Manulife Financial

As a Matter of Tax

from Manulife's Tax & Estate Planning Group

Stop-loss pitfalls

A recent CRA technical interpretation (#2009-0310601I7 dated June 9, 2009) dealt with a reassessment in the following situation:

- The taxpayer was the sole shareholder of a company at the time of his death;
- A capital gain was realized on the deemed disposition of his shares;
- During the first year of the estate, the corporation redeemed all of the common shares held by the estate but it did so in two steps. A number of shares was redeemed and the deemed dividend on that redemption transaction was elected as a capital dividend and then the remaining shares were redeemed resulting in a deemed taxable dividend to the estate.

The question related to the amount of the capital loss which could be carried back against the gain realized by the taxpayer in his terminal return as a result of the two redemptions. The CRA concluded that "each of the two redemptions… should be treated as a separate transaction for purposes of calculating the impact of stop-loss rules in subsection 112(3.2) of the Act." This had the effect of reducing the capital loss which could be claimed by the taxpayer's estate.

This type of result can occur any time the Capital Dividend Account (CDA) credit used is less than the full redemption amount. This can occur if the 50% solution is used, if the redemption is only partially funded with insurance or if the insurance policy has an adjusted cost base at the time of death. The Act requires the election for a capital dividend be made in respect of the "full amount of the dividend." Therefore, as a practical matter, it is not possible to do a single redemption that results in a "split" dividend where a portion of the dividend is a capital dividend and a portion is a taxable dividend.

As shown in this technical interpretation, if the redemption is undertaken in two steps – a redemption for the amount of the desired capital dividend, then a redemption for the remainder as a taxable dividend – the stop-loss calculation will apply to each redemption separately. If the calculation is done separately for each redemption, the total available loss carryback will be less than it would be if it were possible to do a single redemption with both capital and taxable dividend components. As a result, additional planning is

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needed in order to accomplish the result contemplated by the 50% solution and other scenarios where the CDA is less than the full redemption amount.

One way to deal with this issue is to do a paid up capital (PUC) “bump” prior to the redemption equal to the desired capital dividend. This will create a deemed dividend pursuant to subsection 84(1) of the Act. If a capital dividend election is made in respect of this dividend, no tax will arise to the shareholders. Then the corporation can redeem the shares, and since the PUC has been bumped up, the deemed dividend will equal the desired taxable dividend, and the allowable loss carryback will equal the amount that would have arisen if it had been possible to create a “split” dividend on the redemption.

This commentary also serves as a warning that the CRA is going to stick to the letter and not grant administrative relief even where a taxpayer could have done a different series of steps to accomplish the same result but with more a favourable outcome. This may cause tax professionals to modify their standard practices to include PUC bumps prior to redemption any time the CDA credit is less than the redemption amount.

These columns are current as of the time of writing, but are not updated for subsequent changes in legislation unless specifically noted

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