

The Capital Dividend Account and Investments

The Canadian income tax system is designed to integrate corporate and personal income taxation, so that individuals who make investments using Canadian private corporations face the same income tax consequences as individuals who invest directly in the markets. If a corporation has made capital gains, it receives funds that are partially exempt from tax. Only 50% of the capital gain is subject to income tax. Tax must be paid on the balance. Income flowing out of a corporation to shareholders is taxed to the shareholders. The concept of integration tries to eliminate double taxation on the same income and eliminate tax on monies flowing out of a corporation that were not subject to income tax in the first place. The mechanism used to flow these tax-free amounts through to the shareholders is the capital dividend account (CDA). A corporation can pay a capital dividend from the capital dividend account tax-free to shareholders.

The capital dividend account is a notional account used to keep track of realized capital gains that are not subject to taxation, 50% of the total. On donation of publicly traded shares to a registered charity, 100% of the gain is added to the capital dividend account. The shareholder can withdraw this non-taxable portion of the net capital gain on a tax-free basis. The capital dividend account is not a bank account and does not appear on the company's balance sheet. The balance may be reported in the notes to the financial statements for information purposes only.

The computation of the balance in that capital dividend account is very complex, and subject to many special rules. Please consult your tax accountant before paying out a capital dividend.

The balance in the capital dividend account is comprised of:

- the excess of non-taxable portion of capital gains over non-deductible capital losses at the appropriate fraction for the year.
- capital dividends received from other corporations like a subsidiary company
- the non-deductible portion of business investment losses
- the non-taxable portion of gains on the sale of eligible capital property like goodwill
- life insurance proceeds received by the corporation, net of the Adjusted Cost Base of the policy as the result of the death of an insured person
- The non-taxable portion of capital gains distributed by a trust to the corporation in respect of capital gains of the trust or capital dividends received by the trust
- payouts from the capital dividend account.



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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 a 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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The balance of the capital dividend account is the cumulative total of all of the above items since 1972 (when capital gains started to be taxed). Even though the individual components of the capital dividend account calculation cannot be negative, it is possible to have a negative balance because of the cumulative nature of the calculation. As stated earlier, only private corporations are entitled to have a capital dividend account. A corporation that existed as a non-private corporation only starts to accumulate a capital dividend account after the date it became a private corporation.

The capital dividend account is defined in section 89(1) of the Income Tax Act (Canada) (the Act). A corporation can pay a tax-free dividend to its shareholders to the extent that it has a positive capital dividend account balance, pursuant to subsection 83(2). The corporation must file a T2054 election in order to have the dividend qualify as a capital dividend. 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.
- If a corporation files a T2054 election for an amount exceeding its capital dividend account balance at that time, the excess amount is subject to a 75% penalty under Part III of the Act. It is important to ensure that there is an adequate credit in the capital dividend account before electing to pay a capital dividend. If the election is not filed before or at the same time the dividend is paid, the CRA will impose a late-filing penalty of approximately \$42 per month.

Understanding when credits arise will help avoid penalties for excess capital dividend elections. Generally, the timing of the credits to the account is as follows:

- The credit created in the capital dividend account by the non-taxable portion of a capital gain occurs at the time of disposition of the property giving rise to the gain. Similarly, the deduction for the non-deductible portion of a capital loss also occurs at the time of disposition of the property.
- The credit created by the non-taxable portion of a gain realized on the disposition of eligible capital property occurs at the end of the selling corporation's tax year.
- The credit for life insurance proceeds in excess of the company's adjusted cost basis in the policy occurs at the time of receipt of the life insurance proceeds.
- The credit for capital dividends from a corporation that is a member of a partnership that has sold eligible capital property occurs at the end of the partnership's fiscal year, not at the corporate partner's year-end.
- The credit for capital dividends to a corporate beneficiary from a trust occurs at the end of the trust's taxation year.
- If a corporation distributes tax-free capital gains as a capital dividend, and then has offsetting capital losses, the capital dividend account must be replenished with capital gains or other positive components before tax-free dividends can be paid.

The balance in the capital dividend account at any point in time determines how much can be paid out as a tax-free capital dividend. Be very conscious of events that can reduce the balance in the account or the ability to elect or



receive a capital dividend. One planning point is to declare and pay a capital dividend before a limiting event. Keep a running balance in the accounting records so as not to miss opportunities to pay capital dividends.

For example, public corporations are not allowed to make capital dividend elections. Consider payout of capital dividends while the corporation is still private.

An asset sale may trigger a capital loss. The non-deductible portion of capital losses reduces the capital dividend account balance. Look at paying out capital dividends before the sale.

Only Canadian residents receive capital dividends tax-free. Non-residents are subjected to a withholding tax on any dividends received by Canadian corporations. Consider paying out capital dividends to shareholders before they give up Canadian residency. U.S. persons receiving capital dividends are taxed on those payments for U.S. purposes.

Capital dividends can be declared and paid at any time in the corporation's fiscal year. Pay them out as soon as a significant balance builds up in the capital dividend account.

The capital dividend account is an important tax and estate planning tool for individuals who have private incorporated business interests. Seek out qualified professionals who can help optimize the use of this special account.

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