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Due to fewer and less important updates, our weekly COVID coverage now follows our feature article.

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

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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 series² (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").³ As the Series progresses, the discussion will progress from a review of the most basic principles to more advanced planning concepts. Part I of the Series reviewed gain and loss taxation at its most basic, and it also reviewed certain key aspects of the CDA relevant to the Series theme, including what I refer to as Strategic CDA Planning. This 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.

Negative NCG Pool May Not Restrict CDA Dividends

Depending on timing, the net capital gains pool ("NCG Pool") of a corporation can be in a negative balance. While the NCG Pool is in a negative balance it will not be possible to pay CDA Dividends out of the CDA from the NCG Pool.

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

² Unless otherwise noted, defined terms in this article have the meaning designated in Part I of the Series.

³ 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*.

However, a negative NCG Pool balance will not necessarily restrict a corporation's ability to declare CDA Dividends. This is because each CDA pool is calculated and tracked separately from each other CDA pool, and when aggregating the CDA pools any particular CDA pool in a negative balance is treated as having a balance of nil.⁴

As this concept is complex, it will be illustrated by way of example using the facts for Mr. Wise and Holdco discussed in Part I of the Series with a couple of changes. Assume that Holdco and the investment advisor didn't consult you, its tax advisor, and liquidated all of the securities in loss positions realizing \$1,000,000 of capital losses. Holdco's NCG Pool would be calculated as 50% of the realized capital losses, or negative \$500,000.

In addition to the original facts, assume that a \$900,000 life insurance policy owned by Holdco matured and that the full \$900,000 of life insurance proceeds are capable of being added to the Insurance Pool. In this case, because the NCG Pool balance, which would otherwise be negative \$500,000, is deemed to be nil, the aggregate of the corporation's CDA pools will be \$900,000. Consequently, on the basis of Holdco's facts, Holdco would have an available CDA balance out of which to distribute CDA Dividends of \$900,000.

Prior CDA Dividends Will Limit the Ability To Pay Future CDA Dividends

It is not enough to track and aggregate CDA pools. It will only be possible to pay CDA Dividends to the extent that the aggregate of the CDA pool balances exceeds the cumulative amount of CDA Dividends paid by a corporation.⁵ The excess amount, if any, is a corporation's CDA balance.

Again, using Holdco to illustrate may be helpful. This time let's assume that the three steps in a Strategic CDA Plan described in Part I of the Series:

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

were implemented to maximize and distribute the CDA by way of CDA Dividend and then the \$900,000 of insurance proceeds were received by Holdco.

The realization of \$1,000,000 of capital gains will result in the NCG Pool of Holdco initially being \$500,000. The payment of CDA dividends of \$500,000 will be possible because previously no CDA transactions had ever taken place in Holdco. Following the realization of the unrealized \$1,000,000 of capital losses the NCG Pool will be reduced to nil. It is worth noting that had the unrealized capital losses been realized before the unrealized capital gains or before the payment of CDA Dividends, the NCG Balance would still be nil.

Because it is assumed that \$500,000 of CDA Dividends have been paid by Holdco and the aggregate of Holdco's CDA pools is nil, until Holdco's CDA pools aggregate \$500,000 no further CDA will be able to be paid out of Holdco since there will be no CDA balance.

When Holdco receives the \$900,000 of insurance proceeds its Insurance Pool will increase to \$900,000. Nevertheless, as noted above, because of the prior payment of \$500,000 of CDA Dividends, Holdco will only have CDA available to distribute to Mr. Wise of \$400,000 (Total CDA pools of \$900,000 less total prior CDA Dividends of \$500,000).

In addition to illustrating the basic functioning of CDA calculations, this example also indicates that maximizing the CDA using a Strategic CDA Plan may block the ability to pay additional CDA Dividends, which may create future planning issues for clients such as Mr. Wise. However, given the assumption that Mr. Wise has urgent current needs to

⁴ Pursuant to section 257 of the *Income Tax Act* (Canada) R.S.C. 1985 Ch .1 (5th Supp.), as amended (the "Act"), unless otherwise specifically provided negative calculations determined under the Act are treated as nil. Unless otherwise noted all statutory references are to the Act.

⁵ See the post-amble to the CDA definition in subsection 89(1).

access money at the lowest cost possible, a downside such as this, i.e., one that will hopefully only become relevant in the distant future, is likely a cost that Mr. Wise would be willing to incur. Furthermore, with careful planning, including having a deep understanding of Mr. Wise's and Holdco's factual situation, it might have been possible to avoid a blockage of this nature.

Excess CDA Dividends — Part III Tax

If a CDA Dividend is declared in an amount that exceeds a corporation's CDA, subsection 184(2) will impose a punitive tax of $\frac{3}{5}$ of the excess (Part III Tax) on the corporation paying the CDA Dividend. It may be possible to avoid Part III Tax provided appropriate additional elections are made to treat the amount in excess of the CDA balance as taxable dividends to the dividend recipient(s).⁶ The making of such elections requires the consent of the dividend recipients and must be made within specific time limits.

CDA — Some Best Practices

As mentioned in Part I of the Series, a valid T2054 election requires that the corporation submit a calculation of the CDA. Due to the complexity of the calculation and the risk of incurring Part III Tax it would be best that a qualified professional prepare or at least review the CDA calculation.

Where one has significant time to do so, best practices will include requesting the CDA balance from the CRA.⁷ Unfortunately, the CRA's typical response time will often be quite slow and if one is implementing planning to create liquidity on an urgent basis, the client is unlikely to be willing to wait for a response.

In the absence of confirmation of the CDA from the CRA, and to protect against the possibility of errors creeping into the CDA calculations, which could lead to tax under Part III or tax on taxable dividends to the extent the CDA Dividend exceeds the CDA balance, best practices will include adopting a few additional defensive practices. For example, the corporate CDA Dividend authorizing resolutions should be drafted to provide as much evidence as possible of the director or directors' intention that the CDA Dividend amount was to be limited to the CDA balance.⁸ Also, to protect against the risk or aggravation of Part III Tax or tax on taxable dividends to the extent the CDA Dividend exceeds the CDA balance, the director or directors may wish to choose a more conservative CDA amount than would otherwise be available in a best case scenario. Even a conservative approach that doesn't maximize the full CDA balance will be better than missing out on the opportunity afforded by implementing a Strategic CDA Plan and will often provide meaningful access to tax-free corporate funds for shareholders such as Mr. Wise.

Finding Capital Gains and/or Capital Losses

Portfolios of marketable securities that include both unrealized capital gains and unrealized capital losses can make implementing Strategic CDA Plans a relatively straightforward process.⁹ Nonetheless, just because a corporate taxpayer doesn't have readily available unrealized capital gains or unrealized capital losses in the form of marketable securities doesn't mean that a Strategic CDA Plan will be unavailable.

⁶ See subsections 184(3) – (5).

⁷ It is always a good idea to check the CRA's calculations internally as the complexity of the calculation could lead to errors having been made by the CRA.

⁸ For example, see *5551928 Manitoba*, 2019 DTC 5124 (BCCA), where the BCCA approved rectification of an excess CDA Dividend, in part as a consequence of the clear intention set out in the corporate dividend documentation to "clean out" the CDA.

⁹ Subject to complexities associated with the CDA discussed throughout the Series.

To illustrate this enhanced type of Strategic CDA Plan let's return to Mr. Wise and Holdco's situation, but we'll change the facts to assume that Holdco's portfolio only contained \$1,000,000 of unrealized capital losses. In addition, let's assume that Holdco owns \$5,000,000 of shares of Juiceco Industries Inc. ("Opco"), an operating company.¹⁰ Holdco's ACB and paid-up capital¹¹ ("PUC") in the Opco shares is nominal. If Holdco was to actually sell some of its shares it would be possible to realize up to \$5,000,000 of capital gains.

Assuming that Holdco has no intention of selling the shares of Opco, another possibility could be to implement planning to internally realize a portion of the unrealized capital gains sufficient to maximize the CDA and minimize taxes in Holdco (about \$1,000,000). There are many different ways to crystallize capital gains and the technical details of such planning will not be reviewed in the Series.

Sometimes assets with unrealized capital gains and unrealized capital losses may not be in an appropriate entity. In some cases it may be appropriate to reorganize ownership of such assets to move the assets into a corporation such as Holdco on a tax deferred basis¹² and then to implement crystallization strategies.

I refer to Strategic CDA Plans that include a crystallization strategy as a "4C Strategy"— **C**apital gain **C**rystallization, **C**DA, and **C**apital loss Strategy. The additional steps in a 4C Strategy will add complexity, cost, and time to the process of implementing Strategic CDA Plans and it is recommended that clients work closely with their tax advisory team to ensure the planning is appropriate not only for tax purposes but with their overall strategic plans.¹³

¹⁰ Famous for making fabulous lemonade.

¹¹ As defined in subsection 89(1).

¹² Such as, under section 85.

¹³ The best tax planning should take into account a client's vision, mission, and values and be consistent with their overall estate, succession, and continuity objectives.

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