Co. v. MNR 69 DTC 5166 footnote at 5169 (Ex. Ct.).

[8] Cockshutt Farm Equipment Ltd. v. MNR 66 DTC 544 at 551 (T.A.B.).

case of a property that a taxpayer manufactures for his or her own use, material, labour and overhead costs reasonably attributable to the property.

Components of Cost

These definitions still leave open the question as to what is included in the "historical" cost:

The Exchequer Court in *Sherritt Gordon Mines Ltd. v. MNR*[9] held that interest expense incurred on borrowed money used to build depreciable property during its construction could be capitalized and added to its capital cost for the purposes of the Act. This concept was later incorporated specifically into the Act in section 21.

However, in the case of non-depreciable property, the Federal Court of Appeal in *The Queen v. Geoffrey Stirling*[10] held that interest incurred on money borrowed to acquire gold bullion during the period that the gold bullion was held pending its sale, did not form part of the cost of the property.

The two decisions are not necessarily inconsistent. In Sherritt Gordon, the interest expense was incurred during the period the asset was being constructed, before it was effectively acquired, and arguably was as much a part of its construction cost as labour, electricity, materials and other inputs. Once the asset was completed, the interest component would form part of the fixed acquisition cost. In Stirling, the interest expense was incurred after the asset was acquired so it is more difficult to treat it as an acquisition cost. Further, the interest expense in Stirling continued to accumulate over the period that the gold bullion was held, so that if such interest formed part of the asset cost, the cost would be constantly increasing.

Although the Court of Appeal did not refer to Sherritt Gordon in the Stirling decision, it has called into question its validity, stating:

> *As we understand it the word "cost" in those sections [40 and 54] means the price that the taxpayer gave up in order to get the asset; it does not include any expense that he may have incurred in order to put himself in a position to pay that price or keep the property afterwards.*

In *Alberta Wheat Pool and Saskatchewan Wheat Pool v. The Queen*[11] the Tax Court was asked to determine whether construction period interest could be added to the cost of depreciable property without reliance on section 21 of the Act. Judge Bonner held that the inclusion of interest in the cost in the absence of an election under section 21 was contrary to the scheme of

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[9] 68 DTC 5180.

[10] 85 DTC 5199.

[11] 96 DTC 1795 (TCC), aff'd FCA docket A-835-96, decision dated April 13, 1999.

the Act and further commented (in obiter) that notwithstanding that Parliament had subsequently adopted the result in Sherritt Gordon by incorporating it into the Act, in his view:

> *That case was not correctly decided. It is difficult to comprehend how "... the return or consideration or compensation for the use or retention by one person of the sum of money, belonging to, in a colloquial sense, or owed to, another, ... can, in the absence of express statutory direction, be regarded as part of the "... capital cost to the taxpayer of property ..." within paragraph 20(1)(a).*

The Federal Court of Appeal agreed with Judge Bonner's reasoning and conclusion that the appellants were not entitled to capitalize interest on money borrowed during the construction of a terminal elevator. Rothstein, J.A., however, stated that he did not find it necessary to address Judge Bonner's "obiter comment that Sherritt Gordon ... was wrongly decided". Rothstein, J.A., instead, held that section 21 had superseded Sherritt Gordon, "... at least with respect to the capitalization of construction period interest".

V-Day Value Adjustments

For capital property owned prior to December 31, 1971, adjustments to either the cost of property or the proceeds of disposition are made to compensate for the fact that prior to 1972, capital gains were not subject to taxation.

In the case of depreciable property, the adjustment is made by decreasing the proceeds of disposition by the amount of any increase in value of the property from the time of purchase to December 31, 1971 ("V-day") under section 20 of the Income Tax Application Rules ("ITAR").

In the case of non-depreciable property, the cost of such property is determined by the V-day value rules described in section 26 of ITAR. Generally, the cost of non-depreciable property is the median of 3 values (i.e. neither the greatest nor the least):

(i) the historical cost of the property;

(ii) the fair market value of the property on V-day; and

(iii) the proceeds of disposition of the property, or if the property has not been sold, its fair market value as of the date cost is being determined.

If any of the above values are the same, the cost is that value.

Section 52 Cost Amounts

Section 52 specifies the cost for certain types of property. Most importantly, subsection 52(1) provides that where a taxpayer receives property, and an amount in respect of that property was included in the taxpayer's income, the amount so included shall be added to the taxpayer's cost of the property, except to the extent the amount was otherwise added to cost or included in computing the ACB of the property. Section 52 also provides that:

- the cost of any property received as a dividend in kind is the fair market value of the property (subsection 52(2)).

- the cost of shares received as a stock dividend is the amount of the dividend (defined under subsection 248(1) of the Act, as the increase in PUC arising from the stock dividend) less (if the Technical Amendments of November 22, 2006 come into force) the amount of the dividend that the shareholder may deduct under subsection 112(1) in computing taxable income (subsection 52(3)).

- the cost of property acquired as a prize is the fair market value of the property (subsection 52(4)).

Absent the amendment to subsection 52(3) proposed by the Technical Amendments of November 22, 2006, a corporate taxpayer could transfer property with an accrued gain to a subsidiary and elect under subsection 85(1) for the transfer to occur at the adjusted cost base of the property, with the result that although no gain would be realized on the transfer, the adjusted cost base of the shares taken back (assuming no boot) would be limited to the original cost base of the transferred property. The corporate taxpayer could then boost the total adjusted cost base of its shares in the subsidiary by causing the subsidiary to declare a stock dividend equal to the difference between the fair market value of the transferred property and the elected amount. The amount of the stock dividend would effectively be tax free to the corporate taxpayer by reason of the deduction from taxable income provided under subsection 112(1) of the Act and, assuming that the stock dividend was not part of a series of transactions that included the future transfer of the shares received as a result of the stock dividend, subsection 55(2) would not apply to convert the stock dividend to a capital gain. Presumably the Department of Finance felt that this tax free boost in the adjusted cost base of shares in these circumstances was inappropriate given the rules for computing the adjusted cost base of shares on a section 85 rollover. However, the proposed amendments go too far. It has always been accepted that a corporate shareholder could strip surplus from a subsidiary on a tax free basis using a dividend payable from safe income, but the proposed amendments would effectively prohibit a corporation from distributing safe income to a subsidiary using a stock dividend. There is no policy basis for prohibiting the distribution of safe income in this way.

Adjustments to ACB

After the cost or capital cost of the property is established and any variations with respect to V-day are made under ITAR, section 53 of the Act requires further adjustments to cost to arrive at the adjusted cost base ("ACB") of property. Increases to cost are mandated by subsection 53(1) and decreases by subsection 53(2) of the Act.

The adjustments are too numerous to describe each specifically, but generally are designed to avoid amounts being both included in (or deducted from) income and forming part of a taxable capital gain (or allowable capital loss). Thus, if the cost of certain property was deductible in computing a taxpayer's income, the amount of such income deduction is deducted from the adjusted cost base of the property (paragraph 53(2)(m)), or if the receipt of certain property resulted in an income inclusion, such income inclusion would be added to the ACB of the property (paragraph 53(1)(j) employee stock options and subsection 52(1) other property).[12] Some specific adjustments required by subsections 53(1) and (2) are:

Additions to ACB

- the amount of deemed dividends arising from an increase in the PUC of shares under subsection 84(1) less (if the Technical Amendments of November 22, 2006 come into force) the amount of the deemed dividend that the shareholder may deduct under subsection 112(1) in computing taxable income that is attributable to the conversion of contributed surplus into paid-up capital[13] is added to the ACB of those shares (paragraph 53(1)(b)).

- where a shareholder makes a contribution of capital to the corporation (excluding rollover transactions and contributions which conferred a benefit on a related person other than the corporation) the ACB of each share of the shareholder is increased by the proportion of the capital contribution that (i) the amount that the fair market value of the share has increased as a result of the contribution is of (ii) the amount that the fair market value of all shares of the corporation owned by the shareholder have increased as a result of the contribution[14] (paragraph 53(1)(c)).

- the amount of any benefit included in a taxpayer's income under section 7 in respect of an employee stock option is added to the ACB of the share acquired under the option (paragraph 53(1)(j)).

Deductions from ACB

- the amount of dividends received on a share (other than taxable dividends or dividends in respect of which an election under subsection 83(2) or (2.1) was made) is deducted from the ACB of the share on which the dividends were received (subparagraph 53(2)(a)(i)).

- any amount received by a shareholder on a share in reduction of the PUC of the share that was not deemed to be a dividend under subsection 84(4) or (4.1) is deducted from the ACB of such share (subparagraph 53(2)(a)(ii)).

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[12]There does not appear to be any policy reason why some of these adjustments are made under section 52 and others under subsection 53(1).

[13] This proposed technical amendment addresses the same point as the proposed amendment to subsection 52(3), however here the proposed amendment would allow a deemed dividend attributable to safe income to increase the adjusted cost base. We do not understand the reason for the more onerous treatment of stock dividends compared to an increase in PUC achieved through a stated capital increase.

[14]Based on the application of this formula any capital contribution which results in any increase in the FMV of a shareholder's shares (excluding rollover transactions and benefits to related persons) will allow the full amount of the capital contribution to be added to the ACB of the shareholder's shares. If the capital contribution does not increase the FMV of the shares at all, the CCRA takes the position in paragraph 5 of IT-456R and Technical Interpretation SE91-204 dated September 4, 1991 that no amount of the capital contribution may be added to the adjusted cost base of the shares.

- the amount of limited recourse debt used to acquire certain interests in a partnership excluding partnership interests that are tax shelter investments (see section 143.2), may be deducted from the ACB of that partnership interest (subparagraph 53(2)(c)(i.3)).

- the amount of government assistance (grants, subsidies), other than specified exclusions, is deducted from the ACB of the property in respect of which the government assistance was received (paragraph 53(2)(k)).

- where the cost or any part of the cost of property was deductible in computing the taxpayer's income such cost or part thereof is deducted from the ACB of the property (paragraph 53(2)(m)).

Interpretation Bulletin IT-456R dated July 9, 1990 sets out the CCRA's views on adjustments to cost base for various capital properties including a share of a corporation, substituted property, a capital interest in a trust and vacant land.

Identical Properties Rule

Under section 47 of the Act, the ACB of an "identical property" of a taxpayer is the average of the costs of all property of the taxpayer that is identical property of the same class. Identical property is not defined in the Act (except in respect of bonds in subsection 248(12)). The CCRA, in Interpretation Bulletin IT-387R2 has stated that identical properties:

> *are properties which are the same in all material respects, so that a prospective buyer would not have a preference for one as opposed to another.*

The classic examples of identical properties are shares of the same class of a corporation, bonds or debentures of the same issue and gold certificates. The advantage of the identical properties rule is that a taxpayer need not seek to specifically identify which particular item of a group of identical properties has been sold (the first acquired or the last). In some cases, it may be physically impossible to distinguish between identical properties. The disadvantage of the rule is that it may trigger gains or losses earlier than a taxpayer anticipates.

Assume a taxpayer acquired 50 shares of a company for a total price of $100 ($2 per share) in 1997. The shares have now risen in value to $8 per share and the taxpayer proposes to buy 10 more shares to give as a gift to his or her child. On the gift of the shares, the taxpayer will be deemed to have disposed of the shares under section 69 for their fair market value of $80 (the same as the cost of the recently acquired shares). However, the 10 shares gifted to the child will have an ACB of $30[15] resulting in a capital gain of $50. As a result of the ACB averaging rule, the taxpayer is taxed on a capital gain even though he purchased and sold shares for the same price.

[15] $180 [total purchase price of all shares] ÷ 60 [total number of shares purchased] x 10 [number of shares disposed of].

The same rule can be used to the taxpayer's advantage. If a taxpayer holds shares which have decreased in value and he wishes to realize the loss on those shares without disposing of the shares, he can acquire identical shares, hold the shares for 30 days (to avoid the application of the superficial loss rule) and then sell the desired number of shares to trigger the loss.

Negative ACB

Where amounts to be deducted from the ACB of a property (other than an interest in certain partnerships)[16] under subsection 53(2) exceed the cost of such property plus amounts to be added to its ACB under subsection 53(1), subsection 40(3) deems such negative amount to be an immediate capital gain. The ACB is then brought back to zero by adding such gain to the ACB of the property (paragraph 53(1)(a)). Consequently, if a corporation is returning capital to its shareholders, the amount by which the return of capital exceeds the ACB of the share[17] will be a deemed capital gain, notwithstanding that the shareholder has not disposed of the share.

Allocating and Manipulating ACB

As discussed earlier, where property is converted, exchanged or transferred for shares under one of the rollover provisions of the Act, the ACB of the shares received on the transaction cannot exceed the ACB of the property converted, exchanged or transferred, less the amount of any non-share considerations received by the taxpayer. When the taxpayer is receiving more than one class of share as a result of the rollover transaction, subsections 51(1) (convertible property), 86(4) (reorganization of capital) and 87(4) (amalgamations) allocate the available ACB amongst the classes of shares pro-rata based upon the fair market value of each class of shares received on the transaction.[18]

The allocation of ACB is determined differently for classes of shares received on a transfer of property under section 85. Under paragraphs 85(1)(g) and (h) of the Act the amount of ACB available to be allocated amongst shares is allocated first to preferred shares (up to but not exceeding the fair market value of such shares) and secondly to common shares. This allows a taxpayer to use section 85 to create a class of high value, high ACB shares.

For example, assume a taxpayer owns 100 shares (all of the outstanding shares of a private corporation) which have an ACB of $250,000 and a fair market value of $600,000. The taxpayer wishes to sell 50 of the shares to a key employee. A straightforward disposition of the shares would result in a capital gain of $175,000. Alternatively, the taxpayer could transfer all of

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[16] Subsection 40(3) applies to all capital property except partnership interests, and subsection 40(3.1) applies a similar deemed capital gain rule to negative ACB to all partnerships other than partnerships in which the partner is an active participant in the business of the partnership.

[17] A return of capital may exceed the ACB of the share whenever the PUC of the share exceeds its ACB. This will arise whenever the current shareholder has acquired the share from a person other than the issuing corporation at a price less than the original subscription price.

[18] $$\text{ACB of particular class} = \text{ACB available} \times \frac{\text{FMV of particular class}}{\text{FMV of all classes of shares received}}$$

his common shares to the corporation in exchange for 50 preferred shares and one common share. The terms of the preference shares would allow each such shares to be converted to 1/50th of a common share.

The taxpayer and the corporation would elect, under section 85, for the exchange to take place at $250,000, the ACB of the 100 common shares. Under section 85 the elected amount is first allocated to any non-share consideration received by the transferor (to the extent of its fair market value), then it is allocated to the preferred shares received (to the extent of their fair market value), and finally to the common shares. As a result of the section 85 election, all of the $250,000 ACB of the initial common shares would be allocated to the preferred shares.

The taxpayer could then sell the preferred shares to the key employee for $300,000, realizing a capital gain of only $50,000 ($300,000-$250,000). As a result of the section 85 reorganization, the taxpayer was able to allocate all of the ACB of its existing common shares to the special class of preferred shares intended to be sold. The purchaser of the preferred shares could then exercise the conversion feature of the shares to receive one common share (50% of the issued common shares).[19]

In other transactions, taxpayers have attempted to use the rollover provisions of subsection 73(1) and the identical properties rule to achieve income splitting. The CCRA has reassessed these transactions to deny the income splitting on the basis that they are contrary to the general anti-avoidance rule.[20] Without commenting on the application of GAAR, here is an example of such a transaction to demonstrate the possible manipulation of ACB that can occur under the rules.

Assume a taxpayer was planning to dispose of 100 shares of a corporation which had a fair market value of $2,000,000 and an ACB of $500,000. Before selling the shares to a third party, the taxpayer would sell one half of the shares to his or her spouse for their fair market value, electing that the provisions of subsection 73(1) not apply (no automatic rollover at ACB). The spouse would therefore acquire these shares at a cost equal to their fair market value of $1,000,000. The taxpayer would then gift the balance of the shares to his or her spouse. Under subsection 73(1) the taxpayer would be deemed to dispose of those shares for their ACB of $250,000 (1/2 of $500,000). Under the attribution rules, any gain by the spouse arising from the sale of the gifted shares would be attributed back to the taxpayer. The spouse would then sell all of the shares to a third party.

As a result of the transfer of shares to the spouse, the application averaging provisions of section 47 and the attribution rules, the gain of $1,500,000 inherent in the shares would be allocated $375,000 to the spouse and $1,125,000 to the taxpayer, as follows:

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[19] As this transaction results in a benefit to the transferor, the provisions of section 245 would need to be analyzed to determine if GAAR might recharacterize the transaction.

[20] It is my understanding that the taxpayers who have been reassessed on this issue have either not appealed the reassessments or have abandoned such appeals before trial.

- Sale of 50 shares with an ACB of $250,000 to spouse for proceeds of $1,000,000 (electing out of section 73) results in a gain of $750,000 to taxpayer and an ACB of the shares to spouse of $1,000,000.

- Gift of 50 shares with an ACB of $250,000 to spouse results in a transfer to spouse under section 73 at a value of $250,000 (no gain to taxpayer) at an ACB to spouse of $250,000.

- The ACB of the first lot of shares and the second lot of shares are averaged resulting in an ACB per share of $12,500 (ACB of all shares is $1,250,000 [$1,000,000 from first lot + $250,000 from second lot] ÷ 100).

- Gain on sale of first lot of shares by spouse is $375,000 ($1,000,000 proceeds - $625,000 ACB [50 x 12,500]). This gain is not attributed back to taxpayer since spouse paid fair market value for these shares.

- Gain on sale of second lot of shares by spouse is $375,000 ($1,000,000 proceeds - $625,000 ACB). This gain is allocated back to taxpayer as these shares were gifted to spouse.

DISPOSITION AND PROCEEDS OF DISPOSITION

Definition of "Disposition"

The term "disposition", in addition to having the meaning given to it by ordinary usage of the English language, is also specifically defined in subsection 248(1) of the Act to include:[21]

(a) any transaction or event entitling a taxpayer to "proceeds of disposition",

(b) any transaction or event by which:

- shares, bonds, or debentures[22] are redeemed or cancelled,
- debts are settled or cancelled,
- shares are converted because of an amalgamation or merger,
- options to acquire or dispose of property expire, or
- a trust acting as agent for all the beneficiaries under the trust ceases to act as agent for a beneficiary under the trust with respect to any dealing with any of the trust's property,

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[21] Note that the word "disposition" is defined with reference to disposition of "property".

[22] The enumeration goes longer. Please refer to the Act.

(c) any transfer of property to a trust or, where the property is property of a trust, any transfer of the property to any beneficiary under the trust, and

(d) where the property is a taxpayer's capital interest in a trust, a payment made after 1999 to the taxpayer from the trust that can reasonably be considered to have been made because of the taxpayer's capital interest in the trust.

The definition of "disposition" specifically excludes:

(e) any transfer of property in which there is a change in legal title but not beneficial ownership (other than specified exclusions),

(f) any transfer of property dealing with a trust governed by a registered retirement savings plan or by a registered retirement income fund, if specific conditions are met,

(g) where the property is part of a capital interest of a taxpayer in a trust, a payment after 1999 from the trust in respect of the capital interest:

- where the number of units in the trust that are owned by the taxpayer is not reduced because of the payment, or
- to the extent that the payment:
- is out of the income of the trust *for a taxation year* or out of the capital gains of the trust *for the year*, if the payment was made in the year or the right to the payment was acquired by the taxpayer in the year, or
- is in respect of an amount designated in respect of the taxpayer by the trust under subsection 104(20),

(h) any transfers of property intended only as security for a debt or a loan,

(i) any issue by a corporation of a bond, debenture, note, certificate, mortgage, or hypothecary claim, and

(j) any issue by a corporation of a share of its capital stock.

Definition of "Proceeds of Disposition"

The term "proceeds of disposition" is also defined in an expansive way in section 54 by reference to what it specifically includes and excludes. Not surprisingly, proceeds of disposition includes the sale price of property that has been sold, compensation for property unlawfully taken or destroyed, and compensation for expropriated property. The definition specifically excludes amounts that would otherwise be proceeds of disposition but are deemed by section 84, 84.1 or 212.1 to be a dividend. This exclusion is important to note when computing the gain or loss arising on the disposition of a share to the corporation that issued the share. Such a purchase or a redemption may result in both a capital gain (or loss) and a deemed dividend.

Assume a share with a PUC of $10 and an ACB of $50 is redeemed by the issuing corporation for $100. The holder will be deemed by subsection 84(3) to receive a deemed dividend of $90 ($100-$10). The holder must also compute the capital gain or loss from the transaction. The proceeds of disposition of $10 (sale price of $100 less deemed dividend of $90) minus the ACB of $50 results in a capital loss of $40.[23]

Proceeds of Disposition of Non-Capital Property

This methodology works satisfactorily when computing the deemed dividend and capital gain or loss arising from the disposition of a share that is capital property. The computation is less clear when computing the profit or loss from the disposition to the issuing corporation of a share that is not capital property. The definition of "proceeds of disposition" in section 54 is only applicable for the purposes of Subdivision c of Division B of the Act (the Subdivision applicable to the computation of taxable capital gains and allowable capital losses). Consequently, the expansion from, and the limitations to, the ordinary meaning of "proceeds of disposition" should have no application to the interpretation of that term when it is applied in the computation of profit and loss outside of Subdivision c. Does this mean that in the example given for capital property earlier, the holder of the share that was redeemed would be subject to tax on both a deemed dividend of $90 ($100 proceeds less $10 PUC) and a profit of $50 ($100 proceeds less $50 cost base)? Subsection 248(28) of the Act, which provides that the Act should not be read or construed to require the inclusion or deduction of the same amount twice in computing income, should apply to avoid this result.

The CCRA has accepted the proposition that where shares which are not capital property are purchased by the corporation which issued the shares, the holder will be required to include in income a deemed dividend equal to the amount by which the proceeds exceed the PUC, and will only be considered to have made a trading gain to the extent the PUC exceeded the cost base of the shares (i.e. the same amount will not be taxed twice, once as a deemed dividend and secondly as a trading gain).[24] However, the CCRA will not apply this analysis to its logical conclusion to determine that a trading loss will arise on a disposition in circumstances where the proceeds of disposition exceed the cost base of the share which also exceeds its PUC. In comparable circumstances dealing with shares that are capital property, the CCRA accepts that a capital loss would arise on the disposition of the shares to the issuing corporation (as demonstrated by the example given earlier for capital property where a capital loss arose upon the sale of shares when the cost base of the property exceeded its PUC). However, in the CCRA's view, this result only arises because the statutory definition of "proceeds of disposition" which is applicable only to capital transactions, specifically excludes deemed dividends from inclusion in the proceeds of disposition.

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[23] Depending on the circumstances, this loss could be deemed to be nil by the operation of stop-loss rules such as subsections 40(3.6) or 112(3).

[24] Technical Interpretation titled "Shares Held as Inventory" dated March 30, 1994, Doc. # 9337225. However, consider also the different treatment afforded to mark-to-market property in the Technical Interpretation titled "Redemption of Shares Held by Financial Institutions" dated June 6, 1997, Doc. #9631867.

The CCRA's position on this point has been criticized by a number of commentators and rightly so.[25] Subsection 248(28) precludes an amount from being included, "directly or indirectly, in computing income" if that amount has already been included in computing income. Consequently if an amount is included in income as a deemed dividend, it cannot also be included in the computation of a trading gain or trading loss. Further, even in the absence of subsection 248(28), a deemed dividend arising on the disposition of a share should not form part of the proceeds of disposition. The courts have ruled that the effect of a statutory deeming provision is to make a thing something that it is not. Subsection 84(3) of the Act deems an amount that would otherwise be proceeds of disposition to be a deemed dividend. It is logical to conclude that the portion of the proceeds of disposition, which the Act deems to be a dividend, is also deemed to no longer be proceeds of disposition, as proceeds of disposition and dividends are two very different things. It is quite within the purview of Parliament to deem a dog to be a cat, but if it wishes a dog to be both a cat and a dog simultaneously, it should use very clear language to achieve that result.

It may be argued that under this interpretation, the specific exclusion of deemed dividends from the definition of "proceeds of disposition" for capital property is redundant and is unnecessary. It is suggested that the exclusion was included in the definition for greater certainty, in the same manner that the definition specifically includes, "the sale price of property that has been sold". The CCRA would never suggest that in computing the proceeds of disposition of non-capital property, a taxpayer should exclude the sale price of property, because the sale price of property is specifically included in the definition of proceeds of disposition of capital property, and that therefore the failure to have such a definition for non-capital property must mean that Parliament intended that the term should have a narrower meaning for dispositions of non-capital property. Yet, this is exactly the approach the CCRA seeks to apply in its interpretation of proceeds of disposition with respect to the specific exclusion for deemed dividends.

Section 69

Where property is disposed of in a non-arm's length transaction for proceeds not equal to fair market value of the property, section 69 in certain circumstances operates to deem the cost to the taxpayer and the proceeds of disposition to be equal to fair market value.

THE STOP-LOSS RULES

The stop-loss rules contained in the Act are designed to prevent a taxpayer from triggering a loss for tax purposes through a temporary disposition of property or a disposition of property to an "affiliated person". The policy underlying these rules is that a loss from the disposition of property should not be recognized for tax purposes unless the property is effectively out of the control or economic family of the taxpayer.

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[25] M. Meredith and J. Mulcaster, *Traders, Dealers and Other Financial Intermediaries*, 1997 Conference Report 20 at 20:22 (Canadian Tax Foundation) and R. Ashton, M. O'Connor and R. Dabydeen, Consolidation in the Financial Services Sector, 1997 Conference Report 21 at 21:27 (Canadian Tax Foundation)

The Concept of "Affiliated Person"

The concept of "affiliated person" is central to the stop-loss rules. It is defined under subsection 251.1(1) of the Act. It is distinct from the concepts of "associated persons", "related persons", or "connected persons". One of its distinctive features is that an individual is only considered to be affiliated with his or her spouse or common law partner, and not with his or her children, sisters, brothers, or parents. Moreover, as opposed to the "associated persons" rules, there is no 25% cross-ownership requirement. Although the definition of "affiliated person" is quite detailed, the following basic rules are helpful to keep in mind:

- Individuals are affiliated with one another only if they are spouses or common law partners. Persons (including partnerships) are affiliated with themselves (subsection 251.1(4)).

- Corporations are affiliated with persons and groups of affiliated persons that control the corporation, directly or indirectly, in any manner whatever (de facto control).

- Corporations are affiliated with each other if the person or group that controls one corporation is affiliated with the person or group that controls the other. In applying this test, a person is affiliated with a group if he is affiliated with each member of the group. Two groups are affiliated if each member of each group is affiliated with at least one member of the other group.

- Partnerships are affiliated with a majority interest partner (a person or partnership who is entitled, or is affiliated with any persons or partnerships who in the aggregate are entitled to more than one-half of the income of the partnership or more than one-half of the amounts distributed to the partners on the winding-up of the partnership).

- Partnerships are affiliated with each other if there is a common majority interest partner or each member of a majority interest group of one partnership is affiliated with at least one member of a majority interest group of the other partnership.

- A majority interest group of partners is any collection of partners entitled in the aggregate to more than one-half of the income of the partnership or one-half of the property of the partnership on a dissolution, but not including any partner whose exclusion from the group would not prevent the remaining members of the group from meeting the "one-half" test. There can be more than one majority interest group of partners for any partnership. In a partnership composed of three equal partners, A, B, and C, the groups of AB, BC, and AC would each be a majority interest group of partners.

Specific Stop-Loss Rules

The stop-loss rules are a set of rules contained in many provisions of the Act, each rule specific to a particular set of circumstances. Following is a review of a few stop-loss rules found in the Act.

Losses on the Disposition of Non-Depreciable Capital Property (Subsections 40(3.3) and (3.4))

When a corporation, trust, or partnership (but not an individual) disposes of a non-depreciable capital property,[26] triggering a loss, and during the period that begins 30 days before and ends 30 days after the disposition, the transferor or a person affiliated with the transferor reacquires that property or an identical property ("substituted property"), the loss will be deferred in the hands of the transferor until the earliest of:

(a) a subsequent disposition of the property to a person that is neither the transferor nor a person affiliated with the transferor;

(b) a deemed disposition of the property due to a change of residence or a loss of tax exempt status of the transferor;

(c) where the transferor is a corporation, an acquisition of control of the transferor or a winding-up of the transferor; or

(d) a deemed disposition of a bad debt or of a share of a corporation that became bankrupt or insolvent during the year (other than personal-use property).

Losses on Disposition of Shares (Subsection 40(3.6))

Where a taxpayer disposes of a share (other than a distress-preferred share) of a corporation, to that corporation and that corporation is affiliated with the taxpayer immediately after the disposition,

(a) the taxpayer's loss from the disposition will be deemed to be nil, and

(b) in computing the adjusted cost base of the taxpayer's remaining shares of that corporation, there shall be added the proportion of the amount of the taxpayer's loss from the disposition that (i) the FMV of the share (immediately after the disposition) is of (ii) the FMV of all the shares of the corporation owned by the taxpayer (immediately after the disposition).

Losses on Shares that Are Capital Property and on which Dividends Have Been Received (Subsection 112(3))

A loss realized by a taxpayer (other than a trust) from the disposition of a share that is capital property of the taxpayer (other than a share that is property of a partnership) is deemed to be the amount of the loss minus

(a) where the taxpayer is an individual, the lesser of (i) the capital dividends received by the taxpayer and (ii) the amount by which the loss exceeds the taxable dividends received by the taxpayer; and

[26] And other than a disposition referred to under paragraphs (c) to (g) of the definition of "superficial loss" in section 54.

(b) where the taxpayer is a corporation, the total of all amounts received by the taxpayer on the share that is (i) a taxable dividend, (ii) a capital dividend, or (iii) a life insurance capital dividend.

Various Losses Deemed Nil (Paragraph 40(2)(g))

The following losses incurred by a taxpayer from the disposition of property will be deemed nil:

- A superficial loss (a superficial loss is defined under section 54 and means the taxpayer's loss from the disposition of a particular property where during the period that begins 30 days before and ends 30 days after the disposition, the taxpayer or a person affiliated with the taxpayer reacquires that property or an identical property ("substituted property"). Subsections (c) to (h) list a number of exceptions.).

- A loss from the disposition of a debt unless the debt was acquired by the taxpayer for the purpose of gaining or producing income from a business or property (other than exempt income) or as consideration for the disposition of capital property to a person with whom the taxpayer was dealing at arm's length.

- A loss from the disposition of personal-use property (other than listed personal property or a debt referred to in subsection 50(2)).

- A loss from the disposition of property to:

  (a) a trust governed by a deferred profit sharing plan, an employees profit sharing plan or a registered retirement income fund under which the taxpayer is a beneficiary, or

  (b) a trust governed by a registered retirement savings plan under which the taxpayer or the taxpayer's spouse or common law partner is an annuitant.

* * *

The Act contains over twenty stop-loss provisions dealing with specific circumstances where losses occur upon a disposition of property. Other common stop-loss rules are the ones referred to under subsections 13(21.1) and 14(12), dealing with dispositions of depreciable properties and eligible capital properties. Every time a property is disposed of at a loss, care must be taken to ensure that the stop-loss rules in the Act are not triggered.