

Tax Topics

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TAX PLANNING FOR THE NON-SPECIALIST ADVISOR UNLOCKING LIQUIDITY IN CORPORATE CAPITAL LOSSES — PLANNING TO MAXIMIZE THE CAPITAL DIVIDEND ACCOUNT — PART I

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Recently, I published a short note on LinkedIn¹ with a list of some recessionary planning tools and strategies that advisors may wish to consider using to assist their clients in these difficult times. In that short note I also mentioned I was hoping to write about some of those ideas. This three-part series of articles (the "Series") is part of my effort at following through on my good intentions.

In particular, the Series has been designed to encourage advisors to strategically plan corporate loss transactions to enable their clients to maximize the tax-free benefits of the Capital Dividend Account ("CDA").²

As the Series progresses, the discussion will progress from a review of the most basic principles to more advanced planning concepts. This Part I of the Series will review gain and loss taxation at its most basic, and it will also review certain key aspects of the CDA relevant to the theme of the Series, including what I refer to as Strategic CDA Planning. Part II of the series will flesh out a number of other relevant CDA matters and introduce what I refer to as a 4C Strategy. Finally, Part III of the Series will review some strategies to enhance Strategic CDA Planning and also discuss a few cautions.

In the middle of a recession, any way that we, as advisors, can assist clients to keep their hard-earned money and generate liquidity will be incredibly valuable to them. In addition, providing advice of this nature may assist advisors in strengthening their relationships with clients.

Capital Gain and Capital Loss Basics

Even in recessionary times commerce continues, and that includes the sale by clients of properties they own; some with embedded gains and some with embedded losses.

There are many reasons why clients may sell properties that they own. It could be that liquidity is desired. Maybe the client just wishes to diversify out of an asset. Perhaps the client is moving from one financial advisor to a new advisor who insists on a liquidation of the prior financial advisor's portfolio.

Regardless of the reasons, such transactions have tax consequences.

A gain³ will generally arise upon a disposition⁴ or deemed disposition⁵ of a property if the proceeds of disposition⁶ of the property exceed the aggregate of the "adjusted cost base"⁷ ("ACB") of the property and the amount of disposition-related outlays or expenses. If the value of a property disposed of is less than its ACB and the amount of disposition-related outlays or expenses, a loss⁸ will generally arise upon a disposition or deemed disposition.

Where the property was held on capital account, any gain will usually be taxed as a capital gain and any loss will usually be taxed as a capital loss.⁹ Presupposing that the disposition of a property has been on capital account is an assumption that cannot always be assured. However, when dealing with dispositions of Canadian securities, a Canadian resident may improve their likelihood that transactions are on capital account by filing an election pursuant to subsection 39(4).

Throughout the remainder of the Series it will be assumed that all sale transactions discussed are on capital account.

Once a gain or loss has been determined to be on capital account, the general rule is that 50% of the capital gain or capital loss will be considered to be either a taxable capital gain or an allowable capital loss.¹⁰ A taxpayer may utilize allowable capital losses realized in a particular taxation year to reduce income from taxable capital gains realized in the particular taxation year.¹¹ If there are excess unapplied allowable taxable capital losses the excess may be carried back for up to three taxation years or carried forward forever.¹²

While in most cases loss transactions should not give rise to any income tax liability to the vendor,¹³ unless corporate sale transactions are structured to maximize CDA, corporate capital loss transactions could cost your clients **material** amounts of tax-free cash.

¹ https://www.linkedin.com/posts/magoldberg_tax-planning-in-recessionary-times-michael-activity-6685984129349234688-sivQ

² As that term is defined in subsection 89(1) of the *Income Tax Act* (Canada) R.S.C. 1985 Ch .1 (5th Supp.), as amended (the "Act"). Unless otherwise noted all statutory references are to the Act.

I often refer to the process of taking *tax lemons* (for example, capital losses) and making them into something positive (for example, maximizing the benefits of the CDA) as making *tax lemonade*.

³ The general rules relating to the calculation of gains of a taxpayer in a taxation year are found in paragraph 40(1)(b).

⁴ As that term is defined in subsection 248(1).

⁵ Some examples of deemed dispositions under the Act include: on death (subsection 70(5)); on emigration (paragraph 128.1(4)(b)); on an acquisition of control (paragraph 111(4)(d)); and on a trust's 21st anniversary (paragraph 104(4)(b)).

⁶ As that term is defined in section 54.

⁷ As that term is defined in section 54.

⁸ The general rules relating to the calculation of losses of a taxpayer in a taxation year are found in paragraph 40(1)(b). However, the ability to claim losses under the Act can be restricted or even denied. For example, a loss realized from the disposition of many types of "personal use property", as that term is defined in section 54, is deemed to be nil. Another example is a loss that is determined to be a "superficial loss", as that term is defined in section 54. In the case of superficial losses, the ability to claim the loss may be postponed or even denied under certain circumstances.

⁹ Detailed rules and exceptions to the rules for determining the existence of capital gains and capital losses are found in section 39.

¹⁰ Detailed rules and exceptions to the rules for determining the inclusion rate are found in section 38.

¹¹ Subsection 3(b). I often find people forget that capital gains can also be reduced by non-capital losses and allowable business investment losses ("ABILs"), as that term is defined in paragraph 39(1)(c).

¹² Paragraph 111(1)(b). ABILs that remained unclaimed for 10 taxation years following their realization become "net capital losses" (as defined in subsection 111(8)). While "non-capital losses" (as defined in subsection 111(8)) are subject to the same loss carryback rules as allowable capital losses, non-capital losses can only be carried forward for 20 taxation years.

¹³ Sales of "depreciable property" can give rise to recapture in accordance with section 13.

CDA — A Way To Strengthen Relationships

The CDA is a purely corporate concept. It is also extremely complex. As a result, the discussion that follows is intended to provide a “high level” review of the matters discussed. Actual details of CDA concepts and calculations of CDA balances are much more involved than will be described below.

In good times and/or where capital transactions are modest, there may be little attention given to taking steps to maximize a corporation’s CDA, since capital losses will hopefully be rare. However, in recessionary times, taking steps to ensure that a corporate client maximizes the use of its tax pools, including enabling its shareholders to access as much CDA as possible, could be a massive value-added service, strengthen client relationships, and in some cases, even make advisors seem like *heroes* to their clients.

In many cases all it will take is an understanding of the CDA and a little strategic planning.

CDA Basics

At the risk of oversimplifying the concept, the CDA is a notional corporate tax account that allows a corporation to make non-taxable dividend distributions of certain amounts that, if received by an individual, would have been taxed preferentially.

In the Series a CDA distribution, whether paid or payable and whether made by actual or deemed dividend, will often simply be referred to as a “CDA Dividend”. The technical requirements to have a distribution treated as a CDA Dividend are described in Regulation 2101, which requires a prescribed form (T2054) to be filed with the Canada Revenue Agency (“CRA”) together with:¹⁴

- (1) A certified resolution of the director(s) declaring the CDA Dividend as required per Regulation 2101; and
- (2) A calculation of the CDA of the particular corporation immediately prior to the declaration of the CDA Dividend.¹⁵

As set out in the CDA definition in subsection 89(1), there are many components or pools that aggregate together to form a corporation’s CDA. For most corporations, the key pools include and tend to be derived from:

- (1) net capital gains realized by a corporation over time (“NCG Pool”);
- (2) CDA Dividends from other entities; and
- (3) insurance proceeds (“Insurance Pool”).

The discussion in the Series will focus on the NCG Pool.

As with all CDA pools, the calculation of the NCG Pool is determined on a cumulative basis since 1971 or incorporation, whichever is later.¹⁶ The NCG Pool is determined by:¹⁷

- (1) adding the non-taxable portion (currently 50%)¹⁸ of corporate capital gains to the NCG Pool; and
- (2) subtracting the non-taxable portion (currently 50%) of corporate capital losses from the NCG Pool.

Even though realizing capital losses will not create a tax liability, doing so will reduce the balance of the NCG Pool, which will impair and possibly eliminate the ability to pay tax-free CDA Dividends out of the NCG Pool.

Because most corporate clients will hold assets with a mixture of capital gains and capital losses, strategically timing the capital losses can often allow a corporation to generate material NCG Pools out of which to declare CDA Dividends. In particular, maximizing CDA Dividends can be accomplished by:

- (1) selling some or all of the corporate holdings with unrealized capital gains;
- (2) declaring a CDA Dividend; and
- (3) realizing the capital losses¹⁹

(collectively, a “Strategic CDA Plan”).

¹⁴ Because it is often difficult to comply with the timelines in subsection 83(2) and because penalties for late filing Form T2054 are modest (subsection 83(4)), in my experience, it is relatively common for Form T2054 to be late-filed.

¹⁵ While taxpayers may use SCHAT289, my experience has been that many CDA election filings are made with Excel spreadsheets containing only relevant components of this schedule.

¹⁶ Corporate reorganizations, including wind-ups and amalgamations, may make tracking CDA balances difficult.

¹⁷ See paragraph (a) of the CDA definition. The actual calculation is more complex than described below.

¹⁸ The non-taxable portion of corporate capital gains and capital losses has fluctuated from time to time.

¹⁹ Best practice will involve complying with all of the CDA Dividend filing requirements noted above before realizing any capital losses.

²⁰ The liability would be nearly \$200,000 if Holdco was able to declare eligible dividends.

The tax liability amounts noted in the Series are approximate amounts and are based on the assumption that Mr. Wise is a top rate Ontario taxpayer. The net tax cost also assumes that Holdco has no RDTOH accounts that would be refunded on the payment of taxable dividends. Other planning might be implemented to access the funds at lower potential tax cost than shown in the illustration.

Strategic CDA Plan — A Simple Example

A simple numerical example can help to illustrate the value that can be unlocked with a Strategic CDA Plan. For now, let's assume that a corporate client, TL Investments Inc. ("Holdco"), has had no prior CDA activity and owns a portfolio of marketable securities that includes assets with \$1,000,000 of unrealized capital gains and \$1,000,000 of unrealized capital losses.

For whatever reason, the controlling shareholder of Holdco, Mr. Wise, wants liquidity and wants to sell loss positions or perhaps liquidate the entire portfolio. Regardless of the reasons, on these facts the sale transactions should not give rise to any net tax liability in Holdco. However, assuming that Mr. Wise wanted \$500,000 personally and Holdco is only able to pay ordinary taxable dividends, then removing these funds from Holdco could cost Mr. Wise nearly \$250,000.²⁰

If a Strategic CDA Plan had instead been implemented, the \$1,000,000 capital gain would have generated an addition to the NCG Pool of Holdco of \$500,000, which on the basis of Holdco's facts would also be the available CDA balance. Assuming that \$500,000 of CDA Dividends are paid to Mr. Wise, taking these simple steps could have saved him nearly \$250,000 of taxes. In a recession, or really at any time, this strategic planning could make a huge difference.

While all of this may seem very basic to most readers, it may not be basic to the people who are actually making the decisions to realize the capital losses. For instance, without education, clients such as Mr. Wise and/or the investment advisors who make the decision to realize capital losses might not appreciate the importance of timing these steps and may miss out on the opportunity to maximize the benefits of the CDA with a Strategic CDA Plan.

As a result, the take-away from Part I of the Series is for us, as advisors, to try to reach these decision makers and educate them on the basics of Strategic CDA Planning before they realize material capital losses.

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