

CARM

The Chartered Accountant Risk Management Newsletter
Conseils d'Assurance Responsabilité pour les Membres

Volume XVI
Issue 1
March 2007

SALE OF ELIGIBLE CAPITAL PROPERTY

CAPITAL DIVIDEND OR CAPITAL PUNISHMENT?

When eligible capital property (ECP) is sold in circumstances which give rise to an excess calculated pursuant to the formula in paragraph 14(1)(b) of the Income Tax Act (Canada) (the "Act"), the resultant income inclusion also leads to an addition to the corporate vendor's Capital Dividend Account (CDA). The CDA addition arises pursuant to the provisions of paragraph 89(1)(c.2) (definition of CDA) of the Act.

Private corporations are permitted to pay tax-free capital dividends to their shareholders who are residents of Canada in certain circumstances. Generally, the rules permit a corporation to elect in respect of the full amount of a dividend that is payable by the corporation to the extent of the corporation's CDA immediately before the time at which the dividend became payable.

The CDA consists of the tax-free portion of capital gains realized since 1971, some life insurance proceeds, capital dividends received from other corporations and the non-taxable portion of gains arising on a disposition of ECP.

With respect to taxation years that end after February 27, 2000, the CDA ad-

dition in respect of the non-taxable portion of gains on ECP is now made *only at the end of the taxation year during which a disposition of such property occurred*. This arises because the provisions of paragraphs 89(1)(c.2) of the Act define the addition to the CDA by reference to

addition to the CDA can not be made until, at the earliest, the first day of the following taxation year.

Under paragraph 89(1)(c) (applicable to taxation years that end before February 27, 2000), the addition to the CDA occurred immediately following

the disposition of the ECP, since the calculation was not otherwise tied into the provisions of paragraph 14(1)(b) of the Act. This allowed for the making of a capital dividend election immediately following the ECP disposition transaction, rather than waiting until the first day of the next fiscal year.

You should ensure that any future capital dividend transactions which arise as a consequence of the disposition of ECP not be made until, at the earliest, the first day of the following taxation year.

amounts required by paragraph 14(1)(b) of the Act to be included in computing the corporation's income.

The preamble to paragraph 14(1)(b) of the Act clearly states that the calculation is made "at the end of a taxation year".

Consequently, although a disposition giving rise to gains in respect of ECP occurs during the year, the relevant addition to the CDA is not made until the end of the taxation year in which the disposition took place. Accordingly, a capital dividend in respect of the

The result, of course, of paying a capital dividend in excess of the balance in the corporation's CDA is to subject

Circulate to:		<input checked="" type="checkbox"/>
1.		
2.		
3.		
4.		
5.		
6.		
7.		
8.		
9.		
10.		

the paying corporation to a penalty of 75% of the excess under subsection 184(2) of the Act. If the July 18, 2005 amendments are passed, this amount may be reduced from 75% of the excess capital gains dividend to 60% of the excess. (Bill C-33 received First Reading on November 22nd 2006).

The situation can be mitigated, to some extent, by causing the paying corporation to elect under subsection 184(3) of the Act, to treat the excess as an ordinary taxable dividend, to the extent of the excess. However, unless the payee is a corporation, this will not solve the tax consequences to the recipients, if the recipients are individuals.

Canada Revenue Agency ("CRA") has recognized that this change caught many practitioners by surprise and has provided administrative relief in respect of excess elections, in a virtually unpublicized program. In order to receive relief, the parties had to demonstrate that they did not know of the change in the timing rule for additions to the CDA for tax years commencing after February 27, 2000. This pro-

gram has now ended.

At this point, there are only two likely avenues for relief. The first consists of an Application for Fairness Relief pursuant to subsection 220(3.2) of the Act. Since the CDA Election under subsection 83(2) of the Act is listed under subsection 600(b) of the Regulations, the possibility of revoking the Election exists. The circumstances for the granting of such Fairness Relief are outlined in Information Circular 92-1. To the extent that Fairness Relief is granted, the recipient taxpayer would obviously be left with a taxable receipt from the paying corporation which might, depending upon the circumstances, be treated as an appropriation or, alternatively, a shareholder loan debit (with consequent s. 80.4 implications).

The second form of relief consists of a Rectification Order which can be obtained in a Superior Court. For the most part, such an order can be applied for in any of the Provincial and Territorial Superior Courts. In general terms, the Court must be satisfied that the purpose of the application is not to

engage in retroactive tax planning but, rather, to implement the genuine and pre-existing intentions of the parties. Generally, notice of such an application will be given to the Attorney General and will be reviewed, in advance by a committee of senior lawyers at the Department of Justice and CRA personnel. Such an application will be resisted by CRA if it feels that the taxpayer is attempting to engage in retroactive tax planning.

The object lesson from all of this is that you should ensure that any future capital dividend transactions which arise as a consequence of the disposition of ECP not be made until, at the earliest, the first day of the following taxation year.

About the Author

Keith M. Trussler, B.A., LL.B. is a Partner of Giffen & Partners, Barristers & Solicitors. Keith has worked with AICA Services Inc. for many years providing defence services for claims against Chartered Accountants. Keith's practice focuses, as well, on tax litigation at all levels of Court.

YOUR PROFESSIONAL LIABILITY INSURANCE COMMITTEE

To contact your PLIC representative, mail, fax or e-mail c/o AICA Services Inc.

Chairman Phillip Gaunce, CA
Halifax, NS

Committee Members

Robert Boisjoli, CA
Montreal, QC

Gregg Clifton, CA
Toronto, ON

Robin Elliott, FCA
Vancouver, BC

Mark Gray, LLB, CA
Winnipeg, MB

Douglas Mundell, FCA
Lethbridge, AB

For further information:

AICA Services Inc.
277 Wellington Street West
Toronto, Ontario
M5V3H2

Toll free numbers:

English: 1-800-267-4734

French: 1-800-268-2630

Fax: (416)204-3418

www.aica.ca

email: services@aica.ca

CARM (The Chartered Accountants' Risk Management newsletter) is published by AICA Services Inc. for members in the professional liability insurance program. CARM is designed to alert you to loss prevention/risk management considerations in your accounting practice. CARM deals with a number of complex issues in a concise manner; it is recommended that accounting, legal or other appropriate professional advice be sought before acting upon any of the information contained herein. Although every reasonable effort has been made to ensure the accuracy of the information contained in this newsletter, no individual or organization involved in either the preparation or distribution of this newsletter accepts any contractual, tortious, or any other form of liability for its contents or for any consequences arising from its use. Editor - Kathleen Aldridge