TaxNewsFlash

Canada

Intercorporate Dividends — Get Audit-Ready

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Canadian groups that pay intercorporate dividends should be prepared to respond to possible queries from the CRA. As part of its ongoing audit activities, the CRA is requesting information regarding intercorporate dividends, including safe income calculations, adjusted cost base and paid-up capital schedules, and the purpose of each dividend paid, among other information.

KPMG has a national Corporate Reorganizations team that can help corporate groups navigate the complex rules that can apply to intercorporate dividends and prepare for possible CRA queries.

Background

The Department of Finance introduced significant amendments to the rules in section 55 of the *Income Tax Act* as part the 2015 federal budget, applicable to intercorporate dividends received after April 20, 2015. Specifically, Finance expanded the rules that can recharacterize certain otherwise tax-deductible intercorporate dividends as capital gains or, in the case of a share redemption, additional proceeds of disposition, potentially resulting in additional tax. These changes include new purpose tests and a narrowing of the exception for transactions between related parties. In recent years, the CRA has published revised and new administrative positions regarding the calculation and allocation of safe income and adjusted cost base, including in a lengthy position paper on various aspects of the application of section 55. Those CRA administrative positions have not yet been tested in the courts. Corporate taxpayers continue to face uncertainty regarding the amended rules in section 55 and the CRA's related administrative positions.

Purpose tests

A tax-deductible intercorporate dividend may be recharacterized as a capital gain under the rules in section 55 where the dividend exceeds the safe income attributable to the shares on which the dividend is paid and one of the purposes of the dividend is to effect any of:

- A significant reduction in a capital gain that, but for the dividend, could have been realized on a disposition of any share
- A significant reduction in the fair market value of any share, or
- A significant increase in the cost of property of the dividend recipient.

The payment of a non-safe income dividend only needs to have one of these purposes (even if it is not the main purpose) to be recharacterized under section 55.

KPMG observations
Canadian corporate groups that pay intercorporate dividends should consider documenting the purpose of each dividend at the time it is declared, such as in the relevant corporate resolution, board minutes, or an internal memorandum. These groups should also consider whether it may be beneficial to establish a written policy on intragroup dividends in certain circumstances.

Safe income exception

Canadian corporations that rely on the safe income exception must be prepared to support the amount of safe income by preparing and maintaining detailed safe income calculations for each corporation paying a dividend, including the safe income of any Canadian and foreign subsidiaries (direct or indirect) of the Canadian dividend payor. For foreign subsidiaries, safe income is based on the complex foreign affiliate surplus regime, with modifications for purposes of the safe income rules.

The safe income exception is only available to the extent there is an accrued capital gain on the shares on which the dividend is paid. Corporations must be able to provide support for the fair market value and adjusted cost base of the shares at the time of each dividend payment.

KPMG observations
As a best practice, we recommend that affected Canadian corporate groups:

- Prepare and update annual safe income calculations, including surplus calculations if applicable
- Prepare and update adjusted cost base and paid-up capital schedules.

Preparing this information is important in light of the CRA's recent audit activities.

We can help

Your KPMG adviser and the Corporate Reorganizations team can help you assess the effect of these developments on your current operations, and review business strategies and options that might help you address some of the tax challenges and uncertainties. For more details, contact your KPMG adviser.