STEPUP

Sales Tax Estate Planning Underwriting & Product Newsletter

Peter A. Wouters,
Director, Tax
Retirement &
Estate Planning
Services

The Capital Dividend Account

The objective of this newsletter is to provide a detailed description of a Canadian Controlled Private Corporation's notional capital dividend account. For readers who wish to know more about how different forms of corporately held investments may impact the capital dividend account, we invite you to consult our newsletters "The Taxation of Corporately Owned Investments" and "The Taxation of Corporately Owned Segregated Funds".

The taxation of private corporations in Canada is based on the fundamental tax principle of integration, which means that the income earned by a private corporation and distributed to its shareholders should be subject to approximately the same amount of tax as if the income had been earned directly by the shareholders.

The capital dividend account (CDA) is a notional account only relevant for tax purposes. It is created to track certain tax-free surpluses accumulated by a private corporation that may be distributed as tax-free capital dividends to the Canadian shareholders of a corporation. Therefore, it can be an important tax planning tool for private Canadian corporations and their shareholders.

Capital dividend account balance determination

The CDA is defined under subsection 89(1) of the Income Tax Act (Canada) (ITA). The definition contains the various components that are added and deducted from the CDA balance. It is the sum of the following components that should be added or subtracted in the computation of the CDA balance including:

1. The excess of the non-taxable portion of capital gains over the non-deductible portion of capital losses incurred by the corporation since 1971. Please note that a negative balance in this component is not carried over to the computation of the CDA balance itself. What that means is that no amount in respect of this first component will be recognized as an addition to the corporation's CDA until the running balance of this component is a positive amount.
2. Capital dividends received from other corporations;

Peter works with independent advisors and other professionals raising awareness on issues and concerns faced by affluent individuals, professionals and business owners. He supports efforts in researching and developing optimal solutions for clients aimed at improving their financial well-being and supporting their personal wishes and lifestyles. He has provided 1000s of workshops, seminars and technical support throughout the country on tax, retirement income and estate planning issues, concepts and strategies to both advisors and consumers. As an accredited Registered Financial Gerontologist, a good deal of his time is spent on building awareness and educating people of all professions who work with or specialize in the needs, expectations and issues of elders. Comprehensive lifestyle planning is an important element of these processes.

The Sales, Tax, Estate Planning, Underwriting & Product (STEPUP) team provides internal and broker support, including seminars, education, advanced concept illustrations & Client case technical consultations.

Peter can be reached at peter.wouters@empire.ca

Empire Life Investments

3. The life insurance proceeds net of the adjusted cost basis (ACB) of a policyholder's interest in the policy immediately before the time of death;
4. The non-taxable portion of capital gains distributed by a trust to the corporation in respect of capital gains of the trust

Also, a corporation's CDA is reduced by the total amount of capital dividends payable by the corporation.

These components are specified in paragraphs 89(1) (a) to (g) ITA.

Effective Jan.1, 2017, the rules respecting eligible capital property were repealed so that the untaxed portion of gains on eligible capital property are no longer added to the CDA. Instead, the treatment of eligible capital property now falls under Class 14.1 of Schedule ll of the Regulations dealing with depreciation. The non-taxable portion of capital gains realized on the disposition of depreciable property under Class 14.1 is added to Component 1.

The CDA is calculated on a cumulative basis for a particular basis for a particular period. This period starts at the beginning of the corporation's first tax year that ended after 1971. The period ends immediately before the balance of the CDA is to be determined (eg when a capital dividend is about to be paid). As stated earlier, only private corporations are entitled to have a CDA. A corporation that existed as a non-private corporation only starts to accumulate a CDA after the date it became a private corporation. Even though the individual components of the CDA calculation cannot be negative, it is possible to have a negative balance because of the cumulative nature of the calculation.

Also, if the CDA is credited because of non-taxable capital gains realized by the corporation, consider declaring a capital dividend to avoid a reduction of the CDA because of future potential non-deductible capital losses.

Capital dividend election

Pursuant to ss 83(2) ITA, a private corporation can elect to pay a tax-free dividend to its shareholders. The corporation must file Form T2054 Election for a Capital Dividend Under Subsection 83(2) in order to have the dividend qualify as a capital dividend. A certified copy of the resolution of the directors authorizing the election must be filed with Form T2054. The election must be made in respect of the full amount of the dividend that is to be paid.

The election must be filed on the earlier of:

a. the day on which the dividend becomes payable (the day stipulated by the directors' resolution declaring the dividend), or
b. the first day on which any part of the dividend is paid.

Excess capital dividend election

If a corporation files a capital dividend election for an amount exceeding its CDA balance immediately before the moment when the dividend becomes payable, only the portion of the dividend that does not exceed the CDA balance is deemed to be a capital dividend. The corporation will be subject to Part III tax which is equal to 60% of the portion of the dividend that does not qualify as a capital dividend.

As an alternative to the payment of Part III tax in respect of an excessive election, the corporation liable for the tax may make an election under ss 184(3) ITA to have the excess portion of the dividend treated as a separate taxable dividend that became payable at the time the original dividend became payable.

Only Canadian residents receive capital dividends tax-free. Capital dividends paid to non-residents are subject to non-resident withholding tax of 25%. However, the withholding tax rate may be reduced if the dividend is paid to a person that is resident in a country that has a tax treaty with Canada.

Capital Dividend and Life Insurance

The Income Tax Act (Canada) establishes that a corporation's CDA includes amounts related to proceeds of a life insurance policy received as a consequence of the death of a person. If life insurance proceeds are received by a trust (other than a bare trust) and flowed through to a corporation as beneficiary of the trust, the corporation's CDA cannot be credited, as the life insurance proceeds represent distributions of property from a trust in satisfaction of an interest in the trust, not proceeds of a life insurance policy.

The amount credited to the CDA of a corporation which is beneficiary of a life insurance policy is increased by the insurance proceeds net of the ACB of a policyholder's interest in the policy immediately before the time of death.

The corporation does not have to be the policyholder of the life insurance policy in order to obtain the credit to its CDA. The rules governing calculation of the CDA for situations where the corporation is not the policyholder

and the beneficiary of the life insurance policy were changed in 2016 under Bill C-21. Since these changes were adopted, the amount included in the CDA of the beneficiary corporation is decreased by the amount of the ACB, immediately before death, of a policyholder's interest in the policy, whether or not the beneficiary corporation was the policyholder (clause 89(1)(d)(iii)(B) ITA). Also, the changes made under Bill-21 in 2016 mean that even term insurance has an ACB that must be considered in calculating the net credit to the CDA.

Designating multiple corporations as beneficiaries of a life insurance policy may result in undesired tax consequences. In such situations, when the corporate beneficiaries receive the proceeds from the life insurance policy, the CDA balance of each of the corporations will be reduced by the full amount of the ACB of the policyholder's interest in the policy. The ACB of the policyholder's interest in the policy is not prorated to reflect the percentage of the total life insurance proceeds received by each corporation. Therefore, the cumulative credits to the CDA balances of all the corporate beneficiaries will likely be less than if a single corporation had been designated beneficiary.

Among other things, the ACB is increased by the premiums paid into the policy, the repayment of a policy loan, the purchase of paid-up insurance, the purchase of term additions and the cost of an interest in the policy acquired by the policyholder. On the other hand, it is reduced by the net cost of pure insurance (NCPI), taking a policy loan, the payment of dividends under a participating policy, and partial dispositions of the policy.

A corporation must normally be the beneficiary of a life insurance policy in order to obtain a credit to the capital dividend account. In certain circumstances, a lender offering creditor's life insurance will insist on being named owner and beneficiary of the life insurance policy. This was the case in decision Innovative Installation Inc. v. The Queen (2009 TCC 580; 2010 FCA 285). In 1999, Innovative Installation Inc. ("Innovative") borrowed money from RBC and obtained key person insurance from Sun Life Financial on the life of its founder. When the founder died, the death benefit was paid directly to RBC to repay the loan. The Canada Revenue Agency (CRA) denied the addition of the insurance proceeds net of ACB to the CDA of Innovative, since RBC had "received" the death benefit (as per subparagraph 89(1)(d)(ii) ITA), not Innovative itself. Innovative brought a court application seeking to overturn CRA's decision. The judge hearing the application held that the meaning of "received" does not require proceeds to pass directly to the taxpayer. Rather, the taxpayer can notionally or constructively receive it. In this case, Innovative had its loan paid off and its net worth increased. The judge allowed the credit to Innovative's CDA. CRA appealed the decision and lost (Canada v. Innovative Installation Inc., 2010 DTC 5175 [at 7317], 2010 FCA 285); therefore the Tax Court of Canada decision still stands.

There may be valid business reasons for structuring a life insurance policy where the owner and beneficiary are different. One must consider all tax implications to avoid unanticipated tax consequences of this type of structure. For example, prior to Bill C-21, where the owner of the life insurance policy was a holding company (owner of the shares of an operating company) and the beneficiary was the operating company, CRA indicated that such a structure could be challenged as an avoidance transaction.

Capital Dividend and Shareholder's Agreements

Most shareholders' agreements include a corporate repurchase arrangement which requires the corporation, when a shareholder dies, to purchase the deceased's shares. The purchase of the shares may be funded by the proceeds of a life insurance policy previously acquired by the corporation on the life of the deceased shareholder. For tax purposes, the purchase of the estate's shares by the corporation will likely result in a deemed dividend received by the estate. Such deemed dividend will result if the purchase price exceeds the paid up capital of the shares (which is often the case). Therefore, a careful writing of a shareholders' agreement will likely include some dispositions to insure that the corporation makes all the necessary elections (see "Capital dividend election" section hereinabove) so that the deemed dividend resulting from the purchase of the shares would be a capital dividend and tax-free for the estate. Failure to include such dispositions may lead to undesired consequences and potentially litigation.

This is precisely what happened in the decision Ribeiro Estate v. Braun Nurseries Ltd (2009 CanLII 1149). Mr. Ribeiro was a key employee and minority shareholder of "Canco". Canco was the owner and beneficiary of a $1 million life insurance policy on the life of Mr. Ribeiro, who died in 2004. When Mr Ribeiro died, his shares were valued at approximately $1.6 million. Substantially all of his shares were redeemed by Canco after his death as required under the shareholder's agreement. After receiving the insurance proceeds, Canco added almost

$1 million to its CDA. However, Canco did not elect to treat any of the deemed dividend on the redemption of the deceased's shares as a capital dividend. Therefore, the whole deemed dividend was considered a taxable dividend received by Mr Ribeiro's estate. If the estate had received a capital dividend on the redemption, rather than a taxable dividend, it would have realized a tax savings of $250,000. This case is a good example of the necessity to clearly document who is entitled to benefit from the capital dividend account in the shareholders' agreement and in what proportion. The court considered the provisions of the agreement when it dismissed the motion for an oppression remedy against Canco brought by the Ribeiro estate representative. A properly worded and comprehensive shareholder's agreement would greatly help stave off litigation on the death of the shareholder.

How we can help

Our tax, retirement and estate planning team can assist you and your client's other professional advisors in your tax planning involving corporately owned life insurance policies. Also, for readers who wish to know more about how different forms of corporately held investments may impact the capital dividend account, we invite you to consult our newsletters "The Taxation of Corporately Owned Investments" and "The Taxation of Corporately Owned Segregated Funds".

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Reference: Income Tax Folio S3-F2-C1, Capital Dividends

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Empire Life Investments Inc.
165 University Ave., 9th Floor, Toronto, ON M5H 3B8

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empire.ca info@empire.ca 1 877 548-1881

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