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GALLOWAY
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Chartered Professional Accountants

Inter-corporate dividends

As a general rule, if a Canadian resident corporation ("**Recipient**") receives dividends from another Canadian corporation ("**Payer**"), the dividends are tax-free for **Recipient**. More specifically, **Recipient** will include the dividends in income, but will be allowed an offsetting deduction in computing taxable income. With no net addition to taxable income, there is no tax payable.

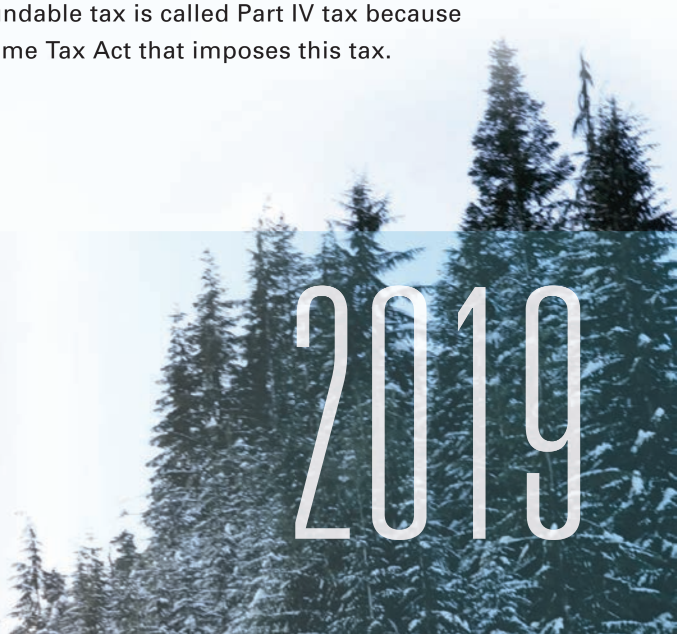
The reason **Recipient** can receive the dividend without paying tax is that **Payer** presumably paid corporate income tax on its earnings that generated the dividend. (Dividends are paid out of after-tax corporate profits). If **Recipient** were also subject to tax, there would be double taxation.

However, in two scenarios, **Recipient** will be required to pay a *refundable* tax on dividends it receives from **Payer**. The tax is 38.33% of the dividends received, and is refundable when **Recipient** in turn pays out dividends to its shareholders, as further explained below. The refundable tax is called Part IV tax because that is the Part of the Income Tax Act that imposes this tax.

REFUNDABLE TAX FOR CERTAIN DIVIDENDS

SEE **INTER-CORPORATE** P. 2

Wishing you a happy and prosperous New Year!



INTER-CORPORATE CONT'D FROM P. 1

Inter-corporate dividends Scenario 1

Recipient is a private corporation and it receives dividends on "portfolio shares". The refundable tax will apply. By "portfolio shares", we mean that **Recipient** owns 10% or less of the shares of **Payer** (counting either votes or fair market value). The 38.33% tax is added to a notional account of **Recipient** called Refundable Dividend Tax on Hand ("RDTOH").

The tax is refunded to **Recipient** when it pays dividends to its shareholders, on a basis of 38.33% of the dividends paid to its shareholders. The payment of those dividends then reduces the RDTOH.

EXAMPLE

You own shares in **Recipient** which in turn owns portfolio shares in **Payer** (a widely traded public company).

In Year 1, **Payer** declares and pays a $1,000 dividend to **Recipient**. In Year 2, **Recipient** pays you a $1,000 dividend.

As a result, in Year 1, **Recipient** pays $383.33 Part IV tax, which is added to its RDTOH. In Year 2, **Recipient** receives a tax refund of $383.33, as a result of paying the $1,000 dividend, and that amount is subtracted from the RDTOH.

As might be appreciated, if **Recipient** paid you the $1,000 dividend in Year 1, the refund would apply in Year 1 so that no net tax would be payable by **Recipient**.

Inter-corporate dividends Scenario 2

Recipient is a private corporation that owns more than 10% of the shares of **Payer** (counting both votes and fair market value), or controls **Payer**. **Recipient** will be subject to Part IV tax if **Payer** receives a refund upon payment of dividends to **Recipient**. This will happen, for example, if **Payer** was subject to Part IV tax on dividends it received from other corporations and was now receiving a refund because of its payment of dividends to **Recipient**.

The Part IV tax levied on **Recipient** will equal a proportionate amount of the dividend refund of **Payer**, based on the dividend it received relative to dividends paid by **Payer**.

EXAMPLE

Recipient owns 50% of the shares of **Payer**. **Payer** declares and pays a $1,000 dividend to **Recipient**, which is 50% of the dividends paid by **Payer** in the year. As a result of the payment of dividends, **Payer** receives a dividend refund of $600 (which means that a large amount of its dividend paid to **Recipient** came out of **Payer's** RDTOH).

Recipient will be subject to $300 Part IV tax (50% of $600), which will be added to its RDTOH. That tax will be refunded to **Recipient** when it pays dividends to its shareholders, again on a basis of 38.33% of dividends it pays.

Note that beginning in 2019, a corporation's RDTOH account will be split into two accounts, being the "eligible RDTOH" and the "non-eligible RDTOH". Any dividends paid out of the former account can result in a refund for the corporation, whereas only non-eligible dividends paid out of the latter accounts will result in a refund.

Royalties qualified for small business deduction

THE BACKGROUND

A Canadian-controlled private corporation ("CCPC") is entitled to the small business deduction on the first $500,000 of its active business income in a taxation year.

The small business deduction reduces the corporate tax rate to around 11-14%, depending on the province, as compared to the regular corporate tax rate of around 25-30%, again depending on the province.

As a general rule, active business income does not include income from a "specified investment business", which includes a business the principal purpose of which is to derive income (including interest, dividends, rents and royalties) from property.

THE CASE

In the recent *Rocco Gagliese Productions* case, the taxpayer was a CCPC whose sole shareholder was Mr Rocco Gagliese.

Mr Gagliese was a music composer who wrote music for various television programs. He did so as an employee of the CCPC. The CCPC received royalties for the use of the music from the Society of Composers, Authors and Music Publishers of Canada, which collects and distributes royalties to music creators.

The CCPC claimed the small business deduction on its earnings.

THE ASSESSMENT

The Canada Revenue Agency assessed the company, disallowing the small business deduction on the grounds that its business was a specified investment business the principal purpose of which was to earn royalty income.

THE APPEAL

The company's appeal of the assessment to the Tax Court of Canada was allowed. The judge held that the principal purpose of the taxpayer's business was to earn business income from Mr Gagliese's daily activities of originating and recording music tracks for television episodes.

THE OUTCOME

Because this was an active business of the taxpayer, the small business deduction was allowed.

Do you always need to file a tax return?

That depends! Of course the simple answer is no. Normally, you do not have to file a tax return for the year if you have no income tax payable for the year.* What's your tax situation this year?

You have no income tax payable for the year.	**No.** You do not have to file a tax return.
Tax was withheld from your salary or wages for the year and you have no tax payable, so the withheld tax will be refunded to you.	**Maybe.** Even if you are not required to do so, it may be beneficial to file a tax return.
You paid tax instalments for the year and have no tax payable, so you are entitled to a tax refund for the year.	
You want to claim the GST/HST Credit that applies to low-income individuals or families, or you want to receive the Canada Child Benefit.	
You have a taxable capital gain or you have disposed of capital property in the year.	**Yes.** Even if you have no tax payable, you must file a tax return.
You received a demand to file a return from the Canada Revenue Agency.	
You withdrew money from your Registered Retirement Savings Plan ("RRSP") under the Home Buyers' Plan or the Lifelong Learning Plan, and have an outstanding balance payable in respect of the repayment of that amount to your RRSP.	

*Note that having no tax payable at year-end because of source withholdings does not get you out of a filing obligation. For this purpose, "tax payable" includes amounts you have already paid or that were withheld from payments to you.

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