Tax Notes
Eligible Capital - Some Big Changes
Part I

By: David Louis, J.D., C.A., Tax Partner.
Minden Gross LLP

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As you can see, this article is about eligible capital. Don't stop reading. I know what you're thinking – you have probably been privy to complex dissertations about this subject. (Let's see now, it's 3/4 of this and 3/2 of that. Or is it 3/4 of *that* and 3/2 of *this*?)

But seriously, folks, some of the most exciting recent developments in taxation have centered around eligible capital.**[i]** In this article, I will try to hit the highlights. I promise – no 3/4 of this, 3/2 of that.**[ii]**

Lower corporate tax

So what's so exciting about eligible capital? The difference between eligible capital and capital gains treatment at the corporate level is fairly dramatic. In Ontario, for example, a corporate-level capital gain attracts a tax rate of 24.9%,**[iii]** whereas, for a gain in respect of eligible capital, the tax rate will be only 18.06%.**[iv]** This is nearly a 7% swing, or to put it another way, a tax reduction of nearly 30%. The reason for this reduction is that the taxable portion of eligible capital does not attract the 6-2/3rds refundable surtax,**[v]** while qualifying for the 7% rate deduction available for "business income".**[vi]** In fact, theoretically at least, when contrasted to a share sale, there may be little effective tax from a "bilateral standpoint": the tax rate on the eligible capital may, depending on the discount rate, be quite similar to the present value of the tax shield generated by the eligible capital.**[vii]** Whether the purchaser will gross up the purchase price is another matter!

But at a cost

For both eligible capital and capital gains, 50% of the gain will qualify for capital dividend treatment. But in the case of eligible capital, there's a price to pay: while the taxable portion of a capital gain will qualify for refundable tax treatment, this is not the case with the taxable portion of eligible capital.

But how *big* a price is this? For a large-scale sale of a business, my contention is – usually not very. Yes, there may be an element of double-taxation when the taxable portion of eligible capital is distributed from the corporation. In Ontario, for example, a distribution of the taxable portion of an eligible capital gain as a dividend will attract a tax rate in excess of 56.1%. (This, of course, is double the effective tax rate on the entire gain.)

But this may be many years in the future. As I said earlier, 50% of the gain can qualify as a capital dividend and therefore be eligible for timely removal (at least fairly timely – see below). In a large business sale, the owner-manager will often desire to retain what's left of the taxable portion of eligible capital for his or her family, especially if the income generated from the business itself is no longer available. For this reason, the retention of the capital in the corporation until death - or even later - is a distinct possibility. And if the corporate surplus is realized as a capital gain - e.g., on death - the Ontario tax rate will drop to just under 51% - only about three points more than a distributed taxable capital gain.**[viii]** Furthermore, an estate freeze can effectively reduce the death tax exposure.**[ix]**

Subsection 14(1.01)

If, however, capital gains treatment is desired, it may well be possible to obtain this through an election under subsection 14(1.01) of the Act. This potentially allows eligible capital (other than "goodwill") to be treated as a capital gain.**[x]**

For the reasons above, the consequences of this election can be far reaching. In fact, there are other effects of a subsection 14(1.01) election.[xi] For example, if the vendor has capital loss balances, they can be used where a subsection 14(1.01) election is filed. However, pre-existing capital losses would also offset the CDA addition. If, on the other hand, a CDA addition is by virtue of eligible capital – i.e., without a subsection 14(1.01) election - there would be no netting effect on either ground: capital losses cannot be applied against gains from eligible capital, and the excess of capital losses over capital gains will not reduce the capital dividend account attributable to eligible capital. The timing of the addition to CDA may also be relevant in terms of being able to take out the funds. The addition to CDA without a subsection 14(1.01) election arises only at year-end (because eligible capital is a year-end calculation).[xii] In the case of a subsection 14(1.01) election, while certainly open to question, it has been the CRA's view that the CDA addition does not occur until filing.[xiii] Subsection 14(1.01) proposals now provide for the election to be filed either in the taxpayer's return of income for the year or in the capital dividends election[xiv]; the latter may allow the taxpayer to accelerate the capital dividend (if the CRA's policy is of concern). Finally, it appears that a subsection 14(1.01) election permits a reserve[xv] whereas a disposition of eligible capital does not.[xvi]

There continues to be uncertainty in respect of whether "internally developed" eligible capital qualifies for the election. The original wording of the subsection 14(1.01) election required that "the <u>cost</u> of the property to the taxpayer can be determined". Apparently, there were concerns on the part of the CRA that internally developed eligible capital may not have a "cost". The current wording, which allows for an election "in respect of the <u>acquisition</u> of the property", requires that the "<u>eligible capital expenditure</u> can be determined." It has been observed that the wording continues to suggest that the election may be restricted to property acquired from a third party.[xvii]

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[i] For the most part, I will dispense with the precise terminology relating to section 14, referring to an eligible capital "expenditure", "amount", "property" etc. as "eligible capital". To be frank, after more than 25 years of practice, I think I'm entitled (and, yes, references herein to "tax brackets" mean "marginal tax rates"). For the record, though, here is a summary of the rules/terminology, which I have brazenly lifted from "Eligible Capital Property Update", by Bradley Severin, 2003 PPC, p. 4:2/3:

1. Qualifying *eligible capital expenditures* made in the taxpayer's year are added to the pool, known as the "*cumulative eligible capital*" property pool, at a specified inclusion rate [currently 75%];

2. The pool is decreased in a particular year by each "e*ligible capital amount*" for the year or any required adjustments necessary under the application of subsection 80(7). An *eligible capital amount* results from a disposition of *eligible capital property* and the *eligible capital amount* is generally determined as a specified rate multiplied by the "base for the eligible capital amount";

3. Where a positive balance exists in the cumulative eligible capital account pool at the end of the taxpayer's taxation year, the taxpayer may elect to take a deduction under paragraph 20(1)(b) in computing the taxpayer's income for the year. The amount that may be deducted cannot exceed 7% of the pool balance at the end of the year. The pool is decreased appropriately for the amount of the deduction; and,

4. In the event that there is a negative balance in the pool at the end of the year, subsection 14(1) requires that an amount be included in the income of the taxpayer, in a manner that emulates the recapture of previously recognized capital cost allowance deductions.

[ii] I will do this by assuming (for the most part) that, in respect of the disposition of eligible capital, there is no pre-existing cumulative eligible capital pool. Alas, those who present full-scale papers on the subject do not have this luxury. For those who want a more detailed review of eligible capital, in addition to Mr. Severin's paper, see also "Non-Taxable Payments & Eligible Capital Property", L. Branham, 2003 BCC 14.

Where there are pre-existing pools, the taxable amounts of eligible capital and amounts in the capital dividend account may differ from equivalent capital gains (see also notes to the discussion of proposed subsection 14(1.01), below). One remark I will make about pre-existing pools is that a principal difference between the taxation of dispositions of depreciable and eligible capital property is that, in the former case, the pool absorbs

proceeds up to the original cost of the particular asset, whereas the entire pool balance is available to absorb a disposition of eligible capital.

[iii] The effective rate can be reduced to about 24.1% by a distribution to a top-bracket individual shareholder, ignoring RDTOH "blockage"; however there is still an element of under-integration, since the personal rate on capital gains is about 23.2%.

[iv] All tax calculations ignore the small business deduction and assume a top-bracket Ontario-resident individual, where applicable.

[v] Per section 123.3.

[vi] Per section 123.4.

[vii] 75% of the expenditure is added to eligible capital and is subject to an amortization rate of 7%. While 75% of 7% is 5.25%, amortizing the entire expenditure on a 5.25% declining balance basis (e.g., running a CCA tax shield calculation on this basis) will, of course, overstate the value of the tax shield. The Ontario corporate tax payable on a $10M "gain" in respect of eligible capital property is about $1.8M, whereas the present value of the tax shield generated is about 100K lower, assuming a 4% discount rate.

[viii] See note 3, above. Of course, this assumes that the surplus retained at the corporate level will be taxable at death on a dollar-for-dollar basis, which may not be the case.

[ix] This can be the case even if the freeze occurs after the sale. If the taxable proceeds from a sale of a business are reinvested, the income may generate refundable tax. If so, this can be used to "redeem out" the freeze shares, so that, effectively, the double-tax exposure will be passed on to the next generation. Of course, this effect can be enhanced by the re-injection/retention of proceeds reflected in the capital dividend account to the corporate level, to generate increased amounts of refundable tax.

[x] Subsection 14(1.01) cannot be used to trigger a capital loss. In addition, an individual's exempt gains balance must be nil.

[xi] This article has assumed that there are no pre-existing eligible capital pools. However, if there are, the taxable amount as well as the capital dividend account may differ, depending on whether a subsection 14(1.01) election is made. Conceptually, eligible capital taxation, like the rules relating to depreciable capital property, is based on a "pool" (in this case for all eligible capital in respect of a business) and "recapture" concept, as well as "gains", with the latter included in the capital dividend account. A subsection 14(1.01) election credits the pool to the extent of the cost of the item, then determines the capital gain and potential inclusion in the capital dividend account based on the same cost. Some sample calculations I did showed that, while the taxable amount by virtue of a subsection 14(1.01) election could be greater or less than eligible capital treatment, the CDA resulting from the election would normally exceed the eligible capital CDA, presumably because the other assets in the pool convert the would-be CDA to recapture or shelter within the pool.

[xii] See paragraph (c.2) of the "capital dividend account" definition in subsection 89(1) and paragraph 14(1)(b). Administrative relief is available for elections filed prior to February 1, 2002 on the basis that CDA was enlarged at the time of disposition. The CRA's rationale for the deadline is that the tax community became aware of the provisions by virtue of an article by Karen Yull ("CDA on Sale of ECP"), published in the January 2002 issue of *Canadian Tax Highlights*.

It has been observed that the CDA cannot be paid out until the first moment of the following taxation year. Subsection 83(2) allows CDA to be paid out that is on hand immediately before the time the dividend becomes payable. Since the addition to the CDA only occurs at the end of the year, the dividend cannot be made payable until the first moment of the following year. See Doc. No. 2002-0142127, dated June 19, 2002. This may be significant where a capital dividend is to be paid in connection with a share sale, since there is a deemed year-end by virtue of the acquisition of control. For further discussion, see "Non-Taxable Payments & Eligible Capital Property", L. Branham, 2003 BCC 14.

[xiii] Doc. No. 2003-0030245, September 16, 2003. However, per Doc. No. 2002-0163825, October 22, 2002, the date of the deemed disposition per the subsection is the date of the actual disposition.

[xiv] Subsection 14(1.01) of the Act does not include a provision that would entitle a taxpayer to late-file such an election. Furthermore, for the purposes of subsection 220(3.2) of the Act, a late-filed election under subsection 14(1.01) of the Act may not be made since it is not prescribed in section 600 of the Regulations. See Doc. No. 2003-0183625, January 28, 2003. Per Doc. No. 2002-0123107, April 8, 2002, a subsection 14(1.01) election cannot be amended or revoked.

[xv] See Doc. No. 2002-0133797, April 18th 2002, which overrides an earlier technical interpretation.

[xvi] See subsection 14(2).

[xvii] See “ECP Election and Equity” by Doug Frost and Sheryl Mapa, *Canadian Tax Highlights*, March 2003. The authors also indicate that the wording of subsection 14(1.01) still suggests that the election applies only if there is some original positive cost. Alas, the prospect of curing this apparent deficiency by flipping the property in question into another taxpayer pursuant to subsections 85(1) or (2) - i.e., on a rollover basis - is foreclosed by proposed paragraph 14(1.03)(b).

The “acquisition issue” was also raised in the CBA/CICA Joint Committee submission in respect of the December 20th, 2002 Technical Amendments; however, the wording was not changed in the February 27th, 2004 draft legislation.