TD Wealth

Strategic Uses of the Capital Dividend Account

An important tax planning device for owner-managers of private corporations resident in Canada is the capital dividend account (CDA). This is a notional corporate account that is used to track the following:

1. The excess of non-taxable capital gains realized by the corporation over the non-deductible portion of its capital losses;
2. Capital dividends received by the corporation from other corporations;
3. Non-taxable capital gains and capital dividend distribution from trusts;
4. Proceeds of life insurance received by the corporation in excess of the adjusted cost base (ACB); and
5. Non-taxable portion of the gains realized by the corporation on the disposition of eligible capital property (e.g. goodwill).

The CDA is important from the owner-manager perspective in that it is one of the few ways a Canadian resident owner-manager can receive funds from the company without being subject to tax. Positive balances in the CDA may be distributed to the owner-manager by way of tax-free dividends known as capital dividends.

Before a capital dividend can be paid, the corporation must file an election with the Canada Revenue Agency (CRA) along with certain other documents, including the directors' resolution authorizing the election and schedules showing the amount of the corporation's CDA. These documents must be filed no later than the day on which the dividend becomes payable or the date on which any part of the dividend is paid, whichever is earlier. Otherwise, a late filing penalty may apply.

There are a number of planning opportunities involving the CDA. Some of these planning opportunities are discussed in this article.

1. Distribute positive CDA balances

The CDA balance is calculated on a net cumulative basis over time. A current positive CDA balance may be eroded at a subsequent time. It may be preferable therefore to distribute amounts credited to the CDA as they become available.

For example, suppose a new private company was incorporated today. One year later, the company realized a capital gain of $100,000 on the sale of an asset. Six months after that, the company sold another asset and realized a capital loss of $100,000.

In this case the company's CDA will have a balance of $50,000, representing the non-taxable portion of the capital gain, immediately following the first asset sale. The company will have the ability to pay this amount out tax-free to its shareholders up to the time of the second asset sale. If the company has not done so, then the opportunity to receive tax-free corporate distributions may be lost since the $50,000 non-deductible portion of the capital loss will reduce the CDA balance to $0 following the second asset sale.

Distributions of positive CDA balances are particularly useful in advance of a sale where significant capital losses may be realized, where the company is about to be sold, or where the company is about to go public (since public corporations may not pay capital dividends).

2. CDA Streaming

Capital dividends are tax-free only to Canadian resident shareholders. A non-resident shareholder who receives a capital dividend payment may be subject to a 25% (or less by tax treaty) Canadian withholding tax on the amount of the dividend. It may therefore be preferable to make capital dividend payments only to Canadian resident shareholders to maximize the value associated with such payments. This is known as CDA streaming.

There are several ways in which CDA streaming can be accomplished. One way may be to establish two separate classes of shares on incorporation and attach capital dividend entitlement rights to one of the two classes of shares.

If separate classes of shares were not created at the time of incorporation, CDA streaming could still be accomplished through a series of redemptions or repurchase of shares by the company.

For example, if the company had only one class of shares that was equally owned by a Canadian resident and a non-resident shareholder, a redemption or repurchase of a portion of the Canadian resident shareholder's shares could result in capital dividends paid to the Canadian resident shareholder. However redeeming a portion of the shares held by the Canadian resident shareholder may also reduce his or her equity ownership in the company unless other steps are taken to ensure that equal equity ownership is maintained.

3. CDA and Buy/Sell Agreements

Life insurance is commonly used to fund buy/sell agreements. The life of each shareholder is insured to make sure adequate funding is available to purchase the shares of a deceased shareholder from his or her estate. Careful consideration should be given to whether such life insurance policies should be acquired personally or by the corporation.

Factors that favour using corporate owned insurance may include tax savings if the corporation is at a lower tax rate than that of the individual shareholders. As insurance premiums are generally not tax-deductible, an insurance premium of $1,000 would require approximately $1,250 in pre-tax corporate dollars assuming a corporate tax rate of 20%, and $1,818 in pre-tax personal dollars assuming a personal tax rate of 45%.

Where corporate owned life insurance is used, the corporation's CDA will be credited with an amount equal to the excess of the life insurance proceeds received by the corporation following the death of the life insured less the ACB of the policy immediately before death.

Depending on the situation, a corporation can then use capital dividend payments to:

1. Redeem the shares of the deceased shareholder from his or her estate (corporate redemption method);
2. Provide surviving shareholder(s) with the funds necessary to acquire the deceased shareholder's shares directly from the estate (promissory note method); or
3. A combination of both (hybrid method). The choice of which of these methods is to be used will depend, in part, on whether the $750,000 capital gains exemption can be utilized by the deceased shareholder.

4. CDA and Corporate Surplus

When a business has been sold through an asset sale, oftentimes the proceeds are left in the company to invest as opposed to paying it out to the owner-manager, either as salary or dividends, as there would be less available to invest after the taxes have been paid.

If the proceeds are not required to support the owner-manager's lifestyle needs and are intended to be passed on to the owner-manager's beneficiaries, then a planning opportunity may be to invest the corporate surplus in a universal life insurance policy with the company as owner and beneficiary of the policy, and the owner-manager as the life insured.

The benefit of investing the corporate surplus in a universal life insurance policy is that the corporate surplus can be distributed tax-free to the owner-manager's estate or heirs following the death of the owner-manager. While the owner-manager is alive, the growth in the investment portion of the policy can occur on a tax-deferred basis. Following the death of the owner-manager, the insurance proceeds (including the investment portion) is paid to the company tax-free. The insurance proceeds received by the company, less the ACB of the policy immediately before death (which generally reduces to zero over time), are credited to the company's capital dividend account which can then be distributed as tax-free capital dividends to the owner-manager's estate or heirs.

The above are just some examples of the planning opportunities involving the capital dividend account. By planning ahead in consultation with a professional tax advisor, the benefits associated with this ability to extract tax-free funds from the company can be maximized.

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