shares, from which they hope to be rewarded for their efforts, at more or less nominal prices before any other shares are issued. While section 61(1) (d) refers to escrowing or pooling with respect to securities issued for a consideration other than cash, the officials, presumably relying upon the Director's "discretion", have in one case made a very determined effort to require the escrow of shares issued for cash although they relented after the individuals concerned, who no longer controlled the company, flatly refused to comply on the ground such shares had been previously escrowed for two years, at the behest of another commission, and subsequently released.

A cross-reference sheet must be filed with each preliminary prospectus and prospectus showing the location therein of the information required to be included in response to items contained in the complex forms prescribed in the regulations. Each of the Quebec and Saskatchewan Securities Commissions requires a similar instrument, under a different title, with reference to the respective Securities Acts of those provinces. There are various additional formal requirements of the officials in some of the other provinces, and, of course, each province exacts a filing fee.

The end result is certainly a more readable prospectus, but investment dealers and others distributors of securities report that very few purchasers ever read any prospectus. Certainly, one practical result of the new legislation will be to substantially increase the cost of raising money by the sale of corporate securities to the Canadian public. While it may be politically difficult, the substitution of one federally constituted body, charged with the duty of regulating the form and content of prospectuses, for the present ten provincial bodies would vastly increase the efficiency of the whole process; and the existing provincial commissions and their staffs could concentrate their efforts on the enforcement of the new "insider" provisions as well as licensing requirements and the investigation of complaints.

—J. J. SAUCIER*

* J. J. Saucier, Q.C., of the Alberta Bar.

REDEMPTION OF SHARES UNDER THE ALBERTA COMPANIES ACT—THE INCOME TAX ACT, SS. 105, 82, 81, 8; THE COMPANIES ACT, SS. 48(1) (B) (III), 79(3).

This note will deal with two aspects of the redemption of redeemable shares. One aspect will be an outline of why the practising solicitor of today encounters the problem far more frequently than his predecessors in the profession of forty years ago. The other aspect will be a brief comment on the methods available for the redemption of shares of companies incorporated under The Alberta Companies Act.

The popularity of the creation, issue and redemption, in quick succession, of redeemable shares is due mainly to the interaction of Sections 105, 82, 81 and 8 of The Income Tax Act (Canada).

Section 105 in effect provides that where a company has paid dividends in prior fiscal years of the company, then the company may elect to pay

a tax of 15% on an amount equal to the aggregate of those dividends (excluding any amount as to which an election under 105 has already been taken).

Section 82 in part provides that the balance of the amount upon which the 15% tax has been paid under section 105, is classified as "tax paid undistributed income".

Section 81 in part provides that where there is undistributed income on hand in a company at a time when the company distributes or otherwise appropriates funds to its shareholders, then the amount so distributed will be deemed to be a dividend. The section then goes on to provide that where a company capitalizes (i.e. converts to issued capital any of its undistributed income on hand), a dividend is deemed to have been received by each of the parties who hold any of the company's shares immediately before the capitalization occurred. Section 81 (4) provides, however, that the taxpayer who is deemed to have received a dividend by reason of the operation of section 81, is not taxable on the portion of the dividend representing "tax paid undistributed income".

Section 8 provides *inter alia,* that where a company appropriates funds, or property, to a shareholder otherwise than in the course of a *bona fide* business transaction, the amount or value received by the shareholder shall be included in the shareholder's income for the year. However, section 8 excludes from this wide net any distribution made on a reduction of capital, the redemption of shares, and other special situations which are of no relevance in this comment.

When one has finally assimilated these sections, it becomes clear that normally the capitalization of the undistributed income of a company attracts tax at the time the capitalization is made, and the shares are issued, and not when the redeemable (or other shares) are redeemed. There is an exception as to all amounts which are classified as "tax paid undistributed income"; when these amounts are capitalized they do not attract tax at that stage. However, tax paid undistributed income will be caught and taxed in the shareholders' hands under section 8 unless the distribution of the amount is in the form of redeemable preferred shares, (except in special situations, such as upon the winding up, or reorganization of the company) and in order to avoid liability under section 8, the payment to the shareholders in normal cases must be made through the redemption of shares. A tax of 15% is usually appreciably less than the effective rate applicable to the individual shareholders if they receive the distribution from the company as dividends or otherwise without taking advantage of section 105. Thus the creation, issue and redemption of the shares has become common procedure.

Turning to a discussion of the methods by which the redemption of shares may be effected, it is necessary to make some assumptions as to the position of the company at the time the issue and subsequent redemption of the shares is affected. Those assumptions are:

1. That the declaration of the dividend does not contravene the provisions of section 89 of The Companies Act (i.e. which prohibits declaration of dividend which render the company insolvent, etc.).

2. That the company has in its authorized capital adequate redeemable preference shares and adequate mechanics whereby either its

Board of Directors or its shareholders can redeem the issued preference shares.

3. That either for the purpose of utilizing section 105 of *The Income Tax Act,* or some other reason, the company now proposes to issue and promptly redeem preference shares.

4. That all proper steps preliminary to the issue of the shares have been taken, that the redeemable preference shares have been issued and distributed *pro rata* to the shareholders, and that for illustrative purposes, the face amount of the issue, (and also the amount of the proposed redemption) is $50,000.00.

In addition to the foregoing assumptions, which are common to all the examples to be discussed hereafter, there will be one variable factor, namely the amount of the "surplus" of the company on hand at the time of the redemption. For the purposes of this note, surplus will be defined as earned surplus available for dividends. Two cases arise:

Case 1 Where the surplus is $110,000.00;

Case 2 Where the surplus is $65,000.00.

Case One: *Surplus of* $110,000.00.

Under Case 1 there are three ways by which the company may redeem the shares.

Method 1 Pass the appropriate special resolution of the company calling for the redemption of the shares subject to the approval of the court, and apply by petition to the Supreme Court under Section 48 of The Companies Act.[1] The petition will pray for, *inter alia,* an order reducing the share capital of the company by $50,000.00, face amount of the issued preference shares, and the repayment to the shareholders of the amount represented thereby. In addition to the order, the court must approve a minute (pursuant to Section 50 (2) of The Companies Act), which shows the share capital following the order. Copies of the minute, the order and the special resolution must then be filed with the Registrar of Companies. Then, and not until that filing occurs, the company may redeem the shares and pay out the money.

Method 2 Let us assume that the company officers come to the solicitor a few days prior to the company's fiscal year end and request that steps be taken to redeem the shares and pay out the redemption price before the year end. There is no time to obtain a court order. The company must now resort to some other method of dealing with the problem. One way is to pass the appropriate resolution (which may or may not have to be a special resolution of the company, depending upon the provisions of the articles of association of the company) calling for the redemption of the shares and the setting up of the "capital redemption reserve fund". The shares are immediately redeemed, the money distributed, and the balance sheet at fiscal year end will show the reduction in the capital,

---

1 The Companies Act, R.S.A. 1955, c. 53, s. 48 (1) (b) (iii).
s. 48 (1) A company having a share capital by special resolution confirmed by an order of the court,
(b) may alter its memorandum so as to reduce its share capital in any way, and without prejudice to the generality of the foregoing power may modify or alter its memorandum so as to
(iii) either with or without extinguishing or reducing liability on any of its shares, pay off any paid-up share capital that is in excess of the wants of the company.

but as an offsetting item will show "capital redemption reserve fund". This fund is set up because of the mandatory requirement to that effect contained in section 79 (3)[2] of The Companies Act. (There will be further comment on this awkward subsection in reviewing the position under Case 2). The company has now accomplished its immediate objective of effecting the redemption before its year end. At any convenient time thereafter, it may pass the appropriate special resolution calling for the reduction of its capital by wiping out the capital redemption reserve fund and restoring that amount to surplus. That reduction would be accomplished by an application to the Supreme Court under section 48 in the same manner as under Method 1.

Method 3 This method is to proceed by special resolution under section 114 of The Companies Act. That section provides that where a company has accumulated undivided profits, it may, with the sanction of the shareholders by special resolution, distribute those profits among the shareholders in reduction of the paid up capital, thereby increasing the unpaid capital of the company by a like amount. This method would permit the immediate distribution of the money to the shareholders, and would be treated by the Income Tax Department as redemption of the redeemable shares for tax purposes. The special resolution would have to be filed with the Registrar of Companies.

No further step need be taken at that time. This method does not set up any amount in "capital redemption reserve fund", because under the provisions of The Companies Act, the shares are not really redeemed; they are still in existence. In the event the company becomes insolvent, the shareholders are still liable to repay to the company the amount of capital which has been returned to them. The balance sheet of the company would show these shares outstanding, but show that the capital they represent is unpaid. The company, at any convenient time thereafter, may apply to the Supreme Court under section 48, to reduce the capital of the company by cancelling the shares as to which the capital is unpaid, thereby terminating the liability of the shareholders to repay that capital.

Case Two: *Surplus of* $65,000.00.

In applying Method 1 to the Company whose earned surplus is $65, 000.00, an awkward hiatus develops. Here again it is assumed that a petition will be presented to the court praying for an order reducing the share capital of the company by the $50,000.00 face amount of the issued preference shares, and by the repayment to the shareholders of the amount represented thereby. Upon the presentation of the petition, the court may take a strict view of section 79 (3) of The Companies Act. The reasoning here is that the section is mandatory (which is unassailable) and that before the shares can be redeemed, by court order or otherwise, the condition imposed by the subsection must be met. If it cannot be met, no order can be made. The condition imposed is that

2 The Companies Act, R.S.A. 1955, c. 53, s. 79(3).
Where any such shares are redeemed otherwise than out of the proceeds of a fresh issue, a sum equal to the amount applied in redeeming the shares shall, out of profits that would otherwise have been available for dividend, be transferred to a reserve fund, to be called "the capital redemption reserve fund", and the provisions of this Act relating to the reduction of the share capital of a company apply, except as provided in this section, as if the capital redemption reserve fund were paid-up share capital of the company.

upon redemption, a capital redemption reserve fund shall be set up out of profits that would otherwise be available for dividends. The argument is, of course, that since $50,000.00 is to be redeemed, there must be at least another $50,000.00 left in earned surplus before the "transfer" to the capital redemption reserve fund can be made. The counter argument is that the court has jurisdiction to dispense with the setting up of the capital redemption reserve fund; it can therefore proceed to make an order to reduce the company's capital, extinguish or reduce liability on the preference shares, and pay off the paid-up share capital that is in excess of the wants of the company.

In the writer's opinion, section 48 (1) (b) (iii) confers jurisdiction on the court to dispense with the capital redemption reserve fund, with one notable exceptional situation. That situation arises when the company, in its haste to distribute the money, actually redeems the shares before applying to the court. In that situation the capital redemption reserve fund was required before the petition reached court, and the court should refuse the application.

From the foregoing, it becomes apparent that Method 2 is not available to a company under Case 2, because on the interpretation heretofore placed on the wording of section 79 (3) of The Companies Act, there is not a sufficient amount left in profits to effect the transfer to capital redemption reserve fund. It is acknowledged that a fierce argument rages within the legal and accounting professions as to the correct interpretation to be placed on the subsection. Some give it the meaning already described, some say there is a notional conversion, equivalent to the amount paid out on the redemption, and hence if the earned surplus is $50,000.00, a redemption of $50,000.00 is permissible. The writer does not agree with this latter interpretation, and knows of a case (unreported) in which an application made after the money had been distributed, was refused on the reasoning as outlined in the discussion of Case 2, Method 2.

Method 3 of case 1 is always available in case 2 and can be utilized.

In summary, if the money must be distributed immediately to the shareholders, and for any reason a court application is risky or too slow, proceed under methods 2 or 3. Whenever the amount to be distributed exceeds one-half the "earned surplus" at the time of distribution, proceed under method 3. Whenever methods 2 or 3 are utilized, be sure that sooner or later the appropriate court order is obtained to properly tidy up the company balance sheet.

—H. G. FIELD, Q.C.*

* Of the Alberta Bar.