# CAPITAL GAINS STRIPPING: SECTION 55(2)

## What is Capital Gains Stripping?

- Capital gains stripping is a method of avoiding corporate taxes by converting capital gains into dividends
- To stop corporations from stripping capital gains tax free, section 55(2) came into effect

## How do corporations strip capital gains tax free?

Few things to note before explaining capital gains stripping:

- Corporations do not get the life time capital gains deduction; therefore, dividends are better tax-wise for corporations
- Canadian dividends are tax free in the hands of Canadian corporations
- In theory the FMV of a corporation's share is equal to the present value of future cash flows; the payment of dividends will reduce the fair value

## Consider the following examples:

Suppose the parent corporation wants to sell its subsidiary. The subsidiary's shares have the following attributes: ACB = 10,000; PUC= 10,000; FMV=200,000

**Example #1**

- The subsidiary will borrow money and pay dividends equal to the accrued capital gains of $190,000 (200,000-10,000) to the parent
- Because inter-corporation Canadian dividends are tax free , the parent will pay no Part I Tax
- The dividend will cause the FMV of the subsidiary's shares to go down by $190,000 to $10,000
- The parent will now sell the shares of the subsidiary for the fair value of $10,000; since the ACB=Proceeds, no capital gains would result

**Example #2**

- The parent will do a section 85(1) rollover, and transfer the shares of the subsidiary to the purchasing corporation at the adjusted cost base (ACB) = $10,000
- The parent will take back boot of $10,000 preferred shares of the purchasing corporation valued at $190,000
- The parent will redeem their preferred shares, this will trigger a deemed dividend of $190,000
- Canadian dividends are tax free, the parent will pay no Part I tax on the $190,000

## Section 55(2)

Section 55(2) applies when **all** the following are met:

1. A corporation received dividends from a Canadian corporation as part of a transaction that involved the disposal of shares
2. The purpose of the dividends is to reduce capital gains
3. The shares are sold to an arm's length party

## Implications of Section 55(2)

- The dividends will be added to be the original proceeds of disposition

**Example #1 and #2:**

- Section 55(2) will apply to these two examples because the purpose of the dividends is to reduce capital gains and shares sold to an arm's length purchasing company
- CRA will convert the deemed dividends into proceeds of disposition

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|---|---|
| Original Proceeds of Disposition | $10,000 |
| **add: Dividends** | **190,000** |
| Adjusted Proceeds of disposition | 200,000 |
| Less: Adjusted Cost Base (ACB) | (10,000) |
| **Capital Gains** | **$190,000** |

## Safe Income

- Safe Income is defined by the CRA as **income earned or realized by any corporation after 1971**
- **Income earned = division B income**
- **Section 55(2) does not apply to dividends paid out of the safe income balance**
- To find out to what extent the dividends are paid out of the safe income balance:
  - You use your past tax returns and financial statements to determine retained earnings from post 1971 division B income
  - **Safe Income** = post 1971 earnings in retained earnings less dividends paid in the past

- In our example above,
  - if we assume that the subsidiary has $100,000 in its post 1971 retained earnings
  - safe income = 100,000
  - section 55(2) will only apply to $190,000-100,000 = 90,000 of the dividends

| | |
|---|---|
| Original Proceeds of Disposition | $10,000 |
| **add: Dividends** | **190,000** |
| **Less: safe income** | **(100,000)** |
| Adjusted Proceeds of disposition | 100,000 |
| Less: Adjusted Cost Base (ACB) | (10,000) |
| **Capital Gains** | **$90,000** |