The capital dividend account

A unique feature of life insurance is how a death benefit received by a private corporation credits its capital dividend account (CDA). Generally, the amount of the insurance payout less the policy's adjusted cost basis (ACB) credits its CDA which allows it to pay tax-free capital dividends to Canadian resident shareholders. There are other rules affecting the calculation of CDA as it relates to life insurance. This article will take a detailed look at these rules.

- CDA and tax integration
- The benefit of CDA
- CDA and life insurance
- Examples of calculating CDA
  - How various components of calculating CDA fit together
  - How CDA can appear to have a negative balance in certain situations
  - Where there was a non-arm's length policy transfer to a corporation after 1999 and before March 22, 2016
- Paying a capital dividend

CDA and tax integration

The taxation of private corporations is based on the principle of "integration."

Integration exists if the total amount of tax on income earned by a private corporation, and the tax on dividends paid to the individual shareholder(s), is approximately the same amount of tax that would have been paid if the corporation's income was earned directly by the shareholder(s).

One mechanism used to achieve tax integration is a private corporation's "capital dividend account", which is defined in subsection 89(1) of the federal *Income Tax Act* (the Act). This is a notional account and its purpose is to keep track of certain tax-free amounts received by private corporations that would also be tax-free if received directly by the shareholder(s). There are four main components of tax-free amounts that determine the CDA balance.

- The excess of the non-taxable portion of capital gains over the non-deductible portion of capital losses (realized directly or through a trust)
- Capital dividends received by the corporation, including those received via a trust
- The non-taxable portion of gains resulting from the disposition of eligible capital property (for example, goodwill)[1]

[1] Gains from dispositions of eligible capital property are only credited to CDA at the end of a taxation year. There's a risk of over-electing if this gain is added to and included in a tax-free capital dividend that is paid before a corporation's year-end.

Canada Life and design are trademarks of The Canada Life Assurance Company.

- Generally, the proceeds of a life insurance policy, less the policy's adjusted cost basis (discussed in the section titled "CDA and life insurance")

If there was no CDA, these various tax-free surpluses would need to be distributed from the corporation as a taxable dividend. This would conflict with the tax integration principle.

Previously paid capital dividends are also deducted from the CDA balance.

Other key points about CDA are:

- The calculation of CDA is cumulative. It begins from the later of after 1971 and time the corporation became a private company (on incorporation as a private company or ceasing to be a public company). As a result, a full historical calculation of the CDA is required before paying a capital dividend.
- A CDA balance can be calculated at any point in time, not necessarily at the company's year-end. This means a CDA balance can be calculated and paid out following the realization of a capital gain or the receipt of a life insurance death benefit.
- A negative amount in one component of the CDA calculation identified above doesn't affect the other components. For example, a capital loss realized from the sale of property isn't subtracted from the calculation that includes the receipt of a life insurance death benefit.

The benefit of CDA

A balance in a corporation's CDA means that it can pay out funds to a Canadian resident shareholder as a tax-free capital dividend.

This can result in significant tax savings. Across Canada, the average non-eligible dividend tax rate for individuals taxed at the highest marginal tax rate is approximately 44%.

Non-resident withholding tax is required on a capital dividend paid to a shareholder that is a non-resident of Canada. Similarly, non-resident withholding tax is required if a capital dividend is paid to an estate and subsequently distributed to a non-resident. The withholding tax may be reduced by a tax treaty Canada has entered into with the dividend recipient's country of residence.

The CDA credit is not tied to the actual insurance payout received by the corporation. For example, a corporation may purchase life insurance on a key person to mitigate the financial losses following their death. If the key person dies, the corporation will use the life insurance payout for business purposes but it will still obtain the CDA credit which it can use to pay capital dividends out of its retained earnings.

Another example is where a corporation collaterally assigns a life insurance policy to a bank for a loan.[2] All or a portion of the insurance payout would first be used to repay the bank loan. While the repayment would leave less cash (or none) for

[2] Collateral loans involve risk. They should only be considered by sophisticated investors with high risk tolerance and access to professional advice from a lawyer and accountant. The terms of future availability of collateral loans cannot be guaranteed. The loan or line of credit must be negotiated between the policyowner and the lender. It's subject to the lender's financial underwriting and other requirements. The policyowner should have enough income and capital to cover the interest and loan repayment, as well as the insurance premium.

Canada Life and design are trademarks of The Canada Life Assurance Company.

the company, the corporation will still obtain the CDA based on the full insurance payout less the policy's ACB.[3] This is unlike the case with a policy loan where the loan is from the insurer and secured by the policy's cash value. In these cases the corporation's CDA credit is based on the full insurance payout less the outstanding policy loan and the policy's ACB.

CDA and life insurance

The credit a corporation obtains to its CDA by virtue of receiving a life insurance death benefit is the amount by which the death benefit exceeds the following:

(i) The policy's adjusted cost basis

The ACB of a life insurance policy (issued after Dec. 1, 1982) is generally equal to the cumulative premiums paid into the policy, less the cumulative net cost of pure insurance (NCPI).

NCPI is a tax concept set out in the Act's regulations. NCPI tracks the pure mortality costs of the policy's death benefit. It increases each year as the life insured gets older. Typically, in the later years of a policy, the ACB decreases as a result of the NCPI deductions. This has favourable implications for corporate policyowners. A lower ACB means a greater credit to CDA, and consequently, more of the insurance payout may be paid as tax-free capital dividends to Canadian resident shareholders.

For deaths prior to March 22, 2016, a corporation's CDA was reduced by the ACB of the policy *to the corporation* receiving the death benefit. If the corporation is the beneficiary but not the owner, then it would not have an ACB in the policy and the full death benefit would credit its CDA. This may result in a higher CDA credit than what the corporation would have had if it owned the policy.

The 2016 federal budget addressed this unintended result. For deaths occurring after March 21, 2016, the CDA will be reduced by the ACB of the policy, even if the receiving corporation is not the owner of the policy. This amendment creates a reasonable outcome in most cases. However, the CRA has taken a strict interpretation to this amendment which has lead to anomalous results. For example, if a policy has two corporate beneficiaries, the policy's full ACB reduces the CDA credit for each beneficiary. The ACB is not prorated by the portion of the total death benefit received by each beneficiary.[4] Similarly, in a co-ownership arrangement, the policy's full ACB reduces the CDA calculation for a corporate owner, again the ACB amount is not prorated by the portion of the total death benefit received by the corporate beneficiary.[5] In these scenarios the ACB is effectively double-counted. Hopefully this will be addressed by another legislative amendment.

(ii) Outstanding amount of 10/8 policy borrowing

A 10/8 arrangement involves overfunding a life insurance policy and then obtaining a business or investment loan using the policy's CSV as collateral. Under these arrangements, the rate of return on the policy's account value

---

[3] CRA Technical Interpretation 2014-0555581E5, June 5, 2015. The corporation should remain the owner and beneficiary of the policy whenever possible although this was not the case in *Innovative Installation Inc.* v. *The Queen*, 2010 FCA 285 where the bank was the owner and beneficiary of a policy on the life of the business owner. The policy secured a loan to the life insured's corporation. The Federal Court of Appeal found the corporation borrower to be entitled to a CDA credit based on the finding of constructive receipt.

[4] CLHIA 2017 CRA Roundtable, CRA document 2017-0690311C6E.

[5] CALU 2018 CRA Roundtable Q. 2, CRA document 2018-0745811C6.

Canada Life and design are trademarks of The Canada Life Assurance Company.

and loan's interest rate are linked. The growth in the policy is tax-advantaged. The interest paid on the loan is a tax deductible expense and a portion of the premiums paid may also be deductible. The 2013 federal budget ended the tax advantages associated with 10/8 arrangements. One of these measures applicable to deaths occurring after 2013 reduces the CDA credit by the borrowed amounts outstanding under the 10/8 arrangement at the time of death.

(iii) Non-arm's length policy transfers to a corporation after 1999 and before March 22,2016
Prior to March 22, 2016 if a person not dealing at arm's-length with the corporation (e.g., a controlling shareholder) transferred a policy to the corporation, the transfer price for tax purposes was deemed to be an amount equal the policy's cash surrender value (CSV) even where the corporation paid the shareholder consideration equal to the fair market value (FMV) of the policy. This allowed the shareholder to withdraw from the corporation an amount equal to FMV of the policy tax-free.

New rules introduced in the 2016 federal budget stopped the tax loophole exposed by these types of transfers. These rules also amended the calculation of CDA in cases where a private corporation acquired a life insurance policy from a non-arm's length person (rather than a corporation) anytime between January 1, 2000 and March 21, 2016 and the payout is received after March 21, 2016. In these cases the "grind" to the CDA credit is not only limited to the policy's ACB, it's also reduced by the sum of two other factors:[6]

Fixed grind: The FMV of the consideration given by the corporation for the policy, less the **greater** of the policy's CSV and ACB immediately before the transfer.

Declining grind: The amount, if any, by which the **lesser** of the FMV of the consideration given by the corporation for the policy and the policy's ACB immediately before the transfer **exceeds** the policy's CSV immediately before the transfer, **minus** the absolute amount of any negative ACB at the time of death.

The fixed grind is straightforward and does not change over time. If the corporation paid more for the policy than its CSV or ACB, then that amount will reduce the CDA credit.

The declining grind is complicated because it introduces this concept of a negative ACB. Determining a policy's negative ACB involves tracking the NCPI grind on a policy's ACB to an amount below $0 (nil).

Life insurance carriers can calculate a policy's negative ACB. In our case, we can provide this information upon the request of a corporate policyowner after we pay the death benefit.

Examples of calculating CDA

The following examples illustrate how the various components of calculating CDA fit together in practice.

1. Example 1.1 – the components of CDA are calculated independently

It's Oct. 1, 2016 a holding company's (Holdco) accountant is calculating its CDA balance.

[6] In addition, the CDA may also be reduced by the amount of paid-up capital withdrawn from the corporation, if the paid-up capital resulted from contribution of capital by way of transfer of a life insurance policy.

Canada Life and design are trademarks of The Canada Life Assurance Company.

Facts: Holdco's taxation year-end is Dec. 31. There have been no other transactions in Holdco's history that affected its CDA before Sept. 30, 2016. On Sept. 30, 2016, Holdco realized a capital loss of $100,000 (non-deductible capital loss of $50,000) and received a capital dividend from a subsidiary corporation of $50,000.

CDA balance: $50,000

Explanation: The components of CDA are calculated independently so they don't affect other components in the computation. A component in the calculation cannot be negative, thus the capital gain/loss component is $0, and the component relating to capital dividends received from other corporations is $50,000.

CDA component	CDA component calculations		Total
Capital gains/capital losses	Non-taxable capital gains	$0	
	Non-deductible capital loss	($50,000)	$0
Capital dividends from other corporations	Capital dividend from subsidiary	$50,000	$50,000
CDA balance			**$50,000**

2. Example 1.2 – Holdco receives an insurance death benefit

It's Nov. 1, 2016 and Holdco's accountant is calculating its CDA balance.

More facts: Holdco paid a $50,000 capital dividend to its shareholders on Oct. 15, 2016. On Oct. 31, Corporation X realized a capital gain of $80,000 (non-taxable capital gain of $40,000) and received a $500,000 death benefit from a life insurance policy on a key executive. The policy had an ACB of $100,000. The policy is not part of 10/8 arrangement and was not transferred to corporation in a non-arm's length transaction.

CDA balance: $400,000

Explanation: A historical CDA calculation shows capital gain/loss component is $0 since it cannot be negative ($50,000 non-deductible capital loss minus $40,000 non-taxable capital gain). The life insurance death benefit component is $400,000 ($500,000 death benefit less $100,000 adjusted cost basis). The capital-dividends-received component is $50,000, and the capital-dividends-paid component is $50,000.

CDA component	CDA component calculations		Total
Capital gains/capital losses	Non-taxable capital gains	$40,000	$0

Canada Life and design are trademarks of The Canada Life Assurance Company.

	Non-deductible capital loss	($50,000)	
Capital dividends from other corporations	Capital dividend from subsidiary	$50,000	$50,000
Life insurance death benefit received	Death benefit	$500,000	
	Policy ACB	($100,000)	$400,000
Minus Capital dividend paid			($50,000)
CDA balance			**$400,000**

3. Example 2 – CDA can appear to have a negative balance in some situations

As the computation of CDA is done on a cumulative basis, transactions and capital dividends paid in prior years impact the calculation in the current year. A CDA balance cannot be negative, but in some situations it can appear to be depending on the corporation's capital dividend payment history.

Facts: In 2015, Holdco realized a capital gain of $1 million. 50 per cent of this gain (non-taxable portion), $500,000, was added to CDA. Soon after, Holdco declared a capital dividend of $500,000. In 2016, Holdco realized a capital loss of $1 million (non-deductible capital loss of $500,000). Holdco subsequently receives a death benefit of $1,500,000. The policy's ACB was nil.

CDA balance: $1,000,000

Explanation: In this case, only a capital dividend of $1,000,000 may be paid (rather than a full $1,500,000 capital dividend as a result of the tax-free death benefit) because of previous transactions that affect the CDA balance. A historical CDA calculation would be:

CDA component	CDA component calculations		Total
Capital gains/capital losses	Non-taxable capital gains	$500,000	
	Non-deductible capital loss	($500,000)	$0
Life insurance death benefit received	Death benefit	$1,500,000	
	Policy ACB	($0)	$1,500,000
Minus Capital dividend paid			($500,000)
CDA balance			**$1,000,000**

Canada Life and design are trademarks of The Canada Life Assurance Company.

4. Example 3: An individual shareholder has transferred a policy to corporation

Let's look at examples where an individual shareholder has transferred a policy to Holdco for FMV consideration sometime between January 1, 2000 and March 21, 2016.

We'll use a hypothetical level cost universal life insurance policy on the life of 50-year-old female. The policy has $100,000 of coverage, is minimum funded and is transferred at year 20 to a corporation for FMV consideration, which at the time was $35,000. At the time of the transfer the policy had an ACB of $12,500 and no cash value, as a result, Holdco's new ACB in the policy was nil (the prior version of subsection 148(7) applied). The new corporate policyowner paid premiums, which added to the policy's ACB each year. The NCPI applied to decrease the ACB each year. We'll look at three scenarios where the life insured dies at policy years 21, 25 and 30.

As seen in the table below, the new "fixed grind" (described above) attempts to claw back the tax benefits achieved from this transaction by reducing the corporation's CDA credit by the FMV consideration over the policy's ACB.

The new "declining grind" (described above) appears to claw back the tax benefits achieved from the corporate policyowner obtaining a lower ACB than that of the transferor, which could result in a larger CDA credit if the life insured died shortly after the transfer. Over time, the amount of the declining grind is reduced, which makes sense as the NCPI would have reduced the policy's ACB to the corporation anyway.

	Death in policy year		
	21	25	30
CSV at transfer (year 20)	$0	$0	$0
ACB at transfer (year 20)	$12,500	$12,500	$12,500
FMV paid by corporation	$35,000	$35,000	$35,000
New ACB at year 20 (CSV)	$0	$0	$0
Cumulative premium from year 21	$1,250	$6,250	$12,500
Cumulative NCPI from year 21	$1,800	$11,500	$31,750
ACB on death	$0	$0	$0
Negative ACB on death	($550)	(5,250)	(19,250)
CDA credit calculation			
Add: death benefit	$100,000	$100,000	$100,000
Minus: normal ACB	$0	$0	$0

Canada Life and design are trademarks of The Canada Life Assurance Company.

Minus: fixed grind FMV ($35,000) less greater of CSV before transfer ($0) and ACB before transfer ($12,500)	$22,500	$22,500	$22,500
Minus: declining grind Lesser of FMV consideration ($35,000) and ACB before transfer ($12,500), exceeds CSV before transfer ($0), minus absolute amount of negative ACB at death (year 21, $550; year 25, $5,250; year 30 $19,250)	$11,950	$7,250	$0
CDA credit	$65,550	$70,250	$77,500

.

Paying capital dividends

The payment of a capital dividend is optional. A private corporation can pay an ordinary taxable dividend even if, at the time, it has a balance in its CDA. If it does pay a capital dividend, it must follow this procedure:

1. The corporation, usually through its tax advisor, completes a CRA form T2054[7] in which the corporation elects, under subsection 83(2) of the Act[8], that the dividend it proposes to pay will be a capital dividend.

2. An original of this T2054 election form, along with a:

    a. certified copy of the director's resolution authorizing the election; and

    b. schedule showing the CDA calculation immediately before the capital dividend is paid,

    must be sent to CRA on or before the earlier of the date on which the dividend becomes payable or the date it was paid.

The calculation of the capital dividend must always be left to the corporation's tax advisor for two reasons. First, it can be an involved and complex calculation. Second, an error in paying an amount in excess of the corporation's CDA results in the excess being considered a separate taxable dividend to the shareholder(s), if all shareholder(s) agree; or a tax penalty to the corporation. The timing of the payment of a capital dividend is at the discretion of the corporation. It doesn't have to wait until the end of a fiscal year, nor does it have to pay out amounts as soon as they're credited to its CDA. It's good practice for the corporation to inform shareholders that they are receiving a capital dividend, and therefore tax-free assuming they are Canadian residents.

Conclusion

A private corporation's CDA is important for ensuring tax-free amounts it receives maintain their tax-free character. Understanding how CDA is calculated is important. It plays a critical role for the distribution of tax-free amounts to Canadian resident shareholder(s), including a death benefit received by a private corporation as beneficiary of a life

[7] For Quebec provincial tax purposes also file form CO-502 with Revenu Quebec.
[8] For Quebec provincial tax purposes refer to section 502 of Quebec's *Taxation Act*.

Canada Life and design are trademarks of The Canada Life Assurance Company.

insurance policy.

Canada Life and design are trademarks of The Canada Life Assurance Company.