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Marmer Penner Inc. Newsletter

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Capital Dividend 101 or The Elusive Dividend Which Can Significantly Change *Guidelines* Income

There are three types of dividends a shareholder can receive from a corporation: an eligible dividend, an ineligible dividend or a capital dividend. Most family law professionals are well versed with the first two types, however we often receive numerous questions with respect to the elusive capital dividend.

The taxation of private corporations in Canada is based upon the principle of integration. Under this principle, income earned by a private corporation and distributed to its shareholders should be subject to the same amount of tax as if the income had been earned by the shareholders directly. Therefore, an amount which would have been tax-free if received directly by a shareholder should not be subject to tax if it is received by a private corporation and then subsequently flowed through to the shareholder. To accomplish this goal in so far as it relates to capital gains, the capital dividend account ("CDA") was created as a means of tracking the tax free portion of a capital gain when it is earned in a corporation. The CDA is a memo account that is not recorded in the accounting records or on the financial statements of the corporation. The tax-

free amounts are then passed through to shareholders on a tax-free basis by way of a tax-free capital dividend.

Let's look at an example. If Ms. Taxpayer were to realize a $100,000 capital gain from the sale of shares of ABC Co., only 50% of the amount would be taxable on her personal income tax return and the remaining 50% would remain in her pocket tax-free. Similarly, if ABC Co. were to realize the $100,000 capital gain instead of Ms. Taxpayer, it would also only include 50% of the gain in its income on its corporate income tax return. The remaining 50% of the capital gain would not be taxable to the corporation. With the CDA mechanism, this non-taxable portion would be added to the CDA and be available for distribution to Ms. Taxpayer in the form of a tax-free capital dividend. Without the CDA mechanism in place, this non-taxable portion would likely be subject to double taxation.

So when does this CDA arise? A CDA balance is created when there is:

1) An excess of non-taxable portion of capital gains over the non-deductible portion of capital losses. Anytime there are gains on disposition of assets in the company (i.e. real property, stocks, etc.), the CDA increases;

2) Capital dividends received from other corporations;

3) Non-taxable gains resulting from the disposition of eligible capital property, such as goodwill;

4) A distribution from a trust to the company of capital gains the trust realized or capitals dividends it has received; or

5) Receipt of proceeds of life insurance policy on death.

To arrive at the CDA balance, these amounts are added up and reduced by any capital dividends paid out. To make the best use of capital dividends, companies should pay out the CDA as it accumulates because the CDA will be reduced by any capital losses the corporation subsequently incurs. It is prudent to pay out the tax-free capital dividend as it becomes available in order to ensure integration and maximize the tax-free funds available to the shareholder.

The reason that the capital dividend is often overlooked in determining *Guidelines* income is:

1) As the capital dividend is not subject to tax for the shareholder, it is not reported on a taxpayer's personal income tax return;

2) The CDA is not recorded in the accounting records, corporate income tax returns or on the financial statements of the corporation; and

3) A CDA balance may exist, but the shareholder simply elects not to pay themselves a capital dividend.

If a capital dividend is declared and paid by a corporation to a shareholder, it may need to be accounted for in the calculation of *Guidelines* income, as it will not be included in Line 150 of the shareholder's personal income tax return. The issue of an income tax gross-up arises as the capital dividend is received on a tax-free basis. Pursuant to paragraph 19(1)(h) of the *Guidelines*, a court may impute such amount of income to a spouse as it considers appropriate in the circumstances where the spouse derives a significant portion of income from dividends, capital gains or other sources that are taxed at a lower rate than employment or business income. As the capital dividend is received on a tax-free basis, and

therefore taxed at a lower rate than employment or business income, a significant income tax gross-up may be appropriate.

If however a CDA arises in a particular year and the shareholder does not declare a capital dividend in that same year, what should be included with respect to the shareholder's income for *Guidelines* purposes? Unfortunately it appears that there is little guidance from the courts in this regard. As the funds can be distributed to a taxpayer on a tax-free basis and a prudent shareholder would declare the capital dividend as soon as it becomes available, it may be appropriate to include the capital dividend in determining *Guidelines* income in the year it becomes available. In this case, of course, this amount should not be included in determining income for support in a subsequent year, when the capital dividend is actually paid out to the shareholder.

Let's look at another example.

If ABC Co. sells shares and earns a $100,000 capital gain in 2012, leaves the proceeds in its bank account and pays a $90,000 dividend to Ms. Taxpayer in 2013 electing that $50,000 is paid from its CDA (this is the non-taxable portion of the $100,000 capital gain), in which year do we recognize the tax advantage of the CDA?

The money was available to Ms. Taxpayer in 2012 so we include the $100,000 gain from ABC Co. in her 2012 *Guidelines* income. In addition, we consider that ABC Co. paid about $10,000 of tax on the taxable portion of the capital gain and was able to pay $90,000 to Ms. Taxpayer. Ms. Taxpayer reported the $40,000 taxable dividend and not the $50,000 capital dividend as it is paid to her on a tax-free basis. She paid only $14,000 of tax on the taxable dividend leaving her with $76,000. That's the equivalent of earning about $150,000 of pre-tax regular business or employment income. Accordingly, we

would add another $50,000 to her *Guidelines* income in 2012 with respect to the tax advantage of the CDA.

As the inclusion of capital dividends, and the related gross-up, can significantly impact *Guidelines* income, a verification whether capital dividends have been declared and the CDA balance is recommended, particularly when sales of assets by a corporation are evident from financial disclosure. As this information is not directly evident from financial statements and income tax returns, a request should be made to the company's accountants. In addition, as of December 1, 2012, Canada Revenue Agency can provide confirmation of CDA balance requests received through its online service "My Business Account".