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## THE CAPITAL PROPERTY DIVIDEND STOP-LOSS RULES

*Steve Suarez\*\*\*\**

This article discusses the stop-loss rules pertaining to dividends received on shares held as capital property. These rules deny losses realized on the disposition of a share to the extent of certain capital dividends and/or taxable dividends received on the share. The application of these rules depends on whether the holder of the share is a natural person, a corporation, a partnership, or a trust. This article summarizes the policy behind these rules, discusses their application in various circumstances, and notes differences in their application depending on whether shares are held directly or through a partnership or trust.

**KEYWORDS:** STOP LOSS RULES ■ DIVIDENDS ■ SHARES ■ CAPITAL LOSSES ■ LOSSES ■ CORPORATE DISTRIBUTIONS

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\* Of Deloitte & Touche LLP, Toronto.

\*\* Of Deloitte & Touche LLP, Vancouver.

\*\*\* Of Fraser Milner Casgrain LLP, Toronto.

\*\*\*\* Of Osler Hoskin & Harcourt LLP, Toronto. The author wishes to acknowledge the helpful comments and suggestions received from various colleagues, but is alone responsible for any errors.

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## INTRODUCTION

This article reviews the rules in section 112 of the Income Tax Act<sup>1</sup> restricting losses realized on shares held as capital property. These “dividend stop-loss rules” are found in subsections 112(3) to (3.32) of the Act. In very general terms, the effect of the dividend stop-loss rules is to reduce a loss realized on a disposition of shares by the amount of dividends that have been received free of tax on those shares. The intent in policy terms is to deny a loss to the extent that the shareholder has effectively recovered the cost of the shares in the form of tax-free receipts from the corporation. In this sense, the dividend stop-loss rules can be thought of as anti-avoidance provisions designed to prevent the overstatement of losses.<sup>2</sup>

The dividend stop-loss rules are essentially concerned with two kinds of tax-free dividends:

1. dividends payable by a private corporation that are the subject of an election under subsection 83(2) and are not subject to the anti-avoidance rule in subsection 83(2.1) (“capital dividends”);<sup>3</sup> and

1 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act. Certain relatively unusual aspects of the dividend stop-loss rules are not discussed in this article:

- subsection 112(3.3) deals with a share acquired by a trust because of a deemed disposition and reacquisition of the share under the 21-year rule in subsection 104(4);
- some shares held (or deemed to be held) on April 26, 1995 are grandfathered from the application of the existing rules, which otherwise apply to dispositions of shares occurring after that date; and
- “life insurance capital dividends” (defined in subsection 248(1) with reference to subsection 83(2.1), which formerly dealt with life insurance capital dividends) are a form of dividend that was repealed in 1985 but must still be accounted for in the dividend stop-loss rules.

Capital gains dividends (as defined in subsection 131(1)) and dividends subject to tax under former part VII of the Income Tax Act (RSC 1952, c. 148) are generally excluded from these rules: see paragraph 112(6)(a). Shares that are “mark-to-market property” of a “financial institution” (as those terms are defined in subsection 142.2(1) and subsection 112(6)) are the subject of separate rules in subsections 112(5) to (5.6). Shares held as inventory are dealt with in subsections 112(4) to (4.22).

- 2 It is interesting to note in passing that by reducing the taxpayer’s “loss,” the dividend stop-loss rules affect the computation of the taxpayer’s income, notwithstanding the location of these provisions in division C, “Computation of Taxable Income.”
- 3 Strictly speaking, a dividend that is the subject of a subsection 83(2) election is not a “capital dividend” to the extent that it exceeds the payer’s capital dividend account. However, the entire

2. taxable dividends received by a corporation and deductible in computing the corporation's taxable income under subsection 112(1) or (2)<sup>4</sup> ("deductible taxable dividends").<sup>5</sup>

Since dividends paid to partnerships and (to a lesser extent) trusts can retain their character as such when flowed through to members of the partnership or beneficiaries of the trust, special rules are necessary that effectively look through the partnership or trust to the ultimate recipient. No loss reduction occurs in respect of a particular dividend on shares that have been held for the 365-day period immediately prior to the disposition if at the time the dividend was received the shareholder (together with non-arm's-length persons) held no more than 5 percent of any class of the payer's shares.

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amount of such a dividend is treated as a capital dividend for purposes of the dividend stop-loss rules since the entire dividend is received tax-free by the shareholder, subject to the potential for deemed separate dividends if an election under subsection 184(3) is made in respect of the excess portion.

- 4 Or deductible in computing the taxable income earned in Canada of a non-resident corporation under subsection 115(1) or the taxable income of a life insurer under subsection 138(6).
- 5 It should be noted that dividends received on a share that is later exchanged for another share under section 51, 85.1, 86, or 87 may be attributed to the new share to the extent provided in subsection 112(7), discussed in further detail below.