Personal Tax Planning

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REVISITING PRE-1972 CAPITAL SURPLUS ON HAND (THE MORE THINGS CHANGE, THE MORE THEY STAY THE SAME)

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This article reviews the pre-1979 background that today's tax practitioner needs to appreciate the significance of pre-1972 capital surplus on hand (CSOH) and the situations where its existence might make a difference to a taxpayer's personal (or corporate) wealth. The article also considers some of the problems and pitfalls that arise when corporations with pre-1972 CSOH are reorganized a quarter of a century later.

The end of this year marks the silver anniversary of valuation day (V-day), the day capital gains ceased to be free from direct taxation in Canada. From all accounts, the 1971 income tax reforms appear to be the farthest reaching and longest lasting in Canadian tax history. Twenty-five years after the event, taxpayers continue, albeit less frequently, to deal with the aftermath of the 1971 reforms. The more recent introduction and subsequent repeal of the $100,000 lifetime capital gains exemption pales in comparison with the complexities introduced as part of the 1971 tax reforms. One major feature of the 1971 reforms included the ability for corporations to distribute to shareholders their pre-V-day gains on a tax-free basis. The rules for doing so, however, were complicated by the rules dealing with surplus distributions. Each of the various subcomponents of retained earnings required careful tracking for determination of the tax payable as a result of a corporate distribution.

The rules dealing with corporate distributions were vastly simplified in 1977 with the repeal of the 1971 transitional rules dealing with surplus distributions.[1] As part of the 1977 simplification, and subject to planning

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[1] A number of papers were written at the end of 1978 which canvassed extensively many issues dealing with the surplus rules, including the 1978 changes. See, for example,

(The footnote is continued on the next page.)

undertaken by the end of 1978, the CSOH resulting from gains accrued up to but realized after V-day was locked into most corporations pending the ultimate demise of the corporation by way of a taxable liquidation to which the provisions of subsection 88(2) of the Income Tax Act[2] apply. These gains are accounted for in a special account, the pre-1972 capital surplus on hand account[3] (pre-1972 CSOH). Nearly 18 years have passed since the ability to distribute pre-1972 CSOH was eliminated. Although many corporations took steps at the end of 1978 to optimize their surplus balances vis-à-vis their particular shareholder profile, many did not, and they have likely long since realized the pre-1972 accrued gains that spawned the need for the pre-1972 CSOH account. This means that many corporations may unknowingly be flush with pre-1972 CSOH that could be distributed to certain shareholders tax-free upon a taxable liquidation.

PRE-1979 SURPLUS DISTRIBUTION RULES

The original rules applicable to distributions of 1971 surpluses required the tracking of several pools to determine the extent to which tax would be payable. Following the reforms in 1971, it was intended that a company's surplus would be categorized as follows:

- 1971 undistributed income on hand (UIOH),
- tax-paid undistributed surplus on hand (TPUS),
- 1971 CSOH,
- capital dividend account (CDA), and
- post-1971 earnings (now generally referred to as safe income).

UIOH was effectively a corporation's undistributed after-tax income up to the end of 1971. It was computed on a tax basis and accordingly excluded capital gains realized in that period. As a transitional measure and to ease the burden of historical calculations, only years after 1949 had to be considered. TPUS represented UIOH upon which a 15 percent special tax[4] had been paid either before or after 1971, allowing such surplus to be distributed as a return of capital. The 1971 CSOH generally consisted of pre-1972 realized capital gains (losses), pre-1950 undistributed

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[1] Continued . . .
P.M. Farwell, "Public Corporations: Capitalizing Surplus in 1978," in *Corporate Management Tax Conference 1978* (Toronto: Canadian Tax Foundation, 1978), 90-107; D.R. Levitt, "Determination and Methods of Realization of 1971 Surpluses," ibid., 1-24; David G. Broadhurst, "Private Corporation Distributions," ibid., 25-48; and Glen E. Cronkwright, Robert J. Dart, and Robert F. Lindsay, "Corporate Distributions and the 1977 Tax Changes," in *Report of Proceedings of the Twenty-Ninth Tax Conference*, 1977 Conference Report (Toronto: Canadian Tax Foundation, 1978), 279-363. Readers requiring guidance on particular computational issues should refer to these papers.

[2] RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

[3] Subsection 88(2.1).

[4] Part IX tax.

tax-basis earnings (tax equity), and pre-V-day capital gains (losses) realized after 1971. Originally, the 1971 CSOH could be distributed as a return of capital, subject to the payment of the special 15 percent tax on any UIOH. The after-tax balance was designated TPUS. The CDA, then as now, captured, among other things, the non-taxable portion of a capital gain realized after 1971 and could be distributed tax-free without implication to the adjusted cost base (ACB) of the shares. Post-1971 earnings were subject to tax in the shareholders' hands and were often themselves subject to computation in accordance with the safe income concept embedded in subsection 55(2). Public corporations had no CDA but could have 1971 CSOH, 1971 UIOH, and TPUS.

The 1971 tax reforms were designed to facilitate corporate distributions as a return of capital and to provide consistency in the ordering of those distributions. As part of these reforms, taxpayers have, since 1971, been allowed to receive a return of their capital before distributing earnings. In practice, however, the difficulties in administering the system proved onerous because of the complexities of the legislation required to implement the intended policy.[5] One author at the time commented that the drafter of the 1971 corporate distribution reforms must have been raised on snakes and ladders,[6] a reference to the numerous cross-references and definitions required to properly track and limit the various surplus pots.

The 1977 federal budget repealed the complex surplus distribution rules with effect after 1978. As an interim measure, the pre-1971 CSOH at the end of 1978 could be distributed to shareholders as a return of capital without regard to the UIOH (and therefore without the need to pay the 15 percent part IX tax) if this was done before 1979. Non-resident shareholders who either alone or together with other non-residents controlled the paying corporation were required to convert UIOH to TPUS by paying the 15 percent part IX tax before they could gain access to the CSOH.

In spite of the elimination of the pre-1971 surplus pools, the government preserved a corporation's ability to distribute what would have been the pre-1971 surplus balances in an effort to enable pre-V-day gains realized after the 1978 changes to be distributed as a return of capital, but only on the ultimate liquidation of the company.

TAXPAYERS LIKELY TO BENEFIT FROM PRE-1972 CSOH TODAY

Before we review the technical devices for realizing pre-1972 CSOH within today's legislative framework, it might be useful to profile those taxpayers who might benefit most from any available pre-1972 CSOH. As will be discussed in greater detail below, a distribution of a corporation's

[5] Cronkwright et al., supra footnote 1, cite at least eight reasons why the changes were required.

[6] John G. Smith, "Dividend Income; Capital Gains; Distribution of Corporate Surpluses; Corporate Reorganizations," in *Canadian Bar Papers on Tax Reform 1971* (Don Mills, Ont.: CCH Canadian, 1971), 167-76, at 167.

pre-1972 CSOH is not treated as a dividend, but rather forms part of the proceeds of disposition of a particular taxpayer's shares on the liquidation of the company.

In order for the proceeds of disposition to be tax-effective, the taxpayer must either have sufficient ACB in the shares that are disposed of on the liquidation or be exempt from Canadian tax on capital gains, perhaps by virtue of an income tax convention or because of an overabundance of capital losses. In any event, the shareholder with the correct profile will be the one to whom a capital receipt is more attractive than a taxable dividend. Generally, there will be no tax impediment to a capital receipt where the ACB and paid-up capital (PUC) are equal.

An individual may have a high ACB in shares owned but have little or no PUC for a variety of reasons. For example, the shares of an existing company may have been acquired at a price in excess of the PUC, or there may have been an increase in the ACB, but not the PUC, as a consequence of a qualified small business corporation share crystallization.

A foreign corporation investing in shares of a Canadian operating company commonly establishes a Canadian holding company to make the investment. Subsequently, any transactions in the shares of the Canadian holding company (for example, interaffiliate transfers of the shares outside Canada) can result in an increase in the ACB, without any current taxation, as a result of an exemption contained in an income tax convention. The rules contained in section 212.1 generally limit the company's ability to match PUC with the ACB without causing a deemed dividend that would be subject to Canadian withholding taxes.

Finally, a shareholder could have an appropriate level of ACB in shares that was computed by reference to the value of those shares at December 31, 1971 (V-day value), either under the median rule or, in the case of an individual, by virtue of an election under ITAR 26(7).

Whatever the circumstance, where the value of the shares of a Canadian corporation exceeds the PUC of those shares, a shareholder's after-tax wealth will generally be enhanced by any available pre-1972 CSOH, where the time has arrived to liquidate the corporation.

WINDUP OF A CANADIAN CORPORATION

As noted above, access to pre-1972 CSOH occurs only on a taxable liquidation—more specifically, on a windup of a Canadian corporation to which the rules in subsection 88(2)[7] apply. Where subsection 88(2) applies, all of the property owned by the corporation at the time of winding up is deemed to have been sold immediately before the windup at its fair market value (FMV),[8] with all the tax consequences that flow from a disposition.

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[7] Because subsection 88(2) governs the Canadian tax implications of a dissolution not covered by the tax-deferred liquidation provided for in subsection 88(1), it is referred to herein as a taxable liquidation.

[8] Subsection 69(5) and subparagraph 88(2)(a)(v).

The distribution of property on the windup of the corporation gives rise to a dividend[9] to the extent that the value of the property distributed on the windup to holders of a particular class of shares exceeds the amount, if any, by which the PUC in respect of that class of shares is reduced on the distribution. This dividend becomes the basis for layering out various surplus pots and thereby determining the tax payable at the shareholder level as a result of the liquidation.

On the windup, a company's tax surplus pots are automatically distributed in the following order:

1) CDA;

2) capital gains dividend account of a non-resident-owned investment corporation;

3) pre-1972 CSOH.

Any portion of the winding-up dividend in excess of these amounts is treated as a taxable dividend. The tax implications of the first two components are beyond the scope of this article and are well covered elsewhere. The third element is not regarded as a dividend,[10] but rather forms part of the proceeds of disposition of the shares.[11] Consequently, the tax implications of the liquidation will depend on the shareholder's ACB and/or tax profile (that is, individual, corporation, non-resident).

For individuals resident in Canada, proceeds of disposition up to the individual's ACB will enhance the individual's after-tax position. In most Canadian jurisdictions, proceeds in excess of the individual's ACB will likely put the individual in a somewhat worse after-tax position. For example, in Ontario, the top rate of tax on capital gains at present is roughly 40 percent, whereas a dividend qualifying for the dividend tax credit[12] is currently taxed at a top rate of approximately 36 percent.[13] Since the surplus pots are computed automatically, care must be taken in liquidating corporations that could have pre-1972 CSOH to ensure that the shareholder's wealth is not eroded by incremental taxes resulting from insufficient ACB. Where the shares of the company qualify for the $500,000 capital gains exemption for small business shares, additional proceeds of disposition may be received tax-free.

A Canadian corporation will generally prefer to receive a winding-up dividend as a taxable dividend where the company being dissolved is a taxable Canadian corporation or a controlled corporation resident in Canada, provided that the dividend is deductible by virtue of subsection

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[9] Subsection 84(2).

[10] Subparagraph 88(2)(b)(ii).

[11] Paragraph (i) of the definition of "proceeds of disposition" in section 54.

[12] Section 121.

[13] This represents an inversion from 1978, when capital gains and dividends were taxed at top marginal rates in Ontario of 31% and 39% respectively.

112(1) and is not recharacterized as proceeds of disposition by specific anti-avoidance provisions.[14]

From a purely Canadian perspective, a non-resident of Canada will welcome a recharacterization of the taxable dividend as proceeds of disposition provided that the property in question is not taxable Canadian property (TCP), or is TCP but is exempted from taxation in Canada by virtue of a double taxation convention between Canada and the non-resident's country of residence. However, the tax implications in the home country must be taken into account.

PRE-1972 CSOH

The rules for determining pre-1972 CSOH are not, at first glance, easy to locate. Although subsection 88(2.1) provides a definition of pre-1972 CSOH for purposes of subsection 88(2), some publishers have dropped the historical text relevant to the starting point of the computation.[15] For purposes of subsection 88(2), pre-1972 CSOH is computed[16] as the amount by which

the sum of

- the 1971 CSOH at the end of 1978,
- pre-V-day gains from dispositions after 1971 of capital property owned on December 31, 1971,
- positive amounts of pre-1972 CSOH flowing from a qualifying liquidation of a 90 percent or more owned subsidiary, and
- positive amounts of pre-1972 CSOH flowing from an amalgamation of one or more predecessor corporations

exceeds

- pre-V-day losses from dispositions after 1978 of non-depreciable capital property owned on December 31, 1971.

The starting point for pre-1972 CSOH is the corporation's 1971 CSOH at the end of 1978 as that definition read at that time. At the end of 1978, 1971 CSOH was defined in paragraph 89(1)(l);[17] however, special transitional rules were applicable in determining the 1971 CSOH at the end of 1978 to take into account the elimination of the 1971 UIOH, paid-up capital deficiency, and designated surplus.[18] Accordingly, reference must be made to the version of paragraph 89(1)(l) that applied between March

[14] For example, subsection 55(2).

[15] Carswell's TaxPartner [database online] contains an excellent integrated text of the relevant transitional provisions.

[16] Subsection 88(2.1).

[17] Paragraph 89(1)(l) of the Income Tax Act, RSC 1952, c. 148, as amended by SC 1970-71-72, c. 63, and as subsequently amended.

[18] Paragraph 89(1)(l) was repealed by SC 1977-78, c. 1, section 44(5), applicable after December 31, 1978. Transitional rules in section 44(9) of SC 1977-78, c. 1 governed the application of paragraph 89(1)(l) after March 31, 1977 and before 1979.

31, 1977 and December 31, 1978. The appendix to this article contains a table summarizing the principal components that make up the 1971 CSOH at the end of 1978.

The remaining components of pre-1972 CSOH, as indicated above, are conceptually easy to follow. The following points are, however, worth noting and merit some discussion:

- CSOH balances must be positive amounts.
- No restrictions on pre-1972 CSOH arise from an acquisition of control.
- Pre-1972 CSOH does not attach to any particular shares.
- Realization of pre-1972 CSOH does not require ownership of the shares on V-day.
- Reorganizations could affect the ability to realize benefits of pre-1972 CSOH.
- The distribution of pre-1972 CSOH on a liquidation applies automatically.

Pre-1972 CSOH Must Be a Positive Amount

CSOH balances (both 1971 CSOH and pre-1972 CSOH) are computed on a company-by-company basis. The definition is undertaken at a particular point in time, and the definitions of both pre-1972 CSOH and 1971 CSOH contemplate that they must be positive.[19] This means, for example, that a company with pre-V-day capital losses that are realized before 1979 can realize a pre-V-day gain subsequent to 1978 and still have a balance of pre-1972 CSOH. This is because the realized losses would be in the 1971 CSOH component of pre-1972 CSOH; and since, after 1978, that component can give rise only to a positive balance, any deficiency at the end of 1978 simply disappears.

In addition, where there is a combination of two entities by way of a qualifying tax-deferred liquidation or amalgamation, any negative CSOH that had been crystallized before the combination would potentially be eliminated. On the other hand, unrealized negative CSOH that exists at the time of a combination will later erode any positive elements in the combined entity.

No Restrictions Apply on an Acquisition of Control

No restrictions apply on an acquisition of control which would adversely affect the ability of a subsequent shareholder to realize any pre-1972 CSOH on the ultimate liquidation of the company. This could mean that existing companies that have been acquired and had pre-1972 CSOH crystallized either before or after the acquisition will likely still have such amounts available today.

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[19] A negative 1971 CSOH account before the 1977 reforms gave rise to a paid-up capital deficiency that resulted in the payment of the 15 percent part IX tax to the extent of the deficiency.

Pre-1972 CSOH Does Not Attach to Any Particular Shares

Pre-1972 CSOH, like safe income on hand, exists within a particular corporate entity. In this regard, pre-1972 CSOH floats; and until the corporation disposes of its last property, owned or deemed to have been owned on V-day, the balance can increase or decrease. The balance of pre-1972 CSOH, however, does not attach to any particular share of the corporation.[20] Consequently, by virtue of the mechanics on distribution, the potential exists to skew pre-1972 CSOH in favour of a particular shareholder or class of shareholders.

Realization Is Independent of Ownership on V-Day

As indicated above, because the pre-1972 CSOH balance floats within a corporate entity, the ultimate realization is independent of who owns the shares, and there is no requirement for the shares on which the pre-1972 CSOH is ultimately realized to have been owned by the shareholder on V-day.

Reorganizations Could Affect the Ability To Realize Benefits of Pre-1972 CSOH

Because pre-1972 CSOH is an attribute of a corporate entity, transactions with that corporate entity could adversely affect, or alternatively enhance, the ability of shareholders to benefit from any available pre-1972 CSOH. The rules provide a limited flowthrough in certain reorganizations, and certain transactions could block the ability to use the pre-1972 CSOH balance in the future. On the other hand, steps can be taken to maximize (or accelerate realization of) the benefits of any available pre-1972 CSOH.

The Distribution on a Liquidation Applies Automatically

The pre-1972 CSOH balance is automatically recharacterized as proceeds of disposition in a taxable liquidation. This ensures that any benefits are available to the shareholder; however, it also assumes that the shareholder wishes to receive a capital receipt. As discussed earlier, certain shareholders may prefer a taxable dividend.

SHORT-CUTTING PRE-1972 CSOH

At the risk of oversimplification, a means of estimating a corporation's pre-1972 CSOH would be to determine the following from the relevant financial statements (if available):

a) the 1950 retained earnings;

b) net capital gains realized before 1972;

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[20] This is in stark contrast to the safe income concept as applied by Revenue Canada. The department requires that safe income must be allocated to each particular share during the relevant holding period of a particular shareholder. The decision of the Tax Court of Canada in *Nassau Walnut Investments Inc. v. The Queen*, 95 DTC 367, has, however, cast doubt on Revenue Canada's position regarding safe income.

c) contributed surplus at March 31, 1977;

d) pre-V-day gains realized after 1978;

e) pre-V-day losses realized after 1978; and

f) tax-deferred 1971 CSOH dividends paid before 1979.

The formula $a + b + c + d - (e + f)$ would provide a reasonable estimate of the pre-1972 CSOH.

Obviously, such an estimate would have to be corroborated with a much more detailed analysis of the components and the effect of transactions in the intervening periods. One effect of flowing forward only positive balances is that the CSOH components of particular predecessor corporations can generally only add to the CSOH. Caution must be exercised in tracing through the flow of CSOH balances of predecessors to ensure that nothing in a particular corporation's history causes erosion of that balance. The effect of related-party transactions also must be considered.[21] The only reported case dealing with pre-1972 surplus computations is a curious one involving a determination whether a taxpayer had made a reasonable attempt to compute its 1971 CSOH before electing to pay a tax-deferred dividend.[22] While the tax on excessive tax-deferred TPUS and CSOH dividends has ceased to be applicable after 1979, the case is likely of interest to anyone who today may be required to determine pre-1972 CSOH and wishes to gain insight into the standard to be applied. One particular passage from that case seems relevant:

> A "reasonable attempt to *correctly* determine" pre-1972 surpluses must exact an attempt to determine those sums in accord with the facts, or the truth, as the taxpayer knows it to be, not merely as the taxpayer would like it to appear in order to gain a tax advantage which would not otherwise be available. The taxpayer, under the statutory standard is not required to be "right" as the plaintiff has argued; but it is required not to be duplicitous, or deceitful, or knowingly to evade the duty to make a *reasonable* attempt to meet the standard of *correctly* determining its tax paid 1971 C.S.O.H. The taxpayer knowingly fell woefully short of that statutory standard.[23]

PROBLEMS AND PITFALLS

Problems relating to pre-1972 CSOH can still arise in transactions today. If one is not aware of an older corporation's pre-1972 CSOH position (keeping in mind the various flowthrough provisions), a risk exists that current and future transactions may erode the pre-1972 CSOH. In addition, the liquidation of a company with pre-1972 CSOH could produce a different result than that intended by virtue of the automatic distribution on liquidation. In particular, the problems discussed below can arise.

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21 For example, see the discussion on subsection 88(2.2) below.

22 *Special Risk Holdings Inc. v. The Queen et al.*, 94 DTC 6151 (FCTD).

23 Ibid., at 6165.

Taxable Liquidation Where Pre-1972 CSOH Exists

Pre-1972 CSOH can be eliminated in a transaction involving a corporation with a previously crystallized pre-1972 CSOH balance. For example, assume that company A and company B own all of the shares of company C. Company C has sold all of its properties for cash and is about to be liquidated under subsection 88(2). Company C has a balance of pre-1972 CSOH. Unless one of the shareholders is a taxable Canadian corporation owning more than 90 percent of the shares of company C and the companies deal with one another at arm's length, the balance of any pre-1972 CSOH will be realized at that time. When realized in these circumstances, the balance does not represent a distributable pool. Rather than being flowed up to each shareholder for subsequent realization by each shareholder, the pre-1972 CSOH will be crystallized and recharacterized as proceeds of disposition with all of the consequences that flow therefrom.

All or Substantially All of the Property Being Distributed

In order to ensure that any pre-1972 CSOH balance is maximized, the timing of distributions of property is critical. Subsection 88(2) applies to a winding-up dividend where all or substantially all of the property of a corporation is distributed to the shareholders. This provision generally is taken to refer to the last such distribution.[24] It should be kept in mind that the final distribution to be made should at least be sufficient to match the balance of the pre-1972 CSOH existing immediately before that time. Revenue Canada has illustrated the effect of this requirement in recent correspondence,[25] in the situation where a corporate taxpayer made four equal distributions over several months in the course of its windup as cash flows permitted. Revenue Canada adopted the view that since the final distribution was less than the balance of the pre-1972 CSOH, the full amount of pre-1972 CSOH was not used, and all earlier distributions were regarded as taxable dividends. This administrative position can, of course, be of use in splitting the surplus between proceeds of disposition and capital gains where the circumstances are such that a dividend of some amount is preferable to proceeds of disposition to a particular shareholder.

Liquidation/Amalgamation into a Blocking Deficit

Subject to other commercial realities of the day, taxpayers should be aware that when combining a company with a pre-1972 CSOH balance with a company with an unrealized pre-V-day capital loss, such a loss, when realized, will grind any available pre-1972 CSOH in the combined entity. A similar situation would arise if a company with a positive CSOH balance in its account were wound up in a taxable liquidation at a time when it still had a 1971 asset with an unrealized pre-1972 loss.

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24 *Interpretation Bulletin* IT-149R4, "Winding-Up Dividend," June 28, 1991, paragraph 1.

25 See "Multiple Distributions on Wind-Up of a Corporation," October 26, 1995, Revenue Canada file no. 9520545.

RELATED-PARTY TRANSACTIONS

Gains and losses realized after 1978 in certain non-arm's-length transactions will be ignored for purposes of computing the pre-1972 CSOH by virtue of subsection 88(2.2).[26] These rules are designed to ensure that pre-1972 CSOH cannot be created in non-arm's-length transfers. These transactions include

- any gain or loss arising as a result of a liquidation of a more than 90 percent owned subsidiary or an amalgamation of controlled corporations, and
- a disposition of a share of the capital stock of a controlled Canadian corporation disposed of to a person with whom the transferor was not dealing at arm's length immediately after the disposition.

In addition, a capital property owned on December 31, 1971 and acquired from a corporation involving a subsection 85(1) rollover transaction will not give rise to a crystallization of pre-1972 CSOH to the other corporation at the time of transfer but will be available to increase the pre-1972 CSOH to the transferee in a subsequent arm's-length sale. Keep in mind that ITARs 26(21) through 26(27) defer the realization of pre-1972 CSOH in certain rollover transactions for property owned on December 31, 1971 or deemed to have been owned on that date by virtue of ITAR 26(28).

REALIZING PRE-1972 CSOH

For pre-1972 holding companies that have realized all of their pre-1972 gains, the optimum time to liquidate will be when the value of the assets in the company equals the aggregate of the capital dividend, pre-1972 CSOH, and PUC. A shareholder who owned the shares on V-day will likely have an ACB at least equal to the PUC and the remaining pre-1972 CSOH; accordingly, the liquidation can be achieved on a tax-free basis.

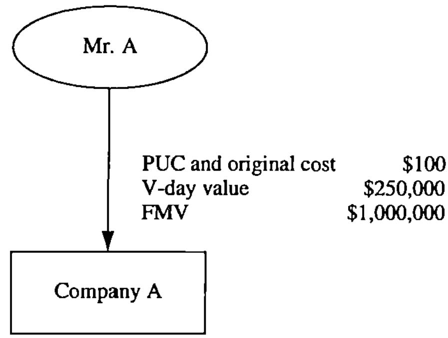
There will be no tax cost at all where a corporation with a pre-1972 CSOH balance has assets that can be distributed without giving rise to a tax cost within the corporation, and the shareholder can shelter an equivalent amount if received as proceeds of disposition, either because the shares have an ACB (but no PUC) equal to the amount of the pre-1972 CSOH or because the shareholder has capital losses or is treaty exempt.

It may be possible to reorganize to facilitate the distribution of the pre-1972 CSOH. This will be particularly important where the company has other assets that cannot be distributed without realization of a taxable gain. Such a reorganization might be achieved using a paragraph 55(3)(a) reorganization. For example, assume the following facts. Mr. A owns all of the common shares of company A, having an original cost of $100, an FMV on V-day of $250,000, a balance of pre-1972 CSOH of $250,000,

[26] Subsection 88(2.2) is virtually identical to subsection 89(5) of the Act as it read at the end of 1978. Accordingly, pre-1978 related-party transactions should be considered in the computation of pre-1972 CSOH.

and an FMV today of $1 million. Company A has PUC of $100, cash of $250,000, and an investment property acquired after 1971 with an ACB of $250,000 and an FMV of $750,000.

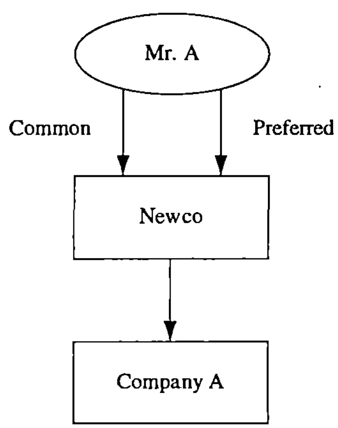
Figure 1



Subject to the applicable corporate laws, the reorganization steps might include the following:

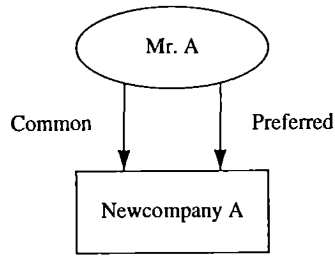
1) Mr. A incorporates Newco and transfers the shares of company A to Newco in exchange for common and preferred shares of Newco. The preferred shares will have a value equal to the balance of the pre-1972 CSOH. An election will be made under subsection 85(1) to effectively transfer the ACB of the existing common shares to the preferred shares of Newco. The PUC of the shares issued will be limited, either deliberately under the relevant corporate law or by virtue of section 84.1, to the PUC of the Newco shares.

Figure 2



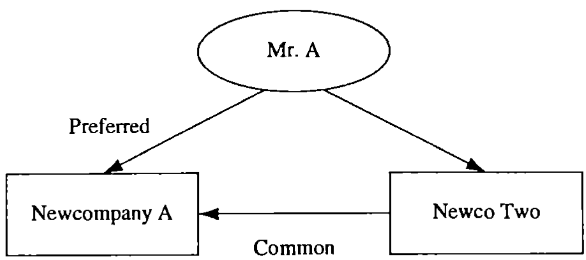
2) Company A and Newco are amalgamated to form Newcompany A. The provisions of paragraph 88(2.1)(c) will ensure that the previously crystallized balance of pre-1972 CSOH will flow through to Newcompany A for purposes of a subsequent taxable liquidation of Newcompany A.

Figure 3



3) Mr. A incorporates Newco Two and transfers the common shares of Newcompany A to Newco Two in exchange for additional common shares of Newco Two, electing under subsection 85(1) in respect of the common shares of Newcompany A.

Figure 4

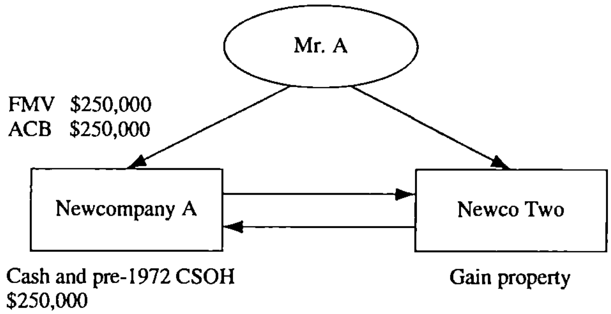


4) Newco Two acquires the gain property currently owned by Newcompany A, in exchange for preferred shares of Newcompany A, which are immediately cross-redeemed against the common shares that Newcompany A owns in Newco Two. The provisions of paragraph 55(3)(a) should protect the deemed dividends arising on the cross-redemption from being recharacterized as a capital gain or as proceeds of disposition by virtue of subsection 55(2). The intercorporate dividends do not give rise to any movement of the pre-1972 CSOH.[27]

5) At the end of step 4, Mr. A would have effectively the same tax attributes vis-à-vis Newcompany A that he had in company A immediately before step 1. Newcompany A could then be liquidated under the provisions of subsection 88(2), thus releasing the pre-1972 CSOH. Because Mr. A has an ACB of $250,000 in the Newcompany A preferred shares, the $250,000 of additional proceeds of disposition as a result of the existence of the pre-1972 CSOH balance on liquidation is effectively distributed without tax cost.

[27] However, be alert to the impact of any refundable dividend tax on hand.

Figure 5



Whether or not subsection 245(2) might have application to the above series of transactions would depend on the actual facts of the situation; however, where the taxpayer is merely realizing the benefit of pre-V-day surplus against pre-V-day cost base, no misuse or abuse should be present.

CONCLUSION

While many companies distributed their 1971 CSOH before the end of 1978, for a variety of reasons, many others did not. A distribution may have necessitated a tax cost in the form of the special 15 percent tax on UIOH (as in the case of non-residents), a tax cost at the shareholder level owing to insufficient ACB, or complications in a foreign jurisdiction. In any event, despite numerous changes in the Canadian tax landscape since 1978, pre-1972 CSOH continues to survive after nearly a quarter of a century, buried deep within the Income Tax Act like a sunken treasure, just waiting to be discovered.

While the circumstances that enable pre-1972 CSOH to be distributed to a shareholder are limited, tax practitioners today should be cognizant of the impact of current reorganizations on pre-1972 CSOH, lest the ability to realize the benefit be lost forever.

APPENDIX

Principal Components of 1971 Capital Surplus on Hand at the End of 1978

Component	References
The amount, if any, by which the aggregate of	
tax equity at the end of the corporation's 1971 taxation year (this component is intended to reflect the taxed retained earnings applicable to the period 1950 through 1971)	89(1)(l)(i), 89(1)(h)
capital gains realized after the corporation's 1971 taxation year	89(1)(l)(ii), (iii)
tax-deferred dividends received from other corporations, except to the extent that the dividend was payable out of the other corporations' TPUS	89(1)(l)(iv)
eligible capital amounts realized by a private corporation on goodwill dispositions after 1971, subject to the transitional rules in ITAR 21	89(1)(l)(v), (vi)
proceeds from resource property dispositions	89(1)(l)(vii), (viii)
certain deemed dividends arising from a paid-up capital deficiency	89(1)(l)(xi)
contributed surplus arising before April 1, 1977, to the extent that it was not otherwise returned to shareholders as a return of capital or capitalized into statutory capital	89(1)(l)(xi.1), (xi.2), (xi.3), (xvii), (xvii.1), (xvii.2)
tax-deferred dividends paid to non-residents	89(1)(l)(xi.4), 83(1)(c.1)
Exceeds	
the aggregate PUC at the end of 1971	89(1)(l)(xii)
the corporation's UIOH at the end of 1971	89(1)(l)(xiii)
capital losses realized after the corporation's 1971 taxation year	89(1)(l)(xiv), (xv)
certain paid-up capital deficiencies	89(1)(l)(vi)
tax-deferred dividends paid out of 1971 CSOH	89(1)(l)(xviii)

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