Designating excessive capital dividends as eligible dividends

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Canada's *Income Tax Act* (the "Act") strives to achieve equality and neutrality in the taxation of income earned:

1. individually;

2. by a corporation that is taxed at the higher general corporate rate and then distributed to its individual shareholders; and

3. by a corporation that is taxed at the lower rate affected by the small business deduction and then distributed to its individual shareholders.

The general rate income pool ("GRIP") and the low rate income pool ("LRIP") as set out in section 89 of the Act is used to achieve this integration. For Canadian-controlled private corporations, the GRIP is the relevant pool balance that is critical to achieve equality and/or neutrality. Very generally, the computation of GRIP is intended to be the balance of the corporation's undistributed after-tax surplus that has been built up after paying the higher corporate tax rate. Accordingly, the Act is designed to recognize whether a corporation has paid the high or low rate of corporate tax on income it is distributing to shareholders as dividends. To the extent a corporation has paid the high rate of tax on its income and thus has a positive GRIP balance, the dividend may be designated as "eligible" so that the receiving shareholder pays a lower effective rate of tax on that dividend; thus recognizing the increased rate of tax already paid by the corporation. Such a dividend is designated as "eligible" by following the requirements of subsection 89(14) of the Act.

Subsection 89(14) imposes strict timing requirements on designating a dividend as "eligible". Prior to the enactment of subsection 89(14.1), there was no relieving provision for a missed deadline (being the time the dividend is paid). This caused practical difficulties in a number of situations, including when a tax-free capital dividend had been erroneously declared in an amount exceeding the capital dividend account ("CDA") balance and an election was made to treat that excess as a separate taxable dividend (see subsection 184(3)). The Canada Revenue Agency's ("CRA") prior administrative position had been that such taxable dividend could not be designated as "eligible", given that the time in which it was paid had passed (see CRA TI 2007-0244111I7).

Following subsection 89(14.1)'s enactment, which was effective for dividends paid after March 28, 2012, the CRA has reconsidered its previous administration position and recently released a technical interpretation (CRA TI 2013-0475261E5). The CRA's new administrative position is updated to provide for the effect of subsection 89(14.1). Subsection 89(14.1) gives the CRA the discretion to accept late eligible dividend designations within three years of the date on which the designation should have been made, if the circumstances are such that it would be "just and equitable" to permit the late designation. As is the norm, though the CRA has reserved the right to consider each situation on its particular facts and will generally exercise its discretion to allow a late designation of that portion of an excessive capital

dividend which has been elected to be treated as a taxable dividend when:

1. reasonable steps were taken to determine the balance of the CDA at the time of payment;
2. making a late designation request was not intended at the time the capital dividend was paid, and the late designation is not being requested within a series which requests the late designation on a regular basis; and
3. the late designation does not involve “aggressive tax planning” (which is not defined in their new administrative position so it remains to be seen what “aggressive tax planning” means in this context).

And, of course, the corporation must otherwise have been able to designate the amount of the dividend as “eligible” at the time it was paid (e.g. had a sufficient GRIP balance).

The question remains how the CRA will apply its new administrative position in real life files. It seems apparent that CRA is attempting to draw a line somewhere between providing relief to those arbitrarily and negatively affected by the strict time requirements of the subsection 89(14) designation and those who are “too bold” as a result of this ‘late designation safety net’. Where is that bright line?

For example, if a corporation has a positive GRIP balance but a less than certain CDA balance (either the computation of the CDA is not certain or the related documentation to support such calculations may not be available), should it rely on the new CRA administrative position by declaring a tax-free capital dividend for the full amount of the less than certain CDA and hope that the CRA will be lenient and allow a late eligible dividend designation when the payment of the capital dividend turns out to be excessive? Is that “too bold”? Unfortunately, at this time, it seems one will have to fall off the tightrope before knowing if the safety net is there; but if you are purposefully jumping off, chances are it won’t be.

While the new CRA administrative position regarding late designations is certainly welcome, time will tell exactly how and under what circumstances it would be “just and equitable” for the CRA to exercise its discretion to permit late designations under subsection 89(14), to enable taxable dividends to be treated as “eligible” dividends.