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Tax Alert – Canada

CRA updates its views on safe income

EY Tax Alerts cover significant tax news, developments and changes in legislation that affect Canadian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor or EY Law advisor.

On 28 November 2023, at the Canadian Tax Foundation's (CTF) Annual Tax Conference, the Canada Revenue Agency (CRA) gave an update of its views with respect to the computation of "safe income" (i.e., income earned or realized), which is relevant for the application of the anti-surplus stripping rules in section 55 of the *Income Tax Act* (the Act). The purpose of the CRA's presentation was to provide the tax community with an overview of certain clarifications and changes in the CRA's historical positions with respect to the determination of safe income.

A detailed summary of these clarifications and changes will be included in a position paper that will be released by the CRA in the coming weeks. We anticipate that this position paper should constitute the most comprehensive document since 1991 outlining the CRA's most up-to-date positions with respect to the computation of safe income.

After the conclusion of the 2023 CTF Annual Tax Conference, the CRA released a statement to indicate that all announcements made at the conference that constitute a change in position will apply prospectively to calculations of safe income for taxation years beginning after 28 November 2023.

Building a better working world

The concept of safe income

Under the Act, "income earned or realized" — that is, safe income — of a Canadian corporation is deemed to be income otherwise computed under the Act, subject only to the modifications referred to in paragraph 55(5)(b) for non-private corporations or paragraph 55(5)(c) for private corporations. A dividend (or deemed dividend) can be exempted from the recharacterization provision in subsection 55(2) where all or a portion of the dividend does not exceed the amount of the income earned or realized by any corporation that could reasonably be considered to *contribute* to the capital gain on the shares.

This particular language was introduced in 2015 along with other changes to section 55, including the addition of two new purpose tests and specific rules applicable to the payment of stock dividends. The amendments were enacted in 2016 in large part to prevent the artificial creation or duplication of tax basis. Prior to 21 April 2015, the applicable test to determine if a dividend was paid from safe income was whether the capital gain on the shares could reasonably be considered to be *attributable* to safe income.

Over the years, given that the Act provided minimal guidance with respect to the calculation of safe income, the CRA stepped in to fill the gap with a number of administrative positions, including the first comprehensive document on the computation of safe income that was presented by John R. Robertson at the 1981 CTF Annual Tax Conference, "*Capital Gains Strips: A Revenue Canada Perspective on the Provisions of Section 55*" (commonly known as the Robertson Rules). This was followed with a paper by Michael A. Hiltz in 1984, "*Section 55: An Update*", as well as an article by Robert J.L. Read in 1988 "*Section 55: A Review of Current Issues*". Finally, Michael A. Hiltz released the article "*Income Earned or Realized: Some Reflections*" in 1991.

The CRA's guiding principle to the computation of safe income

At the CTF Annual Tax Conference, the CRA commented that although Parliament could have opted to exhaustively define what constitutes "income earned or realized" that contributes to the capital gain on a share (formerly "attributable to"), a minimalistic approach was adopted. According to the CRA, a balanced and reasonable approach for determining the amount of "income earned or realized" that contributes to the capital gain is therefore mandated in accordance with the scheme of subsection 55(2) of the Act. The CRA expressed the view that we should refrain from adopting a strict interpretation given that the legislation on safe income is not a complete code.

The CRA reiterated its position that the inter-corporate deduction under subsection 112(1) should not be used to increase the tax cost of property and subsection 55(2) is intended to ensure that a dividend is subject to tax where the dividend is not paid from safe income – i.e., the dividend does not come from income that has already been subject to income tax. In its presentation, the CRA did not mention the purpose tests in subsection 55(2.1), but the purpose tests were acknowledged in the accompanying presentation materials distributed after the conference.

Safe income on hand, *Kruco* and revised subsection 55(2)

The CRA's long-standing position before the decision rendered in *The Queen v. Kruco Inc.* (2003 FCA 284) (Kruco), was that "safe income on hand" with respect to a share of a corporation consisted of income earned or realized that could reasonably be considered to contribute to the capital gain.[1] The CRA was of the view that although "safe income" refers to the corporation's net income for tax purposes, as adjusted by paragraphs 55(5)(b), (c) and (d), amounts such as dividends, income taxes or other amounts not currently deductible would not contribute to the gain inherent in the shares and should therefore reduce the safe income on hand. The term "contribute" was used by the CRA even though, at the time, the language in subsection 55(2) referred to a capital gain "that could reasonably be considered to be attributable" to anything other than "income earned or realized".

In *Kruco*, the Federal Court of Appeal concluded that a two-stage inquiry was required: first, compute the safe income (i.e., income earned or realized as mandated under paragraphs 55(5)(b) and (c)), and second, determine whether the "income earned or realized" was "kept" on hand after its computation. More specifically, Justice Noel held that "*the fact that [phantom income] is fixed by way of a deeming provision precludes an inquiry as to whether it was ever on hand*".

At the CTF Annual Tax Conference, the CRA stated that the concept of safe income on hand was misapplied by the Federal Court of Appeal in *Kruco,* and under the revised language of subsection 55(2), the "safe income on hand" concept is no longer relevant. Instead, the inquiry should be "to which extent the income, as computed under section 55(5), can reasonably be considered to *contribute* to the capital gain on the shares".[2] In other words, the CRA is of the view that the revised language adopted by Parliament in 2016 permits a departure from the reasoning adopted by the Federal Court of Appeal in *Kruco* and, therefore, allows any amount included in net income for tax purposes by a deeming provision to be excluded from safe income on the basis that such income does not contribute to the capital gain on the shares. The CRA further summarized its revised position by stating that safe income is considered to contribute to a capital gain to the extent that it will continue to exist, as a tangible asset, to support the fair market value (FMV) of the shares.

[1] See Question 12 from the CRA Roundtable at the 1993 CTF Conference and Income Tax Technical News No. 33.
[2] As stated in the CRA presentation materials.

Changes and clarifications in the CRA's positions

During the presentation, the CRA focused on the following key areas.

1. Accrued losses on capital assets

If safe income is earned or realized by a corporation and is used to acquire capital assets that subsequently decline in value, the CRA confirmed that it is of the view that such accrued loss should not reduce the safe income provided that the capital gain on the shares is supported by the value of other assets of the corporation.

The CRA illustrated this position using an example in which, during the same period, real property acquired by a corporation (Opco) at the beginning of the period using safe income of $500 declines in FMV by $250 during the period. During the same period, the FMV of Opco's intangible property increases by $400.

Beginning of period		
	Cost ($)	FMV ($)
Cash	200	200
Inventory	300	300
Real property	500	500
Intangible property	0	0
Total assets	**1,000**	**1,000**
Income realized	1,000	

End of period		
	Cost ($)	FMV ($)
Cash	200	200
Inventory	300	300
Real property	500	250
Intangible property	0	400
Total assets	**1,000**	**1,150**
Income realized	1,000	

According to the CRA, Opco's safe income should not be reduced by the accrued loss of $250 since the FMV of the intangible property increased by an amount that exceeds the accrued loss (that is, an increase of $400 in this example). However, when the accrued loss is realized, Opco's safe income will be reduced. In particular, in the case of a non-private corporation, the corporation's safe income will be reduced by the amount of the allowable capital loss as well as by the amount of the non-deductible capital loss pursuant to subparagraph 55(5)(b)(ii) of the Act. In the case of a private corporation, the non-deductible capital loss will reduce the corporation's capital dividend account.

The CRA's comments did not specifically consider whether a transfer of property with an accrued loss to an affiliated person that is suspended under the Act would also reduce safe income.

Also, based on the above position, the safe income that contributes to the accrued gain on Opco's shares would normally be reduced to $750 if the FMV of the intangible property is still nil at the end of the period since the capital gain in the shares would only be $750 in that circumstance. As a general principle, the safe income that contributes to the capital gain in the shares cannot exceed such gain.

2. Redemption of preferred shares

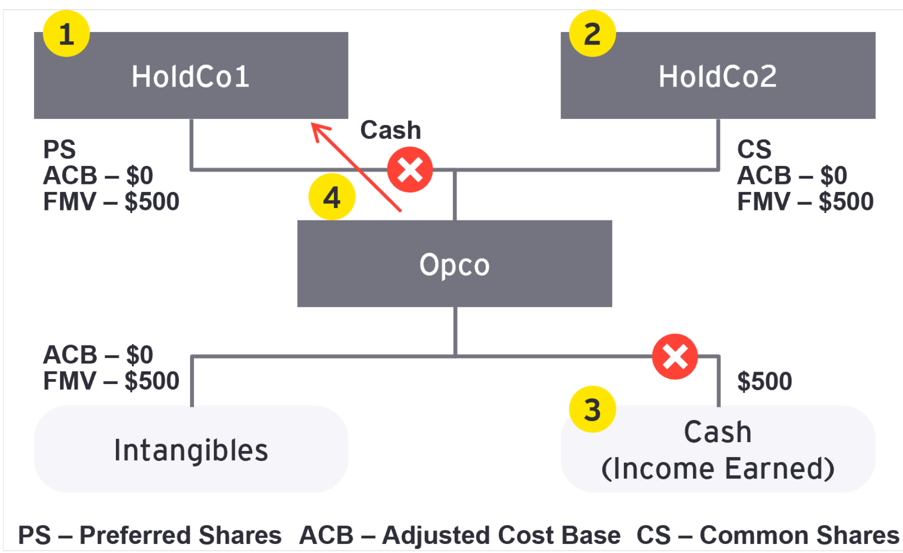
The CRA presented an example to illustrate its position regarding the entitlement to safe income on common shares of a corporation (Opco) where an asset is transferred by another shareholder to Opco on a tax-deferred basis in exchange for preferred shares of Opco.
The facts were as follows:

1) HoldCo1 transfers to Opco, on a tax-deferred basis, an intangible asset with a FMV of $500 in exchange for preferred shares with a redemption value of $500.

2) HoldCo2 subscribes for 100% of the common shares of Opco for nominal consideration.

3) After the share subscription, Opco earns $500 of safe income during the holding period, resulting in a cash balance of $500, which is considered to be safe income contributing to the inherent capital gain on Opco's common shares.

4) Opco redeems the preferred shares held by HoldCo1 using its $500 of cash.



Following the redemption of the preferred shares, the CRA's view is that the $500 balance of safe income would still contribute to the inherent capital gain on the common shares provided the intangible asset still has a FMV of at least $500. According to the CRA, if Opco had borrowed money to redeem the preferred shares, it would have been essentially in the same position as described above (i.e., common shares with a FMV of $500 and a safe income balance of $500) without any question as to whether the safe income was reduced or not.

Therefore, using a reasonable approach, the safe income that contributes to the inherent capital gain on the common shares should not be reduced where the preferred shares are redeemed with proprietary cash or borrowed money.

The CRA did not comment on the potential application of subsection 55(2) to the deemed dividend arising on the redemption of the preferred shares.

3. Contingent liabilities and reserves

Historically, it has been the CRA's view that contingent liabilities and reserves reduced safe income since these amounts do not represent the tangible portion of the corporation's income that will continue to exist to support the value, and thus, contribute to the capital gain on the shares.

The CRA is now of the view that contingent liabilities or reserves should reduce safe income *only* if they reduce, or have the potential to reduce, the income of the corporation on materialization. A contingent liability or a reserve does not reduce safe income if such amount is capital in nature.

4. Income taxes paid (or accrued) and refundable taxes

Income taxes paid (or accrued) decrease safe income because the amount to be set aside to pay the taxes owing cannot reasonably be considered to contribute to the capital gain on the shares. As such, taxes result in a discount in the value of the shares on a sale to an arm's length person.

The CRA's long-standing position was that refundable taxes (i.e., non-eligible refundable dividend tax on hand (NERDTOH) and eligible refundable dividend tax on hand (ERDTOH)) were only included in safe income when the refund was received.

The CRA is now of the view that refundable taxes in respect of income taxes paid (or accrued) that will be refunded to the corporation as a result of a payment of a dividend before the end of the taxation year will be considered to be a reduction of the income taxes paid (or accrued) on the amount of income that constitutes safe income. Refundable taxes that are not refunded in respect of the year as a result of a payment of a dividend after the end of the corporation's taxation year will be included in safe income if and when the refundable taxes are received by the corporation. This position was previously announced at the 2022 Association de la planification financière et fiscal (APFF) annual conference CRA roundtable.[3] In other words, the safe income will only be reduced by net tax paid or payable provided that a dividend is paid in the same taxation year that the Part I tax on the aggregate investment income is payable (or Part IV tax on the receipt of a dividend), which gave rise to NERDTOH/ERDTOH balance. Otherwise, the gross amount of the income taxes paid (or accrued) would reduce safe income until the amount of refundable taxes is actually received by the corporation.

[3] CRA document 2022-0942241C6.

Although this change in the CRA's position is welcomed, it is our view that only net tax paid or payable should reduce safe income where as part of the series of transactions, and before the sale of the shares of the corporation, the dividend that entitles the corporation to a dividend refund is paid whether or not the dividend is paid in the same taxation year that gave rise to the Part I or Part IV tax payable.

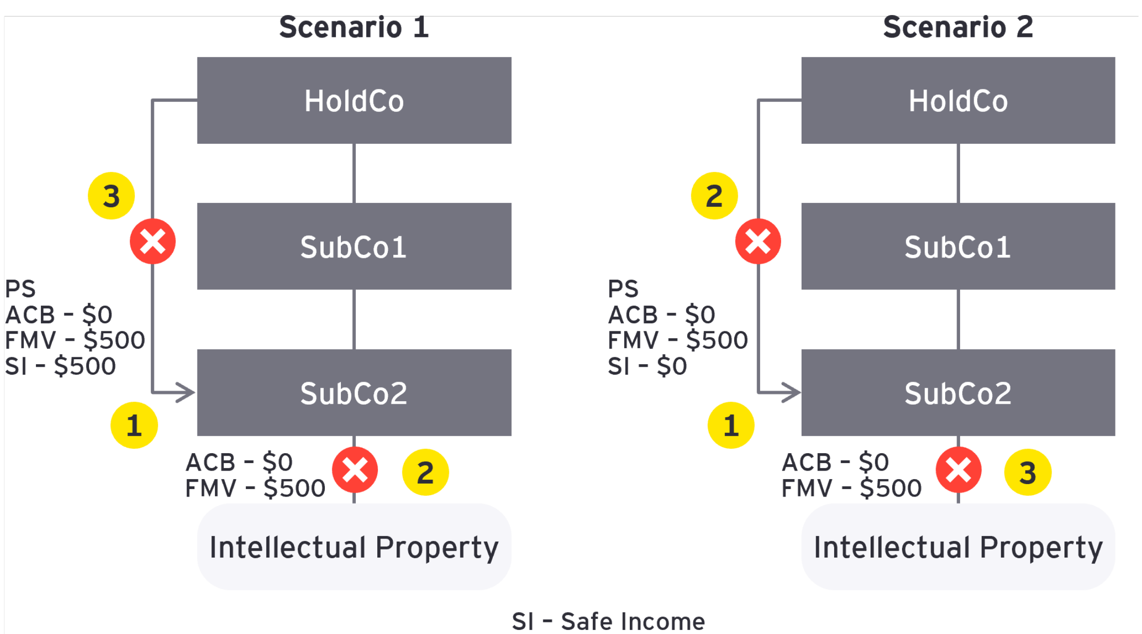
5. Realization of an accrued capital gain at time of acquisition

Where a shareholder transfers a property, other than shares, with an accrued capital gain to a corporation on a tax-deferred basis in exchange for preferred shares, historically, the CRA was of the view that the realization of the accrued capital gain on the property would not increase the amount of safe income that contributes to the capital gain on the preferred shares.

The CRA's new position provides that where the transferred property is disposed of before the preferred shares are redeemed, the accrued capital gain in the property at the time of the original transfer would be considered to contribute to the capital gain on the preferred shares, and such capital gain realized in respect of the property should be included in the safe income of the preferred shares when the accrued capital gain is realized.

The CRA did not specifically discuss how the safe income of the preferred shares would be impacted by income taxes paid by the corporation in respect of the realized capital gain. In addition, the CRA noted that if the preferred shares are redeemed before the accrued capital gain on the transferred property is realized, then such gain realized would not increase the safe income of the preferred shares or the common shares.

The example below illustrates our understanding of the CRA's revised position.



SubCo2 is a wholly owned subsidiary of SubCo1, which in turns is a wholly owned subsidiary of HoldCo. HoldCo, SubCo1 and SubCo2 are private corporations controlled by a non-resident corporation. In scenario 1, HoldCo first transfers on a tax-deferred basis to SubCo2 intellectual property with a FMV of $500 and an adjusted cost base (ACB) of nil in exchange for preferred shares with a redemption value of $500. Second, the following year, SubCo2 sells the intellectual property to an arm's length purchaser for cash consideration of $500. Finally, the preferred shares are redeemed for cash consideration of $500.

Based on the CRA's new position, the capital gain realized on the sale of the intellectual property should be included in the safe income that contributes to the capital gain of the preferred shares. However, the CRA did not specify whether the income taxes payable in respect of the realized capital gain would reduce the safe income allocated to the preferred shares or to the common shares.

In scenario 2, the redemption of the preferred shares of SubCo2 occurs before the sale of the intellectual property. As such, the capital gain realized on the sale of the intellectual property will be excluded from the safe income of the preferred shares or the common shares and, therefore, will be lost.

6. Exclusion of "phantom income" from safe income

Broadly speaking, phantom income is income for tax purposes that is not supported by any tangible cash inflow, as such, phantom income is not income that can be moved through a corporate chain. An example of phantom income is tax credits, such as investment tax credits resulting from scientific research and experimental development, that are included in the taxpayer's income in the taxation year following the year in which the taxpayer files a claim.

Further to the decision rendered in *Kruco*, the CRA had conceded that phantom income was included in safe income on hand. However, as a result of the 2015 amendments to subsection 55(2), the CRA is now of the view that phantom income must be excluded from safe income since no amount in respect of such income can be paid as a dividend – that is, it cannot reasonably be considered to contribute to the capital gain on the shares. The CRA noted that this exclusion should not create any double taxation even if the phantom income was included in the corporation's income for tax purposes because the phantom income is not available to be paid as an inter-corporate dividend.

7. Safe income split on corporate reorganizations

The CRA outlined the main principles supporting its approach on safe income allocation on corporate reorganizations. The cost of property essentially originates from three sources:

(i) After tax income earned or realized;

(ii) Capital invested by shareholders; and

(iii) Proceeds from indebtedness.

The overarching principle is to avoid a misalignment of tax basis as part of a corporate reorganization.

Using a balance sheet approach, the CRA's view is that safe income should be allocated based on the net tax cost of property (i.e., the tax cost of property over the amount of liabilities). The CRA recognized that it is impossible to do an exact or strict tracing of direct safe income in the context of a corporate reorganization, such as a butterfly-type transaction. The CRA therefore reaffirmed its position that was first presented at the 2020 CTF Annual Tax Conference CRA roundtable[4], that direct safe income (DSI) has to be allocated on a pro rata basis to the net cost amount of assets that have been separated between the corporations based on the following formulas:

$$\text{DSI on the shares of NewCo} = \frac{\text{DSI of Opco prior to reorganization X net cost amount of assets transferred to NewCo}}{\text{Total net cost amount of assets of Opco prior to reorganization}}$$

$$\text{DSI on the shares of Opco} = \frac{\text{DSI of Opco prior to reorganization X net cost amount of assets retained by Opco}}{\text{Total net cost amount of assets of Opco prior to reorganization}}$$

The CRA acknowledges that the result must be examined in respect of the specific circumstances of each case and that this allocation is not a "one-size fits all" formula, thus, judgment must be exercised. Transactions that result in streaming of ACB could be challenged when offensive; however, ACB streaming could be considered acceptable if the sole purpose is to avoid a misalignment of tax basis.

The CRA presented examples in the context of a "one-wing butterfly" reorganization where the use of the safe income allocation formula was not warranted as the reorganization did not result in a misalignment of tax basis. It was also noted that in an arm's length bona fide split-up reorganization where the streaming of ACB cannot be mandated by either party, the CRA should be indifferent to the misalignment of basis and, therefore, should not require an allocation of safe income based on the formula above.

Key takeaways

As previously noted, the CRA released a statement after the CTF Annual Tax Conference to indicate that all announcements made at the conference that constitute a change in position will apply prospectively to calculations of safe income for taxation years beginning after

[4] CRA document 2020-0861031C6.

28 November 2023. For example, it is our understanding that for a corporation with a taxation year ending on 31 December 2023, the safe income amount would be computed based on the CRA's administrative policies that were in effect prior to the conference. For the 2024 and subsequent taxation years, the safe income amount would be computed based on the CRA's most recent positions.

The CRA's presentation provided the tax community with an overview of the overarching principles that were relied upon to establish the guidelines that will be discussed in greater detail in the upcoming position paper on safe income. In particular, the CRA will no longer refer to the concept of "safe income on hand" but rather to the safe income that "contributes" to the inherent capital gain of the shares in respect of which the dividend was received.

It is also the CRA's view that, by virtue of the 2015 amendments to subsection 55(2) of the Act, phantom income should not be included in safe income that contributes to the capital gain on the shares, therefore, the CRA will no longer apply the principles established in *Kruco* in that regard.

Conceptually, the simple examples presented by the CRA to outline its view on the entitlement to safe income in certain specific situations and the allocation of safe income in a corporate reorganization may be considered to be sound. However, applying these principles to real life situations is likely to prove to be much more complex.

Learn more

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