Dividends vs. Capital Gains Under Share Redemptions

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Since the early months of 1978, a considerable number of transactions involving take-overs of public corporations and acquisitions of minority interests in public corporations, referred to as "going private", have been observed. Each of these types of transaction has been structured to provide certain shareholders with a choice between the receipt of a capital gain and the receipt of a taxable dividend on the disposition or redemption of their shares. The effects of these transactions on the tax position of individual, Canadian-resident shareholders have attracted the attention of a large number of investors. They have also attracted the attention of the federal government which, through the November 16, 1978 Budget, has proposed to adjust this tax position.

The purpose of this paper is to analyze an anomaly in the application of the provisions of the Income Tax Act to these transactions which can give rise to very large gains for individual investors with very little, if any, financial risk, despite the proposed legislation to block such gains. The first section of this paper will provide some background on the issue by tracing the development of the concept of dividend stripping through to the 1977 changes in the tax legislation and by describing the major elements of the transactions in question. The next section will discuss the specific cause of the anomaly, generate some rules to maximize the benefits to individual shareholders from its use, and show examples of the profits that can be made. Under conditions which will be

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specified, it will be shown that it is possible to produce profits of up to almost $10,000, after all investment costs, with little or no financial risk, again, despite the November 16, 1978 Budget proposal (Resolution 39) to remove such gains. The next section of the paper will present and discuss some potential approaches that might be used to prevent the blatant misuse by investors of the tax legislation, even after the proposed amendment in this area, if such further action is considered to be warranted.

I. Background to the Issue

A. History of Relevant Legislation

In the years when dividends were taxed and capital gains were not, there was an incentive to devise, in certain circumstances, dividend stripping transactions which essentially converted potential dividends into realized capital gains. The concept of designated surplus was introduced in 1950 in an attempt to stop this practice. Also introduced in 1950 was the concept of a deemed dividend to prevent the conversion to capital of corporate surplus that would otherwise be distributed as a dividend. This concept is now contained in s. 84 of the Act. In 1963, a provision for the use of ministerial discretion was passed as the last in a series of measures to prevent dividend stripping.\(^2\) This provision became s. 247(1) of the present Act.

The effective reduction of the tax on taxable dividends introduced in the 1977 Budget, permitted a change in the approach to this problem.\(^3\) The tax on taxable dividends for individual investors in all but the top two federal tax

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\(^3\) Ibid., 278.
brackets is lower than the tax on an equivalent amount of capital gains realized within one year. In the top two tax brackets the advantage of a capital gain is minimal. Thus, now that capital gains are taxed at a rate much closer to that of taxable dividends, the incentive for dividend stripping is virtually eliminated. If anything, the balance has shifted in favour of taxable dividends relative to capital gains realized in the short term for most individual Canadian investors, but particularly those in lower tax brackets. Hence, there may exist the reverse incentive to convert what should be potential capital gains into taxable dividends, a phenomenon which could lead to what might, perhaps, be labelled "capital gains stripping". This, in fact, is a major component of the issue addressed in this paper.

Despite the fact that the difference between the tax on taxable dividends and the tax on capital gains has been all but eliminated such that there will be little tax revenue lost in most situations if one is converted to the other, s. 247(1) remains in the Act to permit the use of a ministerial determination of dividend stripping. It has been suggested that this is necessary because of the removal of the concept of designated surplus from the Act. The repeal of designated surplus in 1977 facilitates the share acquisition transactions observed in many take-over and "going private" situations where one corporation acquires the


5Cronkright et al, op cit., 279.


7Ibid., 549.

8Cronkright et al, op cit., 363.
shares of another. However, the success of these transactions depends on the apparent availability of a choice to the shareholders of either capital gains or taxable dividends on the shares to be acquired.

B. Pattern of the Typical Transaction

Consider a typical "going private" situation with special attention to the position of the minority interest shareholder's position. A holding company is usually formed to facilitate the necessary transactions. The majority shareholders of the public operating company transfer their shares in the operating company to the holding company in return for shares of the holding company. The holding company then offers to purchase for cash, perhaps with borrowed funds, the publicly held minority interest shares of the operating company. This generally provides the shareholders who accept the offer with a capital gains treatment on the disposition of their shares as long as they are not traders in securities.

The holding company and the operating company are amalgamated and the remaining minority interest shareholders who did not accept the cash offer receive a special class of redeemable shares of the amalgamated company in exchange for their shares in the operating company. This exchange of shares is subject to a rollover (s. 85.1) which, in essence, transfers the adjusted cost base of the original shares to the adjusted cost base of the redeemable shares so that no gain or loss is recognized at the time of the exchange. The amalgamation process has been facilitated by the elimination of the former designated surplus provision which would have resulted in the payment of a 25% tax on any such surplus transferred to the amalgamated corporation.

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Next, the redeemable shares are redeemed for cash, again possibly borrowed, by the amalgamated corporation. This results in a deemed dividend under s. 84(3) in the amount of the difference between the redemption price and the paid-up capital of the shares. In the hands of an individual, Canadian-resident shareholder, this dividend would receive normal treatment for taxable dividends unless special elections are filed prior to the end of 1978. The November 16, 1978 Budget, however, proposes to disqualify such deemed dividends from the $1,000 investment income deduction under s. 110.1. The redemption also results in a disposition of the shares by virtue of s. 54(c)(ii)(A). Since the amount of the deemed dividend is not part of the proceeds of disposition as defined in s. 54(h)(x), proceeds of disposition are essentially equal to the amount of the paid-up capital of the share redeemed, from which the adjusted cost base of the shares is subtracted to determine the gain or loss.

The amalgamated company would then be owned solely by the original majority shareholders. It would carry on the original public company's business as a private corporation.

Transactions involving the take-over of a public corporation by another corporation would follow a very similar pattern. In such a case, the role of the holding company described in the "going private" situation would be taken by the acquiring corporation in the take-over. Note the shareholder's opportunity, in both cases, to choose between capital gains treatment and taxable dividends treatment.


12 Notice that this Budget proposal would not affect the shareholder who sells his shares in the market and realizes a capital gain. This gain would still be subject to the $1,000 investment income deduction.
II. The Anomaly

A. The Cause

To illustrate, in specific terms, the issue under consideration, consider the case of the recent acquisition of Y & R Properties Limited by Oxford Developments Limited. This case attracted a considerable amount of investor attention during September 1978, although it is but one of many such situations available and it is used in the following analysis only as a representative case. Prior to the acquisition, Oxford bid $25 for Y & R shares to provide capital gains treatment for shareholders who wished to choose that alternative. The remaining shareholders of Y & R were asked on August 25, 1978 to approve the amalgamation of Y & R with Oxford. When this was done, the remaining Y & R shares were exchanged for redeemable preferred shares of the amalgamated company. These shares were redeemed for $25 cash early in October 1978. Of that $25 amount, $20 was deemed to be a taxable dividend and the remaining $5 was considered to be a return of the paid-up capital of the shares.

During the period between the meeting to approve the amalgamation in August and the date set for the exchange of the Y & R shares for the preferred shares early in October, hundreds of thousands of shares of Y & R were traded on the T.S.E. Many transactions took place at a price in excess of $25. Consider the basic case of an individual investor who bought some shares of Y & R at $25 in September. At this time the amalgamation had been approved and he knew with virtual certainty that he could exchange these shares for the redeemable preferred shares which would be redeemed for $25 within a month. Thus, he would purchase shares for $25, incurring brokerage costs and carrying costs for about a month. He would then receive $25 cash for the redeemable preferred shares which he would have exchanged at no cost for the Y & R shares initially purchased.
Although no investment gain has been made, consider the investor's tax position. He is deemed to have received a $20 taxable dividend which must be grossed up, but is subject to the $1,000 investment income deduction on such dividends (if they were received by November 16, 1978 such that the proposed amendment would not apply) to the extent that the deduction has not been used on other investment income. He is also eligible for the dividend tax credit on the dividends. On the redemption of his preferred shares he is considered to have received proceeds of $5. Since his adjusted cost base on these shares is $25 he has a capital loss of $20 per share resulting in an allowable capital loss of $10 which can be used to offset taxable capital gains from other sources or other income to the extent of the $2,000 allowable capital loss offset provided in s. 3(e)(ii). Thus, to the extent that the capital loss offset can be used, he will experience a tax saving which may be increased by the excess, if any, of the dividend tax credit over the tax on the grossed-up deemed dividend.

B. Rules to Maximize Profits

The profits to an individual investor who enters such a transaction can be substantial as will be demonstrated. The extent of these profits depends on a number of variables which include:

1. the investor's tax bracket including the effect on that bracket of the benefits of general averaging (s. 118);
2. the amount of the $1,000 investment income deduction still available to the investor;\(^\text{13}\)
3. the amount of the investor's capital loss offset (henceforth, abbreviated to CLOFF) defined as his taxable capital gains plus $2,000 less his allowable capital losses for the current year and for the immediately preceding year,

\(^\text{13}\) This will no longer be a relevant variable if the proposed amendment in the November 16, 1978 Budget is passed.
since net capital losses can be carried back one year;
4. the amount of any premium over redemption price paid for the shares subject
to redemption; and
5. investment carrying charges and brokerage costs.

By using a computer simulation technique based on all of the above variables for a very large number of realistic cases of individual investors, it was possible to generate some basic rules under which an individual investor could maximize his after-tax profit from entering the transaction. First, no matter what the investor's tax bracket, he should always purchase sufficient shares in the transaction to fully utilize the unused amount of his $1,000 investment income deduction. \(^{14}\) Second, if the investor has no CLOFF (perhaps, because his allowable capital losses exceed his taxable capital gains plus $2,000), he should purchase shares to the extent that his federal marginal tax bracket remains under 25% (i.e., taxable income under $13,680 in 1978). At this level the dividend tax credit will be greater than the tax on the grossed-up dividend deemed by the transaction and the excess tax credit can be used to offset tax on other income. Third, if the investor has any amount of CLOFF in the current year or the immediately preceding year, he should purchase shares to the extent that he fully utilizes the CLOFF through the capital loss component of the transaction or to the extent that his federal marginal tax rate remains under 37.5% (i.e., $59,319 of taxable income in 1978), whichever arises first. It can be proven algebraically that dividends are taxed at rates lower than rates on capital gains realized in a very short holding period for investors with federal marginal tax

\(^{14}\) The November 16, 1978 Budget proposes an amendment which would make this rule inapplicable but does not affect the next two rules. Prior to the Budget date, the transaction used to the extent indicated would have resulted in a deemed dividend which would have been exempt from tax but still would have provided the dividend tax credit to be applied to tax on other income.
It should be noted that general averaging can result in considerable benefits in this situation, since the process effectively reduces the marginal tax rate on additional income, thereby increasing the amount of income taxed under either the 25% or 37.5% rate suggested in the above rules. It should also be noted that the transaction benefits the investor by reducing the taxes he would otherwise pay on other sources of income. As a result, the maximum profits from the use of the transaction will be limited by the amount of taxes payable on the other sources of income. It is possible to eliminate virtually all of the tax payable on other sources of income under certain conditions and this will still be possible even if the proposed amendment is passed.

C. Examples

1. The Basic Case

Table I presents the range of profits possible from the use of the redemption transaction in the Y & R situation based on a realistic set of assumptions used to build the computer simulation model. Profit figures are shown for five individual, Canadian-resident investors purchasing the Y & R shares at $25 plus standard brokerage charges and interest carrying costs on the funds for one month and then redeeming the shares through the transaction for $25 in cash. The taxable income for these investors for the current year prior to entering the transaction and for the immediately preceding year was assumed to be an amount equal to the mid-point of the five tax brackets shown.

General averaging was used in the computation of all taxes using 110% of the preceding year's net income (before assuming personal exemptions of $5,960 for

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\(^{15}\) Gould and Laiken, *op. cit.*, 662, f.n. 19. Since there is no 37.5% federal marginal tax bracket currently, the effective upper limit is the 36% federal marginal tax bracket which includes taxable income up to $59,319 in 1978.
TABLE I
TAX SAVINGS RESULTING FROM USE OF REDEMPTION TRANSACTION
(Y & R PROPERTIES/ OXFORD DEVELOPMENTS)

<table>
<thead>
<tr>
<th>Federal Marginal Tax Rate</th>
<th>18%</th>
<th>23%</th>
<th>25%</th>
<th>36%</th>
<th>39%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1978 Taxable Income</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$3,042 - $4,563</td>
<td>$10,647 - $13,689</td>
<td>$13,689 - $16,731</td>
<td>$36,504 - $59,319</td>
<td>$59,319 - $91,260</td>
<td></td>
</tr>
<tr>
<td>CLOFF</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$0</td>
<td>$2,000</td>
<td>$3,803</td>
<td>$0</td>
<td>$2,000</td>
<td>$12,168</td>
</tr>
<tr>
<td>Exempt</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$1,000</td>
<td>$259</td>
<td>$417</td>
<td>$317</td>
<td>$4,030</td>
<td>$318</td>
</tr>
<tr>
<td>0</td>
<td>180</td>
<td>417</td>
<td>304</td>
<td>9,109</td>
<td>3,617</td>
</tr>
</tbody>
</table>

CLOFF (available capital loss offset) = taxable capital gains plus $2,000 minus allowable capital losses for both the current year and the immediately preceding year. The three cases shown in the table consist of:

(a) no CLOFF available, i.e., allowable capital losses exceed taxable capital gains plus $2,000 before the redemption transaction;
(b) $2,000 of CLOFF, i.e., allowable capital losses equal taxable capital gains; and
(c) CLOFF equal to the amount of taxable income (mid-point of the tax bracket) used in the calculations, i.e., all taxable income arises from an excess of taxable capital gains plus $2,000 over allowable capital losses (as might be the case for a non-working spouse).

Amount of unused $1,000 exemption for Canadian-source interest, grossed-up dividends and taxable capital gains prior to the redemption transaction.

The results in this row of the table will not be attainable if the amendment proposed in the November 16, 1978 Budget is passed.
marital status, one child under 16 and one child over 16 for 1978) as the basis for the computation (on the assumption that such an amount would be greater than the 120% of the average of the preceding four years' net income). It was assumed that the investor had no other dividend income other than that from the redemption. Hence, where all of the $1,000 deduction was assumed to have been used, it was assumed to have been used to exempt Canadian-source interest income or taxable capital gains. It was further assumed that the saving was received as a refund of taxes upon filing a personal tax return six months from the time of the redemption transaction and, hence, Table I reflects the present value of this saving.

The table confirms the rules previously outlined and shows the maximum profits that can be generated from the use of the rules. Note that it is possible to make a profit irrespective of the individual's tax bracket if the investor has not fully utilized his $1,000 exemption. These are the only profits under discussion that would be eliminated by the proposed amendment.

The entries in the table representing no CLOFF and no unused exemption clearly show that profits will be generated by the transaction only for investors in federal marginal tax brackets under the 25% rate with lower profits at the relatively higher tax bracket of 23%. These profits would still be available if the proposed amendment is passed. Finally, if the investor has CLOFF available from other sources of income, the table shows that profits will result from the transaction to the extent that either the CLOFF is fully offset by the allowable capital loss component of the redemption or the investor's income reaches the 37.5% federal marginal tax bracket, whichever arises first, even if the investor has fully utilized his $1,000 deduction before the transaction. These profits, also, will still be attainable even if the proposed amendment is passed.

Note that at the relatively high tax bracket of 36% the profits are severely reduced by brokerage charges and carrying costs. The number of shares that should
be purchased to fully utilize the investor's CLOFF for the current year and for the immediately preceding year would be given by dividing total CLOFF for the two years by the allowable capital loss component of the transaction, in this case, $10. The potential carryforward of allowable capital losses is disregarded in this analysis on the assumption that the investor can enter another similar redemption transaction in the following years to fully utilize his CLOFF in those years.

It should be emphasized that there is likely a very large number of taxpayers in the 23% and 25% federal marginal tax brackets. It is also very likely that most of these taxpayers have at least the $2,000 of CLOFF allowed by s. 3(e)(ii). Thus, tax savings of $1,092 in the 23% bracket and $777 in the 25% tax bracket, as shown in the table, can be achieved by using the redemption transaction and this opportunity will not be blocked by the proposed amendment.

2. Other Cases

Two other effects are worth noting. First, it is possible to generate a profit from the use of this transaction even if a premium over the redemption price is paid. In the Y & R situation, many investors paid a premium of over $1, i.e., they paid over $26, to purchase the shares which would be redeemed for $25. This premium represents a cash loss which would reduce the profits from the resulting tax savings. For the purposes of analysis, a $1 premium was assumed and the profits were recomputed. In all cases showing a profit greater than $13 in Table I, the premium still resulted in a profit, although that profit was somewhat reduced. The previously mentioned investor in the 23% federal tax bracket with $2,000 of CLOFF would generate a $723 tax saving while the investor in the 25% tax bracket with $2,000 of CLOFF would generate a $432 tax saving, even if the proposed amendment is passed.

Second, general averaging has an important effect in increasing the profits
from the redemption transaction. As noted previously, general averaging effectively reduces the tax paid on abnormal increases in income such that greater amounts of income can be taxed at rates under 25% or 37.5%. This has the effect of increasing the profits available for the redemption transaction.

To test these effects, under somewhat more extreme conditions, one change was made to the set of assumptions used to test the basic case. It was assumed that the investor had no net income in the years prior to the current year when he entered the redemption transaction. This removes the possibility of carrying back a capital loss to the preceding year. This reduced the profits for cases where such a carryback could be used, particularly in the lower tax brackets. However, in all other cases the profits in this case were greatly increased. Again, the previously mentioned investor in the 23% federal marginal tax bracket with $2,000 of CLOFF would generate a tax saving of $1,694 and the investor in the 25% tax bracket with $2,000 of CLOFF would generate a tax saving of $2,168 even if the proposed amendment is passed. Even greater profits are possible in higher tax brackets. For example, consider the case in Table I of the investor in the 36% federal marginal tax bracket having fully utilized his $1,000 investment income deduction and having CLOFF equal to his taxable income of $47,912. The profit shown in Table I for this case is $13. However, the profit for the equivalent case under the more extreme general averaging assumption is $9,595.

These more extreme general averaging conditions are not necessarily uncommon. It is conceivable for a non-working spouse, for example, to own a sizeable capital property which is disposed of for a taxable capital gain of, say, $50,000. If such an individual used a redemption transaction similar to that offered by the Y & R situation, most or all of that taxable capital gain could be offset by the allowable capital loss component of the transaction and, combined with the effects of general averaging, the tax otherwise payable on the gain would be substantially reduced or eliminated, resulting in a tax saving of almost $10,000.
D. The Inequity

The foregoing analysis has focussed on the case of the individual investor who purchased shares subject to a take-over or "going private" transaction after the transaction has been approved such that there is no financial risk to the investor. No economic gain is generated by the investor who, using the case of the Y & R transaction, pays $25 for shares which are effectively redeemed for $25. As has been suggested by the Chairman of the Ontario Securities Commission, there is even less economic justification when a premium is paid for the shares. Yet a great many investors can profit from entering the transaction and generating a tax saving which is well worth the effort involved. These opportunities would be only partially eliminated by the proposed amendments to disqualify the deemed dividend in these cases from the $1,000 investment income deduction.

It should be recognized that many investors will acquire the shares of a company which is ultimately subject to a take-over or "going private" transaction. These shareholders will have made their investments before such transactions are announced and their investments will be subject to normal financial risks inherent in such a situation. The benefits to these investors of entering the type of redemption transaction under discussion will not likely be as great as those outlined above since the capital loss component in their transactions will not be as great. Their situation is, in some sense, more "legitimate". In fact, the legislation in this area with respect to investor choice would appear to be designed for their case. Thus, any attempt to fully remove the anomaly, assuming that such removal is both desirable and worthwhile, must not adversely affect this latter group of shareholders or hinder sound business transactions.

which are expected to produce an economic gain. While sound business practice may suggest the structuring of take-over or "going private" transactions in the manner described and while it may be satisfactory to permit shareholders in these situations, a choice between capital gains and taxable dividends on which these taxes are almost equivalent, it is evident from the foregoing analysis of a very common case that an anomaly exists which can create, in certain circumstances, considerable profits from transactions with little or no economic justification.

III. Analysis of Approaches to Removing the Anomaly

A. Use of the Anti-Avoidance Rule

It would seem possible to use the anti-avoidance rule in s. 55 in the case of an individual investor who has purchased his shares, perhaps at a premium, after the shareholders' meeting to approve a take-over or "going private" transaction. In this specific case, the only advantage of entering the transaction is to obtain a tax advantage. In such a situation, it has been suggested that a transaction of this nature can be appropriately considered to be artificial. Although the transaction in this specific case may be set up within the letter of the law, it hardly seems within the spirit of the law that a tax advantage should be created without any other financial justification. Furthermore, this specific case hardly represents the situation of a taxpayer arranging his "legitimate" business affairs and, thereby, minimizing his taxes.

Some administrative problems are apparent in using the s. 55 approach. Although individual investors are required to report dispositions of securities,


18 Ibid., 110.
the assessment procedures must identify those securities involved in the redemption transactions discussed. In recent months, a large number of companies have had securities subject to such transactions. Furthermore, the assessment procedure must identify only those investors who were in a position to artificially create the tax saving without any financial risk, i.e., only those shareholders who entered the transaction after shareholder approval was granted. Those shareholders who invested in the shares of the company subject to a take-over or "going private" transaction before such a transaction was even announced to the public, for whom the choice offered by taxable capital gains or taxable dividends may be regarded as legitimate, should not be subjected to treatment under s. 55.

Random sampling of cases involving the types of share transactions in question might be the least costly approach to assessment in this area. However, it should be recognized that the costs of entering these transactions after the shareholder-approval stage are so low and the potential tax savings are so high that many taxpayers will be motivated to take the chance of an adverse assessment.

The use of s. 247(1) has been suggested as a possible approach. However, this provision which deals with dividend stripping, i.e., the conversion of an amount that would ordinarily be paid as a taxable dividend to a capital gain, does not appear to be appropriate in the specific case at hand. The case in question, in essence, involves the reverse situation of converting what should, perhaps, result in a capital gain on the disposition of shares into a taxable dividend. Perhaps, what is required is a "capital gains stripping" provision, directed only to the specific case involved in the anomaly described.

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19Birnie, op.cit., 549; Cronkwright et al, op.cit., 363; Ewens, op.cit., 73; Ward, op.cit., 112.
B. Possible Repeal of the Deemed Dividend Rules

As indicated earlier, s. 84 may be considered as a provision which was designed to prevent the problem of dividend stripping. However, this may no longer be regarded as a problem, since, at least in some situations, capital gains are now taxed at approximately the same rates as taxable dividends. This might suggest that s. 84 could be repealed. However, at least three reasons have been indicated for maintaining the provision including: permitting shareholders an opportunity to choose between capital gains and taxable dividends instead of forcing capital gains treatment for all, preventing distributions of surplus to non-residents free of Canadian withholding tax, and preventing tax-free distributions of surplus up to the V-Day value of shares.20

Even if these issues could be addressed in some other way and s. 84 were repealed, the problem of the anomaly would not be solved. It would seem possible to duplicate the effects of the redemption transaction in question by selling the assets of the subject corporation to a new corporation for cash and paying a taxable dividend from these proceeds to the shareholders of the subject corporation followed by redeeming the shares of the subject corporation for their paid-up capital. This would provide investors, who buy the shares of the subject corporation (conceivably after the details have been announced and approved) for an amount equal to the taxable dividend plus the paid-up capital, with the same opportunity for a tax saving without financial risk as the redemption transaction at issue.

C. Possible Changes in the Deemed Dividend Rules

Currently a deemed dividend under s. 84(3) is, in essence, given by the

excess of the redemption price over the paid-up capital of the shares. Perhaps
the investor's adjusted cost base for the shares should be substituted for the
paid-up capital of the shares in the calculation of a deemed dividend. Thus, a
deemed dividend would be considered to be the excess of redemption price over
the shareholder's adjusted cost base and this concept would be used in all cases
where shares are redeemed. This would still permit the concept of a tax-free
return of capital which would be represented by the adjusted cost base of the
shares.

Consider the effects of this approach on the extreme case of the original
investor who, using the Y & R figures, paid the $5 paid-up capital amount for his
shares. In the take-over or "going private" transactions under consideration, he
could choose to sell his shares on the open market and receive a capital gain of
$20 assuming a disposition at a market value of $25. Alternatively, he could
choose to enter the redemption transaction which would result in a deemed divi­
dend of $20 computed as the difference between the redemption price of $25 and
his adjusted cost base of $5. In this case, his proceeds of disposition could
still be considered to be the amount received net of the deemed dividend or $5
($25 - 20) and his cost would be $5 resulting in no capital gain or loss, thereby
returning the original $5 of capital tax free.

Now consider the effects of this approach on the other extreme case of the
investor who buys the shares of the subject corporation after shareholder
approval of the redemption transaction. Again, using the Y & R figures, he
would have purchased shares at $25 and, essentially, redeemed them for $25. His
deemed dividend under the revised concept discussed here would be computed as
the difference between that redemption price of $25 and the cost base of $25
resulting in no deemed dividend. His proceeds of disposition could still be
considered to be the amount received ($25) net of the deemed dividend ($0)
resulting in proceeds of $25. Since his cost base was $25, he would have no
gain or loss on the transaction. Thus, in the case of the artificial use of the transaction, there would be no deemed dividend and no capital loss offset which is as it should be.

If the subject corporation chooses to sell its assets and pay a taxable dividend followed by a return of paid-up capital as outlined previously, the revised deemed dividend concept might work as follows. Again, using the Y & R figures, assume the subject company has $25 in cash per share to distribute after the sale of its assets and a taxable dividend of $20 is paid followed by the redemption of the company's shares for the remaining $5 representing paid-up capital.

Consider the case of the investor who can now benefit from the anomaly by buying the shares of the subject corporation for $25. This investor would receive the taxable dividend of $20. Since the shares are then redeemed, the revised concept of a deemed dividend as the excess of redemption price ($5) over adjusted cost base ($25) produces a negative amount of $20. This "deemed dividend deficiency" could be used to offset the taxable dividend received of $20 in this situation. There should be no need to use the capital gains rules for a disposition, because the whole deemed dividend process has converted what might otherwise have been a capital gain to a taxable dividend and has provided for a tax-free return of invested capital.

It is recognized that this approach, involving a revision of the concept of a deemed dividend, may create more problems than it solves. However, it does represent an approach to the particular problem at hand which could be considered and, in fact, this approach is very similar in concept to the provision in s. 112(3) applicable to corporations. Perhaps further thought along these lines is warranted.
D. A Full-integration System

Perhaps the most effective approach to solving the problem presented by the anomaly in this situation is embedded in the Carter Commission recommendation of a full-integration system. It is the imperfection of the integration system adopted by the current tax legislation that gives rise to the problem under discussion. If, as recommended by the Carter Commission, the integration system were complete such that there were no advantages to dividends over capital gains at all income levels, surplus stripping of any kind would not be a problem and the redemption transaction under discussion would not arise. Although a return to this Carter concept of full integration is the ideal approach to solving this particular problem, it is not the most practical at this stage of the development of Canadian federal tax legislation.

IV. Summary

This paper has analyzed a share redemption transaction common to many take-overs and "going private" offers. An anomaly in the Act provides certain investors with an opportunity to generate large tax savings without financial risk, but also without economic gain. Although the November 16, 1978 Budget (Resolution 39) proposes to eliminate such tax savings, the amendment to the $1,000 investment income deduction, if passed, will not remove all opportunities for generating large tax savings and, in fact, may obstruct a legitimate choice between capital gains and taxable dividends in this situation. Since the proposed amendment does not fully remove the effects of the anomaly discussed, a number of further approaches to addressing the problem of removing these effects are suggested and analyzed with the conclusion that, perhaps a revision in the concept of the deemed dividend is warranted.


