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INCOME TAX
INTERPRETATION BULLETIN

NO.: **IT-269R4** DATE: April 24, 2006

SUBJECT: INCOME TAX ACT
Part IV Tax on Taxable Dividends Received by a Private Corporation or a Subject Corporation

REFERENCE: Sections 186, 186.1 and 186.2 (also sections 112, 113 and 149, subsections 129(3), 187(1), 227(14) and 227(16) of the *Income Tax Act* (the "Act") and Part LXVII of the *Income Tax Regulations* (the "Regulations))

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Explanation of Changes

Application

This bulletin cancels and replaces Interpretation Bulletin IT-269R3 dated November 29, 1991. The effective date of a particular legislative provision discussed in the bulletin may be indicated in the *Explanation of Changes* section (or, in some cases, in the *Discussion and Interpretation* section) of the bulletin. However, where the bulletin is silent with respect to the effective date of a particular provision, such date can be obtained from the legislation itself. Unless otherwise stated, all statutory references throughout the bulletin are to the *Income Tax Act.*

Summary

The purpose of Part IV is to prevent the deferral of tax on portfolio dividend income through the use of private or other closely held corporations. Since corporations are generally permitted to deduct dividend income in calculating their

taxable income, Part IV imposes a tax on dividends received by private corporations or closely-held corporations in order to eliminate the incentive for an individual to obtain a significant deferral of tax on dividend income by transferring investments in shares to such corporations. Part IV tax is intended to approximate the tax that would be paid by an individual taxable at the highest marginal tax rate had the dividends been received by that individual. Generally, this tax is fully refundable as a dividend refund to the corporation when the corporation pays dividends to its shareholders, since the shareholders will then be subject to tax at their marginal rates on the dividends.

Discussion and Interpretation

General

¶ 1. Taxable dividends are included in the income of corporations by virtue of paragraph 12(1)(*j*) or 12(1)(*k*). Where a corporation which is resident in Canada has received a taxable dividend from

(a) a taxable Canadian corporation, or

(b) a corporation resident in Canada (other than a non-resident-owned investment corporation or a corporation exempt from Part I tax) and controlled by the recipient,

section 112 permits the receiving corporation to deduct from income an amount equal to the dividend for the purpose of computing its taxable income. Where the corporation has received a dividend from a foreign affiliate, an amount, as calculated under section 113, may be deducted from the corporation's income for the purpose of computing its taxable income. Although Part I tax is not exigible on taxable dividends received by a corporation resident in Canada to the extent that such dividends are deductible pursuant to sections 112 or 113, section 186 may impose a Part IV tax on such dividends as discussed below.

¶ 2. The Part IV tax applies to "assessable dividends" received by a corporation that was at any time in a taxation year a "private corporation" or a "subject corporation".

Subsection 186(3) defines an "assessable dividend" as an amount received by a corporation at a time when it is either a private corporation or a subject corporation as, on account of, in lieu of payment of or in satisfaction of, a taxable dividend from a corporation to the extent of the amount in respect of the dividend that is deductible under section 112, paragraph 113(1)(*a*), (*b*) or (*d*) or subsection 113(2) in computing the recipient corporation's taxable income for the year.

A "private corporation" is defined in subsection 89(1). Refer to the current version of IT-391, *Status of Corporations*, for a discussion of what constitutes a private corporation.

Subsection 186(3) defines a "subject corporation" as a corporation (other than a private corporation) resident in Canada that is controlled, whether by reason of a beneficial interest in one or more trusts or otherwise, by or for the benefit of an individual (other than a trust) or a related group of individuals (other than trusts). For greater certainty, a corporation may be controlled by or for the benefit of an individual or a related group of individuals even where such control or benefit is derived indirectly through one or more intermediary corporations, partnerships or trusts.

Exemptions from Part IV Tax

¶ 3. Pursuant to section 186.1, Part IV tax is not payable for a taxation year by a corporation

(a) that was a bankrupt at any time in the taxation year, or

(b) that was, throughout the year,

   (i) a bank,

   (ii) a corporation licensed or authorized under the laws of Canada or a province to carry on in Canada the business of offering to the public its services as a trustee,

   (iii) an insurance corporation,

   (iv) a prescribed labour-sponsored venture capital corporation,

   (v) a prescribed investment contract corporation,

   (vi) a non-resident-owned investment corporation (note that a corporation cannot be a non-resident-owned investment corporation after 2003 according to paragraph (*i*) of the definition of "non-resident-owned investment corporation" in subsection 133(8)) or

   (vii) a registered securities dealer that was throughout the year a member of a prescribed stock exchange in Canada.

The term "prescribed labour-sponsored venture capital corporation" is defined in section 6701 of the Regulations and includes:

- the corporation established by the Act to establish the *Fonds de solidarité des travailleurs du Québec (F.T.Q.)*, Statutes of Quebec, 1983, c. 58;
- a corporation registered under the provisions of *The Labour-sponsored Venture Capital Corporations Act*, Statutes of Saskatchewan, 1986, c. L-O.2;
- a corporation that is registered under Part 2 of the *Employee Investment Act*, Revised Statutes of British Columbia, 1996, c. 112;
- a registered labour-sponsored venture capital corporation;
- a corporation that is registered under Part III of the *Community Small Business Investment Funds Act*, chapter 18 of the Statutes of Ontario, 1992;
- the corporation established by *The Manitoba Employee Ownership Fund Corporation Act*, Continuing Consolidation of the Statutes of Manitoba, c. E95;
- a corporation registered under *The Labour-Sponsored Venture Capital Corporations Act*, Continuing Consolidation of the Statutes of Manitoba, c. L12;
- the corporation established by an *Act to establish Fondaction, le Fonds de développement de la*

Confédération des syndicats nationaux pour la coopération et l'emploi, Statutes of Québec, 1995, c. 48;

- a corporation that is registered under Part II of the *Equity Tax Credit Act*, Statutes of Nova Scotia 1993, c. 3; and
- a corporation that is registered under Part II of the *Risk Capital Investment Tax Credits Act*, chapter 22 of the Statutes of the Northwest Territories, 1998.

A "prescribed investment contract corporation" means a corporation described in subparagraph (*b*)(ii) of the definition of "retirement savings plan" in subsection 146(1) of the Act. Such a corporation is one approved by the Governor in Council and licensed or otherwise authorized under the laws of Canada or a province to issue investment contracts in connection with registered retirement savings plans.

¶ 4. Pursuant to section 186.2, Part IV tax is not payable by a corporation that was throughout the year a prescribed venture capital corporation on dividends from a prescribed qualifying corporation. Section 6700 of the Regulations defines a "prescribed venture capital corporation" while section 6704 of the Regulations defines a "prescribed qualifying corporation". In general, if the shares qualify as an eligible investment under the applicable provincial venture capital program at the time of their acquisition, the issuer of the share will qualify as a prescribed qualifying corporation.

¶ 5. Pursuant to subsection 227(14), Part IV tax does not apply to any corporation for any period throughout which it is exempt from tax because of section 149. Such corporations include registered charities and pension corporations. In addition, pursuant to subsection 227(16), a corporation which at any time during the taxation year would be a Crown corporation described in paragraph 149(1)(*d*) to (*d*.6) (see the current version of IT-347, *Crown Corporations*) but for the provisions of an appropriation Act, is deemed not to be a private corporation for the purposes of Part IV. Similarly, federal Crown corporations, which are subject to tax under section 27, are, by virtue of subsection 27(2), deemed not to be private corporations for the purposes of Part IV. As a consequence, Crown corporations are not generally subject to Part IV tax.

Application of Part IV Tax

Calculation of Part IV tax – subsection 186(1)

¶ 6. The tax payable under Part IV for a year by a particular private corporation or subject corporation is equal to the amount by which the total of

(a) 1/3 of all assessable dividends (see ¶ 2) received in the year by a recipient corporation from payer corporations with which it is not connected (see ¶ 11), and

(b) the total of each amount in respect of an assessable dividend received in the year by a recipient corporation from a private corporation or a subject corporation that was a payer corporation connected with the recipient corporation (see ¶ 11), equal to the proportion of the payer corporation's "dividend refund" (see ¶ 7) for its taxation year in which it paid the dividend that

  (i) the amount of the dividend received by the recipient corporation is of

  (ii) the total of all taxable dividends paid by the payer corporation in its taxation year in which it paid the dividend and at a time when it was a private corporation or a subject corporation

exceeds 1/3 of the total of

(c) such part of the recipient corporation's non-capital loss and farm loss for the year as it claims, and

(d) such part of the recipient corporation's

  (i) non-capital loss for any of its 10 taxation years immediately preceding or 3 taxation years immediately following the year, and

  (ii) farm loss for any of its 10 taxation years immediately preceding or 3 taxation years immediately following the year

as it claims to the extent that such amount would be deductible under section 111 if the corporation had sufficient income for the year. The expression "farm loss" as defined in subsection 111(8) includes a loss for the year from a fishing business.

To the extent that the deduction of a non-capital loss is subject to the restrictions of subsection 111(5), such loss can not be applied to reduce the corporation's Part IV tax.

¶ 7. For the purpose of the calculation described in ¶ 6(b), a payer corporation's "dividend refund" is defined in paragraph 129(1)(*a*) to be the lesser of

(a) 1/3 of all taxable dividends paid by the corporation in its taxation year and at a time when it was a private corporation, and

(b) its "refundable dividend tax on hand" ("RDTOH") (see ¶ 18 below) at the end of its taxation year.

¶ 8. For purposes of ¶ 6, the determination of whether an assessable dividend was received from a "connected" corporation must be made at the time that the dividend was received by the recipient corporation. If the assessable dividend was received from the payer corporation at a time when that corporation was not connected to the recipient corporation (see ¶ 11), then the dividend is subject to Part IV tax as described in ¶ 6(a), notwithstanding that the payer corporation may have been connected to, or might subsequently become connected to, the recipient corporation at some other time during the taxation year.

Use of non-capital or farm losses to reduce Part IV tax

¶ 9. Generally, it is more advantageous for a corporation to use its non-capital loss or farm loss to reduce its taxable income rather than to reduce its Part IV tax as described in ¶s 6(c) and (d), because the Part IV tax rate is normally lower than the combined federal and provincial tax rate applicable

to investment income (i.e. non-active business income). A corporation might decide to use a non-capital loss or farm loss to reduce or eliminate its Part IV tax base for a particular year where, for example:

- the corporation is a Canadian-controlled private corporation and all of its income is eligible for the small business deduction (i.e. the effective combined tax rate on its taxable income is lower than the Part IV tax rate), or
- the corporation might not otherwise be able to use all of its non-capital loss or farm loss before the end of the applicable carry-forward period.

Assessable dividends subject to Part IV.1 tax

¶ 10. Where a corporation receives an assessable dividend that is subject to tax under Part IV.1, subsection 186(1.1) reduces the Part IV tax as follows:

(a) where the assessable dividend is one described in ¶ 6(a), by 10% of the assessable dividend, and

(b) where the assessable dividend is one described in ¶ 6(b), by 30% of the amount determined under that paragraph for the assessable dividend.

Part IV.1 levies a tax on certain dividends received on "taxable preferred shares" (defined in subsection 248(1)). Generally, a taxable preferred share will include most preferred shares issued after June 18, 1987.

Connected Corporations

Definition of "connected"

¶ 11. Pursuant to subsection 186(4), a payer corporation is "connected" with the recipient corporation at a particular time where

(a) the recipient corporation controls (see ¶ 12) the payer corporation (otherwise than by virtue of a right referred to in paragraph 251(5)(*b*)) at that time, or

(b) the recipient corporation owns, at the particular time,

 (i) more than 10% of the issued share capital (having full voting rights under all circumstances) of the payer corporation, and

 (ii) shares of the payer corporation having a fair market value greater than 10% of the fair market value of all the issued shares of the payer corporation.

¶ 12. For the purpose of determining whether a payer corporation is connected with a recipient corporation (see ¶ 11(a)), subsection 186(2) expands the normal concept of control and provides that one corporation is considered to be controlled by another corporation if more than 50% of its issued share capital having full voting rights belongs to

(a) the other corporation,

(b) persons not dealing at arms' length with the other corporation, or

(c) the other corporation and persons not dealing at arms' length with the other corporation.

For example, consider the situation where the issued share capital of Corporation A consists solely of 100 common shares of which 90 are owned by Mr. X. The remaining 10 common shares are owned by Corporation B, a corporation that is controlled by the spouse of Mr. X. For the purposes of Part IV, Corporation A would, by virtue of subsection 186(2), be controlled by Corporation B because more than 50% of the issued share capital of Corporation A is owned by Mr. X who is related to and, therefore, deemed not to deal at arm's length with Corporation B.

As noted in ¶ 11(a), control of the corporation is determined by considering the actual ownership of shares, without taking into account any rights referred to in paragraph 251(5)(*b*).

¶ 13. Due to fluctuations in the fair market value of different classes of the shares of the payer corporation referred to in ¶ 11(b), the recipient corporation's percentage interest of the fair market value of all the issued shares of the payer corporation may vary from time to time, which may result in the payer corporation becoming or ceasing to be connected with the recipient corporation. Where a corporation is controlled (as discussed in ¶ 12) by one or more persons and the recipient corporation does not control, and is not a member of the group that controls, the corporation, a discount from the *pro-rata* value would normally be applied to determine the fair market value of the shares held by the recipient corporation to reflect the recipient corporation's minority interest status. Similarly, where restrictions on the marketability of shares exist, a discount will normally be applied in determining the fair market value of such shares to reflect those restrictions.

¶ 14. For the purposes of 11(b), shares which have "full voting rights" do not cease to have such rights even if the holder of such shares limits their voting rights by entering into a shareholder agreement or a voting trust which dictates how the shares are to be voted.

Recipient corporation member of partnership

¶ 15. Where taxable dividends are received by a partnership, paragraph 186(6)(*a*) provides that, for the purpose of computing Part IV tax liability, each member of the partnership is deemed to have received its proportionate share of such dividends in the member's taxation year in which the fiscal period of the partnership ends. Paragraph 186(6)(*b*) provides that the member is considered to own a proportion of the shares owned by the partnership based on the member's share of all dividends received on such shares by the partnership in its fiscal period. This provision is relevant in determining whether a payer corporation is connected (see ¶ 11) to a recipient corporation that is a member of a partnership.

Dividends designated by a Trust

¶ 16. It is not unusual for a private corporation to be a beneficiary of a personal trust. In situations where the trust has received taxable dividends on shares it owns in one or

more taxable Canadian corporations, the trust may pay such income to its beneficiaries and make a designation under subsection 104(19) with the result that the taxable dividend is deemed not to have been received by the trust and to be a taxable dividend received by the designated beneficiaries in the particular year from the payer corporation. Consequently, an amount designated by a trust to a corporate beneficiary will be a taxable dividend received by the corporate beneficiary for the purposes of Part IV. However, there is no provision similar to paragraph 186(6)(*b*) (see ¶ 15) which deems a beneficiary of the trust to own any of the shares of the payer corporation owned by the trust for the purposes of paragraph 186(4)(*b*) (see ¶ 11(b)). Consequently, assuming that the corporate beneficiary does not own any shares of the payer corporation directly, it will not be connected with the payer corporation unless the trust is a personal trust and the trust owns more than 50% of the issued shares of the payer corporation having full voting rights under all circumstances. In such circumstances, paragraph 251(1)(*b*) will deem the corporate beneficiary not to deal at arm's length with the personal trust, and the payer corporation will be connected with the corporate beneficiary by virtue of subsection 186(2) and paragraph 186(4)(*a*) (see ¶ 11(a)). Refer to the current version of IT-419, *Meaning of Arm's Length*, for a discussion of paragraph 251(1)(*b*).

Deemed dividends under subsection 84(3)

¶ 17. For purposes of ¶ 11, where a payer corporation redeems shares owned by a recipient corporation resulting in a deemed dividend under subsection 84(3), the recipient corporation is considered to be the owner of the shares of the payer corporation at the time that the deemed dividend arises, notwithstanding that the shares were redeemed at that time. Thus, if the payer corporation was connected with the recipient corporation immediately before the redemption of the shares, the payer corporation would be connected with the recipient corporation at the time of the deemed dividend. Consequently, the recipient corporation will not be subject to Part IV tax under the general provisions of paragraph 186(1)(*a*) for such taxable dividend (see ¶ 6(a)). However, where the payer corporation receives a dividend refund as a result of the deemed dividend under subsection 84(3), the recipient corporation will be liable to Part IV tax to the extent provided by paragraph 186(1)(*b*), as discussed in ¶ 6(b), since the payer corporation is connected with the recipient corporation.

Refundable dividend tax on hand

¶ 18. The tax payable for the year under Part IV is added to the recipient corporation's "refundable dividend tax on hand" at the end of its taxation year under paragraph 129(3)(*b*). Provided that the recipient corporation is a private corporation when it subsequently pays taxable dividends to its shareholders, all or a portion of such Part IV tax will be refunded to the recipient corporation as explained in the current version of IT-243, *Dividend Refund to Private Corporations*. By virtue of subsection 186(5), a subject corporation is deemed to be a private corporation for the purpose of the dividend refund under section 129; however, the amount of a subject corporation's RDTOH is limited to the total of all taxes payable under Part IV that have not previously been refunded whereas the RDTOH of certain private corporations (for example, a Canadian-controlled private corporation) may include other amounts.

Timing of payment of Part IV tax – dividends received from connected payer corporations

¶ 19. Under subsection 186(1), a recipient corporation is required to calculate and pay any Part IV tax by its balance-due day for its taxation year. Consequently, where the recipient corporation's Part IV tax liability includes an amount calculated under paragraph 186(1)(*b*) (see ¶ 11(b)) a problem may arise when the payer corporation does not determine its dividend refund until a time that is later than such balance-due day of the recipient corporation. In such situations, the recipient corporation should estimate the payer corporation's dividend refund and calculate the tax payable under Part IV. Any subsequent adjustment required, including interest, will be made on assessment. For most corporations, the balance-due day is the day that is two months after the day on which the corporation's taxation year ends; however, for certain corporations that were Canadian-controlled private corporations throughout the year, the balance-due day is the day that is three months after the day on which the corporation's taxation year ends. For a more detailed discussion of the balance-due day, refer to either of those guides T4012, *T2 Corporation – Income Tax Guide*, or T7B-Corp, *Corporation Instalment Guide*.

Circularity of Part IV Tax

¶ 20. In certain divisive reorganizations, a corporation may be both a payer and a recipient of a taxable dividend as a result of the cross-redemption of shares which generally occurs in such reorganizations. Consequently, where either of the transferee corporation or the distributing corporation has, or will have, a balance in its RDTOH account at the end of the taxation year in which the cross-shareholdings are redeemed, the resulting deemed dividends can lead to a circular calculation of the Part IV tax and dividend refund that each corporation is entitled to receive in circumstances where the corporations are connected with each other. Several techniques are available to address this circularity problem, including the use of a subsidiary of the transferee corporation or the staggering of the cross-redemptions to occur in different taxation years of one of the corporations.

Taxable Dividends Exempt from Part IV Tax

¶ 21. Taxable dividends, as defined in subsection 89(1), include taxable stock dividends and deemed dividends such as those referred to in section 84. In addition, interest received on an income bond or income debenture is deemed to have been received as a dividend pursuant to

subsection 15(3) and is, therefore, subject to Part IV tax when received by a private corporation or a subject corporation. Capital dividends (i.e. dividends in respect of which the payer corporation has made an election under subsection 83(2)) are not taxable dividends and are thus not subject to Part IV tax. See the current version of IT-67, *Taxable Dividends from Corporations Resident in Canada*.

Explanation of Changes

Introduction

The purpose of the *Explanation of Changes* is to give the reasons for the revisions to an interpretation bulletin. It outlines revisions that we have made as a result of changes to the law, as well as changes reflecting new or revised interpretations of the CRA.

Reasons for the Revision

We have revised the bulletin primarily to reflect amendments to the *Income Tax Act* enacted by S.C. 1994, c. 7, Schedule VIII (S.C. 1993, c. 24 – formerly Bill C-92), S.C. 1996, c. 21 (Bill C-36), S.C. 1998, c. 19 (Bill C-28), and S.C. 2005, c. 19 (Bill C-33), amendments to Part LXVII of the *Income Tax Regulations* and to add interpretative material.

Legislative and Other Changes

The Summary has been revised to delete the requirement that the corporation be a private corporation at the end of the taxation year as enacted by S.C. 1993 c. 24 (Bill C-92).

¶ 2 has been revised to add the definition of "assessable dividends" as enacted by S.C. 1996, c. 21 (Bill C-36) and to clarify that a corporation may be controlled by or for the benefit of an individual or a related group of individuals even where such control or benefit is derived indirectly through one or more intermediary corporations, partnerships or trusts.

¶ 3 has been revised to note that a registered securities dealer that is a member of a prescribed stock exchange is not liable for Part IV tax by reason of S.C. 1998, c. 19 (Bill C-28) and to identify several prescribed labour-sponsored venture capital corporations that are also exempt from Part IV tax by virtue of section 6701 of the Regulations. The comments in former ¶ 3 relating to section 227 have been moved to new ¶ 5.

¶ 4 has been amended to include a general description of what is meant by a prescribed qualifying corporation.

¶ 5 contains the comments on section 227 previously found in former ¶ 3.

¶ 6 (former ¶ 5), which describes the Part IV tax calculation, has been revised to reflect amendments to subsection 186(1) contained in S.C. 1996, c. 21 (Bill C-36) and S.C. 2005, c.19 (Bill C-33). The most significant of the amendments were the change in the Part IV tax rate from 25% to $33^1/_3$% for dividends received after June 1995 and the change in the non-capital loss carry-forward period from 7 taxation years to 10 taxation years for losses that incurred in taxation years that ended after March 22, 2004. Comments regarding Part IV.1 tax have been moved to ¶ 10.

New ¶ 7 has been added to discuss the definition of "dividend refund".

New ¶ 8 has been added to comment that a payer corporation must be connected to a recipient corporation at the time that dividends are received in order for the dividends to be taxable under paragraph 186(1)(*b*) rather than paragraph 186(1)(*a*).

New ¶ 9 has been added to the bulletin to provide general comments regarding when it is and isn't advantageous to use a loss to reduce or eliminate Part IV tax.

¶ 10 (part of former ¶ 5), describes the reduction in Part IV tax when an assessable dividend is subject to tax under Part IV.1; it has been updated to reflect amendments to subsection 186(1.1) contained in S.C. 1996, c. 21 (Bill C-36).

¶ 11 (former ¶ 6) has been revised to clarify that connected status is determined at a particular time.

¶ 12 (former ¶ 7) has been revised to add an example of the expanded concept of control in subsection 186(2).

¶ 13 (former ¶ 8) has been revised to include a statement that a restriction on marketability may affect the value of a share.

New ¶ 14 has been added to explain the CRA's view concerning the expression "full voting rights under all circumstances".

¶ 15 is essentially former ¶ 9.

New ¶ 16 has been added to clarify that shares owned by a trust are not considered to be owned by a beneficiary thereof.

¶ 17 (former ¶ 10) has been rewritten to provide greater clarity regarding the application of Part IV tax to deemed dividends arising from a redemption of shares.

¶ 18 (former ¶ 11) has been revised to delete, pursuant to S.C. 1994, c. 7, Schedule VIII (Bill C-92), the requirement that a corporation be a private corporation at the end of its fiscal period to be entitled to a dividend refund. Comments have also been added concerning subsection 186(5), which deems a subject corporation to be a private corporation for the purpose of section 129 (i.e., refunds of Part IV tax).

¶ 19 (former ¶ 12) has been revised to reflect that Part IV tax is now due on the corporation's balance-due day, which was enacted by S.C. 2003, c. 15, s. 120, effective for taxation years beginning after June 2003.

New ¶ 20 has been added to describe the potential Part IV circularity problem for dividends arising in certain divisive reorganizations.

¶ 21 (former ¶ 13) has been revised to reflect that subsection 89(1) was restructured as a result of consolidation in R.S.C. 1985 (5th Supplement) and to clarify that a capital dividend is not subject to Part IV tax.

Throughout the bulletin, we have made minor changes for clarification or readability purposes and deleted comments which are no longer timely.