Personal Tax Planning

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REFUNDABLE DIVIDEND TAX ON HAND AND THE DIVIDEND REFUND: PLANNING TO MAXIMIZE THE TAX BENEFITS

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Certain transactions undertaken by a corporation offer an opportunity to maximize the tax benefits of the corporation's refundable dividend tax on hand (RDTOH) account and the related dividend refund. This article first reviews the rules for calculating RDTOH, the operation of the dividend refund mechanism, and transactions that may result in denial of a dividend refund. It then sets out several tax-planning considerations and strategies.

Where a transaction will change the corporation's status as a Canadian-controlled private corporation, the loss of status may reduce the amount of RDTOH that can be accumulated in the account. In this situation, appropriate planning can preserve the benefits of RDTOH and the dividend refund. Strategies for maximizing the utility of RDTOH include using RDTOH to fund the redemption of shares; increasing the paid-up capital of shares and using the dividend refund to return capital to shareholders; and, in some cases, reorganizing the corporation as two separate businesses in order to create the ability to accumulate RDTOH and generate a dividend refund where none was available before.

KEYWORDS: DIVIDENDS ■ REFUNDS ■ GENERAL ANTI-AVOIDANCE RULE ■ PRIVATE ■ PUBLIC ■ CORPORATIONS

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INTRODUCTION

> From a legal perspective, a corporation is an entity separate from its shareholders. In economics, however, there is no more separation between a corporation and its shareholders than between a proprietorship and its proprietor, a partnership and its partners or an investment portfolio and its owner.[1]

The legal separation of a corporation and its shareholders can create a problem of double taxation on the distribution of the corporation's after-tax earnings. The Income Tax Act[2] attempts to solve this problem by means of various integration provisions. An important component of the integration regime is the concept of refundable dividend tax on hand (RDTOH) and the related dividend refund mechanism. More specifically, RDTOH and the dividend refund are intended to prevent double taxation by refunding certain taxes paid by a corporation on earnings where those after-tax earnings are distributed to shareholders in the form of taxable dividends. However, RDTOH and the corresponding tax refund do not always achieve perfect integration; in certain circumstances, they can result in the conferral of a tax advantage on shareholders of a private corporation.[3]

1 Robert E. Beam, Stanley N. Laiken, and James J. Barnett, *Introduction to Federal Income Taxation in Canada*, 24th ed. (Toronto: CCH Canadian, 2003), 669.

2 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

3 For a more detailed discussion of RDTOH and the dividend refund as an integration mechanism, see, for example, CRA document no. 2001-0080815, May 30, 2001; *Canada Tax Service* (Toronto: Carswell) (looseleaf), 129-122; Richard A. Batch, "Year-End Tax Planning," in *2001 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 2001), tab 15, 2; Leonard Glass, "Sale of a Business—Purchaser and Vendor Issues," in *1999 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 1999), tab 7, 31; and Mary V. Power, "Integration," ibid., tab 19, appendix, at 2-3.

This article discusses various tax-planning strategies that can maximize the utility of RDTOH and the dividend refund to corporations and their shareholders. It begins by explaining the components of RDTOH, the rules for computing a corporation's RDTOH balance, and the operation of the dividend refund mechanism. Certain transactions that may result in denial of a dividend refund are also discussed. The article then focuses on transactions and situations where appropriate planning can take advantage of the potential benefits available through RDTOH and the dividend refund. The first issue addressed is the preservation of the corporation's status as a Canadian-controlled private corporation (CCPC), since the loss of that status may reduce the amount that can be included as RDTOH in the taxation year. Other possible strategies are the use of RDTOH to fund the redemption of shares; an increase in the paid-up capital (PUC) of shares to fund a return of capital to shareholders; and, in some cases, reorganization of the corporation to separate business activities and create the ability to accumulate RDTOH.

RDTOH AND THE DIVIDEND REFUND: AN OVERVIEW

Computation of RDTOH

The formula for computing RDTOH is set out in subsection 129(3) of the Act. Generally, the RDTOH of a corporation at the end of a taxation year is a notional account that consists of the amount by which the total of the following three amounts exceeds the dividend refund received by the corporation for its preceding taxation year:[4]

1. in the case of a corporation that was a CCPC throughout the year, up to 26⅔ percent of the corporation's aggregate investment income for the year—that is, the amount that may be added in respect of part I tax (paragraph 129(3)(a));
2. the total of all taxes payable by the corporation for the year under part IV (paragraph 129(3)(b)); and
3. where the corporation was a private corporation at the end of its preceding taxation year, the corporation's RDTOH at that time (paragraph 129(3)(c)).

The calculations under paragraphs 129(3)(a) to (c) and paragraph 129(3)(d) are discussed further below.

Paragraph 129(3)(a)

A corporation must be a CCPC throughout the taxation year in order to include in its RDTOH account at year-end amounts calculated under paragraph 129(3)(a). Accordingly, certain transactions or events that result in a change of the corporation's

4 Compare *Interpretation Bulletin* IT-243R4, "Dividend Refund to Private Corporation," February 12, 1996, paragraph 7, and Norman C. Tobias, *Taxation of Corporations, Partnerships and Trusts*, 2d ed. (Toronto: Carswell, 2001), 242-43.

CCPC status without a concomitant taxation year-end should be carefully considered if the corporation wishes to rely on paragraph 129(3)(a) to increase its RDTOH balance. The effect of this requirement of CCPC status is discussed further and illustrated by examples in the tax-planning section of this article.

The amount that may be included in RDTOH under paragraph 129(3)(a) is the least of the following three amounts:[5]

1. 26⅔ percent of the corporation's aggregate investment income for the year less the excess (if any) of the amount of foreign tax credits on non-business income deducted by the corporation under subsection 126(1) of the Act over 9⅓ percent of its foreign investment income for the year (subparagraph 129(3)(a)(i));
2. 26⅔ percent of the amount, if any, by which the corporation's taxable income for the year exceeds the amount of income earned by the corporation that was taxed at less than full rates through the operation of sections 125 and 126 of the Act (subparagraph 129(3)(a)(ii)); and
3. the corporation's part I tax payable for the year (ignoring any surtax payable under section 123.2 of the Act) (subparagraph 129(3)(a)(iii)).

Paragraph 129(3)(b)

Paragraph 129(3)(b) provides for the addition of part IV tax to the corporation's RDTOH for the year. Part IV of the Act is designed to eliminate the deferral of tax that may otherwise be obtained by an individual who holds investments through a corporation rather than directly.[6] Subsection 186(1) requires a corporation that is, at any time in the corporation's taxation year, a private corporation or a "subject corporation" (defined below) to pay tax equal to the amount, if any, by which the total of the following amounts exceeds ⅓ of certain losses[7] claimed by the corporation:

1. ⅓ of all "assessable dividends"[8] received by the corporation in the year from corporations other than payer corporations connected with it;[9] and
2. generally, the amount of any dividend refund received by a payer corporation in respect of an assessable dividend paid to a corporation connected

5 For a more detailed explanation of the calculations in paragraph 129(3)(a), see, for example, *Canada Tax Service*, supra note 3, at 129-134 to 129-138.

6 See Batch, supra note 3, at 3-4; and David M. Sherman, ed., *Income Tax Act, Department of Finance Technical Notes*, 13th ed. (Toronto: Carswell, 2001), 1938-1939.

7 Paragraphs 186(1)(c) and (d).

8 An assessable dividend is essentially a taxable dividend (or an amount in respect of or in lieu of a taxable dividend) received by a corporation at a time when it is a private corporation or a subject corporation, to the extent that the amount of the taxable dividend is deductible to the recipient under section 112 or 113 of the Act: subsection 186(3), definition of "assessable dividend."

9 Paragraph 186(1)(a).

with the payer, provided that the payer is itself a private corporation or a subject corporation.[10]

The first inclusion brings portfolio dividends within the ambit of part IV. The second promotes smooth integration of corporate and shareholder taxes in the case of a vertical chain of corporations.[11]

Two rules in part IV are particularly worth noting in the context of RDTOH.

First, a payer corporation is connected with another corporation if the payer corporation is controlled by the other corporation at any time[12] or if the other corporation owns at that time

1. more than 10 percent of the issued share capital of the payer corporation (having full voting rights under all circumstances);[13] and
2. shares of the capital stock of the payer corporation with a fair market value (FMV) greater than 10 percent of the FMV of all of the corporation's issued capital stock.[14]

Second, a public corporation may be liable to part IV tax if it is a subject corporation.[15] A subject corporation is a corporation, other than a private corporation, that is resident in Canada and controlled by or for the benefit of an individual (other than a trust) or a related group of individuals (other than trusts).[16] Accordingly, for example, a corporation that has a class of its shares listed on a prescribed stock exchange in Canada[17] and is controlled by a family is a public corporation that is also a subject corporation to which part IV tax may apply. Subsection 186(5) provides that a corporation that is, at any time in its taxation year, a subject corporation is

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10 Paragraph 186(1)(b).

11 *Canada Tax Service*, supra note 3, at 186-116 to 186-117.

12 Paragraph 186(4)(a). Any rights to control through options or other devices referred to in paragraph 251(5)(b) are not relevant for purposes of determining control under paragraph 186(4)(a). Also, subsection 186(2) deems that, for purposes of part IV (other than determining whether a corporation is a subject corporation), a corporation is controlled by another corporation if more than 50 percent of its issued share capital (having full voting rights under all circumstances) belongs to the other corporation, to persons not at arm's length with the other corporation, or to a combination of the foregoing.

13 Subparagraph 186(4)(b)(i).

14 Subparagraph 186(4)(b)(ii).

15 See Peter L. Clark and Mark I. Jadd, "Taking a Family Business Public," in *Income Tax and GST Planning for the Purchase, Sale, and Canada-US Expansion of a Business*, 1996 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1996), 11:1-31, at 11:19. There is discussion in this authority dealing with the fact that a public corporation can be a subject corporation.

16 Subsection 186(3), definition of "subject corporation."

17 Paragraph 89(1)(a), definition of "public corporation."

deemed, for the purposes of paragraph 87(2)(aa) (discussed below) and section 129, to be a private corporation at that time, except that the subject corporation's RDTOH at the end of the year is determined without reference to paragraph 129(3)(a).

Paragraphs 129(3)(c) and (d)

Paragraphs 129(3)(c) and (d) essentially provide for the computation of a corporation's RDTOH on a cumulative basis. Where the corporation was a private corporation at the end of its preceding taxation year, paragraph 129(3)(c) adds the corporation's RDTOH at the end of that preceding year to the increase in the corporation's RDTOH at the end of the current taxation year (as calculated in paragraphs 129(3)(a) and (b)). Paragraph 129(3)(d) reduces the corporation's RDTOH (as calculated in paragraphs 129(3)(a), (b), and (c)) by the amount of any dividend refund received in the preceding taxation year. The calculation of the dividend refund is discussed below.

Flowthrough of RDTOH on an Amalgamation or Windup

On the amalgamation of two or more corporations within the meaning of subsection 87(1) of the Act, paragraph 87(2)(aa) may permit the flowthrough of RDTOH to the amalgamated corporation. Generally, where the amalgamated corporation was a private corporation immediately after the amalgamation, at the end of its first taxation year following the amalgamation, the corporation will add to the computation of its RDTOH account

1. the amount (if any) by which the RDTOH of every predecessor corporation at the end of its taxation year ending immediately before the amalgamation exceeds
2. the dividend refund received by the predecessor corporation in that year.

However, no amount may be added to the amalgamated corporation's RDTOH account in respect of a predecessor that was not a private corporation at the end of its taxation year ending immediately before the amalgamation.[18] Also, if subsection 129(1.2) would have applied to deem a dividend paid by a predecessor immediately before the amalgamation not to be a taxable dividend for purposes of subsection 129(1), no amount in respect of that predecessor's RDTOH may be added to the RDTOH account of the amalgamated corporation.[19] Subsection 129(1.2) is discussed briefly below.

The rules in paragraph 87(2)(aa) discussed above also apply to a windup within the meaning of subsection 88(1).[20]

18 Subparagraph 87(2)(aa)(i).

19 Subparagraph 87(2)(aa)(ii).

20 Paragraph 88(1)(e.2).

Computation of the Dividend Refund

Generally, a corporation may obtain a dividend refund in respect of taxable dividends paid to its shareholders provided that it has a positive balance in its RDTOH account. Pursuant to paragraph 129(1)(a), the amount of the dividend refund due to a corporation in respect of a particular taxation year is calculated as the lesser of

1. ⅓ of all taxable dividends paid by the corporation on shares of its capital stock in the year, at a time when it was a private corporation; and
2. the corporation's RDTOH at the end of the year.

Normally, the amount is refunded automatically on assessment of the corporation's tax return for the year;[21] however, corporations usually indicate on the return that a dividend refund is due and, if one is due, the amount.

Denial of a Dividend Refund

Anti-Avoidance Rule: Subsection 129(1.2)

Subsection 129(1.2) is an anti-avoidance provision that deals specifically with the dividend refund. The provision states that where a dividend was paid on a share of the capital stock of a corporation and the share (or a share for which it was substituted) was acquired by its holder in a transaction or a series of transactions one of the main purposes of which was to enable the corporation to obtain a dividend refund, the dividend is deemed not to be a taxable dividend for purposes of subsection 129(1). Accordingly, the effect of subsection 129(1.2) is to deny the dividend refund to the payer corporation. However, if there are bona fide business reasons for the acquisition, the risk that subsection 129(1.2) will apply may be reduced.

This anti-avoidance provision should be approached with care. It is broadly drafted and could, for example, result in the denial of a dividend refund in the case of an acquisition of control of a corporation. The following example illustrates this point.

Assume that Targetco is a private corporation with a calendar taxation year and $10,000 in its RDTOH account at December 31, 2003. On December 31, 2003, all of the issued and outstanding shares of Targetco are held by A, a Canadian-resident individual. On January 1, 2004, individual B (who is dealing with A at arm's length) acquires A's Targetco shares with the intention of recovering Targetco's RDTOH through the payment of a taxable dividend on those shares. In the first taxation year following the acquisition of control, Targetco pays a dividend of $30,000 on

21 Also, "while the Minister may or may not be required to make the dividend refund, such amount is ordinarily refunded automatically provided the payer corporation files its tax return for the year in which the dividend was paid within the time limits described in subsection 129(1) and the amount is not otherwise applied by the Minister, pursuant to subsection 129(2), against another tax liability owing by the payer corporation." CRA document no. 2003-0049015, December 30, 2003.

its outstanding shares to B. At the end of that year, will Targetco be entitled to a dividend refund of $10,000 pursuant to subsection 129(1)? If one of the main purposes of B's acquisition of Targetco's shares was to enable Targetco to obtain a dividend refund, the answer appears to be no; subsection 129(1.2) will likely deem the $30,000 dividend not to be a taxable dividend, and the dividend refund will be denied.

The problem cannot be avoided by amalgamating Targetco with another corporation controlled by B and paying a dividend from the amalgamated entity. As discussed above, subparagraph 87(2)(aa)(ii) prevents the addition of RDTOH from Targetco's last taxation year before amalgamation to the amalgamated corporation's own RDTOH account if subsection 129(1.2) would have applied to a hypothetical dividend paid by Targetco immediately before the amalgamation.

Deemed Dividends: Paragraph 84.1(1)(b)

Certain transactions may result in a distribution, a payment, or an increase in an account of a corporation that is not considered to be a dividend for corporate law purposes, but is deemed to be a dividend for purposes of either the Act in its entirety or specific provisions of the Act. For example, where a Canadian-resident corporation increases the PUC of a particular class of its shares under the provisions of subsection 84(1) of the Act, that increase is deemed to be a dividend paid by the corporation and received by the shareholders on the issued shares of that class.[22] Similarly, where a Canadian-resident corporation redeems or purchases for cancellation shares of its capital stock under subsection 84(3) (otherwise than by way of a windup or reorganization described in subsection 84(2)), the corporation is deemed to have paid a dividend on a separate class of shares comprising the shares that were redeemed or purchased for cancellation, and the shareholders of that separate class are deemed to have received that dividend. The question that arises in the context of a corporation's RDTOH account is whether a deemed dividend is considered to be a dividend for purposes of the dividend refund.

Generally, dividends that are deemed to have been paid by a corporation and received by its shareholders will be considered to be "taxable dividends paid by the corporation on shares of its capital stock in the year" within the meaning of subparagraph 129(1)(a)(i), and therefore will qualify for a dividend refund. However, as will be discussed further below, the Canada Revenue Agency (CRA) has recently taken the position that certain deemed dividends do not meet the requirement in subparagraph 129(1)(a)(i) and therefore do not qualify for the refund. Since the reason for the denial of a dividend refund (and thus integration of corporate-shareholder taxation) in this instance is not entirely clear, the prudent tax adviser will take the possibility of denial into account in building an appropriate tax strategy for the use of RDTOH and access to the dividend refund.

22 Provided that the exceptions in paragraphs 84(1)(a) to (c.3) are not applicable.

With respect to payments by a corporation to its shareholders under section 84 (as in the two examples briefly described above), the CRA considers that the deemed dividends in question qualify for a dividend refund.[23] It is worth noting that the wording of these provisions appears to support this interpretation. For example, under subsection 84(1) (increase in PUC), a dividend is deemed to have been paid "on the issued shares of the particular class." Similarly, paragraph 84(3)(a) provides that a deemed dividend arising in respect of a redemption of shares, for example, is deemed to be "a dividend [paid] on a separate class of shares." The CRA's administrative position appears to be consistent with these provisions. The CRA is willing to treat dividends deemed to have been paid on the issued shares of a class or on a separate class of shares as "taxable dividends paid by the corporation on shares of its capital stock" within the meaning of subparagraph 129(1)(a)(i).

In contrast, a deemed dividend under section 84.1 of the Act may receive different treatment. Subsection 84.1(1) provides rules for the disposition of certain properties by a Canadian-resident taxpayer (other than a corporation) to a corporation with which the taxpayer does not deal at arm's length. Specifically, where the taxpayer disposes of shares ("the subject shares") of a corporation resident in Canada ("the subject corporation") to another corporation ("the purchaser corporation") with which the taxpayer does not deal at arm's length and, immediately after the disposition, the subject corporation is connected[24] to the purchaser corporation, a dividend may be deemed to be paid to the taxpayer by the purchaser corporation and received by the taxpayer from the purchaser corporation at the time of the disposition.[25] Where no shares or nominal shares are issued by the purchaser corporation and the taxpayer takes back consideration other than shares in respect of the transfer, the deemed dividend will equal the amount by which the FMV of the non-share consideration exceeds the greater of the PUC and the adjusted cost base (ACB) of the subject shares immediately before the transfer.

For example, assume that S is a Canadian-resident individual who holds all of the issued and outstanding shares of two corporations, Holdco and Subco. Holdco and Subco each have PUC of $1, an ACB of nil, and an FMV of $100. Both Holdco and Subco are Canadian-resident corporations. S transfers all of her shares of Subco to Holdco and, as consideration, receives one share worth $1 and $99 in cash. S and Holdco jointly elect (pursuant to subsection 85(1) of the Act) that the proceeds of disposition to S and the cost to Holdco on the transfer are deemed to be $99. Paragraph 84.1(1)(b) will effectively deem the cash consideration in respect of the

23 IT-243R4, supra note 4, at paragraph 3. This administrative practice is subject to the anti-avoidance rule in subsection 129(1.2), discussed above.

24 Within the meaning of subsection 186(4) of the Act if the references in that subsection to "payer corporation" and "particular corporation" are read as "subject corporation" and "purchaser corporation," respectively.

25 Paragraph 84.1(1)(b).

transfer (less the PUC of the Subco shares to S immediately before the transfer) to be a deemed dividend paid by Holdco and received by S.[26]

Whether this deemed dividend will give rise to a dividend refund under paragraph 129(1)(a) is an important question for tax planners where the payer corporation has a positive balance in its RDTOH account. Until 2002, the CRA apparently was of the view that a dividend deemed to have been paid and received pursuant to paragraph 84.1(1)(b) would qualify as a taxable dividend "paid by the corporation on shares of its capital stock," subject to the anti-avoidance rule in subsection 129(1.2).[27]

In 2002, the CRA issued a technical interpretation[28] addressing, in part, the relationship between paragraph 84.1(1)(b) and subparagraph 129(1)(a)(i). In this technical interpretation, the CRA reversed its earlier position. The CRA stated that a dividend deemed to have been paid under paragraph 84.1(1)(b) is not paid (or deemed to have been paid) on shares of the capital stock of a corporation as is required by subparagraph 129(1)(a)(i). As a result, the CRA concluded that it is not technically possible to obtain a dividend refund in respect of a dividend that is deemed to have been paid pursuant to paragraph 84.1(1)(b).[29]

This is an interesting position for the CRA to take. The definition of "shareholder" in subsection 248(1) of the Act deems any person that is entitled to receive payment of a dividend to be a shareholder. Thus, a taxpayer receiving a deemed dividend pursuant to paragraph 84.1(1)(b) appears to be a shareholder for purposes of the Act.[30] According to the CRA's 2002 interpretation, however, the taxpayer is

26 As provided in paragraph 84.1(1)(b), the deemed dividend is computed by the formula (A + D) − (E + F) where

- A is the increase, if any, determined without reference to section 84.1, in the PUC of all shares of the capital stock resulting from the issue of any new shares in respect of the transfer;
- D is the FMV of the non-share consideration received by the taxpayer from the purchaser corporation for the subject shares;
- E is the greater of the PUC and the ACB of the subject shares immediately before the transfer; and
- F is the total of all amounts required to be deducted by the purchaser corporation pursuant to paragraph 84.1(1)(a) in computing the PUC of the shares of its capital stock.

Using the facts in the example in the text, A is equal to $100 (the FMV of the Subco shares transferred to Holdco), D is $99, and E is $1. F is equal to the PUC grind in paragraph 84.1(1)(a), or $100. Accordingly, the deemed dividend is equal to ($100 + $99) − ($1 + $100) = $98.

27 CRA document no. 5-9283, January 29, 1990, and CRA document no. 9729855E, January 19, 1998.

28 CRA document no. 2002-0128955, September 26, 2002.

29 The CRA added that there is nothing in the Act or in the explanatory notes to section 129 to suggest that tax policy allows a dividend that is deemed to have been paid pursuant to section 84.1 to give rise to a dividend refund under subsection 129(1).

30 Elisabeth Atsaidis and John Jakolev, "The Scope of Fiction" (2002) vol. 10, no. 11 *Canadian Tax Highlights* 83.

not the recipient of a taxable dividend "paid by the corporation on shares of its capital stock." In effect, the CRA has denied integration to corporations and taxpayers in respect of dividends deemed to be paid under paragraph 84.1(1)(b), although the policy reason for doing so is unclear. Where the deemed dividend paid under paragraph 84.1(1)(b) is a taxable dividend received by an individual, the taxpayer is fully taxable on the amount. Provided that the corporation is a private corporation for purposes of subparagraph 129(1)(a)(i), that it has RDTOH available, and that various anti-avoidance rules in the Act do not apply,[31] it is difficult to see why a corporation should not be allowed a dividend refund on the deemed payment of a dividend to a taxpayer under paragraph 84.1(1)(b).

TAX-PLANNING STRATEGIES

The discussion thus far has provided an overview of the rules and administrative practices applicable to the calculation and use of RDTOH and the availability of a dividend refund. It has also highlighted a number of limitations and risks associated with certain transactions. This section examines several tax-planning strategies intended to make the most effective use of the RDTOH account and the dividend refund mechanism for corporations and their shareholders.

Preserving CCPC Status

The first strategy addresses one of the potential pitfalls discussed earlier: the requirement that a corporation must be a CCPC throughout the taxation year in order to add amounts to its RDTOH account at year-end pursuant to paragraph 129(3)(a). As defined in subsection 125(7) of the Act, a CCPC is a private corporation that is not controlled by one or more public corporations or by one or more non-resident persons, with the additional condition that a class of the corporation's capital stock is not listed on a prescribed stock exchange. Thus, to take a simple example, loss of CCPC status will occur where a private Canadian corporation is controlled by a Canadian-resident individual and that individual becomes a non-resident of Canada. The more complex example that follows illustrates the impact of the CCPC status rule and shows how, given the right facts, prudent tax planning can overcome the restriction in paragraph 129(3)(a).

Assume that Opco is a CCPC with a calendar taxation year. All of Opco's issued and outstanding shares are held by D, an individual resident in Canada. On September 1, 2004, D enters into an agreement to dispose of all of his shares of Opco to Pubco, a public corporation; the closing of the transaction is to take place on December 31, 2004. Opco intends to use RDTOH accumulated in its 2004 taxation year pursuant to paragraph 129(3)(a) (for example, in relation to the disposition by Opco of various securities) to obtain a dividend refund in respect of dividends paid

31 For example, subsection 129(1.2) and the general anti-avoidance rule in section 245.

to D in 2004. The dividend refund will then become cash available to Opco to fund the payment of further dividends to D in 2004.[32]

The problem with this strategy is that Opco will not be a CCPC throughout its 2004 taxation year. For the purposes of the definition of a CCPC in subsection 125(7), Pubco will be deemed to control Opco as of the date of its agreement with D—that is, September 1, 2004;[33] therefore, Opco will be deemed to be directly controlled by a public corporation and will lose its CCPC status effective September 1, 2004. As a result, Opco will not be permitted to add any amount to its RDTOH account pursuant to paragraph 129(3)(a) in respect of its 2004 taxation year.

What might be done differently? One possible option is for Opco to trigger a taxation year-end before the date of the agreement between D and Pubco. This might be accomplished, for example, by the amalgamation of Opco with a subsidiary or sibling corporation, which would give rise to a deemed taxation year-end of Opco immediately before the amalgamation pursuant to paragraph 87(2)(a). As a result, Opco could include in its RDTOH account the amount calculated under paragraph 129(3)(a) in respect of all dividend payments to D before September 1, 2004.

Care should be taken in such circumstances to review the potential application of the general anti-avoidance rule (GAAR) in section 245 of the Act. Subsection 245(2) operates to deny a tax benefit resulting directly or indirectly from an avoidance transaction or from a series of transactions that includes an avoidance transaction. As defined in paragraph 245(3)(a), an avoidance transaction is a transaction that, but for section 245, would result directly or indirectly in a tax benefit, unless the transaction was undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit.

Information Circular 88-2 states that subsection 245(2) will apply to deny a tax benefit resulting from a deemed taxation year-end pursuant to paragraph 87(2)(a) where an amalgamation was undertaken solely for the purpose of obtaining that benefit.[34] In the case of D and Opco, if an amalgamation is completed before the date of D's agreement with Pubco for bona fide purposes other than to obtain a tax benefit, the GAAR should not operate to deny the benefit of the increase in Opco's RDTOH account in the taxation year ending before that date. Assume, for example, that Opco has a number of subsidiaries, and Pubco wants them to be amalgamated with Opco so that it will be purchasing only one corporation. If Opco completes

32 The dividend refund will accrue to Opco when D is no longer its sole shareholder—that is, when Opco's 2004 T2 corporate tax return is assessed, likely in 2005. Accordingly, the payment of dividends to D in 2004 based on any anticipated dividend refund may be the subject of discussions between D and the acquiring public corporation.

33 Subparagraph 251(5)(b)(i). This deeming rule applies because, as of September 1, 2004, Pubco has a right under a contract to acquire all of the shares of the capital stock of Opco at some future time—that is, on December 31, 2004.

34 *Information Circular* 88-2, "General Anti-Avoidance Rule: Section 245 of the Income Tax Act," October 21, 1988, paragraph 21.

the amalgamation before September 1, 2004, it should be able to make the desired additions to its RDTOH account without offending the GAAR.[35]

Although it may be possible to create a new year-end so that amounts can be added to a CCPC's RDTOH account pursuant to paragraph 129(3)(a), whether or not section 245 will apply will depend on the facts of the particular case.

Using RDTOH To Fund Share Redemptions

A corporation's RDTOH account may be used to fund redemptions of shares (or purchases of shares for cancellation) of a shareholder over time. The shareholder can return a portion of the cash received in the form of a loan back to the corporation, which in turn can use the borrowed money to generate additional dividends, thereby increasing its RDTOH balance and associated dividend refund in future years. In the right circumstances, the shareholder receiving the dividend can obtain the further benefit of a deferral of tax.

This strategy may be particularly advantageous in an estate-planning context, either as a complement to or as a substitute for use of the corporation's capital dividend account in combination with insurance on the life of the shareholder.[36] Consider the following example. R is an individual resident in Ontario, with a spouse and children. R holds all of the issued and outstanding common shares of Holdco, a CCPC that is taxable under part I of the Act. Holdco holds a number of income-generating investments and has no active business income. Holdco has a calendar taxation year. Its RDTOH account balance is nil.

Holdco's articles of incorporation provide for authorized share capital consisting of an unlimited number of common shares, each entitled to 1 vote per share, and an unlimited number of preferred shares, each entitled to 1,000 votes per share. The redemption value of the preferred shares is the FMV of the consideration paid for them. The shares of Holdco are capital property to R. The common shares held by R have an ACB of $1, nominal PUC, and an FMV of $100,000.

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35 Note, however, that Pubco's requirement that the purchase be restricted to one corporation (with no subsidiaries) could, at the time of this demand, create a contingent right under a contract within the meaning of subparagraph 251(5)(b)(i), causing loss of Opco's CCPC status for the 2004 taxation year.

36 See generally Wolfe Goodman, "Another Look at Corporate-Owned Life Insurance To Fund Shareholder Buy-Out Agreements," Goodman and Carr LLP, February 16, 2001; Joel Cuperfain, "Estate Planning and Life Insurance," in *Report of Proceedings of the Fifty-Third Tax Conference*, 2001 Conference Report (Toronto: Canadian Tax Foundation, 2002), 26:1-45; Joel Cuperfain, "Got Me Those 'Low Capital Gain, High Dividend Tax, Stop-Loss Rules, Estate-Planning' Blues," Personal Tax Planning feature (2001) vol. 49, no. 3 *Canadian Tax Journal* 764-800; Robin Goodman and Joel Cuperfain, "Life Insurance Planning," in *2001 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2001), tab 12; Jack Bernstein, "Life Insurance Corporate Buy-Sell Arrangements" (2000) vol. 6, no. 11 *Tax Profile* 123-24; and Gail Grobe, "Corporate Redemption Buy-Sell Arrangements and the '50% Solution'—Does It Make Sense?" [December 2000] *CALU Report* 1-8.

R wants to transfer his interest in Holdco to a vehicle that will benefit his family. Accordingly, R settles a trust with a third party as trustee and his spouse and children as beneficiaries. R then transfers all of his Holdco common shares to Holdco in consideration for 100 preferred shares. He receives no non-share consideration in respect of the transfer. R and Holdco jointly elect to have subsection 85(1) apply to the transaction. The agreed elected amount in respect of the transfer[37] is the ACB of the common shares, or $1. Therefore, R has no capital gain on the disposition. The ACB of the preferred shares issued to R is $1,[38] the PUC is also $1,[39] and the FMV is $100,000.

The trust then subscribes for 100 common shares of Holdco for a nominal amount. Accordingly, the trust has 100 votes in respect of shareholder decisions affecting Holdco, and R (with his preferred shares) has 100,000 votes. The FMV of the trust's common shares is nominal. Following these transactions, Holdco's investment-holding business continues as before.

Assume that, at the end of the next taxation year, Holdco has an RDTOH balance of $10,000. Further assume that R causes Holdco to redeem 30 of his 100 preferred shares for total redemption proceeds of $30,000. Holdco pays the redemption proceeds in cash using funds that it has on hand. Subsection 84(3) of the Act will deem a dividend to have been paid by Holdco and received by R to the extent of the difference between the proceeds of redemption ($30,000) and the PUC of the shares redeemed (nominal), resulting in a deemed dividend of approximately $30,000. As we have seen, the CRA will treat this dividend as a taxable dividend paid by Holdco on shares of its capital stock within the meaning of subparagraph 129(1)(a)(i).[40] Therefore, Holdco will receive a dividend refund in the amount of $10,000 in respect of the redemption of R's shares.

Assuming that R pays personal income tax at the highest marginal rate, he will be taxed on the dividend received from Holdco at an effective rate of 31.34 percent.[41] If the same strategy is repeated as amounts are accumulated in Holdco's RDTOH account at successive taxation year-ends, all 100 of R's preferred shares can eventually be redeemed.[42] When all of the shares have been redeemed in this manner over several taxation years, R will have received $100,000 in aggregate redemption proceeds and will have paid effective personal tax of $31,340 on the resulting taxable dividends. Assuming sufficient RDTOH, Holdco will have received $33,333 in dividend refunds as a result of the redemptions.

If instead R were to retain all of the preferred shares until he died, he could pay less personal tax. On death, R would be deemed to have disposed of the Holdco

37 Paragraph 85(1)(a).

38 Ibid.

39 Subsection 85(2.1).

40 Supra note 23.

41 This is the current (2004) rate in Ontario.

42 R may wish to keep one preferred share in order to retain control of Holdco.

shares immediately before death, for proceeds of disposition equal to $100,000.[43] These proceeds would be taxed at R's effective personal tax rate in respect of capital gains, which is 23.2 percent. However, R's estate might realize a deemed dividend (through, for example, an increase in PUC[44] or a redemption of the preferred shares held by the estate[45]) and a capital loss, which could be available for carryback to R's terminal return.[46] In addition, the deemed dividend triggered on R's death could result in a dividend refund to Holdco. (See the above discussion of deemed dividends and subsection 84(3) of the Act.)

Comparing these strategies, the advantage to Holdco from the gradual redemption of R's preferred shares over time is the receipt of successive dividend refunds (rather than the single refund received after R dies) as a result of the payment of taxable dividends. These dividend refunds can be reinvested and used to generate more dividends and more RDTOH. Taking the corporation and the shareholder together, there is a net gain on the payment of taxable dividends by way of redemption; that is, the effective personal tax rate of 31.34 percent on dividends received by R is offset by the refund of one-third of the amount of the dividends to Holdco.[47]

However, it is worth emphasizing that the benefit of the dividend refund does not accrue to R. The redemption amount in respect of the preferred shares is equal to the FMV of the consideration paid for the shares—$1,000 per share. If the dividend refunds increase the value of Holdco beyond the amount needed to redeem the shares, that residual value accrues to the holder of the common shares—that is, the trust. Accordingly, the redemption strategy results in a net cost to R; he pays personal tax on the dividends deemed to be paid by Holdco, but the trust

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43 Paragraph 70(5)(a). This example assumes that subsection 70(6) (that is, the rollover in respect of certain transfers or distributions) does not apply.

44 Subsection 84(1).

45 Subsection 84(3).

46 Paragraph 164(6)(c).

47 Batch, supra note 3, at 4, notes the important planning possibility that arises when the amount of the dividend refund to the corporation exceeds the amount of tax payable by the shareholder in respect of the dividend—namely, that the corporation can realize a net cash inflow, "simply by paying a dividend." The availability of this opportunity will depend on the effective rate of personal tax in the shareholder's province of residence. The wider the spread between the amount of personal tax on taxable dividends payable by the shareholder and the dividend refund, the more advantageous the deemed dividend will tend to be. For example, the benefit will be greater for a shareholder resident in Alberta, with a top marginal personal tax rate of 24.08 percent (current in 2004) and a shareholder resident in Ontario, where the current top rate is 31.34 percent. Also, in some circumstances, a trust that is resident in Alberta can obtain the benefit of the lower Alberta tax rate on dividends for the trust's beneficiaries, even if the beneficiaries are resident in another province. See Craig M. Jones, "Alberta Trusts in Tax and Estate Planning," in *2002 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2002), tab 15, 14-21; and Martin Rochwerg, "Using Trusts as an Income-Splitting Tool," in *Report of Proceedings of the Fifty-Fifth Tax Conference*, 2003 Conference Report (Toronto: Canadian Tax Foundation, 2004), 18:1-30, at 18:21-27.

effectively receives the value of the dividend refunds. As R is amenable to transferring more value to the trust for the benefit of his family members, this may be acceptable to him. Otherwise, the problem may be mitigated somewhat by paying certain amounts to R from Holdco's capital dividend account, provided that a capital dividend election is available.

Once R has satisfied his tax liability with part of the cash paid by Holdco on the redemption, he may choose to lend that cash back to Holdco. Holdco may use the cash to generate more RDTOH through its investment activities. With that additional RDTOH account room, further redemptions of R's preferred shares could take place in like manner.

A variation of the foregoing redemption strategy might be considered where Holdco has a non-calendar year-end. Assume that Holdco's taxation year extends from February 1, 2003 until January 31, 2004 and a redemption of preferred shares takes place in January 2004, resulting in a deemed taxable dividend to R. Holdco will obtain the dividend refund (if any) associated with that deemed dividend on assessment of its tax return in respect of its 2004 taxation year. However, R will include the taxable dividend arising from the redemption in his income for the 2004 calendar year. Accordingly, R will obtain a tax deferral of almost one year in respect of the redemption proceeds. Given this fiscal period for Holdco, redemptions could also be structured to take place every second January, so that R could avoid a requirement to make instalment payments of tax.[48]

This deferral strategy will not be available for a corporation that currently has a calendar taxation year. A corporation may not change its fiscal period for tax purposes without the concurrence of the minister of national revenue.[49] Also, there is a risk that such a change would offend the GAAR.[50] However, if a corporation has a non-calendar year-end, some additional deferral in the hands of the preferred shareholder may be obtained by staggering share redemptions in the manner described above.

Increasing PUC To Fund a Return of Capital to Shareholders

Where a private corporation has no cash on hand but has a positive balance in its RDTOH account, it can use the RDTOH to finance a return of capital to shareholders. By increasing the PUC of its shares, the corporation can trigger a deemed

48 See generally subsection 156(1). Assuming that R's income does not otherwise give rise to any tax instalment requirement.

49 Subsection 249(7).

50 If a change in Holdco's fiscal period were made primarily to obtain a tax deferral in respect of taxable dividends received by R, this would likely be considered an avoidance transaction within the meaning of subsection 245(3). See the previous discussion under the heading "Preserving CCPC Status," and Frank Lavitt, "Getting Dollars Out of Closely Held Businesses," in *Report of Proceedings of the Forty-Third Tax Conference*, 1991 Conference Report (Toronto: Canadian Tax Foundation, 1992), 23:1-32, at 23:29.

dividend, which in turn will increase the cost base of the shares to the recipient of the dividend. With sufficient RDTOH, the deemed dividend will give rise to a dividend refund, providing an inflow of cash that can be used to return capital to the shareholder. The shareholder can use this return of capital to meet her tax liability in respect of the dividend. In Ontario and certain other provinces, the effective rate of personal tax may leave the shareholder with a net after-tax cash gain. Accordingly, this strategy can offer a variety of benefits to both the corporation and the shareholder.

Assume that W, an individual resident in Ontario, holds all of the issued and outstanding common shares of Privateco, a private corporation[51] with a calendar taxation year. The ACB of the common shares is $0 and the PUC is $1. Privateco's RDTOH account has a balance of $100,000.

Late in the 2003 taxation year, Privateco increases the stated capital of W's common shares by $300,000, resulting in an equivalent increase in the PUC of the shares.[52] Upon this increase in PUC, a dividend in the amount of $300,000 is deemed to have been paid by Privateco on the common shares and received by W.[53] The amount of the deemed dividend is in turn added to the ACB of the shares.[54] Therefore, W now holds shares of Privateco with PUC of $300,001 and an ACB of $300,000. W's effective personal tax liability in respect of the deemed dividend is $94,020 (31.34% × $300,000).

On filing its federal income tax return for the 2003 taxation year, Privateco is entitled to a dividend refund in the amount of $100,000 pursuant to paragraph 129(1)(a). Privateco can use this inflow of cash to return stated capital of $100,000 on its common shares to W. W can then apply this payment against her tax liability in respect of the deemed dividend, leaving her with after-tax cash in hand of $5,980 ($100,000 – $94,020).

The reduction of the stated capital of the common shares also reduces their PUC,[55] which in turn reduces their ACB,[56] by the same amount ($100,000). Accordingly, W now holds shares of Privateco with PUC of $200,001 and an ACB of $200,000.

The above series of transactions has essentially converted Privateco's RDTOH account into a return of capital to the shareholder, W; increased the PUC and ACB of the common shares by $200,000; and left W with nearly $6,000 cash in hand after tax. All of this has been accomplished without any initial expenditure of funds by Privateco.[57]

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51 See subsection 89(1), definition of "private corporation."

52 See subsection 89(1), definition of "paid-up capital."

53 Subsection 84(1), assuming that the exceptions in paragraphs 84(1)(a) to (c.3) are inapplicable.

54 Paragraph 53(1)(b).

55 Supra note 52.

56 Subparagraph 53(2)(a)(ii).

57 Disregarding the tax payments (for example, under part I or part IV of the Act) that built up Privateco's RDTOH account in the first place.

This strategy may be of particular interest to the holder of high-low preferred shares of a private corporation. For example, preferred shareholders are often left with high-low shares after undertaking an estate freeze. An increase in the PUC and the ACB of the shares may reduce the amount of any deemed dividend or capital gain accruing on the shareholder's death. Similarly, a holder of high-low preferred shares may benefit from an increase in the ACB of the shares if the shareholder becomes a non-resident. On the change of residence, the shareholder will be deemed to have disposed of the shares. An increased ACB may result in a reduction of any capital gain in respect of the deemed disposition.

As in the case of the share redemption strategy, the benefit of the PUC increase strategy will depend on the difference between the amount of personal tax payable by the shareholder and the amount of the dividend refund received by the corporation in respect of the deemed dividend. As discussed earlier,[58] this spread will vary from province to province, according to the personal tax rate that applies to the recipient of the dividend in the particular case.

Reorganizing the Corporation To Generate RDTOH

The final tax-planning strategy addressed here can, in appropriate circumstances, convert an operating company that does not currently generate income that qualifies for inclusion in an RDTOH account into a two-company structure that allows an RDTOH balance to be built up in one of the corporations. As in the case of the two strategies discussed immediately above, access to the dividend refund can provide a tax benefit to corporations and their shareholders where the applicable personal tax rate creates a spread between the amount of the refund and the amount of tax paid by the shareholder in respect of taxable dividends.

The form of restructuring proposed here is a variant of the butterfly reorganization known as a "single-wing butterfly." Generally, a butterfly reorganization involves a series of transactions whereby the assets and liabilities of a corporation are divided among its corporate shareholders on a tax-deferred basis. In many cases, the butterfly results in the separation of two or more businesses carried on within a single corporation. The following example illustrates how a single-wing butterfly may be used to generate RDTOH.

Assume that individual E, a Canadian resident, owns all of the issued and outstanding common shares of Realco, a CCPC that is taxable under part I of the Act. Realco holds two broad types of assets: machinery and equipment that it uses in its manufacturing business ("manufacturing assets"), and the land and building that constitute the premises. Realco receives no income that would give rise to the accumulation of RDTOH. Consequently, it cannot recover taxes paid in respect of the payment of dividends to E through the dividend refund mechanism.

To address this issue, Realco creates a new corporation, Opco, and holds all of Opco's issued and outstanding common shares. Realco then transfers all of its

58 See supra note 47 and the accompanying text.

manufacturing assets to Opco pursuant to subsection 85(1) of the Act,[59] in exchange for additional common shares of Opco. Realco and Opco jointly elect to deem the proceeds and cost to Opco to be the cost amount in respect of each property so that no gain, recapture, or deemed dividend arises on the transfer. Opco then begins paying rent to Realco under a bona fide lease agreement for the use of Realco's land and building in Opco's manufacturing concern.

Up to this point, Realco still has no income that would allow it to accumulate RDTOH pursuant to paragraph 129(3)(a). Because Opco and Realco are associated corporations within the meaning of paragraph 256(1)(a) of the Act, subparagraph 129(6)(b)(i) deems the rental payments made by Opco (to the extent that such payments would otherwise be included in computing Realco's income from a property) to be income of Realco from an active business. Accordingly, no amount is includible in Realco's RDTOH account at the end of its taxation year.

A different result may be achieved if Realco holds a "specified class" of shares of Opco within the meaning of subsection 256(1.1) of the Act. Assume the same facts as before except that E has a son, F, who is also a resident of Canada. Instead of Realco, it is F who incorporates Opco and holds all of Opco's issued and outstanding common shares. In addition to common shares, Opco is authorized to issue non-voting preferred shares that meet the definition of shares of a specified class. That is, the shares are not convertible or exchangeable into another class of shares; the shares are retractable and redeemable at an amount equal to the FMV of the consideration paid to the corporation on subscription; and the dividends payable on the shares are fixed and do not exceed the prescribed rate of interest in regulation 4301(c) of the Income Tax Regulations.

Again assume that Realco transfers all of its manufacturing assets into Opco pursuant to subsection 85(1), but in this case Realco receives preferred shares of Opco, rather than common shares, as consideration on the transfer. As in the first scenario, Realco and Opco make the same joint election in respect of the proceeds and cost in order to avoid a gain, recapture, or deemed dividend as a result of the transfer. As Realco owns a specified class of the shares of Opco, the two corporations are not associated within the meaning of subsection 256(1). To complete the butterfly (that is, to achieve full separation of the businesses), Opco can redeem the preferred shares.

Now if Opco begins making rental payments to Realco in respect of the land and building, as described above, the treatment of those payments for RDTOH purposes will be different. If Realco and Opco are not associated corporations, the rental payments will not be deemed to be active business income of Realco under subparagraph 129(6)(b)(i). Realco should be able to add amounts to its RDTOH account in respect of the rental income received from Opco, and should therefore be able to exploit the difference (if any) between the dividend refund and the effective personal tax paid by E on dividends received from Realco, as outlined previously.

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59 Assuming that all of the property transferred is "eligible property" within the meaning of subsection 85(1.1).

Using the strategy described above, it may be possible to add amounts to a corporation's RDTOH account where this could not be done previously.[60]

CONCLUSION

For many corporations and their shareholders, the RDTOH account and the related dividend refund can provide a range of tax benefits. For a CCPC, a portion of part I tax paid by the corporation may be added to its RDTOH account and refunded to the corporation when it pays taxable dividends on its shares. In addition, private corporations generally (and in some cases public corporations) may maintain RDTOH accounts and be eligible for dividend refunds in certain circumstances.

Two aspects of the calculation of RDTOH and the dividend refund may create difficulties for some corporations. The first is the requirement that a corporation maintain its status as a CCPC throughout the taxation year in order to add amounts to its RDTOH account pursuant to paragraph 129(3)(a). Loss of CCPC status will result in denial of the dividend refund in respect of taxable dividends paid in the year. The second consideration is the treatment of deemed dividends. While deemed dividends arising under certain provisions of the Act (such as section 84) will generally be considered to be taxable dividends for purposes of the dividend refund, this is not the case with respect to at least one other provision (paragraph 84.1(1)(b)).

These potential pitfalls aside, RDTOH and the dividend refund can offer useful tax-planning opportunities in the following circumstances:

- A corporation's RDTOH may be used to fund share redemptions (or purchases of shares for cancellation). This strategy can be particularly useful in an estate-planning context.
- Where a corporation wishes to return capital to the shareholder but lacks cash on hand to fund the payment, an increase in the PUC of shares can be used to trigger a deemed dividend giving rise to a dividend refund. The refund provides cash that can be paid out to the shareholder as a return of capital. The shareholder in turn can use this payment to satisfy his outstanding tax liability in respect of the deemed dividend and, in certain circumstances, can retain part of the payment in after-tax cash.
- Finally, where a corporation lacks the capability to accumulate RDTOH, it may be possible to use a butterfly reorganization to split the business into two or more corporations, so that an RDTOH account may be created and the benefit of the dividend refund may be obtained.

This article has not addressed all of the possible ways of exploiting the RDTOH account and the dividend refund. Rather, it has focused on strategies that tax advisers may consider and apply in certain situations where the potential benefits of these mechanisms appear to be restricted or denied.

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60 It should also be noted that if Realco qualifies for the small business deduction, this plan will be beneficial in respect of any income that is in excess of the business limit. See generally subsections 125(2) to (5.1).