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Section 93 Elections

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Where an election is made or deemed to have been made by a taxpayer, certain rules in section 93 of the Income Tax Act provide that all or a portion of proceeds of disposition realized by a Canadian-resident corporate taxpayer (or a foreign affiliate of such a taxpayer) on the disposition of shares of a foreign affiliate of that taxpayer are recharacterized as a dividend for certain purposes. In this article, the authors provide an overview of the technical application of section 93 and the relevant supporting regulations in part LIx of the regulations as the statutory scheme exists under the current law. A review of proposed changes to section 93 and the related regulation will be the subject of a separate article.

Keywords: DISPOSITIONS ■ GAINS AND LOSSES ■ SURPLUS ■ ELECTIONS ■ DIVIDENDS ■ FOREIGN AFFILIATES

Contents

Introduction 856
The Elections: An Overview 858
Disposition 859
Consequences of Disposition Absent Section 93 861
Subsection 93(1) 862
General Application and Effect 862
Subsection 40(3) Gain 864
Reason for Making the Election 865
Dividend Source and Surplus Adjustments 865
Determination of Dividend Source 865
Corresponding Adjustments to Surplus as a Consequence of Deemed Dividend 871
Other Rules Applicable to the Dividend Recipient 881
Stop-Loss Rule 882
Compliance 884

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INTRODUCTION

Section 93 of the Income Tax Act\(^1\) contains several rules that provide for an election (or a deemed election) in respect of a disposition of a share of a foreign affiliate. When the rules apply, all or a portion of the proceeds of disposition are recharacterized as a dividend, even though no dividend is actually paid. Section 93 provides a useful planning tool where, for example, payment of an actual dividend would attract foreign dividend withholding tax or where the affiliate is unable to pay a dividend.\(^2\)

That said, the utility of section 93 is limited by an anti-avoidance aspect that prevents the conversion of taxable surplus into exempt surplus in certain circumstances.

This article is the first of two that will survey the rules in section 93 and the related regulations in part LIx of the Income Tax Regulations,\(^3\) under current law and under proposed amendments to the Act and regulations announced on March 16, 2001 and February 27, 2004\(^4\) (or any new proposals announced prior to the publication of the companion to this article). Here we will consider the rules as they exist under current law, including the interaction of section 93 with other foreign affiliate rules. In the second article, we will examine the proposed changes to the Act and regulations.\(^5\)

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\(^1\) RSC 1985, c. I (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act.

\(^2\) For example, the affiliate may have insufficient assets on hand to pay a dividend, or foreign law may restrict the payment of dividends where the affiliate has no realized profits.

\(^3\) CRC 1978, c. 945, as amended.

\(^4\) Canada, Department of Finance, Notice of Ways and Means Motion To Amend the Income Tax Act, the Income Tax Application Rules, Certain Acts Related to the Income Tax Act, the Canada Pension Plan, the Customs Act, the Excise Tax Act, the Modernization of Benefits and Obligations Act and Another Act Related to the Excise Tax Act, March 16, 2001; and Canada, Department of Finance, Legislative Proposals and Draft Regulations Relating to Income Tax (Ottawa: Department of Finance, February 2004).

\(^5\) While there are many articles on various aspects of the section 93 rules (including the proposed amendments), to our knowledge there has not been a general survey of section 93 in the previous tax literature. The literature dealing with various aspects of the current and proposed rules includes the following: K.J. Dancey, R.A. Friesen, and D.Y. Trimble, *Canadian Taxation of Foreign Affiliates*, 4th ed. (Toronto: CCH Canadian, 1986), chapter 10; David Grossman and Nadia Manin, “A Comparison of the Earnings and Profits and Surplus Concepts: Selected
The discussion below assumes that foreign affiliate shares disposed of constitute capital property to the disposing corporation. While the application of subsection 93(1) to the disposition of shares that are not capital property raises interesting questions, discussion of those issues is beyond the scope of this article.\textsuperscript{6} The examples we use to illustrate the effect of the rules also assume that the calculating currency of the particular foreign affiliate and the Canadian dollar trade at par.

\textsuperscript{6} Subsection 93(1) applies to any gains; that is, the rule is not limited to dispositions giving rise to capital gains. This interpretation has been specifically accepted by the Canada Revenue Agency (CRA): see, for example, CRA document no. 860513, May 13, 1986. In contrast, the
For the sake of brevity, references below to “surplus” or “surplus accounts” are intended to refer to the foreign affiliate’s exempt and taxable surplus, exempt and taxable deficit, underlying foreign tax, and pre-acquisition surplus in respect of a corporation, as applicable in the particular circumstances.

THE ELECTIONS: AN OVERVIEW

Two elections are available under section 93 where a share of a foreign affiliate is disposed of and certain other conditions are satisfied. Section 93 also contains two rules that apply to deem section 93 elections to have been made in certain circumstances. In either case, the amount designated (or deemed to be designated) in the election is deemed to be a dividend received from the affiliate on the share disposed of and not to be proceeds of disposition of the share. Put simply, the election converts proceeds of disposition (and therefore, typically, capital gains) into a dividend received from the foreign affiliate.

The first of the elections referred to above applies to a disposition of a foreign affiliate share by a corporation. More particularly, subsection 93(1) provides for a discretionary election in respect of a disposition of a share of a foreign affiliate of a Canadian-resident corporation by that corporation or by a foreign affiliate of that corporation. In addition, subsection 93(1.1) deems an election to have been made under subsection 93(1) in respect of a disposition by a foreign affiliate of a foreign affiliate share that constitutes excluded property.

The second of the elections referred to above applies to a disposition of a foreign affiliate share by a partnership. In this case, subsection 93(1.2) provides for an election in connection with a taxable capital gain arising from a disposition of a foreign affiliate share by a partnership of which a Canadian-resident corporation or a foreign affiliate of such a corporation is a member. In addition, subsection 93(1.3) deems a subsection 93(1.2) election to have been made in respect of a gain realized by a foreign affiliate from a disposition of a foreign affiliate share that constitutes

election in subsection 93(1.2) expressly does not apply to gains on income account since it applies only where a Canadian-resident corporation or a foreign affiliate of such a corporation is allocated a taxable capital gain realized by a partnership of which the corporation or affiliate is a member. For further discussion of this issue, see Nikolakakis, “The 1999-2000 Foreign Affiliate Amendments,” supra note 5.

References below to a “foreign affiliate share” are references to a share of a non-resident corporation that is a foreign affiliate of the Canadian-resident corporation to which the discussion relates.

“Excluded property” is defined in the proposed amendments to subsection 95(1) to mean property used or held by a foreign affiliate principally for the purpose of gaining or producing income from an active business carried on by it; shares of another foreign affiliate where all or substantially all of the fair market value of the property of the other affiliate is property that is excluded property, substantially all of the income from which is or would be income from an active business, including income recharacterized as such by paragraph 95(2)(a) (excluding subparagraph 95(2)(a)(v)); and certain hedging contracts relating to excluded property.
excluded property by a partnership of which the disposing affiliate is a member. No similar rules exist in connection with a disposition of a partnership interest.

As noted above, an election under subsection 93(1) or (1.2) results in a deemed dividend to the disposing Canadian-resident corporation or foreign affiliate of that corporation. While both of these elections deem a dividend to be received, neither provides rules for determining the source of the deemed dividend—that is, the portion of the deemed dividend that is deemed to have been paid from the payer affiliate’s exempt surplus, taxable surplus, or pre-acquisition surplus accounts. The relevant sourcing rules are contained in part LIX of the regulations. In addition to prescribing the relevant sourcing rules, part LIX contains rules that, in some circumstances, apply to adjust the surplus accounts of the relevant affiliates in order to reflect both the receipt of a section 93 deemed dividend and changes in the shareholder’s economic interest in the affiliates.

**Disposition**

The section 93 elections apply where, among other things, there is a “disposition” of a share of a foreign affiliate. The elections are not limited to any particular type of disposition.

The term “disposition” is defined in subsection 248(1) in a non-exhaustive manner and specifically includes a number of transactions that often arise in connection with foreign affiliates. For example, the definition includes transactions entitling a taxpayer to proceeds of disposition (for example, from a share sale), a redemption or cancellation of shares (either on a redemption or repurchase or in the course of a windup), and a conversion of shares on an amalgamation or merger.

In addition, there are rules in the Act that deem dispositions to occur. Of particular relevance to section 93 is the so-called negative adjusted cost base rule in subsection 40(3). This rule applies where the total of all amounts deducted under subsection 53(2) in computing the adjusted cost base of a foreign affiliate share exceeds the cost of the share and all amounts added to the adjusted cost base of the share by subsection 53(1). In such a case, subsection 40(3) provides that

- subject to paragraph 93(1)(b), the excess is deemed to be a gain from the disposition of the share;
- for the purposes of section 93 and the definition of “foreign accrual property income” (FAPI) in subsection 95(1), the share is deemed to have been disposed of; and
- for the purposes of section 93, the excess is deemed to be proceeds of disposition of the share.

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9 Like subsection 93(1), subsection 93(1.3) refers to a gain arising on a disposition. However, subsection 93(1.2) refers to a taxable capital gain. Accordingly, while subsection 93(1.3) deems a subsection 93(1.2) election to have been made in respect of a particular gain, the subsection 93(1.2) election has effect only if the relevant corporation was allocated a taxable capital gain from a partnership in respect of the disposition of foreign affiliate shares.
Subsection 40(3) applies, for example, where a foreign affiliate pays a dividend on a share of its capital stock, the dividend is prescribed to have been paid from the affiliate’s pre-acquisition surplus, and the amount of the dividend exceeds the recipient corporation’s cost (as adjusted) of the share. Where the recipient corporation is a resident of Canada, the dividend is included in the recipient’s income pursuant to section 90 and paragraph 12(1)(k) and an offsetting deduction under paragraph 113(1)(d) is available. In such a case, subsection 92(2) and subparagraph 53(2)(b)(i) apply such that the amount deducted in computing the recipient’s taxable income under paragraph 113(1)(d) (net of foreign withholding or income tax) in respect of the pre-acquisition surplus dividend is deducted from the recipient’s adjusted cost base of the share.10 Similar adjustments in subsection 92(2) apply where the dividend recipient is a foreign affiliate.11 Further, as noted above, where the amount by which the amount deducted under subparagraph 53(2)(b)(i) by reason of the pre-acquisition surplus dividend exceeds the dividend recipient’s cost (as adjusted) of the share, the excess is deemed by subsection 40(3) to be a gain from the disposition of the share and, for the purposes of section 93, the share is deemed to have been disposed of by the recipient.

Subsection 40(3) also applies where a foreign affiliate reduces its paid-up capital in respect of a share and the amount of the capital reduction in respect of the share exceeds the recipient corporation’s cost (as adjusted) of the share. In such a case, subparagraph 53(2)(b)(ii) applies such that the amount received on the reduction of the paid-up capital in respect of the share is deducted from the recipient’s adjusted cost base of the share. As above, where the amount by which the amount deducted under subparagraph 53(2)(b)(ii) by reason of the return of capital exceeds the dividend recipient’s cost (as adjusted) of the share, the excess is deemed by subsection 40(3) to be a gain from the disposition of the share and, for the purposes of section 93, the share is deemed to have been disposed of by the recipient.

In summary, a section 93 election merits consideration in connection with many common species of dispositions (share sales, exchanges, redemptions, windups, and dispositions resulting from pre-acquisition surplus dividends engaging subsection 40(3)).

10 Subsection 92(2) applies by virtue of paragraph 92(2)(a). Technically, subsection 92(2) reduces the adjusted cost base of the share by the amount by which the paragraph 113(1)(d) pre-acquisition surplus deduction exceeds any income or profits tax paid by the owner of the share to the government of a country other than Canada in respect of the portion of the dividend paid from pre-acquisition surplus: see paragraphs 92(2)(c) and (d). In the foreign tax credit context, the CRA’s position is that a foreign tax will be considered an “income or profits tax” if the tax is substantially similar to the tax imposed under the Act—that is, the tax is levied on net income or profits or is a tax similar to part XIII withholding tax. See, for example, Interpretation Bulletin IT-270R3, “Foreign Tax Credit,” November 25, 2004, paragraph 5.

11 By virtue of paragraph 92(2)(b). Although a foreign affiliate cannot claim a paragraph 113(1)(d) deduction because the affiliate is not resident in Canada, paragraph 92(2)(c) provides that the relevant amount is the amount that would have been deductible under paragraph 113(1)(d) if the foreign affiliate had been a corporation resident in Canada.
Further, planning considerations may merit triggering a disposition (and possibly a gain) for the purposes of making a section 93 election. For example, a transfer of foreign affiliate shares in exchange for shares of another foreign affiliate on a tax-deferred basis under subsection 85.1(3) may give rise to capital duty in the transferee affiliate’s jurisdiction because the duty is levied on the value of the shares issued by the transferee affiliate. In some circumstances, the capital duty may be reduced if the affiliate issues debt as consideration instead of shares. If the debt issued by the affiliate exceeds the disposing corporation’s adjusted cost base of the transferred shares, then a gain arises to the extent of the excess, which gain may be reduced without adverse consequences by a subsection 93(1) election to the extent that sufficient surplus is available.

**Consequences of Disposition Absent Section 93**

In order to place the relevance of the section 93 elections and related deeming rules in context, it is worthwhile to briefly review the usual tax consequences that arise on a disposition of foreign affiliate shares held as capital property.

The federal income tax consequences of a disposition of shares of a foreign affiliate by a Canadian-resident corporation are well understood. If the disposition does not give rise to income (or a loss) from a source—as will be the case where the shares are held as capital property—then the corporation’s gain computed under paragraph 40(1)(a) is a capital gain under paragraph 39(1)(a) because the gain is not otherwise included in computing the corporation’s income. Paragraph 38(a) further provides that the corporation’s taxable capital gain is one-half of the capital gain, and the taxable capital gain is included in the corporation’s income under paragraph 3(b). Where the disposition instead gives rise to a loss, a similar analysis applies except that various stop-loss and suspended loss rules must also be considered (for example, subsections 93(2), (4), and 40(3.4)).

The capital gains calculation described above is computed in Canadian currency. That is, the proceeds of disposition for the purposes of the capital gains calculation rules are the Canadian-dollar equivalent of the proceeds at the time of disposition, and the adjusted cost base is the Canadian-dollar equivalent of the corporation’s cost of the shares at the time they were acquired as adjusted by the rules in section 53. Any adjustments to adjusted cost base (for example, under paragraph 53(1)(c) in respect of contributions to capital) for costs incurred in a foreign currency are measured in the Canadian-dollar equivalent on the date the particular cost was incurred, as are foreign-currency expenses incurred for the purpose of making the disposition.

Similar considerations apply where a foreign affiliate of a Canadian-resident corporation disposes of shares of another foreign affiliate, although the context is slightly

12 Luxembourg is an example of such a jurisdiction. See the discussion in Dancey et al., supra note 5, at 186-87, in connection with the Netherlands.

13 Gaynor v. The Queen, 91 DTC 5288 (FCA). This has been confirmed by the enactment of paragraph 261(2)(a).
different. For example, the taxable capital gain realized on a disposition by an affiliate gives rise to FAPI if the shares are not excluded property. Also, for the purpose of computing FAPI, the currency in which the gain or loss is calculated depends on whether the gain or loss is a gain or loss of a controlled foreign affiliate from a disposition of property other than excluded property or from a disposition of property to which one of the reorganization rules in paragraph 95(2)(c), (d), or (e) or 88(3)(a) applies. In each of these cases, the gain or loss is to be computed in Canadian currency. In every other case, the gain or loss is to be calculated in the calculating currency of the foreign affiliate as if the calculating currency were the currency of Canada.

In the computation of surplus balances resulting from the disposition, the calculation of the gain will be made in the currency required in the FAPI determination. However, if the FAPI determination requires a calculation in Canadian currency, then the amount of any gain or loss must be converted from Canadian currency to the calculating currency of the foreign affiliate, which must be a currency other than the Canadian dollar.

Finally, where a partnership disposes of foreign affiliate shares, paragraph 96(1)(a) provides that the partnership is to compute its gain or loss as if the partnership were a separate person resident in Canada. Paragraph 96(1)(f) provides that the partners are to include in income their share of the partnership’s taxable capital gain as determined under the partnership agreement.

**SUBSECTION 93(1)**

**General Application and Effect**

Under current law, subsection 93(1) permits a corporation resident in Canada to make an election in respect of a disposition of a foreign affiliate share by the corporation or by a foreign affiliate of the corporation. The election is only available to Canadian-resident corporations, and not to other types of taxpayers, because the surplus regime applicable to foreign affiliate dividends is only relevant to Canadian-resident corporations and their foreign affiliates.

As noted above, an election under subsection 93(1) significantly affects the treatment of capital gains that result from the disposition of foreign affiliate shares. Before discussing the effect of the election, it is important to note that the election is made on a share-by-share basis, must be made in the prescribed manner and within the prescribed time, and is not affected by an election made under section 93 by another corporation that disposes of shares in a particular affiliate at the same time. In the discussion that follows, the corporation (whether a Canadian-resident corporation

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14 See subparagraph 95(2)(f)(i).
15 See subparagraph 95(2)(f)(ii).
16 See regulations 5907(5) and (6). Regulation 5907(5) requires the conversion from Canadian currency to the calculating currency to be made at the rate of exchange prevailing on the date the shares are disposed of.
17 Subject to the application of the income allocation rules in subsections 103(1) and (1.1).
or a foreign affiliate of such a corporation) that disposes of a foreign affiliate share will be referred to as “the disposing corporation.”

For the purposes of the Act, paragraph 93(1)(a) provides that the amount designated in the election is deemed to be a dividend received on the share from the affiliate by the disposing corporation immediately before the disposition, and not to be proceeds of disposition. While there is no minimum amount that must be designated in the election, the amount designated cannot exceed the proceeds of disposition. Further, there is no requirement that the disposition otherwise gives rise to a gain.

Where the dividend recipient is a Canadian-resident corporation, the Canadian-dollar equivalent of the amount of the dividend is included in the recipient’s income under section 90 and paragraph 12(1)(k), and is considered to be paid from exempt, taxable, and pre-acquisition surplus as determined by the relevant rules in part IIX of the regulations. Accordingly, the relevant deductions in computing taxable income provided by paragraphs 113(1)(a) to (d) are available. The special rules in regulation 5902 applicable to determining the surplus accounts from which the dividend is paid (that is, the source of the dividend) and the related surplus adjustments to the affiliate and its subsidiaries resulting from both the disposition and the subsection 93(1) election are discussed below.

It is important to acknowledge the potential for a disconnect between the desired designated amount for the purposes of subsection 93(1) and the surplus available to support such a designation, which can arise from currency fluctuations. More specifically, since regulation 5907(6) provides that a foreign affiliate’s surplus accounts must be maintained in a currency other than Canadian dollars and the amount of any taxable income deduction under subsection 113(1) is the Canadian-dollar equivalent of the amount prescribed to be paid from the relevant surplus accounts at that time, the implications of a subsection 93(1) dividend in Canadian dollars drawing on surplus accounts denominated in foreign currency must be considered in order to ensure that the intended result is achieved.

Where the dividend recipient is instead a foreign affiliate of a Canadian-resident corporation, the affiliate is considered to receive the calculating-currency equivalent of the amount of the dividend. Since the dividend is from another foreign affiliate, the amount of the dividend is excluded from the recipient’s FAPI18 and is added to the recipient’s surplus accounts to the extent of the portion of the dividend considered to be paid from the surplus accounts of the affiliate whose share was disposed of. In this regard, the special rules in regulation 5902 apply for the purpose of determining the relevant amount of surplus, as do the surplus adjustment rules that are engaged by reason of the disposition and the subsection 93(1) election.

Since the amount of the subsection 93(1) dividend is excluded from the disposing corporation’s proceeds of disposition of the share, any gain otherwise realized by the corporation on the disposition will be reduced by a corresponding amount. In the case of a disposing corporation that is a foreign affiliate, the subsection 93(1) election

18 In accordance with paragraph (b) of element A of the definition of FAPI in subsection 95(1).
will reduce the FAPI arising from the disposition of foreign affiliate shares that are not excluded property to the extent of available surplus.

The subsection 93(1) election is not limited to the amount of gain realized on the disposition (indeed, the rule does not require that there be a gain). It is therefore possible to realize a loss by making an election. This will be the case where the amount designated in the election results in proceeds of disposition that are less than the adjusted cost base of the share. Where a loss is realized, subsection 93(2) denies the loss if the dividend is considered an exempt dividend under subsection 93(3)—for example, if the dividend is an exempt surplus dividend deductible under paragraph 113(1)(a). Subsection 93(2) is discussed further below.

The general effect of the subsection 93(1) election is demonstrated in example 1.

Example 1
Canco, a Canadian-resident corporation, owns 100 percent of a foreign affiliate, Forco, which has exempt surplus of $100. Canco sells all of the Forco shares to a third party, realizes a $200 capital gain, and designates $100 in a subsection 93(1) election.

As a result of the election, Canco is deemed to receive a $100 dividend from Forco. Canco includes the $100 dividend in income and deducts $100 in computing its taxable income because the dividend is considered to be paid from Forco’s exempt surplus. Canco’s proceeds of disposition are reduced by $100, with the result that Canco’s capital gain is reduced by $100.

Subsection 40(3) Gain
Additional rules apply where subsection 40(3) applies to the disposing corporation and a subsection 93(1) election is made. As noted above, subsection 40(3) applies where the amount of a dividend that is considered to be paid from an affiliate’s pre-acquisition surplus or the amount distributed as a return of paid-up capital exceeds the recipient’s cost of the affiliate share (as adjusted). In such a case, the excess is deemed to be a gain from the disposition of the share.

While a subsection 40(3) gain arising from a pre-acquisition surplus dividend implies that the affiliate paying the dividend does not have sufficient exempt or taxable surplus available to support the dividend, a subsection 93(1) election may allow access to the surplus balances of lower-tier affiliates under the rules in regulation 5902. Accordingly, a subsection 93(1) election may reduce the deemed gain (and possibly FAPI) that would otherwise arise under subsection 40(3).

Pursuant to subparagraph 93(1)(b)(i), the amount of the deemed gain under subsection 40(3) is the amount by which the gain computed under subsection 40(3) exceeds the amount designated in the election. In addition, for the purposes of determining the affiliate’s surplus (that is, the surplus adjustment rules), the affiliate is deemed to have redeemed the shares at the time of the disposition. However, subparagraph 93(1)(b)(i) does not apply for the purposes of paragraph 53(1)(a), with the result that paragraph 53(1)(a) “resets” the adjusted cost base of the shares to nil by adding the amount of the deemed gain originally determined under subsection 40(3) to the adjusted cost base.
Reason for Making the Election

There are a number of reasons for a corporation to make a subsection 93(1) election. Perhaps the most common is that the resulting deemed dividend reduces or eliminates a capital gain on the disposition and does not attract foreign withholding tax. This is in contrast to the affiliate’s paying an actual dividend to reduce the capital gain before the disposition. In such a case, the dividend could attract foreign withholding tax, which would not be creditable for Canadian tax purposes to the extent that the dividend was paid from exempt surplus.

Similarly, the election may be made where it may not be practical for the foreign affiliate to pay a pre-disposition dividend to reduce the capital gain—for example, where the shareholder owns less than 100 percent of the affiliate.

Another reason for making the election is to eliminate the capital gain or FAPI, as the case may be, that would otherwise arise by reason of gains arising in the course of a corporate reorganization or as a result of a pre-acquisition surplus dividend in excess of tax basis. Also, there are circumstances where a subsection 93(1) election alleviates surplus dilution that would otherwise arise on certain transfers of foreign affiliate shares.

Having described the application of subsection 93(1) in general terms, we will now consider the source of the dividends from the foreign affiliate and related surplus adjustments (as necessary) where the election is made.

Dividend Source and Surplus Adjustments

The following discussion first outlines the rules for determining the source of the dividend (that is, the portion of the deemed dividend that is deemed to have been paid from the payer affiliate’s exempt surplus, taxable surplus, or pre-acquisition surplus accounts). The relevant adjustments to the surplus accounts of the relevant affiliates (and circumstances where no adjustment is made) will then be surveyed.

Determination of Dividend Source

Where a foreign affiliate pays a dividend on a share of its capital stock, the rules in part LIX of the regulations apply to determine the portion of the dividend that is prescribed to be paid from the affiliate’s surplus accounts. This determination is relevant for the purposes of the deduction rules in section 113 (where the dividend recipient is a Canadian resident) and the surplus accounts of an affiliate (where the dividend recipient is another foreign affiliate).

Conceptually, the source of the dividend is determined through a three-step process:

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19 See the example in the text above at note 12, where a gain is realized under subsection 85.1(3) by reason of receiving debt from the purchasing affiliate in excess of the transferor’s adjusted cost base in the transferred shares.

20 See, for example, Dancey et al., supra note 5, at 187; Minassian and Selby, ibid., at 43:17-18; and Kotecha, ibid.
1. The amount of the “whole dividend” paid by the affiliate on all shares of all classes is determined.

2. The surplus accounts from which the whole dividend is prescribed to be paid are determined under regulation 5901.

3. The surplus accounts from which the portion of the whole dividend (that is, the particular dividend) received by a particular shareholder is prescribed to be paid are determined under regulation 5900.21

Where a dividend is deemed to be received by virtue of an election made under subsection 93(1), regulation 5902 applies for the purpose of determining the amount of the subsection 93(1) dividend that is prescribed to be paid from exempt, taxable, and pre-acquisition surplus of the affiliate under regulation 5900(1). Therefore, regulation 5902 is a critical component of the determination of the source of the dividend.

The objectives of regulation 5902 are twofold:

- First, the rule ensures that the surplus of the particular affiliate and all of the affiliate’s subsidiaries in which the affiliate has an equity percentage, as defined in subsection 95(4), is available in connection with the subsection 93(1) dividend as if the surplus of all of the affiliates had been distributed up the corporate chain. The apparent reason for permitting access to the “consolidated surplus” of lower-tier affiliates is that the gain arising from the disposition of the share may be derived from earnings, and therefore surplus, of lower-tier affiliates. This also explains why the surplus and deficits of sibling corporations in the corporate group (that is, corporations without an ownership stake in the relevant corporate chain) are excluded from the rule: the surplus of these corporations does not contribute to the gain realized on the disposition of the particular share.22

- The second objective of regulation 5902 is to limit the amount of the subsection 93(1) dividend to the proportionate amount of the surplus accounts relating to the shares disposed of. This ensures that the appropriate amount of surplus is available when less than 100 percent of the disposing corporation’s interest is disposed of.

21 The whole dividend concept stems from the fact that the affiliate’s surplus is determined without regard for a particular shareholder’s interest in the affiliate. After the whole dividend is determined, regulation 5900 applies to isolate the portion of surplus from which the particular amount of the dividend received by a particular shareholder is considered to have been paid. It is this amount that is relevant for the deduction rules in subsection 113(1).

22 This “consolidated surplus” approach is, to some degree, analogous to the safe income concept in subsection 55(2): in both cases, tax-paid earnings in the corporate group that contribute to a capital gain arising on the disposition of a share may be extracted by way of a (usually tax-free) intercorporate dividend in a manner that reduces capital gains tax. Accordingly, regulation 5902(1) can be seen as an expression of a general policy in the Act permitting the movement of tax-paid profits within corporate solution without the incidence of tax.
Mechanically, these two objectives are achieved by the operation of regulations 5902(1)(a) to (c), which are applied in consecutive order.

**Regulation 5902(a)(a)**
Regulation 5902(1)(a) requires the determination of an affiliate’s exempt surplus or exempt deficit, taxable surplus or taxable deficit, underlying foreign tax, and net surplus as if every other foreign affiliate in which the particular affiliate has an equity percentage had paid a dividend equal to its respective net surplus, starting with the lowest-tier affiliate and progressing up the ownership chain. That is, the lowest-tier affiliate is deemed to pay a dividend to its immediate parent, and the immediate parent is deemed to receive the dividend immediately before the parent, in turn, is deemed to pay a dividend to its immediate parent, and so on. Thus, regulation 5902(1)(a) determines the maximum amount of surplus of the affiliate available in the corporate chain in connection with the subsection 93(1) dividend.

A fundamental component of regulation 5902(1)(a) is net surplus, which is defined in regulation 5907(1). Net surplus is determined using three rules, which are set out in paragraphs (a) to (c) of the definition:

1. Paragraph (a) provides that if an affiliate has no exempt or taxable deficit, the net surplus is the total exempt and taxable surplus of the affiliate.
2. Paragraph (b) provides that if an affiliate has no taxable surplus, the net surplus is the amount by which the affiliate’s exempt surplus exceeds its taxable deficit.
3. Lastly, paragraph (c) provides that if the affiliate has no exempt surplus, the affiliate’s net surplus is the amount by which the affiliate’s taxable surplus exceeds its exempt deficit.

By definition, net surplus cannot give rise to a negative amount. Therefore, for the purposes of regulation 5902(1)(a), if the lowest-tier affiliate has an exempt or taxable deficit, the deficit will not reduce the surplus of affiliates further up the ownership chain. However, since the dividends are deemed to be paid consecutively up the chain, commencing with the lowest-tier affiliate, deficits of intervening affiliates will reduce the consolidated surplus of the group that is available under regulation 5902(1)(a) if there is net surplus in the chain below an affiliate with a deficit, or if the intervening affiliate has an exempt or taxable deficit and a positive exempt or taxable surplus balance. A simple illustration of this result is shown in example 2.

**Example 2**
Canco, a Canadian-resident corporation, owns 100 percent of a foreign affiliate, Forco 1, which has an exempt deficit of $250. Forco 1 owns 100 percent of another foreign affiliate, Forco 2, which has exempt surplus of $500. Canco sells all of its Forco 1 shares, realizes a gain of $600, and designates $500 in a subsection 93(1) election.

Pursuant to regulation 5902(1)(a), Forco 2 is deemed to pay a dividend equal to its net surplus ($500) to Forco 1, and the whole dividend is determined to be paid from
Forco 2’s exempt surplus ($500). Accordingly, Forco 1’s exempt surplus is $250, which is the difference between the $500 exempt surplus dividend received by Forco 1 and Forco 1’s opening exempt deficit.

Regulation 5902(2) contains two rules governing the application of regulation 5902(1)(a):

1. Regulation 5902(2)(a) provides that, for the purposes of regulations 5902(1)(a) and (b), in determining the surplus, deficit, and underlying foreign tax of a particular foreign affiliate in which another foreign affiliate of the taxpayer has an equity percentage, no amount is included in respect of any distribution that would be received by the particular affiliate from the other affiliate. This rule eliminates the circularity that would otherwise arise in applying regulation 5902(1)(a) where incestuous shareholdings exist between affiliates.

2. Regulation 5902(2)(b) provides that where an affiliate has more than one class of shares, the amount paid as a dividend on the shares of any class is such portion of its net surplus as the affiliate might reasonably be expected to pay on all of the shares of that class. The rule provides no guidelines to illuminate what might be the amount of dividends that an affiliate might reasonably be expected to pay. The answer is obvious in the case of shares bearing a fixed dividend rate: it is the amount of the fixed dividend entitlement. Where discretionary dividend rights attach to multiple classes of shares, the determination of whether the amounts paid as dividends are reasonable is a judgment call based on the particular facts and circumstances. Finally, where shares of a class carry

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23 It is not clear why the rule uses the term “distribution,” given that regulations 5902(1)(a) and (b) only refer to, and contemplate, dividends.

24 However, in some circumstances, technical clarification may be required: see CRA document no. 9309865, February 7, 1994 and the discussion in Nikolakakis, Taxation of Foreign Affiliates, supra note 5, at 5-90. We note that a literal application of this rule could arguably lead to erroneous results. In particular, consider a situation where a foreign affiliate, FA 1, owns all the shares of another foreign affiliate, FA 2, and FA 2 also owns shares of FA 1. Regulation 5902(2)(a) would prevent FA 1 from including in its surplus accounts any distributions from FA 2 and would also prevent FA 2 from including in its surplus accounts any distributions from FA 1. In consequence, no surplus would move between FA 1 and FA 2. In technical interpretations relating to this issue, the CRA has indicated that regulation 5902(2)(a) will not be applied in this manner: see, for example, CRA document no. 9309865, supra, and CRA document no. 1999-0010175, September 23, 2002. The CRA appears to adopt a practical position in this regard, noting that “the purpose of the anti-circulatory provisions is to enable one to determine the starting point for the computation in a structure where circular shareholdings exist and clarify that the starting point is the lowest tier affiliate and downstream notional dividends are to be excluded from the computation”: CRA document no. 1999-0010175, supra. It appears that the CRA’s position is that the anti-circularity rules are not intended to exclude “upstream dividends” from the computation.

25 Preferred shares are a common example. For other subsection 93(1) pitfalls arising in the context of holding preferred shares in a foreign affiliate, see Maikawa, supra note 5.
no dividend rights, the amount of dividends that the affiliate might reasonably be expected to pay on that class would be nil.

**Regulation 5902(a)(b)**

Once the surplus balances under regulation 5902(1)(a) have been determined, the next step is to determine the amount under regulation 5902(1)(b). This regulation requires the determination of the amount of the dividend that would have been received on the shares of the class in respect of which the subsection 93(1) election is made, on the assumption that the particular affiliate had at that time paid dividends on all of its outstanding shares (of all classes) in an amount equal to the affiliate’s net surplus determined under regulation 5902(1)(a). In essence, this amount represents the proportionate amount of surplus applicable to the relevant shares where less than 100 percent of the affiliate’s shares are disposed of.

**Regulation 5902(a)(c)**

Once the relevant amounts under regulations 5902(1)(a) and (b) have been determined, regulation 5902(1)(c) provides two rules that apply for the purposes of the surplus distribution rules in regulations 5901(1) and 5900(1). (The surplus distribution rules ultimately determine the portion of the subsection 93(1) dividend prescribed to be paid from the affiliate’s surplus accounts.)

The first rule, in regulation 5902(1)(c)(i), provides that the affiliate’s surplus, deficit, and underlying foreign tax are deemed to be the relevant amounts determined under regulation 5902(1)(a), described above. This rule achieves the first objective of regulation 5902.

The second rule, in regulation 5902(1)(c)(ii), determines the amount of the whole dividend, as defined in regulation 5907(1), that is deemed to be paid by the affiliate. As noted above, the determination of the whole dividend is relevant for the purpose of applying the surplus ordering rule in regulation 5901(1), which in turn is relevant for applying regulation 5900(1) to a particular dividend. In effect, the whole dividend determined under regulation 5902(1)(c)(ii) is the amount that the affiliate would have had to pay on all of its shares in order for the dividend recipient to have received a dividend on the shares disposed of in an amount equal to the amount of the subsection 93(1) dividend. By thus ensuring that the proportionate amount of the affiliate’s surplus is distributed by way of dividend, this rule satisfies the second overall objective of regulation 5902.26

As a technical matter, regulation 5902(1)(c)(ii) provides that the affiliate is deemed to pay a whole dividend at the time that subsection 93(1) dividends are deemed to be received on the shares of the particular class disposed of, in an amount equal to the product obtained when the total of the subsection 93(1) dividends is multiplied by

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26 As noted, the whole dividend concept is necessary because the surplus accounts of a foreign affiliate are determined without regard to a shareholder’s interest in the affiliate.
1 or

the proportion that the amount of the particular affiliate’s net surplus determined under regulation 5902(1)(a) is of the amount determined under regulation 5902(1)(b),

whichever is greater. In the event that the amount determined under regulation 5902(1)(b) is less than 1, that amount is deemed to be 1. When the amount of the whole dividend has been determined under regulation 5902, regulations 5901 and 5900 will operate in the usual manner.

In the end result, where less than 100 percent of the disposing corporation’s interest in an affiliate is disposed of, the effect of regulation 5902(1)(c)(ii) is that the deemed dividend is considered to be paid from the proportionate amount of the affiliate’s surplus. This is illustrated in example 3a.

Example 3a

Canco, a Canadian-resident corporation, owns 100 percent of a foreign affiliate, Forco, which has exempt surplus of $250 and taxable surplus of $250. Canco sells 50 percent of its Forco shares, realizes a gain of $250, and designates $250 in a subsection 93(1) election.

Regulation 5902(1)(c)(ii) provides that the whole dividend that is deemed to be paid by Forco is $500, which is the product obtained under the formula above. That is, the $250 dividend under subsection 93(1) is multiplied by the greater of 1 and 2, the latter being the quotient obtained when $500 (Forco’s net surplus determined under regulation 5902(1)(a)) is divided by $250 (50 percent of the $500 net surplus, which is the amount of the $500 dividend that would have been received on the 50 percent of Forco’s shares disposed of by Canco that are the subject of the subsection 93(1) election).

Accordingly, in applying regulation 5901(1) for the purposes of regulation 5900(1), Forco is deemed to pay a whole dividend of $500, of which $250 is paid from exempt surplus and $250 from taxable surplus. Therefore, under regulations 5900(1)(a) and (b), $125 of the $250 dividend deemed to be received by Canco as a consequence of the subsection 93(1) election is deemed to be paid from exempt surplus and $125 is deemed to be paid from taxable surplus.

It is important to note that regulation 5902(1)(c)(ii) could give rise to adverse tax consequences where the application of the rule results in part of the subsection 93(1) dividend being paid from taxable surplus, as in the example above, and there is insufficient underlying foreign tax that relates to the dividend. Since taxable surplus dividends are subject to tax at ordinary corporate rates, in such circumstances it may be more advantageous to designate a lower amount sufficient to access the available exempt surplus, by designating an amount that would result in the regulation 5902(1)(c)(iii) whole dividend being equal to the exempt surplus balance. In this case, the balance of the proceeds would give rise to a capital gain.27 This is illustrated by the following variation of example 3a.

27 See the examples in Dancey et al., supra note 5, and Pantaleo, ibid., at 20:15.
**Example 3b**

The facts are the same as in example 3a, except that Canco designates $125 in the subsection 93(1) election.

Regulation 5902(1)(c)(ii) provides that the whole dividend deemed to be paid by Forco is $250. This is the product obtained when the $125 dividend under subsection 93(1) is multiplied by the greater of 1 and 2 ($500/$250, as in example 3a).

Accordingly, in applying regulation 5901(1) for the purposes of regulation 5900(1), Forco is deemed to pay a whole dividend of $250, all of which is paid from exempt surplus. Therefore, under regulations 5900(1)(a), the full amount of the $125 dividend received by Canco as a consequence of the subsection 93(1) election is deemed to be paid from exempt surplus. No amount is deemed to be paid from taxable surplus, and Canco’s proceeds are reduced by the $125 subsection 93(1) dividend. In the result, Canco is subject to tax on a capital gain of $125 (one-half of which is included in income), as opposed to a $125 taxable surplus dividend (the entire amount of which is included in income).

**Other Issues**

When the amount of the whole dividend under regulation 5902(1)(c)(ii) has been determined, the rules applicable to dividends in regulations 5901 and 5900 apply in the usual manner, with three significant exceptions:

1. Regulation 5901(2), which allows pre-acquisition surplus dividends to be paid out of the affiliate’s current-year earnings if the dividend is paid after the 90th day after the commencement of the affiliate’s taxation year, does not apply.
2. Regulation 5900(2), which allows the taxpayer to elect to pay dividends out of the affiliate’s taxable surplus before exempt surplus, does not apply.
3. Paragraph (b) of the definition of “underlying foreign tax applicable” in regulation 5907(1), which allows a claim for an additional amount of underlying foreign tax (that is, an amount greater than the proportionate amount applicable to the dividend determined under regulation 5902(1)(c)(ii)) in certain circumstances, does not apply. Since the amount of underlying foreign tax is then limited to the proportionate amount applicable to the dividend determined under regulation 5902(1)(c)(ii), this exception effectively prohibits the accelerated use of the available underlying foreign tax in circumstances where less than a 100 percent interest is disposed of.

**Corresponding Adjustments to Surplus as a Consequence of Deemed Dividend**

Subsection 93(1) deems the corporate recipient to receive a dividend from a foreign affiliate. The rule does not, however, deem the affiliate to pay the dividend. Moreover, regulation 5902 only applies for the purposes of determining the source of the dividend under regulations 5901(1) and 5900(1) and does not adjust the surplus accounts of affiliates to reflect the deemed net surplus dividends. Accordingly, absent the application of specific surplus adjustment rules, no adjustment of surplus accounts would occur.
Regulation 5902(3) confirms that there is no adjustment in the absence of a specific rule, and further provides that the only rules applicable for adjusting the surplus accounts of the affiliate are those set out in regulations 5905(2), (5), and (8). In the context of a subsection 93(1) election, these rules apply to

- redemptions, repurchases, and cancellations, and gains resulting from the application of subsection 40(3)\(^{28}\) (regulation 5905(2));
- non-arm’s-length share transfers between Canadian corporations (regulation 5905(5));\(^{29}\) and
- dispositions to a corporation and by a corporation to foreign affiliates of the corporation, including dispositions by a foreign affiliate to another foreign affiliate (regulation 5905(8)).

In any other case, no adjustments are made to the surplus accounts of the affiliate whose shares are disposed of or to the surplus accounts of any lower-tier affiliates. Instances where no adjustments are made include a transfer of foreign affiliate shares

- by a Canadian-resident corporation to an arm’s-length taxable Canadian corporation or a corporation resident in Canada that is not a taxable Canadian corporation;
- by a Canadian-resident corporation to an arm’s-length non-resident corporation that is not a foreign affiliate;
- by a foreign affiliate of a particular corporation to a Canadian-resident corporation other than the particular corporation; or
- by a foreign affiliate to a non-resident corporation that is not a foreign affiliate.

In broad terms, the adjustment rules adjust the particular affiliate’s surplus accounts so as to reflect the Canadian-resident corporation’s interest in the profits of the particular affiliate after the disposition.

**Adjustment Because of Redemption or Pre-Acquisition Dividend Deemed Gain**

The surplus adjustment rule in regulation 5905(2) applies where a foreign affiliate redeems, acquires, or cancels its shares in any manner otherwise than on a windup. This includes circumstances where a subsection 93(1) election is made in respect of such a disposition. Regulation 5905(2) also applies to a deemed disposition resulting

\(^{28}\) Subparagraph 93(1)(b)(ii) provides that for the purposes of determining the surplus accounts of the affiliate whose shares are disposed of, the affiliate is deemed to have redeemed those shares.

\(^{29}\) This regulation also applies to amalgamations governed by section 87 and windups governed by subsection 88(1). These two types of reorganization are not relevant here because no gain is realized by the amalgamating or subsidiary corporation (as the case may be), and therefore there is no need to make a subsection 93(1) election.
from the application of subsection 40(3), since subparagraph 93(1)(b)(ii) provides that a deemed gain under subsection 40(3) is to be treated as resulting from a redemption for the purposes of the surplus adjustment rules.

Regulation 5905(2) excludes transactions where the particular share that is redeemed, acquired, or cancelled is held by the affiliate; was previously redeemed, acquired, or cancelled; and was held by the affiliate until the subsequent redemption, acquisition, or cancellation (that is, the one under scrutiny), and an adjustment under regulation 5902 was previously made. The exclusion ensures that there is only one surplus reduction for a redemption, acquisition, or cancellation.

The general thrust of regulation 5905(2) is to adjust the available surplus and underlying foreign tax of the affiliate to reflect the reduced ownership interest in the affiliate resulting from the redemption, acquisition, or cancellation. This is achieved by adjusting the surplus, deficit, and underlying foreign tax accounts proportionately by reference to the reduction in interest that the Canadian-resident parent corporation has in the affiliate. The adjusted accounts then become, respectively, the opening exempt surplus, taxable surplus, exempt deficit, taxable deficit, and underlying foreign tax balances for the purposes of the definitions of those terms in regulation 5907(1).

Where a subsection 93(1) election is made, the rules in regulations 5905(2)(a)(i) to (iii) adjust the affiliate’s surplus accounts to account for the deemed dividend arising as a consequence of the election. In the case of exempt surplus, regulation 5905(2)(a)(i) requires the inclusion in element B of the definition of an amount equal to the product obtained when the specified adjustment factor in respect of the disposition is multiplied by the total amount of all dividends paid from the affiliate’s exempt surplus under regulation 5900(1)(a). This results in a decrease in the affiliate’s exempt surplus (or an increase in the exempt deficit) by a corresponding amount. Regulations 5905(2)(a)(ii) and (iii) require similar adjustments to element B of the definition of taxable surplus and to the affiliate’s underlying foreign tax, respectively.

For this purpose, where the disposing corporation (“the transferor”) is the electing Canadian-resident corporation, regulations 5905(2)(a)(iv) and (vi) provide that the specified adjustment factor is the quotient obtained when 100 percent is divided by the surplus entitlement percentage (discussed below) of the Canadian corporation in the affiliate immediately before the disposition. Where the transferor is instead another foreign affiliate of the Canadian corporation, regulations 5905(2)(a)(v) and (vi) provide that the specified adjustment factor is the quotient obtained when the surplus entitlement percentage of the Canadian corporation in the transferor immediately before the disposition is divided by the Canadian corporation’s surplus entitlement percentage in the affiliate immediately before the disposition. (This reflects the fact that there may be divided ownership at various levels in the ownership chain.)

It is necessary to multiply the amount of the dividend prescribed to be paid from the relevant surplus accounts by the specified adjustment factor in order to ensure

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30 Specifically, subparagraph (v) of element B: see regulation 5907(1), the definition of “exempt surplus.”
that a proportionate reduction of the relevant account occurs. In all cases where the surplus entitlement percentage is less than 100 percent, the amount of the dividend prescribed to be paid from the relevant surplus account will be grossed up so that, in the end result, the surplus reduction will be the same as if an actual dividend had been paid.

Following the initial adjustment (or gross-up) of the affiliate’s surplus accounts under regulation 5905(2)(a), regulation 5905(2)(b) further adjusts the accounts in proportion to the change (decrease) in the Canadian-resident corporation’s surplus entitlement percentage in the affiliate and lower-tier affiliates. Paraphrasing regulation 5905(2)(b), the accounts, as adjusted by regulation 5905(2)(a), are adjusted to the proportion of the amount otherwise determined that the surplus entitlement percentage immediately before the redemption, acquisition, or cancellation (determined on the assumption that the affiliate’s taxation year ended immediately before that time) is of the surplus entitlement percentage immediately after the redemption, acquisition, or cancellation (determined on the assumption that the affiliate’s taxation year ended immediately after that time). Or, put more simply, the account balances are determined by multiplying the relevant account balance by a fraction the numerator of which is the surplus entitlement percentage immediately before the redemption, acquisition, or cancellation and the denominator of which is the surplus entitlement percentage after that time.

As stated above, under regulation 5905(2)(b), the adjustment of the surplus entitlement percentage is determined on the assumption that the affiliate’s taxation year ended immediately before and immediately after the redemption, acquisition, or cancellation. This has the effect of including current-year earnings or loss in the surplus entitlement calculation. However, as discussed below, regulation 5905(12) reduces those amounts by the proportion that the number of days of the hypothetical stub taxation year is of the affiliate’s (regular) taxation year.

Finally, regulation 5905(2)(c) provides that the amounts determined under regulation 5905(2)(b) constitute the opening exempt surplus, taxable surplus, exempt deficit, taxable deficit, and underlying foreign tax balances of the affiliate and each other affiliate of the corporation in which the affiliate has an equity percentage for the purposes of the definitions in regulation 5907(1).

Surplus Entitlement Percentage

Surplus entitlement percentage, defined in regulation 5905(13), is a fundamental component of regulation 5905(2) and is intended to reflect the Canadian parent corporation’s interest in dividends that could be paid by a particular foreign affiliate. Given the significance of this concept, it is worthwhile to review it briefly here.

Where a particular foreign affiliate and each corporation that is relevant to determining the Canadian parent corporation’s equity percentage (that is, all intervening affiliates in the ownership chain) have only one class of shares, regulation 5905(13)(a) provides that the parent’s surplus entitlement percentage in the affiliate at any time is the parent’s equity percentage in the affiliate. In this regard, the definition of “equity percentage” in subsection 95(4) is applied ignoring any shareholding of Canadian-
resident corporations that are subsidiaries of Canadian-resident parent corporations. In some circumstances, this can give rise to anomalous results.\(^{31}\)

In any other case, regulation 5905(13)(b) provides that the parent’s surplus entitlement percentage in the affiliate at any time is the proportion of 100 (that is, the percentage) that the aggregate amount of surplus entitlement for each share owned directly by the Canadian parent in the first-tier affiliate is of the amount determined under regulation 5905(10)(b) to be the net surplus of the particular affiliate at that time. In other words, the surplus entitlement percentage is determined by dividing the aggregate amount of surplus entitlements by the affiliate’s net surplus determined under regulation 5905(10)(b). Where the amount determined under regulation 5905(10)(b) is nil, the percentage is the Canadian parent’s equity percentage in the particular affiliate at that time.

Regulation 5905(10) computes the surplus entitlement of a share of a foreign affiliate of a Canadian-resident corporation in respect of a particular foreign affiliate of the corporation. Surplus entitlement is determined only for the shares of a first-tier foreign affiliate that are directly owned by the Canadian parent corporation. That is, the shares held by the Canadian parent in a directly owned (first-tier) affiliate will have a surplus entitlement in respect of each lower-tier affiliate in the ownership chain.

The calculation in regulation 5905(10) is a two-step procedure. The first step, in regulation 5905(1)(a), is to determine the amount that would be received on the share if the foreign affiliate paid dividends equal to its net surplus (discussed above), assuming that each foreign affiliate in which the particular affiliate had an equity percentage paid dividends equal to its net surplus up the ownership chain. The second step, in regulation 5905(10)(b), is to determine the amount that would be the net surplus of the particular affiliate, assuming, as above, that each foreign affiliate in which the particular affiliate had an equity percentage paid dividends equal to its net surplus up the ownership chain. The surplus entitlement of a share of a foreign affiliate of a Canadian-resident corporation in respect of a particular foreign affiliate of the Canadian-resident corporation is the portion of the amount determined under regulation 5905(10)(a) that may reasonably be considered to relate to the amount determined under regulation 5905(10)(b).

Three application rules apply for the purposes of regulation 5905(10):

1. Regulation 5905(11)(a) contains a rule similar to regulation 5902(2)(a) that eliminates the circularity that would otherwise arise in applying regulation 5905(10) where incestuous shareholdings exist between affiliates.
2. Regulation 5905(11)(b) provides that where an affiliate has more than one class of shares, the amount paid as a dividend on the shares of any class is such portion of the affiliate’s net surplus as the affiliate might reasonably be

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31 See the example in Jack et al., supra note 5, at 20:39.

32 That is, the lowest-tier affiliate is deemed to pay a dividend to its immediate parent, and the immediate parent is deemed to receive the dividend, immediately before the parent is in turn deemed to pay a dividend to its immediate parent.
expected to pay on all of the shares of that class. As in the case of regulation 5905(2)(b), fixed dividend shares and discretionary dividend rights merit careful examination.

3. Regulation 5905(12) provides that the affiliate’s current-year earnings are to be included in computing net surplus of an affiliate under regulation 5905(10). More particularly, since regulation 5905(2)(b) assumes a taxation year-end of the affiliate immediately before the redemption, acquisition, or cancellation, regulation 5905(12) provides that for the purposes of regulation 5905(10), a prorated portion of current-year earnings are included in computing net surplus as at the redemption, acquisition, or cancellation date, even though the affiliate may ultimately not have earnings for the year because its business became unprofitable after the transaction date.

Example 4 ties together the regulation 5905(2) concepts described above in the context of a subsection 93(1) election made in respect of the redemption of shares by a foreign affiliate.

Example 4
Canco, a Canadian-resident corporation, owns 50 of the 100 outstanding shares of a foreign affiliate, Forco, which has $100 of exempt surplus. Canco causes the redemption of 25 of its Forco shares, realizes a gain of $25, and designates $25 in a subsection 93(1) election.

The first step is to analyze the $25 dividend that is deemed to be received by Canco as a consequence of the subsection 93(1) election. Specifically, regulations 5902, 5901, and 5900 must be applied to determine the portion of the dividend paid from exempt surplus.

Pursuant to regulation 5902(1)(a), Forco’s exempt surplus and net surplus accounts are both $100. Further, for the purpose of regulation 5902(1)(b), the amount of the dividend that would have been received on the 25 shares in respect of which the election was made is $25 (that is, this is the amount that would have been received on those shares if Forco had paid a dividend equal to its net surplus of $100 on all 100 of its outstanding shares).

In consequence, regulation 5902(1)(c)(i) provides, for the purposes of regulations 5900(1) and 5901(1), that the amount of Forco’s exempt surplus is $100, and regulation 5902(1)(c)(ii) provides that the whole dividend paid by Forco is $100, being the $25 subsection 93(1) dividend multiplied by 4 (the proportion that Forco’s net surplus of $100 determined under regulation 5902(1)(a) is of the $25 amount determined under regulation 5902(1)(b)). Since the portion of the $100 whole dividend deemed to be paid by Forco and received by Canco is $25, and since that portion of the dividend is deemed to be paid by Forco out of its exempt surplus under regulation 5900(1)(a), the entire amount of the $25 dividend received by Canco is paid from exempt surplus.

The next step is to adjust Forco’s exempt surplus account to recognize the deemed dividend and Canco’s reduced surplus entitlement (since Canco owns only 25 of the 75 Forco shares outstanding after the redemption). To this end, regulation 5905(2)(a) reduces Forco’s exempt surplus from $100 to $50 immediately before the redemption. More specifically, the amount of the surplus reduction under regulation 5905(2)(a) is $50, being the product of the $25 exempt surplus dividend multiplied by the specified
adjustment factor of 2 (the quotient obtained when 100 percent is divided by Canco’s 50 percent surplus entitlement percentage immediately before the disposition).

After Forco’s exempt surplus is adjusted under regulation 5902(5)(a), regulation 5905(2)(b) applies to adjust Forco’s $50 exempt surplus to $75, being the regulation 5905(2)(a) adjusted exempt surplus of $50 multiplied by 1.5 (the proportion that Canco’s surplus entitlement percentage in Forco immediately before the redemption—that is, 50 percent—is of its surplus entitlement percentage immediately after the redemption—that is, 33\(\frac{1}{3}\) percent). This amount becomes Forco’s opening exempt surplus balance in respect of Canco under regulation 5905(2)(c), and Canco’s entitlement to Forco’s remaining exempt surplus is 33\(\frac{1}{3}\) percent, reflecting the change in its ownership interest in Forco after the redemption.

**Adjustment on Non-Arm’s-Length Transfer to a Canadian Corporation**

Regulations 5905(5)(a) and (6) provide for the continuity of surplus balances where a Canadian-resident corporation disposes of shares in a foreign affiliate to a taxable Canadian corporation with which the corporation does not deal at arm’s length. (For present purposes, we will refer to these entities as, respectively, “the disposing corporation,” “the affiliate,” and “the acquiring corporation.”)

Absent these regulations, the disposing corporation’s (proportionate) entitlement to surplus of the affiliate would not be inherited by the acquiring corporation on the transfer. Accordingly, these regulations ensure that the proportionate amount of surplus, deficit, and underlying foreign tax carries over to the acquiring corporation. The regulations also ensure that these balances reflect any dividends deemed to be received pursuant to subsection 93(1).

The regulations achieve this result by determining the opening exempt and taxable surplus, exempt and taxable deficit, and underlying foreign tax accounts of the affiliate in respect of the acquiring corporation. The rules do not, however, adjust the affiliate’s surplus accounts in respect of the disposing corporation because that corporation will have a diluted entitlement to the surplus accounts by reason of the share transfer. This is in contrast to adjustments under regulation 5905(2) in respect of redemptions, including deemed redemptions under subparagraph 93(2)(b)(ii) resulting from subsection 40(3) gains. In these circumstances, there may not be a reduction of economic interest in the affiliate, and therefore special rules are required to reflect the subsection 93(1) dividend.

Regulation 5905(5)(a) applies whether or not a subsection 93(1) election is made. If an election is made, regulation 5905(6) also applies in concert with regulation 5905(5)(a) to ensure that the surplus accounts of the affiliate are proportionately reduced so as to eliminate duplication of surplus.

More specifically, where regulation 5905(5)(a) applies to a transfer of an affiliate’s shares from a Canadian-resident corporation to a non-arm’s-length taxable Canadian corporation\(^\text{33}\) and a subsection 93(1) election is made in respect of the disposition,

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\(^{33}\) The CRA’s view is that the non-arm’s-length requirement must be satisfied immediately before the disposition: see, for example, CRA document no. 2000-0037895, October 6, 2000. However,
regulation 5905(6) applies to adjust the affiliate’s surplus accounts in a manner similar to that set out in regulation 5905(2)(a) (applicable to redemptions, acquisitions, and cancellations, including redemptions resulting from subsection 40(3) gains, as discussed above) except that the proportionate gross-up is determined by reference to surplus entitlement percentage instead of the specified adjustment factor.

As a technical matter, regulations 5905(6)(a)(i) to (iii) adjust the affiliate’s surplus accounts to account for the deemed dividend arising by virtue of the subsection 93(1) election. In the case of exempt surplus, regulation 5905(6)(a)(i) requires the inclusion in element B of the definition of an amount equal to the quotient obtained when the portion of the dividend prescribed to be paid from exempt surplus is divided by the surplus entitlement percentage of the disposing corporation in the affiliate immediately before the transaction. For this purpose, the surplus entitlement percentage of the disposing corporation in the affiliate is determined on the assumption that the shares disposed of by the disposing corporation were the only shares owned by that corporation immediately before the transfer. This adjustment results in a decrease in the affiliate’s exempt surplus (or an increase in the exempt deficit) by a corresponding amount. Regulations 5905(6)(a)(ii) and (iii) require similar adjustments to element B of the definition of taxable surplus and to underlying foreign tax, respectively.

Once the affiliate’s surplus accounts have been adjusted under regulation 5905(6)(a), regulation 5905(6)(b) adjusts the surplus accounts in respect of both the disposing corporation and the acquiring corporation by reference to the proportion of the change in the relevant corporation’s surplus entitlement percentage in the affiliate. The objective of regulation 5905(6)(b) is to ensure that the acquiring corporation’s entitlement to the affiliate’s surplus accounts after the acquisition is equal to its entitlement (if any) to those accounts before the acquisition plus the additional entitlement to those accounts acquired from the disposing corporation.

Regulation 5905(6)(b) achieves this objective in a manner similar to that applied under the redemption adjustment rule in regulation 5905(2)(b), as described above. Paraphrasing regulation 5905(6)(b), the relevant amounts (of the accounts) are deemed to be the proportion of the amounts otherwise determined (in the case of the subsection 93(1) election, as adjusted by regulation 5905(6)(a)) that the surplus entitlement percentage of the disposing corporation immediately before the transfer (determined on the assumption that the affiliate’s taxation year ended immediately before that time and that the transferred shares were the only shares owned by the disposing corporation immediately before that time) is of the surplus entitlement percentage of the disposing corporation.

The CRA concluded in that technical interpretation that a corporation that made its initial issuance of shares in exchange for shares in a foreign affiliate would be considered not to deal at arm’s length with the disposing corporation. See also Nikolakakis, Taxation of Foreign Affiliates, supra note 5, at 6-39. The regulation itself is silent as to when the corporations must be considered not to deal at arm’s length; common sense suggests that this requirement also will be satisfied when the corporations are related as a consequence of the transfer.

34 See supra note 30.
percentage of the acquiring corporation immediately after the transfer (determined on the assumption that the affiliate’s taxation year ended immediately after the transfer). Or, put more simply, the proportionate adjustment to the account balances is made by multiplying the relevant account balance by a fraction the numerator of which is the disposing corporation’s surplus entitlement percentage before the transfer, determined as if the transferred shares were the only shares owned by that corporation, and the denominator of which is the acquiring corporation’s surplus entitlement percentage after the transfer.

Following the adjustments under regulation 5905(6), regulations 5905(5)(d) to (h) apply to determine the opening surplus accounts of the foreign affiliate and all lower-tier affiliates in respect of the disposing corporation in which the affiliate has an equity percentage. For example, regulation 5905(5)(d) provides that the affiliate’s opening exempt surplus in respect of the acquiring corporation is the total of the affiliate’s exempt surplus in respect of the acquiring and the disposing corporations before the transfer less the total of the affiliate’s exempt deficit in respect of those corporations before the transfer. Regulations 5905(5)(e) to (h) operate in the same manner to determine opening exempt deficit (total exempt deficit less total exempt surplus), opening taxable surplus (total taxable surplus less total taxable deficit), opening exempt deficit (total exempt deficit less total exempt surplus), and opening underlying foreign tax (total underlying foreign tax of the acquiring and the disposing corporations).

It is significant that regulation 5905(6) applies only for the purpose of regulation 5905(5). Accordingly, no adjustment is made to the affiliate’s surplus, deficit, and underlying foreign tax in respect of the disposing corporation—a consequence of the fact that the disposing corporation has a diluted entitlement to these accounts by reason of the disposition.

The operation of the surplus adjustment rules in regulations 5905(5) and (6) is illustrated in example 5.

Example 5
Canco, a Canadian-resident corporation, owns 100 outstanding shares of a foreign affiliate, Forco, which has $100 of exempt surplus. Canco sells 50 of its Forco shares to a wholly owned Canadian-resident subsidiary (Subco), realizes a gain of $25, and designates $25 in a subsection 93(1) election.

A $25 dividend is deemed to be received by Canco as a consequence of the subsection 93(1) election. Accordingly, regulations 5902, 5901, and 5900 must be applied to determine the portion of the dividend paid from exempt surplus.

Pursuant to regulation 5902(1)(a), Forco’s exempt surplus and net surplus are both $100. Further, for the purpose of regulation 5902(1)(b), the amount of the dividend that would have been received on the 50 shares in respect of which the election was made is $50 (that is, this is the amount that would have been received on those shares if Forco had paid a dividend equal to its net surplus of $100 on all 100 of its outstanding shares).

In consequence, regulation 5902(1)(c)(i) provides, for the purposes of regulations 5900(1) and 5901(1), that the amount of Forco’s exempt surplus is $100, and regulation 5902(1)(c)(ii) provides that the whole dividend paid by Forco is $50, being the $25
deemed dividend under subsection 93(1) multiplied by 2 (the proportion that Forco’s net surplus of $100 determined under regulation 5902(1)(a) is of the $50 amount determined under regulation 5902(1)(b)). Since the portion of the $50 whole dividend received by Canco from exempt surplus is $50 under regulation 5900(1)(a), the entire amount of the $25 dividend received by Canco is paid from exempt surplus.

The next step is to adjust Forco’s exempt surplus account to recognize the deemed dividend. To this end, for the purposes of regulation 5905(5) only, regulation 5905(6)(a) reduces Forco’s exempt surplus from $100 to $50 immediately before the redemption. More specifically, the amount of the surplus reduction under regulation 5905(6)(a) is $50, being the amount that is the quotient obtained when the $25 exempt surplus dividend is divided by 50 percent (Canco’s surplus entitlement percentage in Forco immediately before the disposition, determined on the basis that the 50 shares disposed of by Canco to Subco were the only shares owned by Canco at that time).

After Forco’s exempt surplus is adjusted under regulation 5905(6)(a) to $50, regulation 5905(6)(b) provides that Forco’s exempt surplus in respect of Canco is $50. (This calculation is only for the purpose of determining Forco’s exempt surplus in respect of Subco under regulation 5905(5).) Forco’s exempt surplus in respect of Canco is the proportion of the $50 exempt surplus (as adjusted under regulation 5905(6)(a)) multiplied by 50%/50% (the proportion that Canco’s surplus entitlement percentage in Forco immediately before the disposition, determined on the basis that the 50 shares disposed of by Canco to Subco were the only shares owned by Canco at that time, is of Subco’s surplus entitlement percentage in Forco immediately after that time). Forco’s exempt surplus in respect of Subco is unaffected by the regulation 5905(6)(a) adjustment.

After the regulation 5905(6)(b) adjustment is complete, Forco’s opening exempt surplus in respect of Subco is $50, being the total of Forco’s exempt surplus in respect of Subco (nil) and Canco ($50) immediately before the transfer (regulation 5905(5)(d)). Forco’s exempt surplus in respect of Canco after the transfer is $100.

This provides the appropriate result, notwithstanding that Forco now has a total of $150 exempt surplus in respect of Canco and Subco. This is proved as follows. Since Forco and Canco each have a surplus entitlement percentage in Forco of 50 percent, if Forco were to pay a dividend of $150 (equal to Forco’s aggregate exempt surplus in respect of Canco and Subco), $50 of the dividend to Canco and $25 of the dividend to Subco (a total of $75) would be from exempt surplus. (With respect to the dividend to Canco, the regulation 5901(1)(a) amount is $100 and the regulation 5900(1)(a) amount is $50 [$75 × $100/$150]. With respect to the dividend to Subco, the regulation 5901(1)(a) amount is $50 and the regulation 5900(1)(a) amount is $25 [$75 × $50/$150].) Since $25 of Forco’s original exempt surplus in respect of Subco was used on Canco’s subsection 93(1) election, the entire amount of Forco’s $100 exempt surplus would then be distributed. In this regard, Forco’s exempt surplus in respect of both Canco and Subco is reduced by the amount of the relevant regulation 5901(1)(a) dividend deemed to have been paid from Forco’s and Subco’s exempt surplus, respectively, which results in a reduction of Forco’s exempt surplus to nil in both cases.

**Transfers to the Corporation or to Other Foreign Affiliates**

Regulation 5905(8) adjusts an affiliate’s surplus accounts where shares of the affiliate are disposed of to the Canadian-resident corporation of which it is a foreign affiliate or to another foreign affiliate of the corporation (including a disposition by a foreign
affiliate to another foreign affiliate) and a subsection 93(1) election is made. For present purposes, we refer to the affiliate whose shares are disposed of as “the affiliate.”

The architecture of regulation 5905(8) is analogous to that in regulation 5905(2), discussed in detail above. In brief,

1. regulation 5905(8)(a) adjusts the affiliate’s surplus accounts to account for the subsection 93(1) deemed dividend;
2. regulation 5905(8)(b) then adjusts the surplus accounts to reflect changes in surplus entitlement percentage; and
3. finally, regulation 5905(8)(c) establishes these amounts as the opening surplus accounts of the affiliate.

As noted above, this rule can sometimes be used to cure dilutions in surplus that would otherwise arise on a transfer that reduces the disposing corporation’s entitlement to the affiliate’s surplus. Consider example 6.

Example 6
Canco, a Canadian-resident corporation, owns all (100) of the outstanding shares of a foreign affiliate, Forco 1, and has an adjusted cost base in the shares of $10. Forco 1 has exempt surplus of $100. Canco transfers all of the Forco 1 shares to another foreign company in exchange for shares that constitute 10 percent of that other company’s outstanding common shares. As a result of the transfer, the foreign company becomes a foreign affiliate of Canco (Forco 2), with Canco holding 10 percent of its outstanding share capital.

Canco will not realize a gain on the transfer since its proceeds of disposition are deemed to be $10 under subsection 85.1(3). However, Canco’s entitlement to Forco 1’s $100 of exempt surplus is reduced to $10 (that is, to 10 percent).

If Canco instead makes a subsection 93(1) election with a designated amount of $1, the regulation 5905(8) adjustments operate as follows. Under regulation 5905(8)(a), Forco 1’s exempt surplus is reduced by the amount of $1, which is the product obtained when the specified adjustment factor (100 percent, because Canco is disposing of all of the shares) is multiplied by the whole dividend considered paid from Forco 1’s exempt surplus under regulations 5905(2), 5901(1)(a), and 5900(1)(a). As a result, Forco 1’s exempt surplus is reduced to $99.

Pursuant to regulation 5905(8)(b), Forco 1’s exempt surplus is adjusted to reflect Canco’s reduction of its surplus entitlement percentage in Forco 1. Accordingly, Forco 1’s exempt surplus is $990 (the proportion of $99 that Canco’s 100 percent surplus entitlement percentage before the transfer is of its 10 percent surplus entitlement percentage after the transfer). Therefore, Forco 1’s original surplus ($99 plus the $1 used by virtue of the subsection 93(1) election) in respect of Canco is preserved. That is, the maximum amount of Forco 1’s $990 exempt surplus to which Canco is entitled with its 10 percent surplus entitlement percentage is $99.

Other Rules Applicable to the Dividend Recipient
A deemed dividend received by a Canadian-resident corporation by reason of a subsection 93(1) election is subject to the same rules as any other dividend received
from a foreign affiliate. Generally, where a subsection 93(1) dividend is received by a Canadian-controlled private corporation or a deposit insurance corporation and the entire amount of the dividend is deductible (even if not deducted) under one of the rules in section 113, the dividend will be added to the corporation’s general rate income pool, as defined in subsection 89(1). However, in certain circumstances, special rules applicable to dividends from foreign affiliates in respect of term preferred shares (subsection 258(3)) or guaranteed preferred shares (subsection 258(5)) may apply and recast the dividend as interest received in a year.

In addition, provided that a number of other conditions are met, a subsection 93(1) dividend may be subject to part IV tax (applicable to portfolio dividends) under subsection 186(1) to the extent that it is an “assessable dividend” as defined in subsection 186(3). A dividend will be an assessable dividend if any amount in respect of the dividend is deductible under one of the rules in section 113. Similarly, a subsection 93(1) dividend could be liable to part IV.1 tax (applicable to taxable preferred shares) under section 187.2 to the extent that an amount in respect of the dividend is deductible under section 113 and other conditions are met.

Accordingly, if subsection 258(3) or (5), part IV, or part IV.1 may apply to the dividend, it may be preferable not to make a subsection 93(1) election.

Stop-Loss Rule

Subsection 93(2) reduces the loss from certain dispositions of a share of a foreign affiliate by the amount of any exempt dividends received on the share or shares for which the share was substituted. This rule is similar in concept to the dividend stop-loss rule in subsection 112(3), applicable in the domestic context.

More particularly, subsection 93(2) reduces the loss that would otherwise be realized by a Canadian-resident corporation on the disposition of a share of a foreign affiliate. The rule also reduces the loss that would otherwise be realized by a foreign affiliate from the disposition of shares in other foreign affiliates that do not constitute excluded property. In general terms, the amount of the loss is reduced by exempt dividends, as defined in subsection 93(3), received by the particular corporation (or affiliate) or related corporations and foreign affiliates on the share or on a share for

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35 The addition to the general rate income pool occurs under element G of that definition.
36 Technically, under one of the rules in paragraph 113(1)(a), (b), or (d) or subsection 113(2).
37 Section 93 contains three other stop-loss rules, in subsections 93(2.1), (2.2), and (4); however, none of these provisions are relevant to the present discussion. Subsection 93(2.1), which reduces an allowable capital loss from certain dispositions by a partnership of which the corporation is a member, is not relevant because the election under subsection 93(1.2) (discussed below) cannot create a loss. (The amount that may be designated in the election is limited to twice the taxable capital gain—that is, there must be a taxable capital gain.) Subsection 93(2.2) is not relevant because it only applies to a disposition of a partnership interest, and section 93 does not provide for an election in respect of such a disposition. Subsection 93(4) is not relevant because the loss reduction provisions in subsections 93(2) and (2.1) effectively provide that no loss can be generated by reason of a section 93 election.
which the affiliate share was substituted. Exempt dividends that previously reduced a loss in respect of the particular share are excluded from this determination.

For this purpose, “exempt dividend” is defined in subsection 93(3). In the case of a dividend received by a Canadian-resident corporation (including a dividend deemed to be received pursuant to subsection 93(1)), paragraph 93(3)(a) provides that the dividend is an exempt dividend to the extent that any amount in respect of the dividend is deductible (even if not deducted) under paragraph 113(1)(a), (b), or (c). Where the dividend is received by a foreign affiliate from another foreign affiliate (or is deemed to be received pursuant to subsection 93(1)), paragraph 93(3)(b) provides that the dividend is an exempt dividend to the extent that the amount of the dividend considered to be paid out of exempt or taxable surplus of the other affiliate exceeds any foreign income or withholding tax on that portion of the dividend.

In the context of a subsection 93(1) election, subsection 93(2) prevents the use of the election to create a capital loss. That is, this rule denies the loss that would otherwise be realized where the amount designated in the election exceeds the accrued gain on the shares. In such a case, the election would reduce the proceeds of disposition to an amount that was less than the adjusted cost base of the shares, thus resulting in a loss. This is illustrated in example 7.

Example 7
Canco, a Canadian-resident corporation, owns 100 percent of a foreign affiliate, Forco, which has exempt surplus of $100. Canco has an adjusted cost base of $90 in the foreign affiliate shares, sells the shares for $100, and designates $100 in a subsection 93(1) election.

As a result of the election, Canco is deemed to receive a $100 dividend from Forco. Canco includes the $100 dividend in income and deducts $100 in computing its taxable income, because the dividend is considered to be paid from Forco’s exempt surplus. Canco’s proceeds of disposition are reduced by $100, with the result that Canco realizes a loss of $90. However, since the $100 dividend that Canco is deemed to receive is an exempt dividend, the entire amount of the $90 loss is denied, and subsection 93(2) deems the loss to be nil.

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38 In this regard, the expanded concept of substituted property in subsection 248(5) must be considered.

39 See paragraphs (a) to (d) of element C in subsection 93(2).

40 Technically, paragraph 93(3)(b) provides that an exempt dividend received by a foreign affiliate of a Canadian-resident corporation from another foreign affiliate of that corporation is the amount by which the portion of the dividend that was not prescribed to have been paid out of the pre-acquisition surplus of the other affiliate exceeds the portion of the income or profits tax that can reasonably be considered to have been paid in respect of that portion of the dividend by the particular affiliate or by a partnership in which the particular affiliate had, at the time of the payment of the income or profits tax, a direct or an indirect partnership interest.

41 In this example, the formula in subsection 93(2) results in a negative amount (that is, $90 - $100 = ($10)). Since a negative result is not permitted, by virtue of section 257, the amount of the deemed loss under subsection 93(2) will be nil.
Compliance

General Filing Requirements

A subsection 93(1) election must be made “in prescribed manner and within the prescribed time.” The prescribed form for making the election is form T2107, “Election for a Disposition of Shares in a Foreign Affiliate.” The filing deadline in the particular circumstances is specified in regulation 5902(5). Where the election is made in respect of a share disposed of by a Canadian-resident corporation, the form must be filed on or before the date on which the corporation’s tax return for the taxation year in which the disposition occurred is due under subsection 150(1) (that is, within 180 days after the end of the relevant taxation year). Where the election is in respect of a share disposed of by a foreign affiliate of a Canadian-resident corporation, the form must be filed on or before the Canadian-resident corporation’s filing due date for the taxation year in which the taxation year of the disposing affiliate ended.

Form T2107 is straightforward, requiring, among other things, a description of the class and the number of shares disposed of. In addition, the elected amount, proceeds of disposition, and adjusted cost base must be reported, in Canadian dollars, on a per share basis (in accordance with subsection 93(1), which stipulates that the election is to be made on a share-by-share basis). A calculation of the exempt and taxable surplus balances must be filed along with the election.

Late-Filed Elections

Late filing of a subsection 93(1) election is permitted within a specified period; however, a late-filing penalty must be paid. More specifically, subsection 93(5) provides that an election may be filed as of right within three years after the filing deadline prescribed by regulation 5902(5). The election must be made in prescribed form (T2107), accompanied by payment of the estimated penalty. The method for calculating the penalty is described in subsection 93(6).42

Subsection 93(5.1) allows the minister to accept a late-filed election after the expiry of the three-year period referred to in subsection 93(5). The minister may also accept an amended election. In both cases, the election must be made in the prescribed form, the penalty under subsection 93(6) must be paid, and the circumstances must be such as to satisfy the minister that it would be just and equitable to allow the election. The minister is not obliged to accept a late or amended subsection 93(1) election filed after the three-year period referred to in subsection 93(5) has passed.43

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42 The maximum penalty is $3,700 (37 months × $100) if the late-filed election is filed as of right, or $8,000 if the election is filed, with the minister’s consent, beyond the three-year period.

43 In the event that the minister refuses to accept a late or amended election, judicial review of the minister’s decision may be sought within 30 days of the minister’s decision being communicated to the corporation: see sections 1 and 18.1 of the Federal Courts Act, RSC 1985, c. 10 (2d Supp.), as amended.
Since the late-filing penalty is de minimis, if there is any uncertainty with respect to the amount to be designated—or even whether an election should be filed at all—the prudent course would be to wait until sufficient information is available within the three-year period, rather than make an amended election.

Subsection 93(7) requires the minister, “with all due dispatch,” to examine the election (or amended election) made under subsection 93(5) or (5.1), assess the penalty payable, and send a notice of assessment to the corporation. The corporation is liable to pay any unpaid balance of the penalty forthwith upon assessment. Since the subsection 93(7) assessment is made under part I of the Act, if the corporation disagrees with the amount assessed, it may file a notice of objection under subsection 165(1) within 90 days of the assessment, in the same manner as it would dispute any other assessment under part I.45

**SUBSECTION 93(1.1)**

Subsection 93(1.1) deems an election to have been made under subsection 93(1) where a foreign affiliate of a Canadian-resident corporation disposes of a share of another foreign affiliate that constitutes excluded property (except dispositions to which paragraph 95(2)(c), (d), or (e) applies). Because the corporation is deemed to have filed the election, no prescribed form is filed. Instead, the designated amount and relevant surplus balances are determined pursuant to the rules in part LIX of the regulations. (For present purposes, we refer to the affiliate whose share was disposed of as “the affiliate” and the affiliate that disposed of the share as “the disposing affiliate.”)

Regulation 5902(6) provides that the prescribed amount deemed to be designated in the election is the lesser of:

- the capital gain (if any) from the disposition of the share otherwise determined; and
- the amount that could reasonably be expected to have been received by the disposing affiliate in respect of the share if the affiliate whose share was disposed of had paid a dividend equal to the amount of its net surplus determined under regulation 5902(1)(a).

The rules applicable in determining the affiliate’s net surplus under regulation 5902(1)(a) are described above.

Subsection 93(1.1) and regulation 5902(6) apply such that the proportionate amount of existing surplus balances of the affiliate and any lower-tier affiliates move

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44 See supra note 42.

45 As with any penalty, a fairness application may also be made under subsection 220(3.1).

46 More particularly, dispositions relating to interaffiliate share-for-share exchanges (paragraph 95(2)(c)), mergers of affiliates (paragraph 95(2)(d)), and dissolution of affiliates (paragraph 95(2)(e)).
up to the disposing affiliate to the extent of the gain. In addition, the proceeds of disposition are reduced by the amount of the deemed dividend, thus eliminating the gain to the extent of the available surplus balances.

It appears that the purpose of the rule is prophylactic, since it prevents the partial conversion of taxable surplus into exempt surplus that may otherwise occur. That is, where the shares disposed of constitute excluded property, no FAPI is realized and one-half of the capital gain realized on the disposition is added to exempt earnings and taxable earnings, respectively, of the disposing affiliate. Therefore, where the affiliate has taxable surplus and low (or no) underlying foreign tax, absent subsection 93(1.1), it would be possible to convert one-half of the taxable surplus into exempt surplus by triggering the gain. The effect of the rule is demonstrated in example 8.

Example 8
Canco, a Canadian-resident corporation, owns 100 percent of a foreign affiliate, Forco 1, which in turn owns 100 percent of another foreign affiliate, Forco 2. Forco 1 has an adjusted cost base of nil in the Forco 2 shares, which have a fair market value of $100. Forco 2 has cash on hand of $100, taxable surplus of $100, and no underlying foreign tax.

Forco 1 sells the Forco 2 shares to a third party for $100 and realizes a capital gain of $100. Absent the deeming rule in subsection 93(1.1), Forco 1 would have exempt earnings of $50 and taxable earnings of $50 as a consequence of the gain.

As a result of the disposition of the Forco 2 shares, subsection 93(1.1) applies such that Forco 1 is deemed to have made a subsection 93(1) election. Pursuant to subsection 93(1) and regulation 5902(6), Forco 1 is deemed to receive a $100 dividend from Forco 2’s taxable surplus. In the end result, therefore, Forco 1 has $100 in cash and $100 of taxable surplus.

If, instead of the disposition, Forco 2 had distributed the $100 cash by paying a dividend, Forco 1 would have had a taxable surplus of $100. Thus, subsection 93(1.1) puts Forco 1 in the same position as if Forco 2 had instead paid a dividend.

As a final comment, where subsection 93(1.1) applies in respect of a particular disposition, all of the rules for adjusting the surplus accounts and underlying foreign tax of the affiliate whose share is disposed of apply as described above in connection with subsection 93(1).

**SUBSECTION 93(1.2)**

**APPLICATION**

Subsection 93(1.2) provides an election in connection with taxable capital gains arising from a disposition of foreign affiliate shares of a class (on a collective, as opposed

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47 To paraphrase one commentator, the purpose must be defensive; otherwise, the subsection 93(1) election presumably would be made voluntarily: Ulmer, supra note 5, at 273.

48 See regulation 5907(1), subparagraphs (d)(iii) of the definition of “net earnings,” (a)(ii) of the definition of “exempt earnings,” and (b)(v) of the definition of “taxable earnings.”
to a per share, basis) held by a partnership of which a Canadian-resident corporation or a foreign affiliate of such a corporation is a member. In the discussion that follows, the corporation (whether a Canadian-resident corporation or a foreign affiliate of such a corporation) that is allocated the gain by the partnership will be referred to as “the disposing corporation.”

In concept, subsection 93(1.2), in concert with section 93.1, is intended to allow the disposing corporation to look through a partnership for the purpose of accessing surplus of the affiliate whose shares are disposed of, in a manner similar to that provided by the subsection 93(1) election.

Subsection 93(1.2) and the companion deemed election rule in subsection 93(1.3) were introduced in 2001 along with a number of amendments to the foreign affiliate rules relating to partnerships. Subsections 93(1.2) and (1.3) apply to dispositions occurring after November 1999. It is worth noting at the outset that, while the clear legislative intention is for subsection 93(1.2) to mirror subsection 93(1), the Department of Finance’s failure to move its legislative agenda forward has resulted in a statutory lacuna: under current law, no portion of a subsection 93(1.2) deemed dividend will be considered to be paid from an affiliate’s surplus accounts. There are, in fact, no regulations currently in force to prescribe the portion of the dividend paid from an affiliate’s surplus where a subsection 93(1.2) election is made. While regulations have been proposed, if they are enacted in their present form, they will not completely address the problem. The proposals are discussed further below.

As with subsection 93(1), the amount resulting from the subsection 93(1.2) election is deemed to be received by the disposing corporation as a dividend immediately before the disposition of the share by the partnership. Moreover, the dividend is deemed to be a dividend received on the number of shares of the foreign affiliate that is the difference between the number of shares that the disposing corporation is deemed by subsection 93.1(1) to own immediately before the disposition and the number of shares that the disposing corporation is deemed by subsection 93.1(1) to own immediately after the disposition. In effect, the disposing corporation is treated as if it directly owned the shares disposed of by the partnership.

Subparagraph 93(1.2)(a)(i) limits the designated amount to twice the amount of the disposing corporation’s portion of the partnership’s taxable capital gain. This is in contrast to subsection 93(1), which limits the designated amount to the proceeds of disposition. This limitation may prevent a corporation from making a “curative” election to prevent surplus dilution in certain circumstances.

49 See the March 16, 2001 notice of ways and means motion, supra note 4. The implementing legislation was the Income Tax Amendments Act, 2000, SC 2001, c. 17, section 70(2). As discussed below, the notice of ways and means motion introduced a number of proposed amendments to the regulations applicable to section 93 elections that have not yet been enacted.

50 Income Tax Amendments Act, supra note 49, section 70(10).

51 See Lockwood et al., supra note 5. See also Kotecha, ibid.
As a technical matter, the limitation in paragraph 93(1.2)(a) is described in a somewhat opaque manner. In effect, the designated amount cannot exceed the amount that is equal to the product obtained by multiplying the taxable capital gain realized by the partnership by a specified fraction. The numerator of the fraction is the number of shares of the class disposed of by the partnership deemed by subsection 93.1(1) to be owned by the disposing corporation immediately before the disposition that exceeds the number of shares of the class of the foreign affiliate deemed by subsection 93.1(1) to be owned by the disposing corporation immediately after the disposition. The denominator of the fraction is the number of foreign affiliate shares of that class that were owned by the partnership immediately before the disposition.

Paragraph 93(1.2)(b) reduces the taxable capital gain of the disposing corporation in respect of the disposition by the amount that is deemed to be received as a dividend by the corporation. Specifically, the rule provides that the disposing corporation’s taxable capital gain is the amount of the taxable capital gain otherwise determined less the amount designated in the election. The designated amount will be different from the amount of the subsection 93(1.2) deemed dividend because of the gross-up in paragraph 93(1.2)(a).

Paragraphs 93(1.2)(c) to (e) provide three supporting rules that ensure that the flowthrough concept underlying the provision is maintained:

1. Paragraph 93(1.2)(c) provides that for the purposes of any regulation made under subsection 93(1.2), the disposing corporation is deemed to have disposed of shares in the relevant foreign affiliate. The number of shares disposed of is the amount, if any, by which the number of those shares that the disposing corporation was deemed to own for the purposes of subsection 93.1(1) immediately before the disposition exceeds the number of those shares that the disposing corporation was deemed to own for those purposes immediately after the disposition.

2. Paragraph 93(1.2)(d) provides that for the purposes of the taxable income deductions in section 113 applicable in respect of the subsection 93(1.2) dividend, the disposing corporation is deemed to have owned the shares on which the dividend was received.

3. Where the disposing corporation has a taxable capital gain allocated from a partnership because of the application of subsection 40(3) to the partnership in respect of a dividend paid on the relevant shares, paragraph 93(1.2)(e) provides that the shares are deemed to have been disposed of by the partnership.

Some aspects of the subsection 93(1.2) rules merit further comment, and are discussed below.

**Foreign Affiliate**

The subsection 93(1.2) election is available only to corporations resident in Canada in respect of taxable capital gains allocated by a partnership to the corporation or to a
foreign affiliate of such corporation, and not to other taxpayers. Further, the subsection 93(1.2) election is available only in respect of shares disposed of by the partnership that are shares of a foreign affiliate of the Canadian-resident corporation.

Where the Canadian-resident corporation has a sufficient equity percentage in the foreign corporation whose shares are disposed of, the foreign affiliate requirement of subsection 93(1.2) will be satisfied. Where the only interest of the Canadian-resident corporation in the foreign corporation is held through a partnership of which the Canadian resident, or a foreign affiliate of the Canadian resident, is a member, determining whether the foreign affiliate requirement is satisfied is more difficult.

More particularly, it is generally understood under partnership law that each partner of a partnership holds an undivided interest in the partnership property, and that the partners do not hold any particular partnership property. In the case of a partnership that owns a share of a foreign corporation, a partner may own an undivided interest in that share. However, the partner arguably may not own the requisite number of shares of the foreign corporation for the corporation to constitute a foreign affiliate of the partner. This is certainly the position that the Canada Revenue Agency (CRA) has historically taken.

In order to clarify the foreign affiliate status of a foreign corporation whose shares are owned by a partnership, subsection 93.1(1) provides, for certain limited purposes, that the partners are deemed to own the shares directly, in proportion to their respective interests in the partnership based on fair market value. More specifically, for the purposes of (among others) section 93 (and the regulations thereunder) and section 95 (to the extent that it is relevant for the purpose of section 93), each partner is deemed to own the number of shares of a foreign corporation held by the partnership that the fair market value of that partner’s partnership interest is of the fair market value of all of the partnership interests. In the result, the partners are deemed to own shares of a foreign corporation held by the partnership on a proportionate basis for certain purposes.

As a result of the reference to section 95, subsection 93.1(1) allows a corporate partner to apply the definitions of “foreign affiliate” in subsection 95(1) and “equity percentage” and “direct equity percentage” in subsection 95(4) for the purposes of determining whether a foreign corporation owned by a partnership constitutes a foreign affiliate of the corporate partner.


Filing Procedure

Subsection 93(1.2) requires the Canadian-resident corporation to file an election in the prescribed manner in respect of the disposition by the partnership. As discussed above, regulation 5902(5) sets out the filing requirements for a subsection 93(1) election; however, neither regulation 5902(5) nor any other regulation applies to an election made pursuant to subsection 93(1.2). Proposed regulations would remedy this omission by providing that regulation 5902(5) will apply. This is discussed further below.

Interaction with the Surplus Regime

In the case of a Canadian-resident corporation, a dividend deemed to be received pursuant to subsection 93(1.2) is included in income. As with subsection 93(1), the theory underlying the dividend inclusion is premised on the fact that amounts in respect of the dividend would be deductible under section 113 in respect of surplus and underlying foreign tax balances, since this allows the extraction of surplus without incurring foreign withholding tax.

Two fundamental conditions must be satisfied in order for an amount in respect of a subsection 93(1.2) dividend to be deductible under one of the rules in section 113:

1. A corporation resident in Canada must receive a dividend on a share of a foreign affiliate of the corporation.
2. Part LXI of the regulations must prescribe a portion of the dividend to be paid out of the relevant surplus account of the affiliate.

These requirements are common to each of the deductions provided by paragraphs 113(1)(a), (b), (c), and (d).

With regard to the first condition, paragraph 93(1.2)(a) deems a dividend to be received on shares deemed to be owned by the disposing corporation pursuant to subsection 93.1(1). Further, paragraph 93(1.2)(d) ensures that for the purposes of section 113, the disposing corporation is deemed to have owned the shares in respect of which the deemed dividend is received.

With regard to the second condition, regulation 5900 determines the amount (portion) of the dividend that is considered to be paid from the affiliate’s surplus accounts. The amount is determined by multiplying the amount of the dividend received by a fraction the numerator of which is the portion of the whole dividend paid by

54 The March 16, 2001 notice of ways and means motion (supra note 4, appendix F, sections 2(4) and 4(2)) proposed to amend regulation 5902(5) to refer to elections made under subsection 93(1.2). Like the election mechanism in subsection 93(1.2), the amended regulation would apply to dispositions occurring after November 1999.

55 Technically, this is the result of the operation of the same provisions applicable in the context of a subsection 93(1) election—that is, section 90 and paragraph 12(1)(k).

56 See, for example, the explanatory notes to the proposed amendment to regulation 5902(1) in the March 16, 2001 notice of ways and means motion, supra note 4, at 651.
the affiliate on the shares of the class that is deemed by regulation 5901 to have been paid out of the affiliate’s particular surplus account, and the denominator of which is the whole dividend paid by the affiliate on the shares of that class.

Regulation 5901(1) will apply to deem an amount to have been paid out of the particular surplus account of the foreign affiliate only where, among other things, the affiliate has paid a whole dividend. However, subsection 93(1.2) (like subsection 93(1)) only deems a dividend to have been received, and does not go further and deem a dividend to have been paid. Since regulation 5901(1) (and therefore regulation 5900(1) and, in consequence, paragraph 113(1)(a)) requires a dividend to have been paid, it is necessary for the regulations to also deem an amount to be paid. While regulation 5902(1)(c)(ii) does so for the purposes of the subsection 93(1) election, the regulation does not currently extend to an election made under subsection 93(1.2).

Given the legislative history of subsection 93(1.2) and the related amendments to regulation 5902 proposed on March 16, 2001, this state of affairs is clearly not intended. Moreover, subsequent proposed amendments (December 20, 2002 and February 27, 2004) to regulation 5902(1) confirm that the regulation will apply to dispositions subject to a subsection 93(1.2) election for all dispositions that occur after December 20, 2002.57

The application dates of the proposed amendments require further comment. In short, if the (most) current proposed amendments to regulation 5902 are ever promulgated, they will be effective for dispositions that occur after December 20, 2002. They will not apply, however, to dispositions occurring between December 1999 and December 20, 2002. (As noted above, subsection 93(1.2) applies to dispositions made after November 1999.) Presumably this will be fixed when (and if) amendments to regulation 5902 become law.

The amendments to regulation 5902 in respect of a subsection 93(1.2) election have been pending for over seven years, and it is unclear when they will become law. This has left taxpayers with considerable uncertainty with respect to the application of the rules.

Somewhat helpfully, the CRA has stated, in the context of the proposed foreign trust and foreign investment entity rules, that taxpayers should file their returns on the basis of proposed law and regulations.58 Even though there is no legal basis for doing so, this is attractive in the case of a subsection 93(1.2) election because the rule is (mostly) a relieving provision. However, recent audit experience (in respect of amendments to the FAPI rules) suggests that the CRA may be unwilling to apply proposed amendments of a relieving nature.59

57 See Legislative Proposals and Draft Regulations, supra note 4, appendix C, section 5.
59 In the round table at the 2005 tax conference, ibid., at 6A:34-35, the CRA publicly articulated its general view on applying proposed legislation that would benefit a taxpayer: “[W]here
Further, generally speaking, for financial accounting purposes the proposed legislation is not considered substantially enacted; consequently, it is usually ignored in preparing audited financial statements.\textsuperscript{60} This may be undesirable for some corporations.

**CORRESPONDING ADJUSTMENTS TO SURPLUS AS A CONSEQUENCE OF DEEMED DIVIDEND**

Notwithstanding the uncertainty from the perspective of the subsection 93(1.2) dividend recipient, adjustments to the foreign affiliate’s surplus balances that depend on changes in surplus entitlement percentage may still be required. In this regard, regulation 5902(3) does not apply to a disposition in respect of which a subsection 93(1.2) election is made, and therefore there is no restriction to the surplus adjustment rules that could apply. Put another way, even though the surplus cannot be used to shelter the subsection 93(1.2) dividend, corresponding adjustments may be required.

As noted, paragraph 93(1.2)(c), which applies for the purpose of any regulation made under subsection 93(1.2), provides that the disposing corporation is deemed to have disposed of certain shares of the foreign affiliate. This provision is linked to the proposed changes to regulation 5905(2)(a) in the March 16, 2001 amendments.\textsuperscript{61} If enacted, this should provide appropriate adjustments to the surplus balances of the relevant affiliate (and lower-tier affiliates) because the surplus adjustment rules applicable as a consequence of subsection 93(1.2) will apply.

**SUBSECTION 93(1.3)**

Subsection 93(1.3) deems an election to have been made under subsection 93(1.2) where a foreign affiliate of a Canadian-resident corporation has a gain from a disposition by a partnership of foreign affiliate shares that constitute excluded property. Subparagraph 93(1.2)(a)(ii) provides that the amount designated on the deemed election is the amount prescribed.
As discussed above, regulation 5902(6) sets out the prescribed amount for the purposes of a deemed subsection 93(1) election arising by virtue of subsection 93(1.1). However, under current law, regulation 5902(6) does not apply to a deemed election made pursuant to subsection 93(1.3), and no other regulation currently in force provides the prescribed amount for this purpose. This too is the result of the delay in the promulgation of proposed regulations that were initially announced on March 16, 2001 and revised by draft legislation released on February 27, 2004. If enacted, proposed regulation 5902(7) will determine the prescribed amount of the deemed subsection 93(1.2) election, subject to the timing problem noted above for dispositions between December 1999 and December 20, 2002.  

Since subsection 93(1.3) deems a subsection 93(1.2) election to have been made in respect of a particular disposition, all of the rules applicable to adjust the exempt and taxable surplus and underlying foreign tax of the affiliate whose share is disposed of in connection with subsection 93(1.2) apply equally to a deemed election pursuant to subsection 93(1.3).

CONCLUSION

This article has provided a survey of section 93 and the associated regulations under current law. As noted above, numerous amendments have been proposed that will affect the application of these rules. The forthcoming companion article will provide a more detailed examination (and explanation) of the proposed amendments.

BIBLIOGRAPHY INFORMATION


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62 Proposed regulation 5902(7) will apply on the same basis as proposed regulation 5902(1). See also Legislative Proposals and Draft Regulations, supra note 4, appendix C, section 5.