The Capital Dividend Account

The Capital Dividend Account (CDA) mechanism is an extremely important tax planning tool for private corporations and their Canadian shareholders. A fundamental principle of the Canadian income tax system is "integration." With integration, the taxes paid by a person should be the same whether income is earned by him or her personally, or is earned by a corporation and then distributed to him or her. There are instances where income received personally is either tax-exempt or tax-preferred. The CDA allows similar income earned by a corporation to be distributed to the shareholder tax-free to achieve integration.

I. General Discussion

The CDA is defined in subsection 89(1) of the Income Tax Act (ITA). It is a notional tax account that tracks various tax-free amounts accumulated by a private corporation. Such accumulated amounts may be distributed to a corporation's Canadian-resident shareholders on a tax-free basis.

For example, if an individual were to realize a $1,000 capital gain, only 50% of the amount would be taxable to the individual. Similarly, if a corporation were to realize a $1,000 capital gain, it would also only include 50% of the gain in its income. However, 50% of the capital gain would not be taxable to the corporation. With the CDA mechanism, this non-taxable portion is added to the CDA and is available for distribution to the shareholder in the form of a tax-free capital dividend. Without the CDA mechanism, the non-taxable portion would in all likelihood be distributed as a taxable dividend. (Of course, whenever we are referring to taxable dividends paid after 2005 by corporations resident in Canada, there will have to be a determination of the portion that is an "eligible dividend", and that which is not.[1])

The CDA is comprised of the following components, as set out in the definition of the CDA in subsection 89(1) of the ITA:

The sum of:

- The cumulative excess of the non-taxable portion of capital gains over the non-deductible portion of capital losses incurred by the corporation since 1971 (or since it last became a private corporation);
- Capital dividends received from other corporations;
- The non-taxable portion of gains from the disposition of eligible capital property such as goodwill or customer lists;
- Life insurance death proceeds received by the corporation less the adjusted cost basis (ACB) of the policy to the corporation; and
- Certain distributions made by a trust and received by the corporation in respect of non-taxable capital gains realized by the trust and capital dividends received by the trust

Less

- The total of all capital dividends previously paid by the corporation to its shareholders.

Although the components appear relatively straight forward, care should be taken when calculating the balance in the CDA. Capital gains inclusion rates have changed over time. Also, there have been recent changes in timing issues relating to the inclusion of gains from the disposition of eligible capital property.[2] Professional

[1] See definition of "eligible dividend" contained in subsection 89(1) of the Income Tax Act (Canada) (ITA).

[2] The government tabled the *Income Tax Amendments Act, 2006* (Bill C-33) on November 22, 2006. Clause 53 of the *Income Tax Amendments Act, 2006* proposes changes to subsection 14(1.01) of the ITA, whereby a taxpayer will be permitted to simultaneously elect to report a capital gain on the disposition of eligible capital and to add an amount to the CDA. This pending amendment will apply to dispositions of certain eligible capital property that occur on or after December 20, 2002. Also, see CRA document # 2005-0147671I7, dated September 20, 2005.

advice should be sought to ensure accurate calculation of balances. It is also essential that the appropriate elections be filed in a timely manner. (See below discussion on "Electing to Pay a Capital Dividend".)

When calculating the CDA balance, it is important to realize that it is not appropriate to calculate the amount on a "carry-forward basis" (i.e., by simply taking the balance as the date the last capital dividend was paid and adjusting this balance for subsequent transactions).

Changes in a corporation's status or control (e.g., a private corporation becomes a public corporation because it becomes controlled by the public corporation) may adversely impact the ability to pay Capital Dividends. It is essential that professional advice be obtained in these circumstances.

II. Capital Dividend Account Trap

As is outlined above, the CDA is made up of several components. In calculating the balance of the CDA when the payment of a dividend is contemplated, it is essential to calculate the account balance for the "period." Each component is in fact computed on a cumulative basis for the "period."(The "period" starts on the first taxation year ending after 1971 and after the corporation last became a private corporation and ends immediately before the CDA balance is to be determined.)

Let's look at an example. Assume that a private corporation was incorporated on June 1, 2002. In its first taxation year ending May 31, 2003, it realized a $180,000 capital gain. (The corporation did not choose to pay a capital dividend at that time.) On February 1, 2004, life insurance death proceeds of $500,000 were received, with $450,000 of this amount being credited to the CDA account. Thus, on April 1, 2004 the corporation elected to pay a capital dividend of $540,000 (being for the $90,000 non-taxable portion of the capital gain plus the $450,000 of life insurance death proceeds credited to the CDA account). Thus, following the payment of the capital dividend, the CDA balance was nil.

Let's assume that in the following taxation year, the corporation realized a capital loss of $150,000. Shortly following this, additional life insurance death proceeds were received, of which $250,000 could be credited to the CDA. The corporation is interested in immediately paying out the maximum capital dividend.

If we erroneously assume that the CDA balance at the start of the year is nil, the corporation would pay a capital dividend of $250,000. However, the maximum capital dividend it could pay is in fact calculated as follows:

- The cumulative excess of the non-taxable portion of capital gains over the non-deductible portion of capital losses incurred by the corporation since 1971 (or since it last became a private corporation);

50% of capital gain of $180,000 realized in 2003, less 50% of capital loss of $150,000 realized in 2005	
	$15,000
• Life insurance death proceeds (net of ACB) previously received ($450,000), plus amount just received ($250,000)	$700,000
	$715,000
Less: Capital dividend previously paid	(540,0000)
	$175,000

The corporation believed it could pay a capital dividend of $250,000, or $75,000 too much. What happened here was that the corporation's accountants assumed that since the maximum dividend had been previously paid, they had a carry-forward balance of nil. They did not look closely at the legislation and see that the non-deductible portion of the capital losses must first be used to offset the taxable portion of the capital gains.

In order to avoid the risk of having capital losses grind down the amount that could be lowed out as a tax-free dividend, consideration could be given to establishing a single-purpose corporation. The corporation's only role would be to own the life insurance. Having a single-purpose corporation could also provide other benefits (creditor proofing, etc.).

III. Life Insurance Proceeds and the Impact on the CDA

(i) Amount of Credit to CDA Account

The fact that all or part of life insurance proceeds (depending upon the adjusted cost basis (ACB) of the insurance contract at the time of death) paid to a private corporation upon the death of a person is added to the CDA is a significant tax advantage that life insurance products enjoy. The Canada Revenue Agency (CRA) has stated:

> "The capital dividend account is part of the system for integrating the corporate and shareholder income tax of private corporations and is intended to preserve the character of non-taxable receipts (such as the proceeds of certain life insurance policies) of a corporation in the hands of its shareholders."[3]

Where the ACB of the contract is nil, 100% of the life insurance proceeds would be credited to the CDA. In this case, the individual shareholder will be in the same situation as he or she would have been had they received the death benefit directly.[4] However, where the ACB is greater than zero, only the portion of the life insurance proceeds in excess of the ACB may flow via the CDA account. Since the amount equal to the ACB will generally be paid out as a taxable dividend, the shareholder will retain less of the death benefit than he or she would have had the life insurance proceeds been received directly. From a practical perspective, if the insured lives to normal life expectancy the ACB is often minimal, or even nil. Hence, the shareholder may indeed be able to receive the entire life insurance proceeds tax-free.

(ii) ACB Considerations

The ACB of a life insurance contract is defined and calculated in subsection 148(9) of the ITA. Generally, the ACB of a policy is equal to the total deposits made into the policy less the sum of the net cost of pure insurance (NCPI) (the NCPI is only deducted for policies last acquired after December 1, 1982). NCPI is essentially the pure mortality costs under the contract each year. The Canadian Institute of Actuaries calculated the NCPI rates in 1982 at the request of the Department of Finance. While all insurers use these same NCPI rates, there may in some instances be differences in interpretation and application of these rates. For example, insurers may differ as to whether "ultimate" or "select" rates are used once the life insured attains age 71. There may also be differences in how substandard risks are treated and in the determination of the equivalent single life age with joint (first or last-to-die) policies

There are other factors that decrease and increase the ACB. For example, partial dispositions, taking a policy loan and the payment of dividends under a participating contract will decrease the ACB; whereas, the repayment of a policy loan, previously taxed gains, the purchase of paid-up insurance, and the purchase of term insurance riders, attached to the underlying contract, will increase the ACB.

(iii) Policies Issued by Non-Resident Insurers

There may be situations where a corporation is the beneficiary under a policy issued by a non-resident insurer that does not operate an insurance business in Canada. This situation could arise where a private corporation that is resident in Canada has a non-resident shareholder. CRA is of the view that where the policy is a "life

[3] See Summary section of *Interpretation Bulletin IT-430R3 – Life Insurance Proceeds Received by a Private Corporation or a Partnership as a Consequence of Death [Consolidated]*, issued December 2, 2002.
[4] For death benefits received before May 23, 1985, the rules relating to the "corporation's life insurance capital dividend account" contained in part (e) of the definition of the "Capital Dividend Account" contained in subsection 89(1) of the ITA should be referred to.

insurance policy" within the meaning of the ITA, the CDA may be credited with the excess of the life insurance death proceeds over the ACB of the policy. The private corporation is itself responsible for calculating the ACB.[5]

(iv) Collateralized Policies

Care should be taken where a contract is used as security for a loan. Issues that should be considered here include: (a) whether or not there has been a "disposition" for tax purposes, and (b) the impact on the CDA. (A discussion of whether or not any portion of the life insurance premiums is deductible in such situations is beyond the scope of this document, but clearly warrants consideration.) On the "disposition" issue, the taxpayer would want to be certain that the assignment is not considered to be a disposition of the insurance contract within the meaning of the ITA, as income taxes could well arise on such a disposition.[6] Generally, a collateral assignment, as opposed to an absolute assignment, is not considered a disposition. (In the province of Quebec, where the policy is the subject of a hypothecary claim by a creditor, a disposition is not considered to have occurred.)

CRA's position on collateralization and how this impacts amounts that may be credited to the CDA has changed over time. The most recent significant modification to its position occurred on February 10, 1997. As is provided for in the Interpretation Bulletin IT-430R3, if an insurance contract, where a private corporation is the named beneficiary, has been assigned to a lending institution as collateral for a bank loan and a death occurs, the full amount of the insurance proceeds (net of ACB) should be credited to the named corporation's CDA, provided the corporation remained the beneficiary under the contract. The corporation is considered to have constructively received the life insurance proceeds even though such proceeds are actually paid directly to the lending institution to settle the loan.[7] On December 2, 2002, CRA clarified its position on hypothecary claims in Quebec. It confirmed that with such hypothecary claims the corporate debtor would be entitled to the credit to the CDA account.[8]

(v) Policy Loans

Where there is a policy loan, the life insurance death proceeds payable by the insurer are reduced by the amount of the policy loan, plus any accrued interest. At the same time, the ACB of the policy will also have been reduced by the amount of the policy loans. CRA has confirmed that it is the net of these two amounts that is added to the CDA.[9]

For more information on policy loans, please refer to *Policy Loans* [PC 6140].

(vi) Different Corporations as Owner and Beneficiary

Another situation that warrants review is where one corporation (say Parentco) is the beneficiary of a life insurance contract on the life of the controlling shareholder, and another corporation (say Subco), a wholly owned subsidiary is the owner of the contract and pays the premiums. At issue is whether on the death of the controlling shareholder Parentco could add the full amount of the insurance proceeds to its CDA, without taking into account the ACB of the contract to Subco. CRA has issued a number of technical interpretations in this area. In the most recent technical interpretation of which we are aware, CRA has confirmed a number of key points.[10]

The first item it deals with is whether there has been a shareholder appropriation by Parentco pursuant to subsection 15(1) of the ITA. CRA makes the comment that "generally subsection 15(1) of the Act would not

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[5] See CRA document # 2005-0132331C6, dated October 7, 2005.
[6] See part (f) of the definition of "disposition" contained in subsection 148(9) of the ITA.
[7] See paragraph 6 of *Interpretation Bulletin IT-430R3 – Life Insurance Proceeds Received by a Private Corporation or a Partnership as a Consequence of Death [Consolidated].* For more information on this change, refer to CRA document # 9707185, dated April 8, 1997.
[8] See "Bulletin Revisions" section at end of *Interpretation Bulletin IT-430R3 – Life Insurance Proceeds Received by a Private Corporation or a Partnership as a Consequence of Death [Consolidated].*
[9] See CRA document # RCT A-0579, dated December 12, 1984,
[10] See CRA document # 2004-0065461C6, dated May 4, 2004.

apply to include a benefit in a beneficiary's income as a consequence of the policyholder paying the premiums due under the policy or upon receipt by the beneficiary of the proceeds of the life insurance policy as a consequence of the death of the insured."

The second item it deals with is with the General Anti-Avoidance Rule (GAAR) would be applied to reduce the amount that Parentco credits to its CDA account by the amount of Subco's ACB. Here CRA has stated that "unless there was a bona fide reason for this structure, other than to obtain a tax benefit, the GAAR could be applied to reduce the amount of the life insurance proceeds to be included in the capital dividend account of Parentco by the adjusted cost basis of the policy to Subco." It is clear that it will be incumbent upon the taxpayer to prove that the structuring the insurance in this way was not an "avoidance transaction." That is, the taxpayer will have to be able to establish that "… the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit."[11]

For more information, CRA's Interpretation Bulletins *IT-66R6 - Capital Dividends* and *IT-430R3- Life Insurance Proceeds Received by a Private Corporation or a Partnership as a Consequence of Death [Consolidated]* should be referred to.

IV. Electing to Pay a Capital Dividend

A corporation may consider paying a tax-free capital dividend where its CDA has a positive balance. Corporations electing to pay capital dividends should file *Form T2054 – Election for a Capital Dividend Under Subsection 83(2)* with the CRA on or before the earlier of the day the dividend becomes payable or was paid. The corporation will also have to submit additional information with the election, including:

a) A certified directors' resolution authorizing the election (or where the directors are not legally entitled to administer the affairs of the corporation, a certified copy of the authorization of the making of the election by person(s) legally entitled to administer the affairs of the corporation), and
b) A schedule showing the calculation of the CDA immediately before the election.[12]

The taxpayer should retain the detailed supporting schedules for the CDA calculation, should CRA want to review these at a later time. Also, evidence that the election was filed on a timely basis should be retained.

Where a capital dividend is to be paid, the corporation must elect "in respect of the full amount of the dividend."[13] A dividend cannot be declared where a portion of the dividend is a capital dividend and a portion is a taxable dividend. Where a corporation believes that it may not be able to sustain the position that the full amount of the capital dividend elected upon is truly a capital dividend that will withstand scrutiny by CRA, it might consider filing two elections. One for the amount of the CDA that is not in doubt, and a second election for what may be contentious. (An example of this might include a situation where a taxpayer has included the non-taxable portion of a capital gain that CRA might contend is not "on account of capital" but is "on account of income".)

If the election is late-filed, CRA will generally accept a late-filed election, provided the appropriate interest and penalties are paid. The penalty is calculated as $1/12^{th}$ of 1% of the amount of the capital dividend for each month (or part month) that the election is late, to a maximum of $41.67 per month, or $500 per annum. If, however, CRA has made a written request for a late-filed election, and the election is not filed within 90 days, the election may no longer be made.[14]

[11] See section 245 of the ITA and *Information Circular 88-2 and Supplement: General Anti-Avoidance rule.*
[12] Regulation 2101 of the ITA should be referred to for requirements relating to the filing of the election to pay a Capital Dividend.
[13] See subsection 83(2) of the Income Tax Act (Canada).
[14] See paragraph 5 of *Interpretation Bulletin IT-66R6 – Capital Dividends*, dated May 31, 1991.

If a corporation has a permanent establishment (PE) in Quebec, it will also have to file the appropriate election.[15] We understand that the Quebec taxation authorities also take the position that where a corporation does not have a PE in Quebec, yet has Quebec resident shareholders, the CDA election will still be required.[16]

V. Capital Dividends in Excess of the CDA Balance

It is essential that the amount per the dividend election not exceed the balance of the CDA at the time that the election is made. Should there be an excess, a penalty tax (referred to as Part III Tax) may be payable.[17] The Part III Tax is extremely punitive and under current legislation is calculated as 75% of the excess dividend and is payable at the time of the election. Fortunately, the "excess" on which the corporation has paid the 75% Part III Tax is not included in the taxable income of the recipient.[18] Technical amendments that were first introduced in 2004 propose that this tax be reduced to 60%, effective for dividends paid after the 1999 taxation year of the corporation.[19]

By way of example, let's assume that a taxpayer believed that the balance of the CDA was $1,000,000 and declared a capital dividend equal to this amount. It later became evident that the true balance of the CDA was $800,000. Here, the taxpayer would be subject to the Part III Tax on $200,000. Thus, $120,000 would be payable (assuming the reduced rate of 60% is legislated). Interest and penalties would be added to this amount.

Where CRA mails out the Notice of Assessment for the Part III Tax, the corporation has a 90-day period in which to make a further election.[20] Regulations specify the manner in which this second election must be made.[21] As provided for by the proposed technical amendments (again, effective for dividends paid after the 1999 taxation year of the corporation), the election allows the dividend first elected upon (that is, on Form T2054 originally filed) to be divided into three parts: a tax-free capital dividend, a taxable dividend and the "excess" dividend that will be subject to the Part III Tax. Every effort should be made to make the election to avoid the Part III Tax. It is much preferred to have the shareholder treat the excess dividend as a taxable dividend and pay the appropriate taxes thereon (approximately 30% for an individual shareholder), rather than have the corporation pay the 75% (or 60%, assuming the reduced rate is legislated) Part III Tax thereon. Where Part III Tax cannot be avoided, a second Form T2054 would be submitted, with the "excess amount" (i.e., amount subject to Part III Tax) duly entered into the appropriate areas of the form.

However, this second election may only be made if certain requirements are met. First, this second election must be made with the concurrence of all the shareholders who were entitled to receive a portion of the capital dividend and whose addresses are known to the corporation. Second, the election must be made either: (a) on or before the date that is 30 months after the date on which the original dividend became payable, or (b) each shareholder who was entitled to receive a portion of the capital dividend concurred with the election and paid the appropriate personal tax, interest and penalties on the amount (including for otherwise statute-barred years). (Special rules apply for shareholders who are exempt from Part I tax.[22]).

Under the recently enacted legislation for "eligible dividends", a corporation must designate an eligible dividend as such at the time that it is paid.[23]

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[15] Form CO-502 is required under section 502 of the *Taxation Act (R.S.Q., c. I-3)* by private corporations declaring capital dividends in Quebec.
[16] See N 87-06 – Ernst & Young Commentary, September 6, 2006.
[17] See subsection 184(2) of the ITA.
[18] See paragraph 17 of *Interpretation Bulletin IT-66R6 – Capital Dividends*, dated May 31, 1991.
[19] See Clause 165 of the *Income Tax Amendments Act, 2006* (Bill C-33) tabled by the government on November 22, 2006, which amends subsections 184(2) to (5) of the ITA.
[20] See subparagraph 184(3) of the ITA.
[21] Regulation 2106 should be referred to here.
[22] See section 103 of the *Draft Technical Amendments and Explanatory Notes to Amend the Income Tax Act*, dated February 27, 2004, for changes to subsection 184(5) of the ITA.
[23] See subsection 89(14) of the ITA.

VI. CDA Elections for Statute-Barred Years and Impact on Dividend Refund

While in certain circumstances late-filed elections can be made to convert excess dividends into taxable dividends, getting into these situations is best avoided. In addition to the tax consequences outlined above, the possible adverse impact on the dividend refund needs to also be understood.

As outlined above, a subsection 184(3) election in respect of an excess Capital Dividend allows the excess dividend to be deemed to be a taxable dividend. As confirmed by CRA in a recent technical interpretation, in such a situation, the recipient (individual or corporation) will be liable for the appropriate taxes (i.e., personal taxes or Part IV taxes), even if the year for which the dividend is received is statute-barred. However, the payor corporation cannot receive the dividend refund to which it would otherwise have been entitled, if the taxation year of the payor corporation is statute-barred.[24]

In their recent joint submission, the Canadian Bar Association (CBA) and the Canadian Institute of Chartered Accountants (CICA) requested that the Department of Finance consider amending subsection 184(4) of the ITA. The submission highlighted the concern that a corporation may not necessarily have funds to pay an additional dividend in the situation described above, hence the refundable dividend tax on hand (RDTOH) becomes “trapped.” Here, the reality would be that the RDTOH becomes a permanent tax. The CBA and CICA urged the government to amend the legislation to permit a reassessment of the payor corporation when the taxation year of the payor corporation is otherwise statute-barred, so that a dividend refund could in fact be obtained.[25]

It is clear that the need to take care in quantifying the amount of the CDA cannot be over-emphasized. Imagine if in the situation described above the requirements for converting the excess to a taxable dividend were not met. The cost of declaring an excess capital dividend is truly exorbitant!

VII. Capital Dividends Paid to Non-Residents of Canada

The provisions of the ITA that deal with non-resident withholding taxes applicable to dividends paid to non-residents of Canada specifically provide that capital dividends are subject to a 25% rate of withholding.[26] Income tax treaties that Canada has entered into with various foreign jurisdictions should be referred to for a possible reduction of this 25% rate. For example, the Canada-US Tax Convention reduces the rate to 15%, with a further reduction to 5% where the shareholder is a corporation holding at least 10% of the shares of the company paying the dividend.[27]

A private corporation should investigate “streaming” distributions from the CDA in order to maximize the tax position of the various shareholders. Of course, this will have to be done in a manner that does not provoke CRA. Additionally, the anti-avoidance legislation dealing with capital dividends will have to be taken into consideration.[28]

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[24] See Technical Interpretation # 2003-0051211I7, dated January 30, 2004.
[25] See submission of July 29, 2005 to the Department of Finance by The Joint Committee on Taxation of The Canadian Bar Association and The Canadian Institute of Chartered Accountants to the Department of Finance.
[26] See paragraph 212(2)(b) of the ITA.
[27] See Article X(2) of the Canada-US Tax Convention.
[28] See subsection 83(2.1) of the ITA.

VIII. Summary

Private corporations have a significant tax tool—the CDA—at their disposal. Life insurance is acquired in a myriad of circumstances: estate and succession planning, creditor protection, key man protection, etc. Taxpayers and their advisors are urged to explore how the use of the CDA mechanism can be used to their best advantage.

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