The Capital Dividend Account
Jean Turcotte, Director, ITS Group
June 21, 2021

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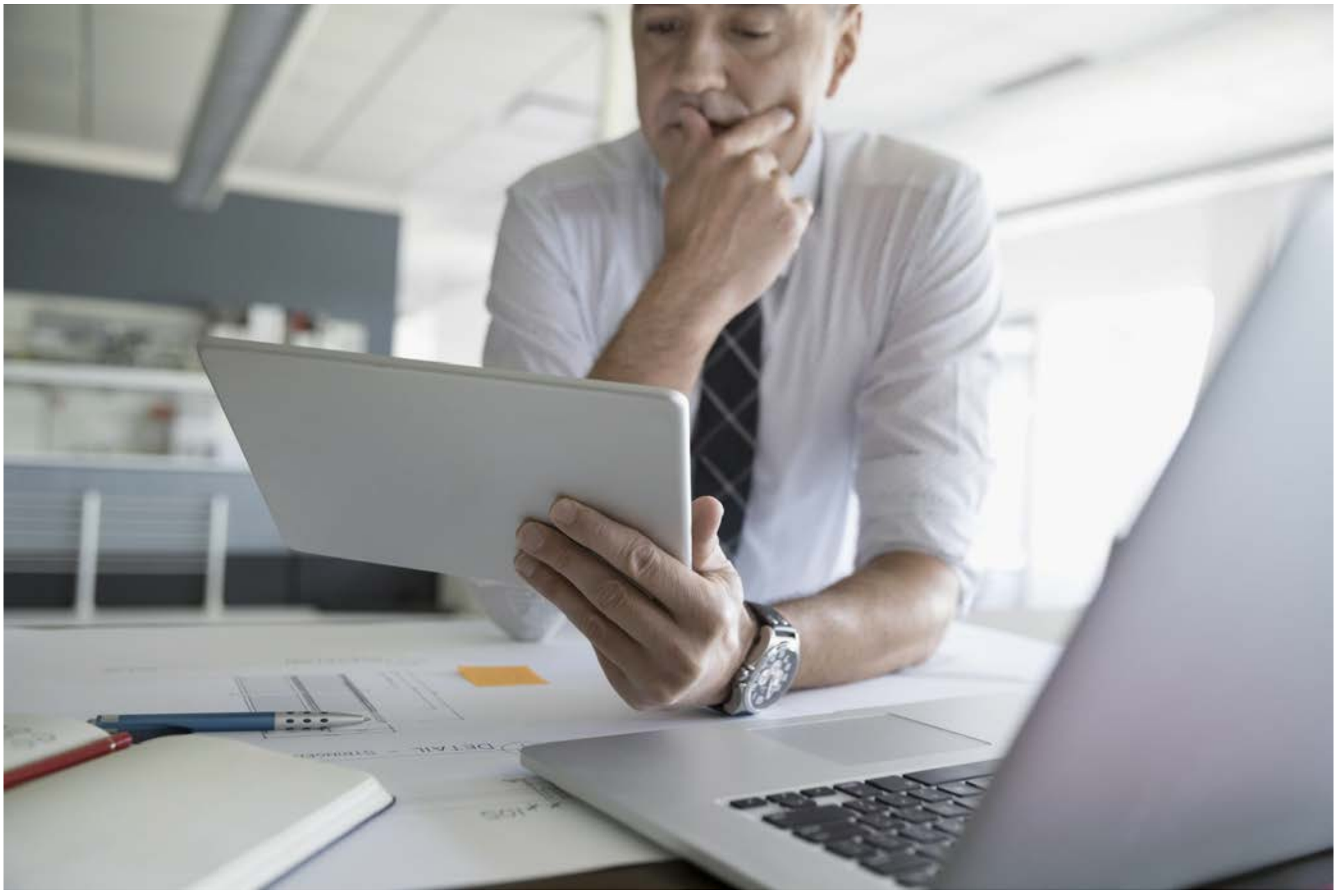

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Why the Capital Dividend Account exists

The Capital Dividend Account (CDA) is part of the system of integration in the *Income Tax Act* (ITA).[1] The ITA, through mechanisms such as the dividend tax credit and the CDA, attempts to ensure to the extent possible that income is subject to the same total tax burden regardless of whether it is earned directly by an individual or through a corporation and then distributed to an individual. The system, however, is far from perfect.

The CDA is an example of an ITA provision designed to provide integration. It is intended to allow tax-free amounts received by a private corporation to be distributed tax-free to shareholders of the corporation.

How it works

CONDITIONS FOR PAYMENT OF A CAPITAL DIVIDEND

In order for a capital dividend to be paid by a private corporation to its shareholders, an election must be made under the ITA.

[1] Subsection 89(1) of the Income Tax Act (ITA) defines various types of property and distributions including the contents of the Capital Dividend Account. In Quebec, paragraph *b* of section 570 of the Taxation Act (TA) refers to the ITA. CRA Interpretation Bulletin IT-66R6 reviews the inclusions in the CDA and the CDA mechanism.

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Certain tax-free amounts, when received by a corporation, are added to its CDA. A CDA is not a bank account. It won't be reflected in the balance sheet of the company, although it may be included in a footnote to the financial statements. It is, in essence, a notional account that is only relevant for tax purposes. Shareholders can receive the balance in this account on a tax-free basis if the corporation files an election with the Canada Revenue Agency (CRA).

The CDA is a cumulative calculation that is carried forward from year to year and is relevant at a particular time (e.g., when a dividend is paid on which a capital dividend election may be made). It is important to note there is no tracking of the actual tax-free cash received by a corporation. The cash used to pay the tax-free dividend can come from any source.

What is included in the CDA?

Qualifying corporation

Only dividends paid by private corporations qualify for the CDA election. Where a private corporation is taken public, the balance in the CDA will not be extinguished. However, while a corporation remains public, it will not be entitled to elect capital dividend treatment of dividends it declares and pays. Generally, where corporations having capital dividend accounts are merged, their combined CDA belongs to the new corporation.

A number of conditions must be met in order for a dividend to be considered a capital dividend pursuant to subsection 83(2) ITA. First, the corporation must be a private corporation. According to subsection 89(1) ITA, a "private corporation" is defined as a corporation that is resident in Canada and is not a public corporation or a corporation controlled by one or more public corporations. Non-resident shareholders are subject to Part XIII 25% withholding tax on dividends they receive from a corporation's CDA; therefore, capital dividends are not tax effective to non- residents.

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Qualifying dividends

Subsection 83(2) ITA states that a capital dividend is a dividend that becomes payable at any particular time after 1971 by a private corporation to shareholders of any class of shares of its capital stock where the corporation has made an election in respect of the full amount of the dividend.

The ITA does not specifically define the word "dividend" in the subsection 248(1). The definition given only states that the term "dividend" includes stock dividends. Because there is no specific meaning given to the word "dividend" in the ITA, it must be given its generally accepted meaning. The election mentioned in subsection 83(2) ITA can be made in respect of cash dividends, dividends in kind or stock dividends. According to the CRA:

> "(….) any distribution by a corporation of its income or capital gains made pro rata among its shareholders may properly be described as a dividend unless the corporation can show that it is another type of payment. The fact that a distribution of this kind may not be called a dividend does not affect the nature of the distribution."[2].

Calculation of the Capital Dividend Account

Additions to and subtractions from the CDA are only applicable for a certain period. This period starts on the first day of the first corporate taxation year ending after April 1, 1971 (and at which time the corporation was private) and ends immediately before the balance in the CDA is to be determined.

[2] CRA Interpretation Bulletin IT-67R3, January 1, 1995 (archived).

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The CDA for a given period consists of the aggregate of[3]:

- the excess of the non-taxable portion of capital gains over the non-allowable portion of capital losses (including business investment losses) incurred by the corporation;
- the aggregate of capital dividends received by the corporation;
- the non-taxable portion of gains resulting from the disposition, in the period, of eligible capital property of each business of the corporation;
- the net proceeds of a life insurance policy received by the corporation as a beneficiary under the policy, less the adjusted cost basis (ACB) of that policy. For deaths on or after March 22, 2016 the credit to the CDA will be reduced by the ACB of the policy regardless of who owns the policy.

less:

- the aggregate of all capital dividends that became payable by the corporation in the period.

[3] Income Tax Folio S3-F2-C1, Capital Dividends, July 15, 2019.

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Determining the balance in the Capital Dividend Account

More specifically, the definition of "capital dividend account" in subsection 89(1) ITA sets out the components that make up the CDA, as follows:

Paragraph (a)	Non-taxable portions of capital gains realized by the corporation during the calculation period, less the non-deductible portions of capital losses incurred during the period.
Paragraph (b)	Capital dividends received by the corporation.
Paragraphs (c), (c.1) and (c.2)	Non-taxable portions of gains resulting from the disposition of eligible capital property.
Paragraphs (d) and (e)	Life insurance policy proceeds received as a consequence of the death of a shareholder, less the adjusted cost basis (ACB) of the policy or policies.
Paragraph (f)	Non-taxable portions of **net** capital gains distributed to the corporation by a trust of which it is a beneficiary.
Paragraph (g)	Capital dividends distributed to the corporation by a trust of which it is a beneficiary.

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The balance in the CDA will itself be always positive or nil. For the purposes of Quebec's tax legislation, the CDA is calculated in accordance with federal tax legislation[4].

Procedure for declaring a capital dividend

First, a capital dividend is declared by the directors of the corporation and is made payable to the shareholders. A resolution of the directors declaring the dividend is recorded in the minutes of the corporation.

In order to transform an actual or deemed dividend into a capital dividend, it is necessary to file an election in prescribed form with the CRA no later than the earlier of the time the dividend is paid or becomes payable. A validly filed election is made by means of Form T2054[5], "Election for a Capital Dividend Under Subsection 83(2)."

The election must be on the full amount of the dividend. If the total dividend is greater than the amount of the CDA, it is generally necessary to declare two separate dividends, one equal to the amount to be paid as a capital dividend (to the extent of the amount of the available CDA) and the other a taxable dividend in an amount equal to the remainder.

Certain precautions must be taken when a dividend from the CDA is declared. Although the election must be on the full amount of the dividend, it is not necessary that the dividend from the CDA be paid in a lump sum.

[4] Section 570R2 of the Regulation respecting the Taxation Act, CQLR c I-3.

[5] Section 2101 ITR. Form CO-502 in Quebec

Timing is everything

It is the balance in the CDA at a given point in time that dictates how much can be paid out as a tax-free capital dividend. Therefore, it is critically important to be aware of events that can reduce or eliminate the CDA balance or negate the ability to elect a capital dividend. Where either of the following events are expected to occur, it may be prudent for the corporation to consider declaring and paying a capital dividend before the occurrence of that event:

- The sale of a capital asset likely to cause a capital loss. Where the CDA includes the non-taxable portion of previously realized capital gains, it will be reduced by the non-allowable portion of realized capital losses (but only to the extent that the CDA includes the non-taxable portion of previous capital gains). Consider paying and electing a capital dividend before the sale of the asset.
- A private corporation going public. Public corporations are not allowed to pay capital dividends. Consider paying out the balance of the CDA of a private corporation before it goes public.

A late election can also be filed pursuant to subsection 83(3) ITA. It must be approved in a resolution of the directors and is subject to a late filing penalty calculated in the manner set out in subsection 83(4) ITA.

General anti-avoidance provision

The general anti-avoidance rule (the GAAR)[6] may apply where shares are acquired in order

[6] Subsection 245(2) ITA

to enable a shareholder to have access to the CDA of a corporation and to thereby receive a capital dividend in certain circumstances that the CRA considers to be a misuse and abuse of the tax rules.

If the CRA applies the GAAR, the CRA can asses the taxpayer and do one or more of the following:

- disallow the capital dividend election; therefore, the dividend will be taxable;
- deny an increase in the CDA of a recipient corporation;
- allow for the penalty on excess elections to apply to the dividend.

The CRA may also use a specific anti-avoidance rule in ITA subsection 83(2.1) to deny a taxpayer a capital dividend. For example, in *Groupe Honco Inc. v. The Queen*, 2013 FCA 128, the CRA re-characterized capital dividends as taxable dividends by applying subsection 83(2.1). This case is of significant importance since it is the first case where a Court expressed an opinion on this specific anti-avoidance rule in relation to the CDA.

Non-resident shareholder

A capital dividend paid to a non-resident shareholder is subject to a federal withholding tax of 25%[7] (or a lower rate if specified by tax treaty). Therefore, if a private corporation in Canada has both resident and non-resident shareholders, it might be a good idea to create separate share classes so that a capital dividend can be paid to resident shareholders only.

[7] Paragraph 212(2)(b) ITA

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Life insurance and the Capital Dividend Account

Private corporations will often acquire a life insurance policy as a way to ensure funds are available in the event of a shareholder's death. The decision to purchase life insurance may be based on several considerations, one of which is that a policy will provide funding in the event of death for the purpose of proceeding with a buyout or paying off a loan.

Life insurance proceed

As stated in paragraph (d) of the definition of “capital dividend account” in subsection 89(1) ITA, the net proceeds of a life insurance policy will be added to the CDA of a private corporation. The expression “net proceeds” is defined as the amount of the life insurance policy proceeds received as a consequence of the death of the person insured minus the ACB of the policy immediately before the death of the person insured. In a recent document, the CRA stated that each life insurance policy is a contract with terms that can vary, whether or not a payment under a particular life insurance policy would be proceeds of a life insurance policy in consequence of death is a question of fact which can only be determined upon the review of a particular life insurance policy. Accordingly, a review of the facts including the terms and conditions of the life insurance policy would be required to determine the nature of a particular amount received.[8]

[8] 2020 CALU CRA roundtable Question : document 2020-0842141C68

In the same document, the CRA stated that where proceeds of a life insurance policy are received by a corporation as a beneficiary under an exempt life insurance policy in consequence of death of any person, the proceeds would not, be received as the result of a disposition in relation to an interest in a life insurance policy under subsection 148(9) of the Act. Furthermore, pursuant to the definition of CDA in subsection 89(1) of the Act, the amount by which such proceeds exceed the amounts described in subparagraphs (d)(iii) to (d)(vi) of the CDA definition would be included in the corporation's CDA.

In another technical document[9], the CRA stated that upon the death of the life insured with an UL policy, an amount equal to the fund value of the policy is added to the initial face amount. The fund value is the accumulated balance of the investment accounts within the policy at the time of the death of the life insured. The first was the face amount of the policy and the second was the balance in the investment account that had accumulated within the exempt single-life policy up to the time of the death of the life insured. In this fact pattern, the CRA stated that the total of these two amounts would be "proceeds of a life insurance policy" for purposes of subparagraph (d)(ii) of the definition of "capital dividend account" in subsection 89(1) of the Act.

Adjusted cost basis (ACB)

The ACB of a life insurance policy is calculated using a complex formula that takes into account all deposits into, withdrawals or loans from, dividends and the cost of insurance charges of a policy. A simplified definition for the vast majority of policies, assuming no cash withdrawals, cash dividends or loans from the policy, looks something like this:

[9] 2020 CALU CRA roundtable Question : document 2020-0842151C6

Policies issued before December 2, 1982 (G1 type)	Total premiums paid including those for riders and ancillary benefits under the policy without any reduction.
Policies issued after December 1, 1982 but before January 1, 2017 (G2 Type)	Total premiums paid excluding accidental death benefit, disability benefits, sub-standard ratings and other ancillary benefits Less: Net cost of pure insurance

Change to NCPI effective January 1, 2017

As of January 1, 2017, the NCPI is calculated using the Canadian Institute of Actuaries 1986-1992 mortality tables, rather than the 1969-1975 tables. The updated tables reflect the improvement in life expectancy in this country. In addition, the NCPI is now calculated according to a new method and is determined as the difference between the death benefit and an actuarial reserve referred to as the net premium reserve. The combined effect of these measures and the new tables has a substantial impact on the ACB of insurance policies issued after January 1, 2017 ("G3" type policies) and, in turn, on the amount that can be credited to the CDA. This means that the NCPI of policies issued after January 1, 2017 is generally lower, so their ACB will remain positive over a longer period of time. The end result is that the amount that can be credited to the CDA will be lower.

NCPI is calculated based on a prescribed mortality charge applied to the amount at risk (i.e., the total death benefit less the accumulating fund of the policy). It is a separate calculation for tax purposes and need not have any relationship to the actual mortality charges assessed under the policy.

For policies issued after December 1, 1982, the ACB generally increases in the early years when the premium is greater than the NCPI and then is gradually reduced to zero in the later years when the NCPI is greater than the premium being paid, if any.

Example:

A private corporation is the beneficiary of a life insurance policy with a death benefit of $1,000,000.00. The ACB of the policy at the time of the insured shareholder's death is $150,000. The amount that will be credited to the corporation's CDA is $850,000 ($1,000,000 - $150,000). This amount can be paid tax-free to the shareholders of the corporation as a capital dividend. The balance of $150,000 can be paid to the shareholders as a taxable dividend.

Ownership structure for corporate-owned life insurance

Private corporations that acquire a life insurance policy can structure ownership of the policy in various ways. In some cases, one corporation will be the beneficiary of an insurance policy on the life of a shareholder, while another corporation in the group will be the owner of the policy and will pay the premiums.

New tax rules that apply after March 21, 2016

In the past, the use of certain specific structures allowed corporations to receive the full death benefit as a credit to their CDA, without a corresponding reduction for the policy's ACB, but that is no longer the case. As an example, this outcome was often achieved by having a holding company own the policy, but then designating an operating company as the beneficiary. Because the operating company did not own the policy, it could claim the full death benefit as a CDA credit without a reduction for the ACB of the policy.

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The new rules state that the death benefit is now reduced by the ACB for purposes of calculating the CDA credit, regardless of the ownership structure in place. There may be valid business reasons for structuring insurance ownership this way (for example, strengthening creditor protection by having the holding company own the policy and making the death benefit payable to the operating company to meet needs of key employees). No matter which structure is used, however, it can be assumed that the CRA is going to review all situations involving a group of corporations where the life insurance proceeds are credited to the CDA of one corporation.

Adjustments to CDA for policies transferred to a corporation after 1999 and before March 22, 2016

New rules also exist for policies that were transferred from an individual to a corporation after 1999 but before March 22, 2016. There will be no retroactive impact to the tax-free distribution received by the individual from the corporation. However, the CDA credit available to the corporation when the insured person dies will be adjusted where death occurs after March 21, 2016. As a result, the reduction of the CDA credit can take two forms, i.e., a "temporary" reduction and a "permanent" reduction, depending on the situation.

The "temporary" reduction of the CDA credit is equal to the lesser of the consideration given for the transfer and the ACB, minus the net cash surrender value of the policy. In contrast, the "permanent" reduction is equal to the consideration paid for the transfer minus the higher of the policy's net cash surrender value and its ACB.

Let's look at an example:

Mr. X is the owner of a life insurance policy with a death benefit of $500,000, an ACB of $50,000, a cash surrender value of $30,000, and an FMV (as determined by an actuary) of $100,000. On March 1, 2016, Mr. X transferred this policy to XYZ Inc., a corporation of which he is the sole shareholder, for consideration in the amount of $100,000. Mr. X dies at some point in 2020, when the policy's ACB is $0. The CDA credit available to XYZ Inc. will be calculated as follows:

Death benefit: $500,000

Permanent reduction:
$100,000 (consideration paid) – $50,000 (ACB) = $50,000
Temporary reduction:
$50,000 (ACB) – $30,000 (cash surrender value) = $20,000

The net result is that the credit to the CDA would be $430,000.

Life insurance as collateral for a corporate loan

Life insurance may sometimes be assigned to a financial institution as collateral for a loan. In Quebec, this is accomplished by means of a movable hypothec. The transaction is not considered a "disposition" of the policy within the meaning of the ITA. On the death of the insured person (for example, a shareholder or key employee), the insurer will generally pay the death benefit to the lending institution up to the amount of the loan. Any remaining balance is paid to the corporation designated as beneficiary in the policy.

If the beneficiary is a private corporation, the amount of the death benefit will be added to the corporation's CDA pursuant to subsection 89(1) ITA, even though a portion of the insurance proceeds may have been paid by the insurer directly to the lending institution.

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The CRA has confirmed[10] that the death benefit of an insurance contract can be credited to the CDA where a corporation is the owner and beneficiary of the contract and the contract is collaterally assigned. According to the CRA:

> In the definition of CDA, the condition that life insurance proceeds must be received as a consequence of the death of the insured is satisfied when the corporation receives the proceeds as beneficiary of the contract. If the life insurance contract is assigned to a financial institution as collateral for a debt owed by the beneficiary to the institution, the proceeds will be considered to have been implicitly received by the corporation even if they were paid directly to the financial institution.

The CRA specified, however, that the CDA credit would be reduced by the insurance contract's ACB for the debtor corporation that owns the contract.

In situations involving group creditor insurance, the Federal Court of Appeal in *Canada v. Innovative Installation Inc*[111] confirmed that even where a corporation was not the owner or beneficiary of a life insurance policy, it would nonetheless be able to add to its CDA the life insurance benefit received by the lending institution in repayment of the loan. This position was subsequently confirmed by the CRA in a number of technical interpretations[12] with fact situations similar to the *Innovative Installation* case.

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[10] CRA Document No. 2014-0555581E8, "Life insurance proceeds assigned as collateral," June 19, 2015.
[11] Canada v. Innovative Installation Inc., 2010 FCA 285 (CanLII)
[12] CRA Document No. 2011-0401431C6, "ICCA Roundtable Q. 7 CDA and Life Insurance," August 5, 2011 and CRA Document No. 2011-0401991E5, "CDA and Life Insurance Proceeds," August 12, 2011.

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The CRA has confirmed that in the case of group creditor life insurance, there would generally not be a reduction of the CDA for the ACB of the contract. This is because this type of term insurance is a "pure" insurance product that is non- participating, has no cash surrender value, and is intended only to pay the outstanding balance of a loan contracted by the corporation.[13]

Trusts and the Capital Dividend Account

In order to receive a credit to the CDA, a corporation must be the beneficiary of a life insurance policy. This means that the death benefit cannot be paid directly to a trust. The CRA has indicated that amounts received by a trust and paid to a corporation cannot be credited to the CDA, as they do not represent life insurance policy proceeds. Rather, they would be a distribution of property by the trust. The CRA will also deny the notion of implicit use, and life insurance proceeds received by a trust and paid to a corporation named as beneficiary will not be included in the corporation's CDA.[14]

Life insurance received by a partnership

Where a partnership receives life insurance proceeds, subparagraph 53(1)(e)(iii) of the ITA will apply to add an amount to the ACB of the interest of a partnership in respect of the net amount of the life insurance proceeds attributed to a partner. This treatment is confirmed in paragraph 1.65 of CRA Income Tax Folio S3-F2-C1, which makes reference to Interpretation Bulletin IT-430R3 (archived).

[13] CRA Document No. 2012-0447171E5, "Creditor's Group Life Insurance and CDA," April 12, 2013.

[14] CRA Document No. 2011-0399771C6, "CDA, Innovative Installation Case," June 24, 2011.

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Multi-life insurance policies with accumulating fund payable on first death

Where a private corporation is the owner of an insurance policy on multiple lives, issued prior to December 31, 2016, the policy has only one ACB. As a result, at the death of one of the insureds, the full amount of the ACB will be deducted from the death benefit when the credit to the CDA of the beneficiary corporation is calculated. After that, future death benefit payments will not result in any adjustment to the policy's ACB and the ACB will again be deducted from future death benefits when determining the amount of the credit to the corporation's CDA.

The tax changes that went into force on January 1, 2017, changed the way the ACB is treated in cases involving exempt policies on multiple lives issued after December 31,

2016. Under these changes, the ACB of a multi-life policy will decrease as the death benefits are paid out. Payment of the accumulating fund on the occurrence of the first death will be treated as a partial disposition if the payment exceeds the maximum amount allowed for coverage that would normally have been paid under an individual exempt policy.

The Capital Dividend Account and buy-sell agreements

Most buy-sell arrangements cover the event of the death of a shareholder. Arrangements often articulate the share valuation method and the funding mechanism to be used for the purchase. Often, life insurance on the life of each shareholder is used as the funding mechanism. The CDA is a vital component of many life insurance-funded corporate buy-sell arrangements where the corporation is the beneficiary of the policy.

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Criss-cross buy-sell agreement using corporate-owned life insurance

In a corporate-owned insurance arrangement, the buy-sell agreement may stipulate that the surviving shareholder(s) will buy the shares of the deceased shareholder. The corporation will generally be the owner, premium payor and beneficiary of the life insurance policy. The death benefit of the policy on the life of each shareholder should equal the purchase price of his/her shares as stipulated in the buy-sell agreement.

On the death of a shareholder, the following steps are typically taken:

1. The estate of the deceased shareholder sells the deceased's shares to the surviving shareholders and takes back a promissory note or some similar debt.
2. The surviving shareholder(s) now own 100% of the shares and cause the corporation to declare and pay dividends sufficient to allow them to pay off the debt to the estate. The cash for this comes, in whole or in part, from the proceeds of the life insurance policy. To the extent of the available CDA, an election is filed to deem such dividends to be tax-free capital dividends. Any amount in excess of the CDA is declared and paid as a taxable dividend.
3. Using the proceeds from the dividends, the debt to the estate is repaid.

The capital gains tax burden, if any, resulting from the deemed disposition of the shares immediately before death at their fair market value, will be borne by the deceased (and his/her estate). The deceased's personal representative may be able to use some or all of the lifetime capital gains exemption[15] to reduce or eliminate the tax consequences arising from the deemed disposition[16]. The surviving owner will have acquired new shares with an ACB equal to their fair market value.

[15] $883 384 in 2020, indexed annually to changes in the rate of inflation.

[16] CRA Document No. 2011-0399771C6, "CDA, Innovative Installation Case," June 24, 2011.

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Share redemption by corporation

In an arrangement where life insurance is to be used for share redemption by the corporation, the shareholders' agreement may stipulate that the corporation will repurchase (redeem) the shares of the deceased shareholder directly. There are a number of provisions in the ITA that address such situations. In our example, share redemption would be funded using the death benefit paid by the life insurance policy. On the death of a shareholder, the following steps are typically taken:

1. The shares of the deceased shareholder are redeemed from his/her estate using the proceeds of the life insurance policy.

2. The share proceeds from the redemption may potentially result in the estate receiving both

   a. a deemed dividend, in respect of which an election would be made to make such dividend a tax-free dividend to the extent of the CDA, and

   b. a capital loss arising on the disposition of the shares.

This generally results in the total or partial extinguishment of the capital gain in the hands of the deceased shareholder and a tax-free capital dividend to the estate.

3. The corporation cancels the redeemed shares, leaving the surviving shareholders with 100% of the issued shares, but they have not paid anything for the additional value they have acquired. The fair market value of the shares they own is increased proportionately by the fact that, because of the redemption, they now own a larger percentage of the business. In tax system terms, the surviving shareholders do not receive an increase in the cost of their now more valuable shares.

In a share redemption buy-sell at death, the tax burden with respect to any capital gains on the shares of the deceased shareholder will effectively be borne by the surviving shareholders by reason of the fact that the shares held by the survivors do not receive an increase in their adjusted cost base for tax purposes.

This tax will only be payable, however, at such future time as they sell the shares or die, leaving the shares to someone other than their spouse.

In essence, the transfer of ownership occurs without requiring any payment by the surviving shareholders or the use of any assets of the corporation (other than the life insurance proceeds).

Lastly, the stop-loss rules should be taken into consideration when structuring options within a shareholders' agreement dealing with share redemption in the event of a shareholder's death.

Conclusion

The CDA is a critical component of estate and tax planning for the shareholders of a private corporation. Life insurance policy proceeds received by a corporation will give rise to a credit to the CDA. This credit can be paid out to the shareholders as a tax-free capital dividend. The CDA can be optimized to create advantageous and cost-effective strategies. It is incumbent upon tax advisors and other professionals to be aware of its application and limitations.

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Other reading

- Income Tax Folio S3 F2-C1, Capital Dividends, July 15, 2019.

Every effort has been made to ensure the accuracy and currency of the information provided. However, any examples presented in this article are for illustration purposes only. No one should act upon the information presented here without first seeking the professional services of a personal advisor and having a thorough analysis of his/her specific legal or tax situation performed.

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