FIRST YORK

Deferring Capital Gains Tax in Share Redemptions through "Grandfathering"

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As Gary Clark noted in his presentation to STEP Toronto in October, there continues to be some confusion with respect to the "grandfathering" provisions to the "Stop Loss" rules which affect the use of the Capital Dividend Account (CDA) to redeem private company shares.

Prior to April 27, 1995, it was possible to eliminate the capital gains tax payable on shares at death of a shareholder by electing the full deemed dividend on redemption to the shares to be a Capital Dividend. It was limited only by the amount of insurance in place (which creates a balance in the Capital Dividend Account).

However, since April 27, 1995, the "Stop Loss" rules have applied such that the loss carried back against the gain in the estate is limited to 50% thereby requiring the other half to be taxed as a "regular" dividend (currently set to go to 36.47% or 33.85% in Ontario, depending on whether the dividend is "eligible" or "ineligible").

Importantly, certain shares are grandfathered and will continue to get full access to the CDA without the "Stop Loss" rules affecting the transaction. Here are the basic rules, only one of which must be met in order for grandfathering to be available:

A) Shares are redeemed pursuant to an agreement that was in effect on April 26, 1995, OR

B) On April 26, 1995 the corporation was beneficiary of a policy and it is reasonable to conclude that a main purpose of the insurance was to fund the redemption of shares.

I try to keep these e-mails conceptual – not too technical – and so I won't attempt to detail all of the requirements, rulings and technical interpretations here. I will refer you to the * PPI website library "Capital Dividend Stop Loss" where there are two excellent articles by Glenn Stephens of PPI and Kevin Wark of CALU for Federated Press.

Why is it so important to understand "grandfathering" of shares?

- Not only can tax on the gain on the shares as at April 26, 1995 be deferred, but in many cases the tax on all future growth to today and beyond may also be deferred.

- Changes to an agreement that was in effect on April 26, 1995 could cause the loss of grandfathering. This should be weighed against the legal and business needs that would be served by the proposed changes.

It is possible to replace or add to existing coverage without impacting the grandfathering, but records of the prior insurance should be kept and preserved as they will be required in the future to validate the shares were grandfathered. Agreements that were in force on April 26, 1995 but that have since been terminated should also be kept on file, as they may provide evidence as to the purpose of life insurance that was in force on that date.