CAPITAL DIVIDEND ACCOUNT

iA Financial Group

A capital dividend account[1] ("CDA") is a tax account for Canadian private corporations that results from the calculation for tracking certain elements that should not be taxed in the hands of shareholders for purposes of the integration principle.[2]

It's a tax account, not an accounting account, and does not appear on the financial balance sheet or tax returns. There is no money in this account, it's just a calculation. This calculation is used to determine the amount of capital dividend (non-taxable) that can be paid by a corporation. It applies to private corporations only.[3]

The CDA is calculated on a continuous basis starting from the company's incorporation.

Begins on the first day of the first taxation year ending after April 1, 1971.

The calculation should always be done this way, not using the previous year's account balance.

The CDA calculation includes several elements.[4]

In particular:

Non-taxable portion of capital gains	$

For example, a capital gain realized on the disposition of a capital asset (e.g., investments, shares of another company, buildings, etc.). Non-taxable portion = 50% of the capital gain. The corporation must pay tax on the taxable portion of the capital gain.

LESS (-)

Non-deductible portion of capital losses (including BILs[5])	$

For example, the capital loss realized on the disposition of a capital asset (e.g., investments, shares of another company, buildings, etc.). Non-deductible portion = 50% of the capital loss.

The subtotal is either positive or zero	$

This means that the balance cannot be negative and that even if the corporation realizes a lot of losses, this does not reduce the other elements of the CDA.

PLUS (+)

1. Total capital dividends received by the Corporation	$

For example, an operating company can pay a capital dividend to a management company and the latter can then pay this dividend to its shareholder.

The non-taxable portion of gains realized on the disposition of the corporation's eligible capital property (prior to the fiscal period ending before January 1, 2017 (change to class 14.1)). This class is now included in element 1.	$

2. Life insurance proceeds (which the corporation receives as beneficiary) reduce the ACB of the policy.	$

The life insurance proceeds, less the ACB of the policy, increase the CDA and allow a capital dividend to be paid to the estate.

The total is either positive or zero	$

LESS (-)

3. All capital dividends that became payable by the corporation during the period.	$

Total CDA balance	$

Note that the insurance death benefit must not have been received through a trust.[6]
For example, if the trust receives the life insurance death benefit as a beneficiary and distributes the amount to the corporation, there will be no amount added for the CDA calculation.

Example of CDA calculation

ABC Corporation realizes capital gains and losses during its existence and also receives proceeds from a life insurance policy

	Non-taxable capital gain	Non-deductible capital loss	Net life insurance proceeds	Capital dividend paid	CDA balance at a given time
Year 1	$150,000			$150,000	**$0** (after payment of capital div.)
Year 2		$75,000			**$0** (must be positive or zero)
Year 3			$1,000,000		**$925,000** (after payment of life insurance proceeds)

Explanation of CDA calculation in year 3, after payment of life insurance proceeds:

All non-taxable capital gains **$150,000** (year 1) – All non-deductible capital losses **$75,000** (year 2)

Subtotal year 3 (positive or zero result)	$75,000
PLUS (+) Net life insurance proceeds (life insurance benefit – policy's ACB)	$1,000,000
Subtotal	$1,075,000
LESS (-) capital dividends paid (year 1)	($150,000)
Total CDA year 3	**$925,000**

Non-deductible capital losses reduce the first component of the calculation, namely non-taxable capital gains, while capital dividends already paid reduce the total CDA calculation.

Procedures for paying the capital dividend to shareholders

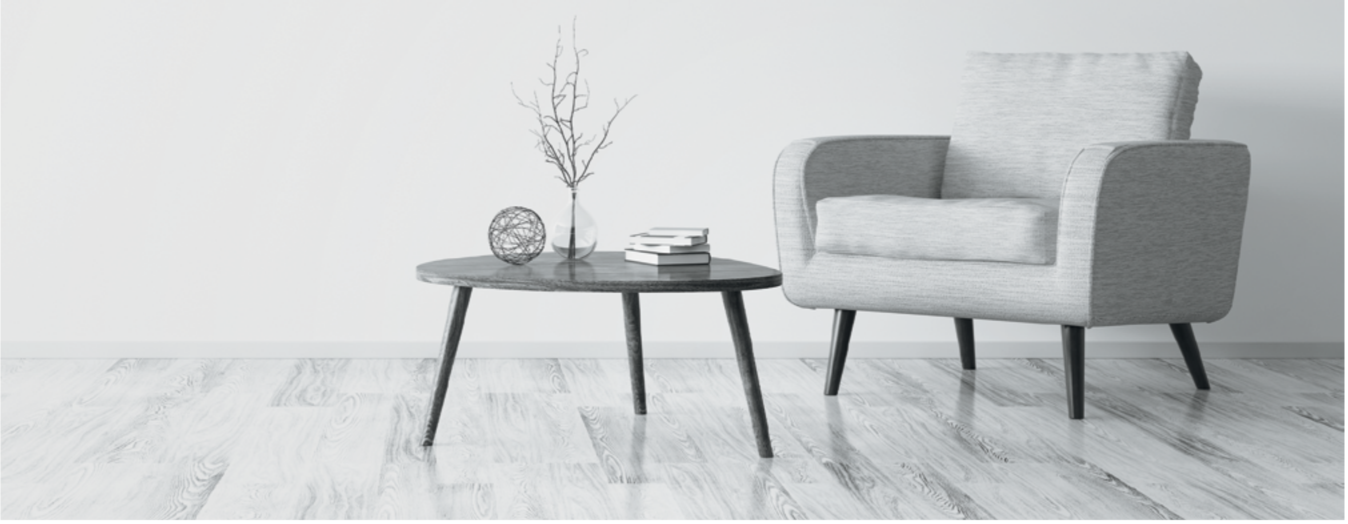
— The capital dividend is allocated equally to each share in the same class. This means that when a dividend is paid out of the CDA for a class of shares, all shareholders of that class receive a tax-free capital dividend based on the proportion of shares held.

— The amount of the designated dividend must equal the CDA balance. The CDA balance must be positive.[7]

To pay a dividend from the CDA, a tax election must be filed with the Canada Revenue Agency (CRA) using the prescribed tax form, along with a request for a CDA balance verification. The CDA balance must be confirmed by the tax authorities before it can be paid.

Timing of capital dividend payments

As illustrated in the previous example, the timing of the capital dividend payment is important, especially when receiving life insurance proceeds. It may be necessary to wait until capital gains are generated again before paying a capital dividend to the deceased's estate or to the surviving shareholders in full. In addition, it's a good idea to consult your tax advisor to verify the balance in the capital dividend account prior to the declaration and payment of any capital dividend.



[1] Subsection 89(1) of the *Income Tax Act* ("ITA") defines "capital dividend account" and subsection 83(2) of the ITA defines "capital dividend."

[2] Under the integration principle, the taxation of income should always be the equal, regardless of whether the income is earned by an individual or a corporation.

[3] A 25% federal withholding tax is charged in respect of a CDA paid to a shareholder who is not a resident of Canada. The withholding rate may vary depending on the shareholder's country of residence and applicable tax treaties, if any.

[4] Subsection 89(1) ITA, definition of "capital dividend account."

[5] Business investment losses.

[6] If a trust received the death benefit directly as a beneficiary, the CRA has already indicated that amounts received by a trust as beneficiary and distributed to a corporation cannot be credited to the CDA, CANADA REVENUE AGENCY. Technical Interpretation 2011-0399771C6, "CDA, Innovative Installation case," May 20, 2011.

[7] Any capital dividend payments in excess of the CDA balance are subject to a 60% penalty on the portion of the capital dividend in excess of the CDA payable by the corporation that declared and paid the capital dividend. The ITA avoids this 60% penalty on the portion of the capital dividend in excess of the CDA by allowing the corporation that declared and paid the capital dividend to treat the excess portion as a separate taxable dividend.

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