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Budget 2024

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Quirk in capital gains tax rules raises risks for incorporated clients

A company could face 60% tax on unintentional payout of excess amounts from its capital dividend account

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Clients with private corporations may face a nasty tax hit if they make assumptions about how much they can distribute from their capital dividend account (CDA) in 2024.

A CDA is a notional account — not an actual pool of money — that keeps track of tax-free amounts accumulated by a private corporation. A corporation may distribute amounts from the CDA to shareholders at any time during its fiscal year in the form of tax-free capital dividends.

Clients may believe that a capital gain realized before June 25, 2024, resulted in adding 50% of the gain to the corporation's CDA.

That's not necessarily the case.

According to transitional rules released by the federal government on June 10, the calculation for determining the CDA balance for a corporation's fiscal year that includes June 25, 2024, when the capital gains inclusion rate (CGIR) rose to two-thirds from one-half, is determined based on a blended CGIR — not 50% before June 25 and 67% after June 25.

That means a corporation may have a lower CDA balance than expected when it distributes a capital dividend in its 2024 fiscal year. A corporation that distributes capital dividends above the amount available in its CDA faces a 60% tax on the excess, although this penalty can be avoided by electing to have the dividends treated as taxable dividends.

"It's not fair that a taxpayer that incurred gains in a fiscal year that includes June 25, 2024, properly calculated the CDA balance based on the law at that time, and [for example] made a capital dividend election prior to the federal budget [when the CGIR hike was announced] could be faced with a future excess amount penalty because of the mechanics of how the computation is proposed to work," said Emily Mantle, founder of CPA Compass in Sudbury, Ont.

The Department of Finance did not directly respond to questions from *Investment Executive* regarding whether it was aware of the CDA issue and said draft legislation implementing the capital gains taxation changes would be published over the summer.

Tax-free amounts accumulated by a private corporation include the tax-free portion of capital gains realized by the corporation that exceed the non-deductible portion of its capital losses.

A corporation may declare a capital dividend at any point during the taxation year based on the CDA balance at that time. To make a distribution from the CDA, the corporation must file an election using Form T2054 Election for a Capital Dividend Under Subsection 83(2).

For example, a corporation that realized a $100 capital gain before June 25 might expect to distribute $50 of tax-free capital dividends from its CDA even if it filed the election after June 25.

However, the June 10 proposed legislation introduced a new formula to calculate taxable capital gains to account for the two CGIRs in 2024.

The formula works like this: the taxpayer multiplies their pre-June 25 (Period 1) net capital gains by half, then multiplies their post-June 24 (Period 2) net capital gains by two-thirds and adds the two figures together. That figure is then divided by the total gains in Periods 1 and 2 — the full fiscal year's net gains.

A June 17 report from EY Canada gives an example.

A corporation with a Dec. 31, 2024, year end realizes a $100 capital gain and pays out a capital dividend of $50 in Period 1. It also realizes a $100 capital gain in Period 2.

Using the formula above, the corporation's blended inclusion rate is 58.33% for the year.

Thus, at the time the corporation made the distribution, the CDA balance was only $41.67, not $50. The corporation would be subject to the 60% penalty tax on the $8.33 excess amount.

While the corporation and the shareholders who received the dividend can elect to treat the excess amount as a taxable dividend, everyone is still left in a worse position overall.

The proposed transitional year rules create uncertainty for corporate clients, said Kenneth Keung, director of Canadian tax advisory with Moodys Tax in Calgary.

A client with a corporation that realized a capital gain in Period 1 and would like to distribute a capital dividend this fiscal year, but hasn't yet, won't know its blended CGIR at the end of the year unless it knows the amount of capital gains it will realize in Period 2.

An incorporated client could choose to pay out a capital dividend assuming a two-thirds blended CGIR, the highest CGIR possible, with only one-third of the gain added to the CDA, Keung said. If the corporation's blended CGIR for the year is lower than two-thirds, it would result in a higher CDA balance that could be distributed later.

Mantle said she's recommending clients wait to distribute capital dividends until their corporation's fiscal year end, when their blended CGIR for 2024 can be determined with certainty.

Clients may also choose to wait until Finance releases draft legislation this summer to see whether and how they address the issue, Mantle said.

"[If Finance] eliminates the application of a blended inclusion rate, then the timing of a capital dividend election can be re-evaluated because there wouldn't be any uncertainty in the computation [of the CDA balance]," Mantle said.

In guidance published June 10, Finance said draft legislation to implement technical changes to the CGIR would be available at the end of July. The department did not directly respond to a question as to whether the draft legislation would be available by then.