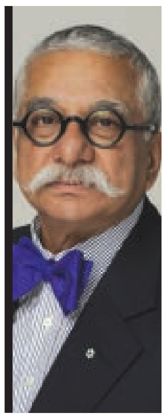
Corporate transactions require experienced eye



TAX VIEWS

By Vern Krishna

> **For corporate purposes, a corporation may reduce its stated capital only if it satisfies two tests: The reduction must not impair either the liquidity or solvency of the corporation.**
>
> *Vern Krishna, TaxChambers LLP*

Accountants and lawyers who transact corporate business must take into account corporate, tax, and accounting principles. The concepts of capital under the *Canada Business Corporations Act* (and similar statutes) and the *Income Tax Act* vary with the purpose of the respective statutes.

In corporate law, capital (technically, "stated capital") reflects the margin of safety that shareholders provide to creditors and, therefore, the risk that shareholders assume when they invest in the corporation. The concern of the corporate statutes is to prevent the inappropriate reduction of stated capital, which can prejudice the claims of creditors.

In tax law, capital (technically, "paid-up capital") is the yardstick of the amount that shareholders can retrieve from the corporation on a tax-free basis. The *Income Tax Act* levies a tax on income, and not on capital. Thus, the concern of the tax statute is to prevent the inappropriate increase of paid-up capital, which the shareholder could then withdraw tax-free to the prejudice of the treasury.

The *Income Tax Act* contains many provisions that deem a corporation to pay a taxable dividend in circumstances where corporate law does not consider the transaction to give rise to a dividend. A fundamental premise of the corporate income tax system is that the shareholders of a non-public corporation can always take back the paid-up capital of the corporation tax-free. A capital distribution that exceeds the corporation's paid-up capital will generally trigger either a shareholder benefit under section 15, or a deemed dividend under section 84.

The "stated capital account" serves two important corporate purposes:

• It serves as a measure of the maximum liability of its shareholders to outsiders; and

• The amount shown in the account represents the initial investment of its shareholders, which also serves as a measure of security for creditors who loan money to the corporation.

As a general rule, a corporation may not reduce its stated capital. There are exceptions to this rule, but the exceptions apply only in narrowly confined circumstances. Thus, corporate statutes control adjustments, particularly downward adjustments, to stated capital.

The *Income Tax Act* also controls adjustments to the corporate paid-up capital account. Shareholders can extract capital without tax, whilst taxing distributions in excess of capital as dividends. However, the *Income Tax Act* is concerned with upward revisions of stated capital to prevent inappropriate tax-free withdrawals of capital.

For corporate purposes, a corporation may reduce its stated capital only if it satisfies two tests: The reduction must not impair either the liquidity or solvency of the corporation. Thus, a corporation may reduce its stated capital only if it is able to pay its obligations as they fall due and it is able to discharge its obligations to its shareholders and creditors. The tests are intended to protect creditors.

The extent of the liquidity and solvency tests varies with the reason for the reduction of capital and the potential for harm to investors. The less the risk of harm, and the lower the potential for abuse, the less stringent the tests that the corporation must satisfy to reduce stated capital.

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

A corporation may not redeem its shares unless it satisfies two financial tests.

• First, a corporation may redeem its shares only if there are reasonable grounds for believing that the redemption will not render the corporation unable to pay its obligations as they fall due. Thus, the corporation must be liquid enough to pay its debts as they mature.

• Second, the realizable value of the corporation's assets after the redemption must not be less than the aggregate of its liabilities and the amount required to pay other shareholders who rate equally with or have a higher claim than the holders of the redeemed shares. The concern here is to protect only those who have a claim equal to or higher than the shares redeemed.

The financial tests are less stringent because the corporation would have issued the shares on the basis that they were redeemable, and this information is available to the public.

A return of capital in excess of the paid-up capital of shares triggers a deemed dividend and also affects the adjusted cost base of the shares. For example, assume that both the stated capital and paid-up capital of a share are $100 and that its adjusted cost base is $150. If the corporation redeems the share for $180, the *Income Tax Act* deems the shareholder to receive a dividend of $80.

The *Income Tax Act* also deems the shareholder to have disposed of his share and to have derived proceeds of disposition. The deemed disposition may trigger a capital gain. In order to prevent double taxation, however, the act reduces the shareholder's proceeds of disposition by the amount of the deemed dividend — in this example, $80. Thus, the act deems the shareholder to receive a dividend of $80, but he suffers a capital loss of $50. His net economic gain is $30.

However, the treatment of the dividend and capital loss for tax purposes is quite different. The shareholder obtains a tax credit on the dividend if the corporation that redeems the share is a Canadian corporation. In contrast, only 50 per cent of the capital loss of $50 is deductible for tax purposes, and then only against the shareholder's capital gains. If the shareholder does not have any capital gains, the tax bite can exceed his economic gain.

These deeming provisions are unique to corporate distributions in the tax system, and are a trap for the unwary professional dealing with corporate transactions. It is imperative that he or she consults both statutes before rendering an opinion or structuring a transaction.

Vern Krishna, CM, QC, is Of Counsel, TaxChambers LLP (Toronto) and professor of law, University of Ottawa. E-mail him at *vern.krishna@taxchambers.ca; www.vernkrishna.com*