The Capital Dividend Account

A guide for insurance advisors and other client advisory professionals.

BMO Insurance

The **Capital Dividend Account (CDA)** was part of the concept of tax integration introduced in 1972 as part of the tax reforms relating to the taxation of private corporations. The idea was simple: you should net the same amount after-tax whether you engage in a specific transaction personally or through a private corporation. The CDA is a notional tax account that tracks tax-free amounts received by private corporations and is one mechanism to achieve this tax integration.

Tax-free amounts for individuals include (but not limited to) the non-taxable portion of gains/losses on the disposition of capital property and life insurance death benefits. To ensure similar tax treatment, if these amounts were received by a corporation and proceeds subsequently distributed to a Canadian resident shareholder, the Income Tax Act (Canada) (ITA) introduced the concept of a CDA in subsection 89(1). This subsection contains reference to the definition of the CDA and the life insurance aspect is addressed in paragraph (d) of that definition.

The CDA with respect to life insurance started off very simply as the insurance death benefits received (full integration with outcome if the policy were personally owned). Several adjustments were subsequently introduced including the requirement to reduce the death benefit received by the Adjusted Cost Basis (ACB) prior to death. Prior to March 22, 2016, the ACB would be that of the corporation receiving the death benefit. After that date, it is the ACB of the policy.

A series of additional adjustments have been introduced more recently that have added complexity to the calculation of the CDA. This article addresses some of these adjustments as well as the basics relating to the CDA and distribution of a capital dividend.

This guide was designed to help advisors speak to their clients or other professional advisors about how the CDA may impact their situation.

For a more detailed review of the CDA you should refer to Income Tax Folio S3-F2-C1, Capital Dividends.

Simplified Calculation of the CDA

Although the definition of the CDA is complex, for most situations, the current calculation boils down to the following:

CDA = A + B + C + D - E, where

- **A is the excess of the non-taxable portion of capital gains** over the non-deductible portion of capital losses (if any)
- **B is the amount of capital dividends** received from another corporation (retains character)
- **C is the amount of eligible capital amounts**
- **D is the excess of life insurance proceeds** received by the private corporation over the policy ACB, and
- **E is the amount of capital dividends** previously paid

The CDA is a cumulative calculation over a **defined period** that starts at the beginning of the corporation's first tax year that began after the corporation last became a private corporation and that ended after 1971. The period ends immediately before the balance of the CDA is to be determined. The CDA calculation does not form part of the corporate tax filing and must be maintained separately by the taxpayer for verification at the time a capital dividend is declared.

The CDA rules relating to the life insurance component do not require either the life insured nor the life insurer to be Canadian residents for the insurance death benefit received less the ACB to flow into the CDA of a private Canadian corporation named as a beneficiary under the policy. The ACB of the policy would be calculated in accordance with the rules in the ITA.

The CDA cannot be negative in total, nor can the individual components be negative. As such, timing of events and payments of past capital dividends can reduce the CDA balance which may impact the ability to pay out future insurance death benefit tax-free (see example below).

Example		
January 2000	Non-taxable capital gain	$100,000
March 2000	CDA paid	$100,000
January 2001	Deductible capital loss	$50,000
December 2002	Life insurance death benefit less ACB	$500,000

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Capital Dividend Account Details

Year	Net non-taxable capital gains/losses (A)	Capital Dividends received (B)	Net Eligible Capital Amounts (C)	Life Insurance death benefit in excess of ACB (D)	Capital Dividends paid (E)	Other (F)
1972						
1973						
2000	$100,000				$100,000	
2001	**($50,000)**					
2002				$500,000		
Total	$50,000	$0	$0	$500,000	$100,000	$0
CDA = A+B+C+D-E+F = $450,000						

In this case, the full net death benefit of $500,000 cannot be paid out as a capital dividend, only $450,000 is available in the CDA. The additional $50,000 of death benefit received could flow out as a taxable dividend.

Private corporations may want to consider utilizing and updating a table like this for their records as part of their annual tax filing process.

CDA Adjustments and Canada Revenue Agency (CRA) audits

The CRA has become more vigilant in verifying CDA balances due to the many recent adjustments to the calculation. This often confuses clients and advisors who simply look at the death benefit received less the ACB and wonder why CRA is asking for additional verification.

Some of the recent changes impacting the CDA directly, or indirectly through ACB adjustments, that you should be aware of are discussed below.

a) 10/8 Policy Adjustment
A 10/8 policy is defined in subsection 248(1) of the ITA and involves an arrangement where a policy is collaterally assigned to a lender and the loan rate and credited rate on the policy are linked (i.e. the credited rate is only available if a loan is taken). If a policy meets this definition, subparagraph (d)(iv) of the CDA definition stipulates that for death benefit proceeds received by a private corporation after 2013, the CDA can only be increased by the excess above the loan amount that is outstanding prior to death. So, the death benefit received would be reduced by both the ACB and outstanding loan amount immediately prior to death. As a result, highly leveraged 10/8 policies would have very little credited to the CDA.

b) Leveraged Insurance Annuity Policy (LIA) adjustment
A LIA is defined in subsection 248(1) of the ITA and involves an arrangement where a person collaterally assigns an interest in a life policy and annuity contract to a lender after March 20, 2013, and the loan is repaid at the time of the insureds death. This strategy was often used to increase income, preserve capital, and reduce the corporate valuation for capital gains purposes. In such cases, subparagraph d(ii) of the definition of the CDA provides that any amount of the death benefit received by a private corporation is not eligible for credit to the CDA.

c) Shareholder transfers of Life Insurance to a private corporation adjustment
If a policy was transferred from an individual to a private corporation after 1999 and before March 22, 2016, adjustments may be required to the CDA by virtue of subparagraphs d(v) and (vi) of the definition of the CDA. These adjustments apply if death occurs after March 21, 2016, an interest in the policy was disposed of by a policyholder (other than a taxable Canadian corporation) after 1999 and before March 22, 2016, and subsection 148(7) ITA applied to the disposition. CRA felt these transfers were in part to remove private corporate surpluses without incurring taxes, so this adjustment was enacted and applied retroactively back to the year 2000.

- (v) of the definition of the CDA describes a fixed grind to the CDA equal to the difference between Fair Market Value (FMV) of the actual consideration received and the greater of the Cash Surrender Value (CSV) or ACB at time of transfer.
- (vi) of the definition of CDA describes a variable grind calculated as follows:
  - » (Lesser of the ACB and FMV of consideration immediately before transfer) minus CSV at time of disposition, exceeds
  - » The absolute value of the "negative ACB" of the policy at the time of death

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Example:

- Policy transferred on March 21, 2013, when the following values applied:
  ACB $100,000 CSV $60,000 FMV $200,000
- Policy was transferred by Mrs. X to her Holdco for $200,000 pursuant to subsection 148(7).
  - » deemed proceeds equalled the CSV, $60,000, no gain arose, and the ACB was reset to $60,000
- Death occurs many years later when the ACB is - $20,000 and the Death Benefit (DB) = $1,000,000

CDA credit equals:

[$1,000,000 – ($200,000 – $100,000) – ($100,000 – $60,000 – $20,000)] = **$880,000**

- The first adjustment is the fixed grind and can be calculated immediately, (store for use at time of death)
- The second adjustment is the variable grind and may be reduced over time if the ACB of the policy moves into negative territory before death
- Before these updated rules, the full $1,000,000 would have been credited to the CDA.

d) Adjusted Cost Basis (ACB) used for CDA calculation

Prior to 2017, the ACB used for the CDA calculation was that of the recipient of the death benefit who may have had no ownership interest in the policy and therefore no ACB with respect to the policy. That was changed for periods after 2016 to be the ACB of the policy regardless of who receives the death benefit. This change has had consequences where a Holdco owns the policy and an Opco is beneficiary. Even though Opco is not the owner, it can no longer receive a full credit to the CDA. This change was introduced without grandfathering, so it applies to all death benefits received after 2016.

Ideally, there should have been some apportionment in the new legislation to avoid multiple reductions to the CDA where multiple corporate beneficiaries exist (see examples below). Finance has been made aware of this inappropriate outcome but have not addressed it yet.

d.1) Multiple Corporate Beneficiaries

An unfortunate outcome of the change from recipient ACB to policy ACB is that the same ACB can reduce the CDA multiple times if the beneficiaries of the policy are multiple private corporations. If there are two private corporate beneficiaries (Holdco owns policy with SubCo A and SubCo B as equal beneficiaries), each beneficiary would have to reduce their CDA by the same ACB.

d.2) Multi-Life and Special Death Payouts

New rules relating to the calculation of ACB were introduced in 2017 for G3 policies (policies issued after 2016). These rules included a reduction to the ACB for benefits paid upon death where the contract does not terminate at the same time (death benefits are not a disposition so without these specific changes, payments that qualify as death benefits did not reduce the policy ACB). This is a welcome change for private corporations receiving death benefits in these situations which previously faced a potential double reduction for the ACB when calculating their CDA. Unfortunately, these changes were not introduced for older policies.

In the case of a multi-life policy issued before 2017 with multiple private corporate beneficiaries, each death benefit payout will be reduced by the full ACB prior to such payout. A similar outcome occurs for payouts on first death on joint last to die policies. This potential double reduction for the ACB does not apply to G3 contracts in these situations as specific provisions were introduced to include those transactions as reductions to the ACB.

d.3) Shared Ownership

These arrangements typically involve one party needing insurance protection and another party looking for a tax effective savings option. The arrangement is facilitated by a separate legal agreement stipulating the rights and obligations of both parties. Although the insurance policy has a single ACB, the shared ownership agreement often provides guidance on how that ACB should be split between the two parties (and is important for determining tax outcomes for any future dispositions). With the new rules for determining the CDA, if the death benefit owner is a private corporation, its specific ACB is no longer relevant for CDA purposes. The policy ACB will be used to reduce the death benefits received to determine the private corporations CDA. This may significantly reduce the benefit of this strategy moving forward where a private corporation is involved.

Payment of a Capital Dividend

For a dividend to be treated as a capital dividend it must be paid from a Canadian private corporation and the corporation must elect to pay such a dividend by completing form T2054. Currently, it is not possible to treat part of a dividend to be a capital dividend and the rest a taxable dividend. The election must be for the full amount of the dividend to be paid.

If the election exceeds the available CDA balance, it is possible to file an excessive election under subsection 184(2) but the corporation would be subject to tax under Part III for an amount equal to 3/5 of the excess amount (approximate recovery of the amount not previously taxed). The shareholder receiving the excess amount is not subject to any tax or penalty but is jointly liable with the corporation to ensure that the Part III tax is paid. Alternatively, an election can be made under subsection 184(3) to treat the excess as a taxable dividend. The shareholder would be liable for taxes on such dividends and any interest or penalty applicable for late payments.

Along with the completion of form T2054, the corporation is required to file a certified copy of the director's resolution authorizing the CDA election and a schedule showing the computation of the CDA immediately prior to the proposed distribution. The election needs to be filed no later than the day the dividend becomes payable to avoid penalties.

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Special Rules – Amalgamations and Wind-Ups

A corporation's CDA may be increased (or reduced) as a result of an amalgamation of two or more predecessor corporations or if a subsidiary corporation is wound-up into its parent corporation.

Paragraph 87(2)(z.1) of the ITA provides for the transfer of a predecessor corporation's CDA to the newly formed corporation by deeming the amalgamated corporation to be a continuation of each predecessor corporation. As a result, each component of the predecessor corporation's CDA will be included in the calculation of the CDA of the amalgamated corporation's CDA.

If a subsidiary corporation described in subsection 88(1) of the ITA is wound up into a parent corporation, the cross-reference to paragraph 87(2)(z.1) in paragraph 88(1)(e.2) results in each component of the wound-up subsidiary corporation's CDA being included in the calculation of the parent corporation's CDA.

Special Rules – Creditor Insurance

Life insurance proceeds under group creditor insurance arrangements are now eligible for CDA treatment even though the payments don't typically go directly to the corporation. CRA has used the principal of "constructive receipt" to justify such treatment. In addition, CRA also stated in technical interpretations that no ACB grind would apply to death benefits payable under creditor insurance arrangements (an administrative relief). Typically, group term coverage has minimal ACB at the coverage level and the borrower would not have information to determine the ACB).

Special Rules – Anti-Avoidance, subsection 83(2.1) ITA

When a dividend that would otherwise be a capital dividend is paid on a share acquired in a transaction that had the receipt of the tax-free capital dividend as one of its main purposes, the anti-avoidance rules can apply. In such cases, the dividend will be deemed to be received by the shareholder as a taxable dividend that will be included in the shareholder's income and not be eligible for the recipient's CDA. However, the amount of the dividend would be included for the purpose of determining any liability of the payor corporation for Part III tax in respect of an excessive election and for the purpose of computing the payor corporation's CDA balance.

There are exceptions to the application of the anti-avoidance rule. One is with respect to capital dividends paid by a corporation to distribute net life insurance proceeds which were received due to death. Others include payments of capital dividends to individuals or related corporation's dependent on the composition of the CDA immediately before the dividend is paid.

Conclusion

The CDA has been around for many decades and is a fundamental part of the regime for the taxation of private corporations and the concept of tax integration. Insurance advisors speak about this notional tax account frequently as insurance death benefits are typically the largest component of this account. Stating that the credit equals the death benefit received less the policy ACB is reasonable most of the time. However, other details relating to client specific situations may introduce additional complexities. Knowing what to ask and look for will help ensure that your representations to your clients reflect the recent changes to the calculation of the CDA. It will also help explain why CRA may be asking so many questions at time of audit.

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