MONTHLY NEWSLETTER

The Capital Dividend Account

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Our goal is to provide updates on topical tax issues. Information contained in the newsletters is not meant to be a comprehensive summary of the issues raised. Rather, we wish to bring what we believe to be important issues to the attention of our valued clients. We would be pleased to discuss any questions that you, the reader, might have in greater detail.

WHAT IS THE CAPITAL DIVIDEND ACCOUNT ("CDA")?

When a corporation earns taxable income, there are generally two stages of taxation: 1) corporate tax payable in the year the income is earned and 2) personal income tax payable in the year that the funds are distributed to the shareholders in the form of salary or dividends. In theory, the tax rates are designed so that in the absence of income splitting with family members or the ability to defer personal income tax by retaining funds within the corporation, taxpayers are indifferent whether income is earned through a corporation or personally. This is commonly referred to integration.

Certain types of income such as capital gains pose special challenges to the theory of integration. An example will help illustrate the issue. Assume an individual taxpayer sells a share of a publicly traded company held in an unregistered investment account for $200 and that the cost base of the share is $100. The taxpayer has a capital gain of $100 ($200 - $100). 50% of this capital gain is taxable, $50. The taxpayer would be subject to tax on the $50 taxable capital gain and would pay tax based on their marginal income tax rate. The remaining proceeds could be used for whatever personal reasons the taxpayer chooses.

Compare the income tax implications above to a taxpayer who holds the same share within a corporation. The corporation would have a $50 taxable capital gain and would pay corporate income tax thereon. However, in order to get the funds out of the corporation, in the absence of any special rules, the shareholder would have to take the remaining after-tax proceeds out of the corporation in the form of a taxable dividend. This would be an unfair result. The overall tax burden in the corporate example would be significantly higher as the non-taxable portion of the capital gain ($50) would be subject to tax on the personal distribution. This is where the CDA comes in.

The CDA tracks the tax-free portion of certain types of income and permits funds to be distributed to shareholders as tax-free dividends to help preserve integration for Canadian corporations. The formula for the CDA is quite complex. However, simply, the CDA is a running tally calculated as follows:

$$A + B + C + D + E - F$$

Where:

A is the non-taxable portion of the corporation's capital gains net of capital losses
B is the sum of any capital dividends the company receives from subsidiary corporations
C is the non-taxable portion of any gains on the sale of eligible capital property such as goodwill
D is the proceeds of life insurance policies on death of an individual where the corporation is named as the beneficiary
E is the sum of certain distributions from trusts paid to the corporation
F is the total of capital dividends paid by the corporation

Each of items A to E are computed in isolation. In other words, if A, C, D and E are all nil or negative, but B is positive, the balance of the CDA will be equal to B.

PAYMENT OF A CAPITAL DIVIDEND

A corporation may designate any dividend to be a capital dividend by filing a special election, *Form T2054 – Election for a Capital Dividend Under Subsection 83(2).* A certified copy of the resolution of the directors of the corporation authorizing the payment of the dividend and a continuity schedule which computes the balance of the CDA must also be filed with the election. 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. It is also important to date the election and time the dividend payment to avoid late-filing penalties.

Any time subsequent to the date of the capital dividend election, the corporation can distribute cash to the shareholder on a tax-free basis. Accounting and reporting for tax purposes should reflect the payment in a consistent manner.

The computation of the CDA is the responsibility of the taxpayer. If a capital dividend is declared in excess of the actual CDA balance, the corporation paying the dividend can be subject to a 60% tax on the excess portion of the dividend. In such cases, the recipient can elect to treat the excess portion as a regular taxable dividend which reverses the 60% special tax, but of course attracts regular personal tax. Neither scenario is a good result. Tracking the CDA balance is therefore very important to avoid adverse tax results.

For corporations that have not kept adequate records, the computation of the CDA can prove challenging or impossible. The Canada Revenue Agency ("CRA") allows taxpayers to request confirmation of CDA balances. Currently, this requires the taxpayer to request confirmation in writing. The taxpayer must make a reasonable attempt at calculating the CDA balance as part of the request. The CRA generally responds within about 3 months and confirms the CDA balance. If any uncertainty exists, it is prudent to confirm the CDA in this manner.

The CRA has been working on improving transparency of the CDA. Capital gain and loss information is now available on the CRA's My Account and CRA announced in May of 2015 that they are working to create an online request form to make it easier to confirm the CDA balance. These developments should improve the confirmation process going forward.

TAX PLANNING RELATED TO THE CDA

1) The CDA balance is calculated on a net cumulative basis over time. A current positive CDA balance may be eroded at a later time. It may therefore be preferable to distribute amounts credited to the CDA as they become available. For example, assume a corporation is incorporated. In the company's first taxation year, a $100,000 capital gain is realized. The next year, the company suffers a $100,000 capital loss.

   In the first year, the CDA balance will be $50,000, representing the non-taxable portion of the capital gain ($100,000 x 50%). The company can pay a capital dividend of $50,000 at any time until the capital loss is realized in year two. If a capital dividend is not paid, then the opportunity to receive tax-free corporate distributions will be lost as the $50,000 non-deductible portion of the capital loss will reduce the CDA balance to $0. Best practice is to pay capital dividends on a regular basis where the CDA balance is positive.

2) Capital dividends are only tax-free for Canadian resident shareholders. A non-resident shareholder who receives a capital dividend payment may be subject to Canadian withholding tax which could be as high as 25% depending on the country of residence and the applicable income tax treaty. There may also be income tax implications in their own country. It is therefore best to make capital dividend payments only to Canadian resident shareholders to maximize the value with such payments. This is known as CDA streaming.

   CDA streaming can be accomplished by using separate classes of shares. For example, one class would be held by resident shareholders and the other held by non-residents. Dividends could be declared on one class of shares to the exclusion of the other, allowing capital dividends to be paid to residents and regular taxable dividends paid to non-residents.

3) CDA planning is an important part of any estate plan involving private company shares and life insurance. Life insurance is often owned at the corporate level to save taxes on the payment of the related annual premiums. As life insurance premiums are generally not tax deductible, an insurance premium of $1,000 would require approximately $1,183 of pre-tax corporate dollars assuming a corporate tax rate of 15.5% and $1,960 in pre-tax personal dollars assuming a personal tax rate of 49%.

   Although corporately owned life insurance will generally provide an annual savings, it also creates a layer of complexity in estate and succession planning. It is important to ensure there is a mechanism to stream the life insurance proceeds which get added to the CDA balance to the deceased shareholder's estate. For example, in family succession scenarios this will require the former owner to continue to hold some shares in the corporation to allow a payment of the capital dividend to their estate.

CONCLUSION

When used properly, the CDA is a powerful tax mechanism for private companies which alleviates double tax concerns. The rules are, however, somewhat complex. Careful tax planning should be used to ensure the rules are used to their maximum potential and potential penalties avoided. Should you have questions regarding the CDA or its application to your corporation, please do not hesitate to contact us for more information.