# STEPUP

Sales Tax Estate Planning Underwriting & Product Newsletter

## The Capital Dividend Account

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 (depending on applicable income tax rates) as if the income had been earned directly by the shareholders.

The capital dividend account 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 shareholders of a corporation. Therefore, it can be an important tax planning tool for private Canadian corporations and their shareholders.

**The capital dividend account is defined under subsection 89(1) of the Income Tax Act (Canada) and includes the following amounts (or credits):**

The sum of:

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;
2. Capital dividends received from other corporations;
3. Untaxed portion of gains on eligible capital property;
4. The life insurance proceeds net of adjusted cost basis (ACB) of the policy immediately before the time of death;
5. The non-taxable portion of capital gains distributed by a trust to the corporation in respect of capital gains of the trust

Less:

The total of all capital dividends previously paid by the corporation.

Pursuant to subsection 83(2) of the ITA, a private corporation can elect to pay a tax-free dividend to its shareholders to the extent that it has a positive capital dividend account balance, by filing a special election form T2054, including the directors' resolution authorizing the election. You need to consider paying capital dividend as soon as it becomes available, particularly if there is a risk of incurring losses in the future.

**Peter A. Wouters,**
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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 annually provides 100's 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.

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## Capital Dividend and Life Insurance

The adjusted cost basis (ACB) of an insurance policy owned by the corporation reduces the credit to its capital dividend account for the insurance proceeds paid out when the life insured dies. The adjusted cost basis, among other things, 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 policy gains. 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.

A corporation must normally be both the owner and beneficiary of a life insurance policy in order to obtain a credit to the capital dividend account. 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 capital dividend account 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 rules governing calculation of the capital dividend account for situations where the corporation is not the owner and beneficiary of the life insurance policy were changed in 2016 under Bill C-21. Specifically, the credit to the capital dividend account of the beneficiary corporation is reduced by the adjusted cost basis of the policy regardless of who owns the policy. This is covered in the definition of capital dividend account under clause 89(1)(d)(iii)(B).

In the case of multiple corporations named as beneficiaries, there may be double counting of this calculation of the adjusted cost basis since each company must subtract the full adjusted cost basis of the policy from its respective credit to each capital dividend account.

However, 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 a Tax Court decision, Innovative Installation Inc. v. The Queen (2009 TCC580). 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 capital dividend account of Innovative, since RBC had "received" (as per subparagraph 89(1) (d)(ii) of the Income Tax Act (Canada) the death benefit, 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 capital dividend account. Canada Revenue Agency (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, Canada Revenue Agency (CRA indicated that such a structure could be challenged as an avoidance transaction.

In any structure where the beneficiary of a corporate owned policy is not the owner, there is also potential to assess a taxable benefit to the recipient corporation or its shareholder. This may be in addition to the double counting calculation of the adjusted cost basis which serves to reduce the amount of tax-free life insurance proceeds that may flow through the capital dividend account. Specifically, the adjusted cost basis will reduce the credit to the capital dividend account of the beneficiary corporation. The entire adjusted cost basis may reduce the credit to the capital dividend account for every beneficiary

corporation in the case of multiple corporate beneficiaries. There may be valid business reasons for structuring a life insurance policy where the owner and beneficiary are different. One must consider many applicable provisions of the Income Tax Act in order to avoid surprises.

Another interesting court case dealing with the capital dividend account is the 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. His shares were valued at approximately $1.6 million and 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 capital dividend account. Canco did not elect to treat any of the deemed dividend declared on the redemption of the deceased's shares as a capital dividend. 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, as 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.

The capital dividend account is designed to alleviate double taxation by allowing private corporations to make a tax-free distribution to their shareholders of the untaxed portion of capital gains and life insurance proceeds they have received at the corporate level. As shown above, when and how the capital dividend account may be used is complicated. Our tax and estate planning team can assist you and your client's other professional advisors in your tax planning involving corporately owned life insurance policies.

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