

Corporate Distributions: Income or Capital?

by Jordan M. Atin, Associate Counsel

Are distributions from estate owned corporations income or capital? Several principles assist in the determination.

A. *Testator's Intention*

Chief among the principles is the testator's intention as expressed in the Will. Thus, the testator is permitted to provide guidance on whether distributions from the estate is characterised as income or capital. In some cases, the testator provides the executor with absolute discretion in determining whether payments are to be considered capital or income.

In *Re Welsh*¹, the Judge found that the testator's intention in allocating capital and income was that any increase in value of the shares from the date of death was to be capital. His Honour found, therefore, that a special dividend distributing surplus tax-free capital was a distribution of capital.

B. *The "Form Rules"*

In the absence of sufficient evidence of the intention of the testator, certain rules generally govern the characterization of distributions. These rules are referred to as "form rules". Under these rules of construction, the form of the receipt by the shareholder determines its allocation. Thus, the corporate action of distributing assets determines its allocation as income (for example, by way of dividend) or capital (by way of redemption of shares or issuance of new shares).

However, a fundamental rule of company law is that unless the corporation is in liquidation or engaged in an

authorized reduction of capital, it cannot return capital to its shareholders.² Thus, the general rule is that a cash dividend is income. It does not matter whether the payment is regular dividend payment or an extraordinary one. Similarly it does not generally matter that the payment is undistributed earnings, capital surplus, capital dividends or after tax capital gains.

The form rules have been generally applied by Courts in Canada³. In *Re Zacks*⁴, the fact that a distribution was made in the form of a dividend was conclusive of its allocation as "income". The fact that it was a "capital dividend" and the proceeds which constituted the funds available for the dividend were from the sale of assets owned by the corporation did not alter its characterization.

However, director's decisions will be scrutinized where conflicts of interest exist, such as where one person is the sole director, sole executor and sole life tenant of the estate. In *Re Fleming*⁵, the executor/director was confronted with the option of applying a distribution by declaring a dividend (which would be income) or redeeming preference shares. The executors applied to the court for advice and direction. The court found that the executor had a duty to maintain an even hand between the income and capital beneficiaries. Ultimately, it found that the redemption option best discharged the executors' duty in this regard. This case serves to reinforce how difficult it is to determine whether corporate distributions are income or capital.

1 (1980), 6 E.T.R. 257 (Ont. H.C.) 2 "The Law of Trusts in Canada", D. Waters 3 *Re Waters*, [1956] C.T.C. 217, [1956] S.C.R. 889, 56 D.T.C. 1113, 4 D.L.R. (2d) 673; *Re Hardy*, [1956] S.C.R. 906 4 (1984), 17 E.T.R. 206 (Ont. H.C.J.) 5 [1973] 3 O.R. 588 (H.C.)



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