



Changes to the Dividend Refund Rules for Corporations With Mismatched Year-Ends

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The federal government recently introduced Bill C-31, which would implement several tax changes announced in its 2025 budget. One of these measures would introduce pivotal changes to the dividend refund rules that are relevant to dividends paid between private corporations with different year-ends. This article first provides a high-level overview of the existing rules for the uninitiated or those who need a refresher. If you're familiar with the existing rules, you may wish to skip to the section titled "Federal Budget 2025 Changes", where we begin reviewing the pending amendments.

A Brief Refresher on Refundable Taxes

A private corporation must pay a refundable tax of 38 $\frac{1}{3}$ % on certain dividends it receives. When a private corporation earns investment income (other than dividends), it must also pay a refundable tax of 10 $\frac{2}{3}$ % in addition to the regular federal corporate tax payable on that income.

The reason behind these refundable taxes is that they effectively prevent high-income individuals from attaining a tax deferral advantage by investing in a corporation rather than holding the investments personally. Personal tax rates in the top tax bracket are higher than the corporate tax rate applicable to investment income. Also, dividends are otherwise tax-free to the corporation when received from another corporation in Canada. Consequently, a substantial amount of an individual's tax could be deferred if they receive their dividends by holding their investments in a corporation rather than directly. However, the federal government has maintained a long-standing anti-deferral policy, and the refundable taxes prevent this deferral from occurring.

When these refundable taxes are paid, they are tracked in a private

corporation's refundable dividend tax on hand ("RDTOH") accounts. Very generally, when the corporation pays a taxable dividend, the corporation can become entitled to a refund of the refundable taxes it previously paid (a "dividend refund").

The dividend refund is equal to the lesser of 38½% of taxable dividends paid by the corporation and the relevant RDTOH balance. There are two separate RDTOH accounts: "non-eligible RDTOH" includes refundable taxes paid on passive investment income, including "aggregate investment income" and refundable dividend taxes paid in respect of non-eligible dividends; "eligible RDTOH" includes refundable taxes paid in respect of eligible dividends received.

The payment of an eligible dividend, which qualifies for a more generous dividend tax credit for the recipient shareholder, can generate a refund only to the extent of the corporation's eligible RDTOH. An eligible dividend cannot generate a refund out of the corporation's non-eligible RDTOH. If the corporation pays a non-eligible dividend, it can trigger a refund to the extent of the corporation's eligible or non-eligible RDTOH, but the non-eligible RDTOH must be depleted before the eligible RDTOH.

Federal Budget 2025 Changes

When a connected corporation pays a dividend to a private corporation, the private corporation must pay refundable tax equal to the proportion of the connected corporation's dividend refund for the year with respect to the dividend received by the private corporation. Corporations are generally connected if one controls the other or owns more than 10% of the other's share capital.

However, if the payer and payee corporations have different year-ends, it was possible for the

payer to obtain a dividend refund much sooner than the payee would be required to pay the corresponding refundable tax. In some cases, taxpayers were indefinitely avoiding the tax with clever structuring. This represented a tax deferral that conflicted with the federal government's anti-deferral policy. Consequently, the 2025 federal budget announced the government's intention to prevent this deferral by introducing the rules discussed below.

Suspended Dividend Refund

A dividend will be deemed not to be a taxable dividend, which means that it will not trigger a dividend refund to the payer and becomes a "suspended dividend", if the payee corporation:

- (a) Is affiliated with the payer corporation immediately before the dividend is paid;
- (b) Is a private corporation or subject corporation; and
- (c) Has a balance-due day for the taxation year in which it received the dividend in a taxation year that ends after the balance-due day the taxation year of the payer corporation for the taxation year in which it paid the dividend. (The balance-due day is when a corporation must pay its final estimated tax liability for the year.)

There are two general exemptions from the suspended dividend rule that are discussed below. But otherwise, the dividend refund will not occur and the dividend is suspended until it is subsequently released, which is also discussed below.

Exclusions

There are two exclusions from the suspended dividend rule. First, very generally, dividends paid are exempt where no deferral occurs within an affiliated group because the dividend received is ef-

fectively paid out of the group as a taxable dividend before the payer's balance-due day—though there are complex conditions. Briefly, before the payer's balance-due day, the payee must pay a dividend equal to or greater than the suspended dividend amount. Any "grandparent corporations" (i.e., corporations affiliated with the payer) must also pay a proportionate dividend. The dividends paid by the payee and grandparents (if applicable) must have the same character as the suspended dividend (i.e., eligible or non-eligible).

There is also an exclusion for any dividends paid in the 12-month period preceding an acquisition of control of the payer corporation.

Release of Suspended Dividend

A suspended dividend can eventually be released, which means a taxable dividend is deemed to be paid and the dividend refund can occur if there is a sufficient RDTOH balance. Very complex conditions must be met for a release to occur. Sparing the convoluted details, the amount of the suspended dividend must be distributed to a taxpayer that is neither an affiliated nor connected corporation. This may require tracking the portion(s) of the suspended dividend as it is distributed (possibly in separate parts) from

the payee to any affiliated grandparent corporations or any connected parent or grandparent corporations who also distribute their portion as a dividend. These dividends must have the same character as the suspended dividend (i.e., eligible or non-eligible). The suspended dividend can be released once the whole amount has been paid as a dividend outside of the affiliated/connected corporate structure.

Takeaways

Though at the time of writing the legislation was not enacted, it is expected to become law soon. The changes would apply to dividends paid in taxation years beginning on or after November 4, 2025 (the day of the 2025 federal budget). If you have a corporate structure with the same year-end for each corporation, these new rules do not apply. If you do have mismatched year-ends, this will likely mean additional complexity and compliance affecting your corporate tax plans and considerations surrounding dividend payments, though the implications will vary based on each unique situation. If you are concerned about the impact of these changes on your business, please don't hesitate to reach out for expert tax advice.