Personal Tax Planning

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THE BEST THINGS IN LIFE ARE (TAX-)FREE: A CURRENT LOOK AT THE CAPITAL DIVIDEND ACCOUNT

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The capital dividend account continues to be an important device for tax planning for private corporations and their shareholders. Tax planners should be aware, however, that part III tax may be exigible if a corporation declares capital dividends in excess of the amounts in the capital dividend account. This article reviews several strategies for achieving the most efficient use of the amounts in a corporation's capital dividend account. In particular, since dispositions of eligible capital property by a corporation will not increase the capital dividend account until the corporation's taxation year-end (if at all), an accelerated deemed taxation year-end, where possible, may be appropriate. It is also possible, and often desirable, to stream the capital dividend account to shareholders who will obtain the greatest benefit from capital dividends and to make frequent elections to pay amounts out of the account. In addition, the capital dividend account can be usefully employed as part of various life-insurance-funded redemption strategies in order to maximize the value that a corporation's shareholders (and a deceased shareholder's estate) may obtain upon the death of a shareholder. Finally, tax planners should be aware that, despite recent legislative remedies, problems may arise in respect of excess capital dividend elections if the dividends were declared on the strength of distributions received by the corporation from certain mutual fund trusts.

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INTRODUCTION

The capital dividend account (CDA) continues to be extremely important in tax planning for private corporations and their shareholders in Canada. The CDA is the quintessential expression of integration between personal and corporate income taxation with respect to the treatment of capital gains, dispositions of eligible capital property (ECP), and the receipt of corporate life insurance proceeds[1] because it "includes amounts that a corporation may distribute to its shareholders without triggering taxation at the shareholder level."[2] The CDA's usefulness to taxpayers has increased in recent years because of changes to the Income Tax Act[3] relating to certain stop-loss rules,[4] the mechanics of payments from trusts to private corporations,[5] and the inclusion rates with respect to capital gains and ECP.[6]

This article provides an overview of the CDA and examines some planning techniques that exploit its usefulness. The discussion begins with a description of what is included in the CDA, and how and when amounts in the account can be paid out to shareholders. In some cases, part III tax will be exigible when excess capital dividends are declared; therefore, part III tax and the so-called excess election[7] are addressed. The article then explores a number of planning points concerning the CDA. Readers will be familiar with several of these strategies—for example, the value of frequently paying out positive amounts in the CDA and the concept of CDA streaming. Other techniques—specifically, the timing of inclusions on the disposition of ECP, life-insurance-funded redemptions or purchases for cancellation, and the receipt of certain amounts from mutual fund trusts—may be less familiar but can be equally useful in maximizing the tax benefits associated with the CDA.

OVERVIEW OF THE CDA AND CAPITAL DIVIDENDS

The CDA is a notional account maintained by a private corporation which consists of the following five basic items:[8]

1. generally, the non-taxable portion of capital gains realized by the corporation less the non-deductible portion of its capital losses;[9]
2. tax-free capital dividends received by the corporation from other corporations;[10]
3. the non-taxable portion of the gains realized by the corporation on the disposition of ECP;[11]
4. proceeds of life insurance policies received by the corporation as a consequence of the death of the insured, to the extent that, in most cases, those proceeds exceed the adjusted cost basis of those policies;[12] and
5. certain distributions made by a trust and received by the corporation in respect of non-taxable capital gains realized by the trust[13] and capital dividends received by the trust.[14]

A positive balance in the CDA may be distributed to shareholders, while the corporation is a private corporation, by means of a capital dividend. In order to generate a capital dividend, the corporation must make an election[15] in the prescribed manner and form pursuant to subsection 83(2). Paragraph 83(2)(b) provides that no part of the capital dividend shall be included in the income of the recipients.[16]

Two points are worth noting about the election.

First, on the plain wording of subsection 83(2), the corporation must make the election "in respect of the full amount of the dividend." To the extent that the dividend election is in excess of the amount in the corporation's CDA, a penalty may be exigible on the excess.[17] This means that care must be exercised when the corporation's directors want to distribute a capital dividend on a share redemption. Pursuant to subsection 84(3), a dividend is deemed to have been paid on a redemption of shares of the corporation.[18] The amount of the deemed dividend is the amount paid by the corporation on the redemption less the paid-up capital (PUC) of the shares redeemed. The corporation may elect that the deemed dividend be a capital dividend, but the elected capital dividend must be the full amount of the deemed dividend. If the corporation wants to distribute amounts only from its CDA (so as to avoid both part III tax and a separate taxable dividend paid to shareholders), it will have to select the precise number of shares that it redeems[19] in order to produce a deemed dividend that does not exceed its CDA.

Second, the capital dividend election is supposed to be made by the earlier of the date on which the dividend becomes payable and the date on which any part of the dividend is paid. If the election is not made in time, subsection 83(3) will deem it to have been made in time if the corporation elects in the prescribed form and manner, authorizes the election before the due date, and pays a late-filing penalty. The amount of the penalty, specified in subsection 83(4), is calculated as 1 percent per annum of the amount of the dividend referred to in the election for each month or part of a month outstanding from the due date until the date the election is made, to a maximum of $41.67 per month.

The requirement that the corporation be a private corporation in order to distribute capital dividends to its shareholders is important to bear in mind when a change in status is contemplated—for example, from a private corporation to a public corporation. A public corporation may not pay capital dividends,[20] even if it was previously a private corporation with a balance in its CDA immediately before it became a public corporation.[21] It may therefore be useful to elect and pay out a positive CDA balance before a change in status of a private corporation to a public corporation.[22] The same considerations will apply to a corporation's subsidiaries; when a parent company goes public, a subsidiary that was formerly a private corporation will no longer be a private corporation for tax purposes so that, thereafter, the subsidiary will no longer be able to elect and pay capital dividends, at least so long as it is controlled by a public corporation.

In these circumstances, can the subsidiary that is now controlled by a public corporation, or the public corporation itself, still maintain a CDA of its own? It may be thought that, when a private corporation becomes, or becomes controlled by, a public corporation, its CDA is erased.[23] However, the statutory basis for this view is not clear. It is conceded that the non-taxable portion of a corporation's capital gains in excess of the non-deductible portion of its capital losses cannot be added to the corporation's CDA while it is a public corporation.[24] However, there appears to be no specific provision[25] preventing a corporation whose status changes from private to public from carrying over its CDA (including its non-taxable capital gains in excess of non-deductible capital losses) accumulated during its time as a private corporation.

Furthermore, there appears to be no specific rule restricting a public corporation from continuing to add to its own CDA any capital dividends that it receives from other private corporations.[26] Pursuant to the definition of "capital dividend account" in subsection 89(1),[27] capital dividends received by a corporation that are not included in income are added to the recipient corporation's CDA. There is no explicit requirement that the CDA must be accumulated in a private corporation.

It may therefore be technically possible, in the case of a change of status from a private to a public corporation, to carry over a CDA balance to the new public corporation, to continue to accumulate amounts in the CDA from capital dividends received while the corporation is a public corporation, and then to elect to distribute amounts from the CDA if the corporation once again becomes a private corporation. On one level, the Canada Customs and Revenue Agency (CCRA) should have no objection, since amounts in such a sequence are elected out of the CDA only when the electing corporation is a private corporation. Note that this is the case with respect to the capital dividends elected and distributed by any private corporation(s) to the public corporation. It is unclear, however, how the CCRA may react to the public corporation's position that capital dividends received by it while it is a public corporation can be accumulated in its own CDA.

If there is no CDA in a public corporation or a corporation controlled by a public corporation, and that corporation subsequently becomes a private corporation, it may start accumulating balances in its CDA after the time that it becomes a private corporation—for example, in the case of the non-taxable portion of capital gains, from the beginning of the first taxation year after the corporation last became a private corporation.

Consequences also follow from changes in control involving non-resident persons. Where a private corporation with a CDA becomes controlled by a non-resident person, the private corporation may still be able to retain its CDA, provided that it can retain its status as a private corporation. On the other hand, where a corporation that is controlled, directly or indirectly, by one or more non-resident persons becomes a Canadian-controlled private corporation (CCPC), other than by a change in residence of one or more of its shareholders, one must deduct from the CDA of the new CCPC the amount that was in the corporation's CDA immediately before the change in control.[28] Effectively, the CDA is reset to zero at the time of the change in control. It may be possible and useful, in certain circumstances, to elect and pay capital dividends from the CDA before the change in control—for example, to elect and pay capital dividends to resident shareholders, provided that the anti-avoidance provisions of subsection 83(2.1) and paragraph 83(2.2)(d) do not apply.

In short, the prudent tax planner should be mindful of the consequences flowing from changes in a corporation's status and control when contemplating CDA distributions.

PART III TAX

Where the amount of the capital dividend elected by the corporation exceeds its CDA immediately before the dividend became payable, part III (specifically, subsection 184(2)) imposes tax on the corporation equal to 75 percent of the excess amount. The part III tax is payable at the time of the election. A capital dividend elected in excess of a corporation's CDA may occur in all manner of circumstances, from life-insurance-funded redemption or purchase for cancellation strategies—discussed further below—to simple uncertainty on the part of a corporation's directors about the amount in the CDA. Effective tax planning should therefore address possible exposure to part III tax.

Part III tax is intentionally punitive.[29] The technical notes to section 184 state that "[t]he tax under Part III is set at a rate which ensures that shareholders in the highest marginal rate brackets cannot obtain any advantage through an excessive election."[30] In fact, the rate of part III tax is considerably higher than the current highest marginal tax rate. The message to private corporations is clear: elections of capital dividends in excess of the CDA that go unremedied pursuant to the provisions of part III will be deterred and punished by means of this special tax.

The remedy to the penalty of part III tax is in subsection 184(3), which effectively allows the corporation to split the capital dividend (that is, the amount of the CDA plus the excess) into three separate dividends.[31] This splitting of the capital dividend is accomplished by means of an election made in prescribed manner within 90 days of the mailing of the notice of assessment in respect of the part III tax payable. One of the requirements for the election to be valid is the concurrence of all of the corporation's shareholders who are entitled to receive all or any portion of the capital dividend and whose addresses are known to the corporation.[32] The election brings a number of deeming rules into play. In somewhat convoluted language, even by the standards of the Act, paragraph 184(3)(a) deems "the amount by which the full amount of the dividend exceeds the amount of the excess," or the portion of the capital dividend satisfied by the CDA, to be a separate dividend. This dividend remains non-taxable pursuant to subsection 83(2). Paragraph 184(3)(b) allows the corporation to choose the amount of the excess that it wants to allow to be subject to part III tax and deems that amount to be the second separate dividend. Paragraph 184(3)(c) deems the excess over and above the amount claimed in paragraph 184(3)(b) to be a separate taxable dividend. The taxable dividend is ordinary dividend income subject to the gross-up, eligible for the dividend tax credit, and taxable in the hands of the dividend recipient. Technically, therefore, the separate taxable dividend is just the deemed result of (that is, the amount left over as a result of) the corporation's positive choice about how much of the excess election to leave subject to the penalty tax.

In all cases, the corporation and its shareholders have an incentive to agree to elect that no amount of the excess amount should be left as taxable pursuant to subsection 184(2). It is true that only the corporation is named in the charging provision while only the dividend recipient must pay tax on a separate taxable dividend. Any shareholder receiving a dividend might be tempted to think it in his or her own self-interest to shift the tax burden to the corporation by refusing to concur with an excess election. As has been pointed out, however, even if the corporation is the only party directly penalized by subsection 184(2), "the value of existing shares is obviously diminished as a result of the payment of the Part III tax,"[33] so that the recalcitrant shareholder will still be indirectly affected by the penalty. This may not be of much concern to a dividend recipient in a widely held corporation, since he or she may choose to act as a free rider.

Nevertheless, even if external incentives do not dissuade the shareholder, the Act will. Pursuant to subsection 185(4), every recipient of a capital dividend is jointly and severally liable with the corporation to pay a pro rata share of the part III tax arising as a result of the subsection 83(2) election. This share is the amount of the capital dividend—both the portion satisfied by the CDA and the excess—received by the shareholder as a percentage of the full amount in respect of which the corporation elected pursuant to subsection 83(2), with that percentage then multiplied by the corporation's whole part III tax liability.

It is therefore always preferable for a corporation and the dividend recipient to agree on the amount of an election pursuant to subsection 184(3).[34] The result of not electing to exclude the full amount of the dividend from the penalty tax is that the corporation paying the capital dividend effectively chooses a tax rate of 75 percent over a 0 percent tax rate on the excess and the recipient also chooses a rate on the excess well above his or her top marginal tax rate. As the corporation and the recipient are jointly and severally liable for the tax, it will never make sense not to elect out of a part III tax liability.

One final point is worth making about the subsection 184(3) election. The prescribed requirement that, generally, the directors of the corporation must declare that the election is made with the concurrence of all of the recipients whose addresses were known to the corporation[35] can be an onerous one in a widely held corporation. In such a case, it may be advisable for the corporation to obtain in advance (perhaps on subscription or transfer) the irrevocable concurrence of all shareholders to a possible election under subsection 184(3) if there is any danger of an excess amount that could give rise to part III tax.[36] In a 1980 interpretation letter, the CCRA indicated that the necessary shareholder concurrence with the subsection 184(3) election can be obtained before the election and even before the determination of the excess amount.[37]

TAX-PLANNING STRATEGIES

The discussion above has briefly reviewed the components of the CDA, the methods of electing capital dividends, and the mechanics of the part III tax and excess dividend elections. Against that background, this section explores several planning strategies that can help private corporations and their shareholders to make the most effective use of the CDA.

Disposition of ECP

The first point to be discussed is the effect on the CDA of a disposition of ECP. Generally, amounts are added to the CDA immediately upon the occurrence of specific events or transactions. For example, capital dividends received by private corporation B from another private corporation are typically added to B's CDA at the time of receipt. If this is the only transaction affecting B's CDA, B may make its own capital dividend election in order to pay out the amounts in the CDA to shareholders. In the same way, amounts that are added to a corporation's CDA from the non-taxable portion of capital gains, proceeds of life insurance, and certain trust distributions increase the CDA as soon as those amounts are received by the corporation. Provided that there is a positive balance in the CDA, the amounts received may be paid out to shareholders by means of capital dividends.

By contrast, in the case of dispositions of ECP by a private corporation, the addition to the CDA is postponed to the end of the corporation's taxation year. This delay results from the interaction of two provisions of the Act—paragraph (c.2) of the definition of "capital dividend account" in subsection 89(1) and paragraph 14(1)(b).[38] According to paragraph (c.2) of the CDA definition, the CDA of a corporation, at any particular time, means the total of all amounts required by paragraph 14(1)(b) to be included in the corporation's income in respect of a business carried on by the corporation for a taxation year that ends after October 17, 2000. Subsection 14(1) provides that where there has been a disposition of ECP by the taxpayer in the taxation year, certain amounts in respect of a business shall be included in the taxpayer's income *at the end of a taxation year*. Paragraph 14(1)(b) effectively includes one-half[39] of all amounts the taxpayer received (or is entitled to receive) from the disposition, to the extent that the amounts exceed the taxpayer's cumulative eligible capital (CEC). If, for instance, a private corporation disposes of ECP—and assuming that elements B, C, and D of the formula in paragraph 14(1)(b) do not apply—where the amount received by the corporation is $200 and its CEC is $100, subsection 14(1) will cause the corporation, at the end of its taxation year, to include $50 (or one-half of the excess) in its business income in respect of the year. The non-taxable portion of the excess (also $50) is included in the CDA pursuant to subsection 89(1), but only at the end of the corporation's taxation year, since the amount in paragraph 14(1)(b) is determined at the end of a taxation year.

Accordingly, care should be exercised in planning for the distribution of capital dividends from a CDA following a corporate disposition of ECP. If amounts are distributed from the CDA after the time of disposition of ECP but before the corporation's taxation year-end, the non-taxable portion of receipts from the disposition will not be available to fund the distribution. If a capital dividend is declared because the directors of the corporation believe there are sufficient amounts in the

CDA to fund it, a part III tax liability could be inadvertently generated. Even if it were later determined that part III tax applied, and the corporation and the dividend recipients agreed to elect that no amount would be subject to the penalty (that is, that the entire amount would become a taxable dividend), this would be an unfortunate result given the original intention to pay out the capital dividend tax-free.

It should be noted that the CCRA will provide limited administrative relief from part III tax liability where a private corporation mistakenly added amounts in respect of the disposition of ECP to its CDA too soon if the capital dividend was elected on or before January 31, 2002.[40] The relief will apply only to those dispositions of ECP by corporations during taxation years ending after February 27, 2000—that is, corporations to which paragraph 89(1)(c.1) or (c.2) applies. Where a disposition of ECP involving paragraph 89(1)(c.1) or (c.2) arises, the CCRA will accept the private corporation's mistaken timing, allowing the addition to the CDA before the taxation year-end and reducing the CDA on the election of the capital dividend. The cutoff date for administrative relief was established because of a commentary that appeared in *Canadian Tax Highlights* in January 2002.[41] The CCRA's rationale appears to be that the commentary put the tax community on notice that there is a timing issue with respect to the disposition of ECP and the effects on a corporation's CDA. No relief is contemplated for elections made after January 31, 2002; any additions to the CDA based on dispositions of ECP must take place at the end of the disposing corporation's taxation year.

To avoid the problem of part III tax, the corporation's shareholders may wish to consider taking steps to shorten the lag between the disposition of ECP and the addition of the non-taxable portion to the CDA. This can be done by triggering a year-end immediately after the sale of the ECP. The example that follows illustrates how the desired result may be achieved by means of an acquisition of control.

Individual A owns 100 percent of the common shares of Opco, a private corporation. Common shares are the only authorized, issued, and outstanding capital stock of Opco. A has owned all of the common shares since incorporation, and no other classes of shares of Opco ever existed. Opco carries on two distinct businesses: a manufacturing concern and a retailing business to market the manufactured product. A wants to sell off Opco's two businesses to separate buyers. The retailing business has goodwill that has been built up since the inception of the business, and its CEC is zero. The fair market value (FMV) of the goodwill is $1 million. Opco has a December 31 year-end.

Opco sells the retailing business, including goodwill and other assets, to Buyco, an arm's-length party, on March 1, 2002. Buyco pays cash on the sale, including $1 million for the goodwill associated with the business. On March 1, Opco transfers the assets to Buyco and Buyco pays Opco $1 million in respect of the goodwill; Buyco also pays Opco the FMV of any other assets held by Opco. If A and Opco do nothing more, $500,000 will be included in Opco's income from the retailing business for the year ending December 31, 2002. As described above, paragraph (c.2) of the CDA definition, by reference to paragraph 14(1)(b), will bring the other $500,000 in respect of the goodwill into Opco's CDA at Opco's year-end.

Now assume that, instead of doing nothing after the sale to Buyco, on March 2, 2002 Opco declares a capital dividend in the amount of $500,000. The directors' resolution declaring the dividend states that the dividend will be payable and paid to A on March 2. The resolution also states that when the dividend is paid, it is to be paid out of Opco's CDA, to the extent that a positive balance exists in the CDA at the time of payment.

Immediately after the dividend is declared, and still on March 2, all of the shares of Opco are acquired by Newco. Newco is a different arm's-length party that wants to acquire Opco's manufacturing business. The acquisition of Opco is for cash consideration. Since control of Opco is acquired by Newco on March 2, Opco's taxation year will be deemed to have ended immediately before the time of the acquisition of control.[42] As the change of control will also be deemed to have taken place at the very beginning of March 2, assuming that Opco does not elect out of the deeming provision,[43] Opco's year-end will have been moved up to March 1, 2002 from December 31, 2002. As a result of this acceleration, the $500,000 non-taxable portion of the receipts from disposition of the goodwill to Buyco will be added to Opco's CDA on March 1, 2002 and—assuming that there are no other transactions drawing down the CDA—will be available for distribution on March 2, 2002.[44] The dividend is payable to A on March 2 and, pursuant to the directors' resolution of that same day, is paid to A out of Opco's CDA as a capital dividend after the acquisition of control of Opco.

The specific anti-avoidance provisions in section 83 should be considered when any solution to the problem of delay is contemplated. Specifically, paragraph 83(2.1)(a) provides that, where a capital dividend is paid or payable on a share of the capital stock of a corporation, and the share "was acquired by its holder in a transaction or as part of a series of transactions one of the main purposes of which was to receive the dividend," the capital dividend will be recharacterized as a taxable dividend.[45] In the example above, in which the dividend is paid on the same day as the acquisition of control by Newco, subsection 83(2.1) should not apply, since A did not acquire new shares in order to receive the capital dividend. In fact, A held the same shares of Opco since Opco's inception.

A section 87 amalgamation may also succeed in triggering the necessary year-end pursuant to paragraph 87(2)(a), and the amalgamation should not fall afoul of subsection 83(2.1). The CDAs of Opco and Newco would be combined in the CDA of the amalgamated corporation ("Amalco") pursuant to paragraph 87(2)(z.1). (The anti-avoidance provision in paragraph 87(2)(z.1) will presumably not apply because any capital dividend elected and paid to A by Opco immediately before the amalgamation would not be recharacterized as a taxable dividend by subsection 83(2.1); A's acquisition of the shares of Opco at incorporation presumably did not have, as one of its main purposes, the receipt of capital dividends.) As paragraph 87(2)(z.1) permits the combination of the CDAs in Amalco, paragraph 83(2.2)(b) will not allow the subsection 83(2.1) anti-avoidance provision to apply. This is because paragraph 83(2.2)(b) throws offside only those additions to the CDA that would not have been so added had the amalgamation taken place after a certain date. In the amalgamation example, the additions to the CDA would have been so added (and were, in fact, added) to the CDA of Amalco. In the example above, if A were to receive only shares of Amalco on the amalgamation, A's exit strategy would tend to be more cumbersome. Given the right fact pattern, however, the tax planner should keep a section 87 amalgamation in mind as an option to cause a deemed year-end.

The general anti-avoidance rule in section 245 (GAAR) also should be addressed.[46] Subsection 245(2) will operate to deny a tax benefit resulting to a person from an avoidance transaction, or from a series of transactions that includes an avoidance transaction. Subsection 245(3) defines an avoidance transaction as a transaction, or part of a series of transactions, that would result in a tax benefit "unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit." In the case of the acquisition-of-control example above, where A sells all of her shares of Opco to Newco, a brief review of the facts in the context of the GAAR provisions might proceed this way:

- The bona fide purpose of the resolution declaring the dividend is to pay out the proceeds from the sale of the retailing business by Opco.
- While A thereby clearly obtains a tax benefit, it seems that the resolution was made primarily in order to complete the divestiture of the retailing business.
- Even on a pessimistic interpretation of the facts, it is questionable whether this is an avoidance transaction.

How may the GAAR analysis change if, instead of declaring a dividend to be paid after the sale to Newco, Opco amends its articles of incorporation to create a new class of supervoting shares? Assume that Newco subscribes for sufficient supervoting shares to acquire control of Opco and, after the deemed year-end, Opco pays out $500,000 from the CDA as a capital dividend to A. Immediately thereafter, A sells the common shares of Opco to Newco. On those facts, the subscription for shares by Newco may well be an avoidance transaction, since Newco subsequently acquires all of the common shares of Opco in any event.[47]

In conclusion, any attempt to accelerate the receipt into the CDA of proceeds from ECP dispositions, through the creation of an earlier year-end, should be carefully assessed for possible exposure to both specific and general anti-avoidance provisions in the Act.

CDA Streaming

Capital dividends are worth more to some shareholders than to others. Notwithstanding the general tax-free character of capital dividends, non-resident shareholders receiving them are subject to a 25 percent withholding tax pursuant to paragraph 212(2)(b),[48] so that a capital dividend in the amount of $100 will be more valuable to a Canadian-resident individual than to a non-resident individual. Similarly, in the case of persons that have a statutory exemption from the payment of tax on their taxable income (such as registered charities[49] and non-profit organizations[50]), a capital dividend will be less valuable to them than to a Canadian-resident individual, since the exemption extends to taxable dividends. A private corporation may therefore find it advantageous to "stream" distributions from the CDA in order to maximize the tax benefits available to its various shareholders.

Before we examine the ways in which CDA streaming can be accomplished, it is worth emphasizing that streaming is generally permissible under the Act and that, in the right factual circumstances, the CCRA does not object to the practice. Using various streaming methods, as discussed below, a corporation can elect to pay capital dividends, for example, to preferred shareholders ahead of common shareholders, or to one class of preferred shareholders ahead of another class of preferred shareholders. It is also possible, in certain circumstances, to stream capital dividends to a trust instead of a corporation. If the trustee has full discretion with respect to distributions from the trust, it appears to be possible to stream the capital dividends received by the trust to certain beneficiaries over certain other beneficiaries.[51]

To appreciate the value of streaming the CDA, consider this example. Resident individual A owns 50 percent of a private corporation; non-resident individual B owns the other 50 percent. The corporation is a taxable Canadian corporation. Assume that the corporation has $1 million that it wishes to distribute to its shareholders by means of dividends: $500,000 from its CDA and the other $500,000 as taxable dividends. The corporation wants each shareholder to receive the same amount of dividends. In the first scenario, the corporation simply splits the CDA between A and B and pays them each the same amount in capital and taxable dividends. In the second scenario, the corporation streams the CDA in A's favour; that is, A receives only a capital dividend and B receives only a taxable dividend, each in the amount of $500,000. Table 1 shows the comparative effects of the corporation's different approaches.

The total tax burden is lower when the corporation streams the CDA because, while B gains no advantage from receiving capital dividends, A receives them tax-free. Even if A and B were to agree to equalize their tax liabilities in order to share the benefits of the streaming, A would owe B only $62,500, or $15,850 less than A's personal tax liability without streaming.

In such a fact pattern, it would likely be most efficient to use different classes of shares to effect the streaming. In the example above, involving resident A and non-resident B, two separate classes would ideally be established on incorporation:[52] classes A and B. A capital dividend entitlement would attach to the class A shares owned by A, while the class B shares owned by B would have no such entitlement. Both classes would be the same in most other respects and would allow dividends to be declared independent of other share classes. A could then subscribe for class A shares while B takes up class B shares. Then the streaming of capital dividends portrayed in the table could be accomplished by the distribution of capital dividends on the class A shares and taxable dividends on the class B shares.

If, however, A and B did not foresee the usefulness of streaming, and each owned 50 percent of the same class of shares of the corporation (with no other authorized,

TABLE 1 Streaming of Distributions from the Capital Dividend Account

	Tax payable on a $500,000 distribution to each shareholder	
	No streaming	Streaming
Resident A	$78,350[a]	nil
Non-resident B	$125,000[b]	$125,000[b]
Total tax payable	$203,350	$125,000

[a] Effective personal tax rate of 31.34 percent on dividends received from a taxable Canadian corporation (the current rate in Ontario).
[b] The 25 percent withholding rate applies to both capital and taxable dividends received by non-residents: subsection 212(2).

issued, or outstanding classes of shares), it might be preferable to adopt a strategy whereby A has some or all of her shares redeemed or repurchased by the corporation for cancellation. As mentioned in the overview section, the corporation adopting such a course must take care to ensure that the correct number of shares is redeemed or repurchased in order that the full amount of the dividend does not trigger part III tax. In addition, the redemption approach will dilute A's interest in the corporation unless subsequent steps are taken to boost her share of the capital stock back up to 50 percent. Clearly, it is preferable to anticipate CDA streaming well in advance when residents and non-residents are shareholders in the same private corporation. It will then be possible to avoid the difficulties associated with the redemption or repurchase strategy through the creation of separate classes of shares with different capital dividend entitlements.

The CCRA does not appear to view CDA streaming, in itself, as objectionable tax planning. At the 1991 annual conference round table, the CCRA was asked whether the balance of a CDA can be paid out to one shareholder of a private corporation on a redemption of that shareholder's shares, or whether each shareholder of the corporation is entitled to a pro rata share of the corporation's CDA. The CCRA's answer was that, so long as the anti-avoidance provisions of subsection 83(2.1) do not apply, the corporation can pay the balance of its CDA to one shareholder on a redemption of that shareholder's shares.[53] In a 2000 interpretation letter, the CCRA reaffirmed the position taken at the 1991 conference.[54] Also, the CCRA stated that CDA streaming would not, by itself, offend the provisions of the GAAR.

As discussed above, several methods are available for streaming the CDA of a private corporation. The choice of method should be guided by the basic objective of this planning strategy, which is to direct capital dividends to those shareholders for whom they will have the greatest value.

Circulating the CDA

Because a corporation's CDA can be reduced by certain transactions, it may be efficient for the corporation to distribute positive amounts out of the CDA, to the extent that it is permissible to do so, before those amounts are eroded. This strategy may be called "circulating" the CDA. The objective is to distribute amounts credited to the CDA when they become available, in order to exploit the CDA's full potential to the benefit of the corporation's shareholders. The discussion that follows first reviews the considerations that may influence the decision to circulate the CDA of a private corporation, then examines two structures that may be used for effecting the circulation, and concludes with a brief comment on how circulation might assist in addressing the particular concerns of shareholders holding high-low shares.

It is important to note that, as defined by the Act, a CDA cannot have a negative balance. Several paragraphs of the definition in subsection 89(1) provide that the CDA consists only of the excess, if any, of certain amounts over certain other amounts.[55] In other words, a corporation's CDA cannot dip below zero. For example, with respect to dispositions of capital property, paragraph (a) of the definition states that, generally, the CDA of a corporation at any particular time is the amount, if any, by which the non-taxable portions of capital gains exceed the non-deductible portions of capital losses. As it is only the amount of any excess that falls within the ambit of the definition in paragraph (a), the amount generated by that paragraph cannot be negative.[56] However, as noted above, certain events or transactions may lead to recognition of a negative amount that will grind down an existing positive CDA balance. Accordingly, shareholders may favour the distribution of positive amounts as they accumulate, instead of risking erosion of the funds if they are retained for a longer term.

Of course, tax planning is never quite so simple. While the CDA cannot have a negative balance, the computation of the CDA is a point-in-time calculation covering the entire period during which a private corporation can accumulate amounts in the account. A distribution of capital dividends will have consequences for the computation of the CDA in the future. For example, assume the following facts:

- Immediately after incorporation at the beginning of 2001, a private corporation has a non-taxable portion of capital gain in its CDA in the amount of $100,000.
- During its 2001 taxation year, the corporation elects and pays out a capital dividend of $100,000.
- The corporation's year-end is December 31.
- Before the 2001 year-end, but after the election and payment of the capital dividend, the corporation recognizes a non-deductible portion of a capital loss of $100,000.
- On January 1, 2002, the corporation has another non-taxable portion of capital gain to add to its CDA in the amount of $50,000.
- On February 1, 2002, the corporation has yet another non-taxable portion of capital gain to add to its CDA in the amount of $50,000.

Table 2 shows the computation of the corporation's CDA at both January 2, 2002 and February 2, 2002.

TABLE 2 Circulating the Capital Dividend Account (CDA): Calculation of CDA Balance

	January 2, 2002	February 2, 2002
Non-taxable portion of capital gain received in 2001	$100,000	$100,000
Capital dividend distributed in 2001	($100,000)	($100,000)
Non-deductible portion of capital loss recognized in 2001	($100,000)	($100,000)
Non-taxable portion of capital gain received on January 1, 2002	$ 50,000	$ 50,000
Non-taxable portion of capital gain received on February 1, 2002	na	$ 50,000
Subtotal	($ 50,000)	$ 0
Amount in CDA pursuant to subsection 89(1), paragraph (a) of the definition of CDA	$ 0	$ 0

Even though, on both dates, the amount in the corporation's CDA is at zero, the negative $50,000 "remains" throughout January 2002 and "follows" the corporation until enough non-taxable capital gains are received into the CDA to offset it. Accordingly, while the circulation of amounts out of the CDA may be useful to certain shareholders, it may result in less long-term flexibility for the corporation and its shareholders, to the extent that capital dividends paid out will still be part of the CDA calculation at later dates.

One factor that may affect the decision to circulate amounts out of a private corporation's CDA is the presence of refundable dividend tax on hand (RDTOH) in the corporation. A private corporation may obtain a "dividend refund" from the minister equal to the lesser of one-third of its taxable dividends paid to shareholders in the year and its RDTOH at the end of the year.[57] Assuming that the taxable dividends paid to shareholders in the year do not exceed three times the total RDTOH, some shareholders may prefer to receive taxable dividends from the corporation instead of a capital dividend distribution. For example, in several provinces (such as Ontario, Alberta, and British Columbia), the effective tax rate on dividends, at the top marginal income tax rate for individuals, is less (at 31.34 percent, 24.08 percent, and 31.58 percent, respectively) than the one-third of tax refunded on the payment of taxable dividends by private corporations with RDTOH. Where a private corporation with RDTOH has only one individual shareholder, and that shareholder resides in a province with such a favourable tax rate on dividends, the payment of taxable dividends by the corporation will create a personal tax liability for the shareholder in respect of the dividends received but will entitle the corporation to recover more than that amount as a dividend refund on taxable dividends paid. The combined effect, for the corporation and the shareholder taken together, is to convert the net tax cost of paying a taxable dividend into a net benefit.

This reasoning may not apply, however, where the corporation has more than one shareholder. Consider the situation in which a shareholder holds preferred shares of a private corporation with RDTOH and there are multiple common shareholders. If a taxable dividend is paid on the preferred shares, the one preferred shareholder pays the full amount of personal tax on the dividend. However, it is the common shareholders who receive the benefit associated with the dividend refund, since the presumptive increase in the corporation's value from the dividend refund accrues to those holding the corporation's residual value (that is, the common shareholders). In this case, there is a net tax cost to the preferred shareholder receiving taxable dividends. Such a shareholder may prefer a distribution from the corporation's CDA as a capital dividend (if possible) instead of the payment of a taxable dividend.

There are several possible structures for circulating optimal amounts out of the CDA, assuming that circulation is the most efficient way of employing the funds in the account. Two examples will be addressed here. The first considers the distribution of amounts from the CDA before an acquisition of control. The CCRA has not commented adversely on the timing of the steps in that type of plan. The second example involves a subsidiary that owns and pays premiums on a life insurance policy in respect of which its corporate parent is the beneficiary. The CCRA's view of the latter type of planning appears to have changed over the past eight years; now, if a specific set of facts in which such a structure was employed were to be considered offensive by the CCRA, the structure could be challenged under the GAAR.

When an acquisition of control of a corporation that has a CDA is anticipated (for example, on the outright sale of the shares of the corporation), a strategy to circulate amounts out of the CDA may be useful.[58] Such a strategy will be particularly valuable if the corporation has capital property with an FMV lower than the property's adjusted cost base (ACB), because the operation of paragraphs 111(4)(c) and (d), respectively, causes a writedown of the capital property to its FMV upon a change of control and deems the amount written down to be a capital loss. Pursuant to paragraph 111(4)(f), any capital loss arising by virtue of paragraph 111(4)(d) is deemed, for purposes of calculating the corporation's CDA, to be a capital loss immediately before the time that is immediately before the acquisition of control. A corporation with a positive CDA balance that anticipates a reduction in its CDA in this manner should endeavour to pay capital dividends to its shareholders well in advance of the acquisition of control.

By contrast, a structure that splits the ownership and premiums associated with a life insurance policy from the policy's beneficiary relies on two separate CDAs in order to give effect to the circulation. Consider the following example. Individual A owns 100 percent of the authorized, issued, and outstanding shares of Parentco. Parentco, in turn, owns 100 percent of Subco. Both Parentco and Subco are private corporations and both have CDAs with a zero balance. Subco owns, and pays the premiums in respect of, a life insurance policy on the life of A, but Parentco is the beneficiary of the policy. On the death of A, the policy will pay Parentco proceeds of $1 million. Subco pays premiums during A's lifetime of $100,000. Assume that Subco's cost basis of the policy is also $100,000.[59]

When A dies, Parentco brings the proceeds of $1 million from the life insurance policy into its CDA pursuant to subparagraph (d)(i) of the CDA definition (subsection 89(1)). As Parentco did not pay the premiums on the policy, there is no cost basis of the policy that Parentco must use to reduce the addition to its CDA. The full amount of the proceeds is available for distribution from Parentco's CDA to its shareholders. Subco adds to its CDA the amount, if any, by which the proceeds of the policy received by it (zero) exceed the cost basis of the policy ($100,000). In other words, Subco takes no amount into its CDA: since the CDA cannot be a negative amount, Subco's CDA stays at zero. By splitting the proceeds and premiums between Parentco and Subco, respectively, this strategy intends to circulate the maximum amount out of Parentco's CDA while leaving Subco's CDA at zero.

In 1994, the CCRA issued an interpretation letter[60] confirming that, where a corporation receives proceeds as a beneficiary of a life insurance policy but paid no premiums in respect of the policy, the cost basis of the policy is nil and the full amount of the proceeds is added to the corporation's CDA. No mention was made in that interpretation of the GAAR or its possible application to such a structure, even though the GAAR had then been in effect for several years.

Subsequently, however, the CCRA appeared to reconsider this strategy in the context of the GAAR. In a technical interpretation in 1998,[61] the CCRA expressed the opinion that, generally, subsection 15(1) would not operate to confer a benefit on Parentco as a result of the payment of the life insurance premiums by Subco or on receipt of the proceeds of insurance upon the death of A. However, the CCRA stated that there is a clear policy intention expressed in paragraph (d) of the CDA definition to reduce the proceeds of life insurance by the cost basis of the policy yielding the proceeds. With respect to the GAAR, the CCRA said that it would ask if the split between the beneficiary and the payer of the premiums were undertaken for bona fide purposes other than to obtain the tax benefit of having more to distribute from Parentco's CDA. If there were no such bona fide purpose, the GAAR would operate to reduce the amount of life insurance proceeds to be included by Parentco in its CDA by the cost basis of the policy.

In another interpretation letter written six months later,[62] the example put to the CCRA involved holding companies for individual shareholders. The holding companies owned shares of Opco, a private corporation, and they also owned and paid the premiums for insurance policies on the lives of the other shareholders. Opco would be the beneficiary of these insurance policies. The facts given to the CCRA in this interpretation emphasized two non-tax reasons for this type of structure: (1) creditor-proofing of Opco; and (2) ensuring that each shareholder bears the cost of insuring the lives of the other shareholders. The CCRA reiterated the GAAR position stated in the 1998 letter and concluded that the suggested objectives "do initially appear to be secondary to the purpose of obtaining the tax benefit."[63]

It is worth remembering here that this kind of structure continues to be used for at least one of the reasons suggested in the letter cited above, namely, creditor-proofing.[64] (Opco is the party being made more secure in such a structure; any cash surrender value associated with the life insurance policies, which are owned by the holding companies, cannot be attacked by Opco's creditors.)[65] Accordingly, it seems to be the preferred view that the CCRA may challenge holding-operating or holding-subsidiary company structures pursuant to the GAAR if it cannot be established that the primary purpose of the structure (such as creditor-proofing) was not to obtain a tax benefit. However, if there is a suitable primary bona fide non-tax purpose to the arrangement, this type of planning continues to be acceptable to the CCRA.

Circulating amounts out of a CDA may prove particularly useful for shareholders holding high-low preferred shares of a private corporation. Preferred shareholders of private corporations are often left with high-low shares after undertaking estate freezes. Whether the high-low shares are held inside or outside a trust, the CDA of the corporation can be used to increase the PUC of the high-low shares to allow for more flexibility in disposing of the shares at a later date. Subject to the above comments on streaming (that is, provided that capital dividends can be streamed in favour of the high-low shares in preference to other shares), the PUC of the high-low shares can simply be increased by the corporation to a suitable amount. Pursuant to subsection 84(1), this will result in a deemed dividend to the holders of the high-low shares. The corporation may then elect that the deemed dividend be paid out of its CDA to the extent that it has CDA available and wishes to distribute it to the high-low shareholder. Whether or not the capital dividend involves a distribution of cash to the high-low shareholder, the shareholder will not be taxed on the dividend. At the same time, the ACB of the shares will be increased by the amount of the deemed dividend received because of the operation of paragraph 53(1)(b). This increased ACB can be used to reduce the capital gain realized by the high-low shareholder on any number of dispositions that he or she may undertake in the future. For example, if the preference shares were eventually to have full PUC and ACB, a deemed disposition on death[66] would generate a reduced capital gain in the shareholder's terminal return.

Life-Insurance-Funded Redemptions or Purchases for Cancellation

The inclusion of proceeds of a life insurance policy in the CDA (less the cost basis of the policy) can be a valuable tool for tax planners. A CDA funded by life insurance can be used to help fund the redemption or purchase for cancellation of part or all of a deceased shareholder's capital stock. By providing at least part of the funds necessary for the redemption or purchase for cancellation, life insurance of a corporate beneficiary can provide a measure of security for the shareholder's estate. It can contribute to the smooth transition of the ownership of a business, thereby satisfying the needs of employees and creditors, if any. Also, on the death of a key shareholder, a life-insurance-funded CDA can help maintain the value of the company for the surviving shareholders.[67]

The range of insurance products available also provides opportunities to exploit the characteristics of the CDA beyond the classic life-insurance-funded corporate redemption structure. An example of one class of such products, permanent insurance, will be reviewed below, and some of the rules governing such a scheme will be described. Subsequently, a number of hypothetical scenarios are discussed to illustrate how a corporation can maximize the benefits associated with the receipt of life insurance proceeds in a CDA.

First, it is useful to revisit the standard life-insurance-funded corporate redemption or purchase-for-cancellation structure—the so-called 50 percent solution. Under this strategy, a corporation receives proceeds of life insurance and includes them in its CDA. Upon a redemption of shares of the corporation or a purchase of its shares for cancellation from the deceased's estate, the corporation effectively chooses to treat up to one-half of the resulting deemed dividend to the estate as a capital dividend. Several articles have reviewed the 50 percent solution in considerable detail,[68] and a thorough examination of it here is unnecessary. However, it is helpful to provide a brief overview of the steps involved.

One version of the 50 percent solution may operate as follows. Assume that Canadian-resident individual A dies owning all of the class A common shares of Opco. The class A shares represent one-half of the authorized, issued, and outstanding shares of Opco.[69] Until the death of A, Opco has no amount in its CDA. Opco is a private, taxable Canadian corporation. Another Canadian-resident individual, B, owns all of the class B common shares of Opco, representing the other 50 percent of the company. B is not related to A. The class A and B shares are the same in all relevant respects. A does not have a spouse at death. Neither B, nor anyone related to B, is A's estate trustee. There is a buy-sell agreement between A and Opco providing for the purchase for cancellation of A's shares on A's death. The FMV of A's shares in Opco at the time of death is $10 million, and the price of shares determined by the buy-sell agreement also is $10 million. The ACB of the shares is $0, and the PUC is nominal.[70] The purchase is funded with proceeds from a life insurance policy under which Opco is the named beneficiary. Opco also paid the premiums in respect of the policy. The insurance proceeds less the cost basis are $10 million. A is taxed at the top marginal rate and has no capital gains exemption room available.

A is deemed, immediately before death, to have disposed of class A shares for proceeds equal to $10 million.[71] A's terminal return must therefore reflect a capital gain of $10 million or a taxable capital gain of $5 million. A's estate is deemed to have acquired the shares at a cost equal to their FMV.[72] Opco increases the PUC of the class A shares by $5 million, which results in a deemed dividend to the estate in the same amount.[73] Opco then elects that the deemed dividend (that is, one-half of the amount in its CDA) be paid out of the CDA. The PUC increase has the effect of increasing the ACB of the class A shares held by the estate from $10 million to $15 million.[74] The estate, at this point, holds shares with an ACB of $15 million, an FMV of $10 million, and PUC of $5 million.

Opco then purchases all of the class A shares held by the estate for cancellation for $10 million. On the purchase of Opco shares, the estate is deemed to have received a dividend in the amount of the acquisition price ($10 million) less the PUC of the shares[75]—that is, a deemed dividend in the amount of $5 million. This dividend is a taxable dividend. The estate's proceeds of disposition are reduced by the amount of the subsection 84(3) deemed dividend,[76] resulting in proceeds of disposition equal to $5 million. Since the proceeds of disposition are $5 million and the ACB of the shares is $15 million, the estate now has a capital loss of $10 million.[77]

The taxable dividend of $5 million triggers tax in the estate of $1,567,000 (at an assumed rate of 31.34 percent). Since the capital dividend is one-half the amount of the loss to the estate, the stop-loss rule in subsection 112(3.2) does not reduce the loss available for carryback to A's terminal return.[78] (The loss available for carryback is deemed to be the loss otherwise determined [$10 million] minus the amount by which the lesser of the capital dividend [$5 million] and the loss otherwise determined [$10 million] exceeds one-half of the loss otherwise determined [½ × $10 million = $5 million]. As the capital dividend does not exceed one-half of the loss, there is no grind of the loss available for carryback to A's terminal return.) Accordingly, the estate elects to carry back a capital loss of $10 million to A's terminal return.[79] A's net capital loss is $5 million, which exactly offsets A's taxable capital gain from the earlier disposition of the Opco shares to the estate. The total tax liability resulting from the redemption is $1,567,000 paid by the estate on the taxable dividend, and the planning has left $5 million in Opco's CDA, presumably to be used by B at some later time, should the funds be available to pay B a capital dividend.

How does this version of the 50 percent solution fare when compared with a redemption or purchase structure wherein Opco does not increase the PUC of the class A shares but, instead, elects pursuant to subsection 83(2) in respect of the full amount of the deemed dividend paid to the estate? Comparing these two structures, the cost of the 50 percent solution is a higher tax burden for the combination of A and A's estate.[80] That is, if the maximum capital dividend ($10 million) were elected and paid to A's estate, there would be no taxable dividend received by A's estate. However, the stop-loss rule in subsection 112(3.2) would apply to limit the amount of the capital loss that could be carried back from the estate. In this simplified example, if Opco elected to pay the full amount of its CDA to A's estate, subsection 112(3.2) would limit the loss to the loss otherwise determined ($10 million) minus the amount by which the lesser of the capital dividend ($10 million) and the loss otherwise determined ($10 million) exceeds one-half of the loss otherwise determined ($5 million). Only $5 million of the loss would be available for carryback to A's terminal return from A's estate, resulting in tax payable on the remaining taxable capital gain in A's terminal return (at an assumed rate of 46.41 percent) of $1,160,250. This tax payable is lower than the tax payable by the combination of A and A's estate with the 50 percent solution ($1,567,000). It is worth noting that the amounts in the CDA are attributable to A's death and, in one sense at least, those amounts fairly belong to A's estate. For this reason, it is important to assess the costs associated with the 50 percent solution compared with the situation where A's estate receives the entire amount in Opco's CDA.

While the 50 percent solution has a higher tax cost, it offers the benefit of avoiding the stop-loss rule in subsection 112(3.2). With the 50 percent solution, there is no waste associated with the capital loss carryback, and an amount is left for B in Opco's CDA. If A and B are able to collaborate when building the tax structure before the death of either of them, and if the death of either is to result in the receipt of insurance proceeds by Opco, the two shareholders may agree to minimize the total tax burden, especially since there is a small cost to the preservation of a substantial CDA balance for the surviving shareholder.[81]

It is possible to extend the basic insurance-funded-redemption or purchase-for-cancellation structure in order to accomplish a number of different objectives. The proceeds of life insurance could be used to exactly offset the combined tax to be paid by the individual and his or her estate. Alternatively, an insurance scheme could be adopted whereby permanent insurance that has an investment element attached to it is acquired as a supplement to non-funded life insurance coverage. (The term "non-funded life insurance" is here used to refer to a "basic" life insurance policy that lacks any additional investment component; that is, set premiums are paid for the life of the insured. Non-funded life insurance may be term insurance, term-to-100 insurance, or minimum funded universal life insurance.) Permanent insurance may produce a different quantum of benefit to the individual and his or her estate on death, depending on the funding by the corporation during the individual's lifetime. The various options and their results are best compared through numerical examples reflecting different scenarios in which the amount of insurance and funding is varied. A series of such examples will be discussed below. First, however, it is necessary to review some terminology and the rules governing these structures.

The starting point is a brief explanation of the concept of permanent insurance.[82] As noted above, permanent insurance products provide an investment component in respect of a life insurance policy. Amounts paid to fund permanent insurance can be used to invest in a range of investment vehicles. Provided that the amounts comply with the exempt policy rules,[83] the return on investment will accumulate tax-free. In the case of whole life insurance, the insurer chooses the investments; with universal life, the owner may choose from a range of options. Where a private corporation is the beneficiary of permanent insurance held on the life of a shareholder, the accumulated amounts in respect of the insurance at the time of the shareholder's death are added to the corporation's death benefit and, as a result, its CDA.

The permanent insurance held by the corporation must be an exempt policy in order to escape the application of the accrual taxation rules in section 12.2. In general terms, the policy must be exempt within the meaning of Regulations 306 and 307. Under these regulations, on the anniversary date of the policy, its accumulating fund—that is, the investment and savings component of the insurance—is compared before that date, as of that date, and prospectively with the accumulating fund of a theoretical benchmark policy. If the accumulating fund of the policy is too high, the situation must be remedied in order to maintain the policy's exempt status. One remedy is to pay out some amount of the accumulating fund into a taxable side fund. The benchmark accumulating fund is an amount determined by a complex formula based on conservative assumptions, including endowment at age 85 and the assumption that the policy is fully paid up after 20 years. As demonstrated below, provided that the exempt policy status of permanent insurance products can be maintained, the tax-free accumulations in the policy can provide useful opportunities to improve upon the standard life-insurance-funded corporate redemption strategy.

Consider the following examples, summarized as scenarios 1 to 3 in table 3. As in the example discussed earlier, A is a Canadian-resident individual who owns all of the class A common shares of Opco. Opco is a private, taxable Canadian corporation. A total of 10 million class A shares of Opco are issued and outstanding. These shares represent one-half of the authorized, issued, and outstanding shares of Opco. A is a 45-year-old non-smoker, who is expected to live (and, in fact, does live) another 40 years. A does not have a spouse.[84] Until A dies, Opco has no amounts in its CDA. A second Canadian-resident individual, B, owns all of the class B common shares of Opco, representing the other 50 percent of the company. B is not related to A. There is a buy-sell agreement between A and Opco providing for the purchase by Opco of A's shares on A's death. Neither B, nor anyone related to B, is A's estate trustee.

Now assume that the FMV of each class A common share is $1, so that the FMV of A's holdings in Opco is $10 million. The ACB of A's shares is zero, and the PUC is nominal.[85] In scenario 1, A wants Opco to receive just enough insurance on A's death to offset the tax payable by A's estate and on A's terminal return. Table 3 shows that Opco should apply for non-funded coverage yielding proceeds on A's death of $2,016,599. It is assumed that the premiums associated with this death benefit will equal $15,000 annually over A's remaining lifetime. The premiums are paid by Opco. When A dies at 85, the full amount of the proceeds of life insurance goes into Opco's CDA.[86] All of the death benefit is distributed from the CDA to the estate by means of a capital dividend.

The mechanics of scenario 1 should be examined more closely. As was the case with the 50 percent solution, there is a deemed disposition of the 10 million class A common shares of Opco on the death of A, resulting in a capital gain in A's terminal return of $10 million. A's estate is deemed to have acquired the 10 million class A common shares from A at a cost equal to the FMV of the shares—that is, $10 million. Subsequently, pursuant to the buy-sell agreement with A, Opco purchases from A's estate 4,033,198 class A common shares of Opco, with an FMV of $4,033,198.

The proceeds from the sale of shares to Opco equal $4,033,198; this is an actual cash amount paid by Opco to A's estate. The purchase amount becomes a deemed dividend to A's estate by virtue of subsection 84(3). Pursuant to subsection 83(2), Opco elects that the full amount of the deemed dividend be a capital dividend. Pursuant to subsection 184(3), Opco then elects that the amount of the total deemed dividend ($4,033,198) in excess of its CDA ($2,016,599) is a separate taxable dividend in the amount of $2,016,599.[87]

As the proceeds of $4,033,198 received by A's estate on the purchase for cancellation are, in turn, reduced by a deemed dividend of the same amount pursuant to

TABLE 3 Life Insurance Funding Comparison, Nominal Dollars Assuming a 45-Year-Old Male, Non-Smoker, Expected To Live an Additional 40 Years

Scenario 1: No permanent life insurance component; death benefit amount just offsets taxes but not opportunity costs; portion of shares redeemed by Opco
Scenario 2: Permanent life insurance acquired; death benefit amount offsets all costs (incl. opportunity costs); increased number of shares redeemed by Opco
Scenario 3: Permanent life insurance acquired; increased funding to permanent life insurance component; all shares redeemed by Opco

	Scenario 1	Scenario 2	Scenario 3
		dollars	
Total insurance coverage payable to Opco as beneficiary	2,016,599	4,292,976	10,000,000
Annual premiums: basic life insurance policy	15,000	15,000	15,000
Annual investment: permanent life insurance	0	18,728	45,000
Deemed disposition by A on death (subsection 70(5)):			
FMV of Opco shares at death	10,000,000	10,000,000	10,000,000
ACB of Opco shares held by A	0	0	0
Capital gain	10,000,000	10,000,000	10,000,000
Capital loss carried back to A's terminal return (from below)	−4,033,198	−8,585,952	−10,000,000
Capital gain less reduction carried back	5,966,802	1,414,048	0
Taxable capital gain	2,983,401	707,024	0
Tax on capital gain paid by A[a] (X)	**1,384,597**	**328,130**	**0**

(The table is continued on the next page.)

TABLE 3 Continued

	Scenario 1	Scenario 2	Scenario 3
		dollars	
Effects upon Opco:			
Insurance proceeds received into CDA	2,016,599	4,292,976	10,000,000
Redemption amount	4,033,198	8,585,952	10,000,000
Deemed dividend (subsection 84(3))	4,033,198	8,585,952	5,000,000
Capital dividend (subsection 83(2))	2,016,599	4,292,976	5,000,000
Taxable dividend	2,016,599	4,292,976	5,000,000
Effects upon A's estate:			
Proceeds received on redemption	4,033,198	8,585,952	10,000,000
Deemed dividend	−4,033,198	−8,585,952	−5,000,000
Adjusted proceeds of disposition (subsection 54, "proceeds of disposition," paragraph (j))	0	0	5,000,000
ACB of shares to estate	−4,033,198	−8,585,952	−15,000,000
Capital loss allowed for carryback (subsection 164(6))[b]	−4,033,198	−8,585,952	−10,000,000
Tax paid by A's estate on taxable dividend received[c] (Y)	**632,002**	**1,345,419**	**1,567,000**
Total tax (X + Y)	**2,016,599**	**1,673,549**	**1,567,000**

(The table is concluded on the next page.)

TABLE 3 Concluded

	Scenario 1	Scenario 2	Scenario 3
		dollars	
Summary of insurance plans over individual's lifetime:			
Insurance proceeds received into CDA	2,016,599	4,292,976	10,000,000
Tax on death	–2,016,599	–1,673,549	–1,567,000
Subtotal	**0**	**2,619,427**	**8,433,000**
Cost of basic life insurance premiums	–600,000	–600,000	–600,000
Cost of permanent insurance investments	0	–749,120	–1,800,000
Opportunity cost of insurance funding	–564,949	–1,270,308	–2,259,798
Subtotal	**–1,164,949**	**–2,619,428**	**–4,659,798**
Net (cost)/benefit	**–1,164,949**	**0**	**3,773,202**

[a] Assumed tax rate of 46.41%.
[b] Stop-loss rule in subsection 112(3.2) does not apply.
[c] Assumed tax rate of 31.34%.

section 54,[88] the adjusted proceeds of disposition to the estate are equal to $0. With proceeds of disposition of $0 and ACB in respect of the shares purchased of $4,033,198, A's estate has a capital loss of $4,033,198 available for carryback to A's terminal return. Note that this amount of capital loss is not reduced by the stop-loss rule in subsection 112(3.2). Accordingly, the full loss to A's estate of $4,033,198 created by the purchase for cancellation can be carried back. (More generally, and as indicated earlier, if the loss otherwise determined is at least double the amount of the capital dividend distributed on the purchase for cancellation, the stop-loss rule in subsection 112(3.2) will not apply.)

The loss carried back reduces the capital gain on A's terminal return from $10 million to $5,966,802, the taxable portion of which is $2,983,401. At an assumed tax rate of 46.41 percent on the taxable portion of the capital gain, A's terminal return will record tax payable in respect of the taxable portion of the capital gain of approximately $1,384,597.[89] The tax paid by the estate on the taxable dividend of $2,016,599 received by it (at an assumed effective rate of 31.34 percent) is $632,002. The total of these two amounts is $2,016,599, which is exactly the amount of insurance proceeds received into the CDA of Opco on the death of A.

In scenario 1, only a part of A's total shareholding has been purchased for cancellation by Opco (that is, only the number of shares with enough underlying FMV to support the deemed dividend of $4,033,198); therefore, the estate is left holding 5,966,802 class A common shares of Opco. The estate may opt to retain these shares or instead sell them to B or another third party.

It is important to recognize the cost of financing the insurance plan. This calculation should reflect both the total cost of premiums paid by Opco for the basic non-funded life insurance and the amounts that could have been earned had those funds been otherwise invested by Opco (the opportunity cost). Table 3 shows the opportunity cost as the future value of the return on investments that could have been earned on the amount of the premiums, at an assumed after-tax rate of return of 3 percent over 40 years. Technically, the opportunity cost is a cost to Opco. However, for purposes of illustration in table 3, the opportunity cost and the cost of the insurance premiums are deducted from the net of proceeds of insurance received by A's estate less the taxes paid on death. Table 3 shows that, ultimately, scenario 1 results in a net cost to the combination of Opco, A, and A's estate. That is, even though the death benefit taken into Opco's CDA exactly offsets the taxes payable on the redemption of the 4,033,198 shares, the costs (including the opportunity cost of investing $15,000 per year in a competing investment) result in a net cost of $1,164,949 even after A's estate and personal taxes (in respect of the insurance purchases for cancellation) are paid.

Scenario 2 in table 3 shows that this net cost can be reduced to zero through Opco's purchase of permanent insurance. This scenario assumes that Opco not only pays the basic insurance premium per year of $15,000, but also invests $18,728 annually toward a permanent insurance policy. These proceeds will grow on a tax-free basis and will contribute to a larger death benefit for Opco. Table 3 shows that this death benefit amount is $4,292,976, which is added to Opco's CDA on A's death.

The investment product alternatives in scenario 2 are assumed to have the same annual yield as the non-insurance alternatives. It is assumed that the return on the permanent insurance component is 5.75 percent per year over 40 years (essentially the equivalent of the 3 percent after-tax rate of return used to calculate the opportunity cost in scenario 1) and that these permanent insurance contributions will grow tax-free, along with the unfunded component of the life insurance, to an amount greater than the sum of the capital gains tax on A's death and the tax payable on the taxable dividend received by the estate. In scenario 2, as in scenario 1, all of the amounts are flowed out of Opco's CDA to A's estate.

Scenario 2 involves the same initial mechanics as scenario 1. There is a deemed disposition on A's death of all of A's shares of Opco, resulting in a capital gain in A's terminal return of $10 million. A's estate is deemed to have acquired the class A common shares from A at the FMV of the shares of $10 million. In scenario 2, however, A's estate sells 8,585,952 of the 10 million class A common shares to Opco.

The purchase proceeds paid by Opco, accordingly, equal $8,585,952. The amount paid on the purchase for cancellation is a deemed dividend, and Opco elects to treat the full amount of the deemed dividend as a capital dividend. Opco then elects that the amount of the total deemed dividend ($8,585,952) in excess of its CDA ($4,292,976) is a separate taxable dividend (in the amount of $4,292,976).

The proceeds to the estate of $8,585,952 on the share purchase are, in turn, reduced by the deemed dividend, so that the effect of the disposition on the estate is similar to that in scenario 1: the adjusted proceeds of disposition with respect to the shares are equal to $0. As the ACB in respect of the purchased shares equals $8,585,952 and the proceeds of disposition equal $0, a capital loss of $8,585,952 is generated on the purchase for cancellation. As the loss otherwise determined is double the amount of the capital dividend on the share purchase, the stop-loss rule in subsection 112(3.2) does not prevent carryback of the full amount of the loss to A's terminal return.

The loss carried back reduces the capital gain on A's terminal return from $10 million to $1,414,048, the taxable portion of which is $707,024. At the assumed rate of 46.41 percent on the taxable portion, tax payable on A's terminal return in respect of the disposition of the class A common shares equals $328,130. The tax paid by the estate on the taxable dividend, at the assumed effective rate of 31.34 percent, is $1,345,419. The combined tax between A's terminal return and the estate is $1,673,549, significantly lower than the death benefit of $4,292,976 received into Opco's CDA. In scenario 2, A's estate is left with only 1,414,048 class A common shares of Opco. As in scenario 1, the estate may choose to retain those shares or to dispose of them to a third party.

Although the death benefit exceeds the taxes on A's death, that additional benefit is absorbed by the costs of the basic insurance and the permanent insurance. Table 3 shows that the cost of the premiums on the basic, non-funded insurance is the same as in scenario 1—$600,000 over 40 years. The cost of the annual investment in the permanent insurance equals $749,120 ($18,728 × 40). The opportunity cost of both the permanent insurance investments and the basic insurance premiums equals $1,270,308, calculated in the same manner as the opportunity cost in scenario 1. All of these costs, added together, equal $2,619,428, which almost offsets the death benefit remaining after satisfaction of the tax liabilities arising on the death of A.[90] The benefits associated with scenario 2 almost offset the costs, so that the net effect is neither a cost nor a benefit.

Finally, scenario 3 in table 3 shows the results where non-funded life insurance and permanent insurance are acquired by Opco on A's life and the permanent insurance receives sufficient funding to allow for the purchase for cancellation of all of the class A common shares of Opco on A's death. Assumed premiums in respect of the basic life insurance policy are $15,000, as in scenarios 1 and 2, but the assumed annual investment in respect of the permanent insurance is $45,000. When combined, these policies are assumed to produce a death benefit in 40 years equal to $10 million, matching the FMV of A's total shareholding in Opco.

In scenario 3, the deemed disposition and acquisition of the 10 million class A common shares of Opco by A and A's estate, respectively, have the same consequences as in scenarios 1 and 2. However, in scenario 3, Opco's CDA receives a full $10 million. As only $5 million of that amount can be used to fund Opco's purchase of shares from A's estate (in order to continue to avoid the stop-loss rule in subsection 112(3.2), so that there is no waste of CDA on a distribution to A's estate), the PUC increase version of the 50 percent solution should be implemented here.[91]

Opco increases the PUC of 5 million of the shares held by A's estate and subsequently elects to treat the deemed dividend arising as a result of that PUC increase as a capital dividend pursuant to subsection 83(2). The PUC increase increases the ACB of the shares in the estate from $10 million to $15 million. The estate at this point holds shares with an ACB of $15 million, an FMV of $10 million, and PUC of $5 million.

Opco then purchases all of the shares from A's estate for cancellation for $10 million. On the purchase, the estate is deemed to have received a dividend of the purchase amount less the PUC of the shares—that is, a further deemed dividend in the amount of $5 million. This deemed dividend is a taxable dividend. (In table 3, scenario 3 shows the taxable dividend as being separate from the deemed dividend, but remember that the $5 million listed in respect of each item—that is, the deemed dividend and the taxable dividend—is the same $5 million. That is, the deemed dividend of $5 million is the taxable dividend of $5 million.) The adjusted proceeds of disposition are equal to the share purchase amount ($10 million) less the deemed dividend on the purchase ($5 million), for a total of $5 million. Those proceeds less the ACB of $15 million produce a capital loss for carryback of $10 million, which is the full amount of the capital gain in A's terminal return. Accordingly, there is no tax exigible in respect of the disposition of the shares of Opco in A's terminal return. A's estate pays tax of $1,567,000 on the taxable dividend. This is the only tax exigible in scenario 3.

In scenario 3, the amount of death benefit remaining after taxes have been paid more than offsets the total costs of the basic life insurance premiums plus the permanent insurance investments. The costs are calculated in the same manner as in scenario 2 and, in scenario 3, total $4,659,798. As the death benefit after taxes equals $8,433,000, there is a net benefit of $3,773,202.

In scenario 3, the excess insurance proceeds received by Opco stay in the CDA. The extra amount in the CDA could be used by B once B has complete control of Opco.[92] Alternatively, if sufficient cash is available and if the possibility is allowed for in the buy-sell agreement, a capital dividend may be paid to A's estate after it acquires the shares from A but before the purchase for cancellation. There are many ways of using the excess CDA amounts. For purposes of simplicity, in scenario 3 it is assumed that the amount left over is an enduring benefit to A and A's estate.

An important question to consider is how Opco will fund the amounts paid out to A's estate. After all, it is proposed to pay out double the amount of insurance proceeds received; how does Opco come up with the extra cash required? Opco may be able to borrow the funds, but the interest paid on the borrowings would have to be included in the costs of the structure, and those interest costs have not been included here out of a desire not to complicate the examples given.

It may be that this type of structure is best used when there is sufficient cash available in Opco to fund the taxable dividend without borrowing funds. For example, the strategies addressed here could be useful in the context of shareholders of a holding corporation that has sold off operating corporations and has significant cash, part of which can be used to purchase the insurance products and fund the taxable dividend required by the structure on the death of one of the shareholders.

The key to the operation of any structure involving combined non-funded basic and permanent insurance proceeds received on the death of a shareholder is that the permanent insurance policy amounts accumulate tax-free while the costs of the premiums and the investments are computed on an after-tax basis in the corporation. While the total costs increase as the amount invested in permanent insurance increases, the associated benefits are proportionately greater. From the foregoing review, it is evident that, in certain circumstances, the potential value of the CDA may be exploited through the use of the 50 percent solution.

Several issues are worth mentioning at this point.

First, the examples discussed above assume that the life insurance premiums paid by Opco are paid over a number of years—in these three scenarios, 40 years. What would happen if the basic non-funded life insurance policy premiums and/or the permanent insurance investments were prepaid? In principle, the premiums and investments would be discounted, since fewer premiums and investment amounts would be required to generate the required death benefits. Of course, the opportunity cost of the premiums and investments would be higher since prepayment would take the funds out of Opco at an earlier date. In the same 40-year timeline used in table 3, one would expect that the benefit to A and A's estate would be greater because of prepayment. This is because of the tax-free accumulation of the permanent insurance amounts compared with the after-tax costs of the investment amounts forgone; that is, the after-tax costs (including the opportunity cost) associated with the prepaid investments would be lower than the amounts accumulated in the prepaid permanent insurance policy.

Second, what would happen if A died before or after the 40-year threshold? In table 3, for purposes of illustrating the principles involved, it is assumed that A will live for another 40 years. Because of the accumulation of amounts tax-free in the permanent insurance policy, one might expect that the benefits associated with early death would be greater than would be the case if A lived the full projected 40 years, since the costs associated with the life insurance policies would not be paid over the full 40 years. However, in the case of permanent insurance, the death benefit would have to be adjusted in order to reflect the proper amount due at the time of A's death. That is, a lower death benefit would be payable if A died before 40 years, since there would have been less time to accumulate amounts in the policy on a tax-free basis. With permanent insurance, there might still be a net cost associated with early death, but that cost would decrease further the closer A came to the projected additional lifespan of 40 years. If A lived more than another 40 years, the net benefit might increase with each additional year. Although the time of a person's death cannot be predicted with certainty, the prudent planner will attempt to employ reasonable assumptions concerning the insured's lifespan in this type of situation.

Third, it might be argued that the entire concept of opportunity cost in the three scenarios is misplaced. For example, it might be suggested that there is no opportunity cost associated with buying insurance on A's life because the purchase of insurance is simply a cost of doing business and of facing eventual taxes in a reasonable way. That is, insurance is inevitable, and there is therefore no comparable alternative use of the funds used to purchase and invest in insurance products. By this reasoning, the opportunity cost in the examples should be zero.

It is suggested, however, that this line of argument mistakes the nature of economic opportunity costs. To the extent that Opco may pursue a different strategy (no matter how unwise a strategy without insurance may be), there will, by definition, be an opportunity cost attached to its choice of one of the scenarios in table 3. In fact, any other option available to Opco besides the investment and policy options outlined in table 3 will mean opportunity costs associated with its investment decision(s). How those costs should be measured is open to debate. In table 3, it has been assumed that the opportunity costs of the different scenarios will involve a comparable return on investment. This assumption makes sense, since permanent insurance investments should reflect some of the range of the broader investment market. To the extent that actual opportunity costs are higher or lower than those estimated in this article, however, the net costs or benefits associated with the various scenarios will, of course, be different.

Fourth, it has been assumed for purposes of these examples that none of the shares involved are "grandfathered" shares—that is, shares held on April 26, 1995 that meet certain tests and are not subject to the subsection 112(3.2) stop-loss rule.[93] In the simplest of circumstances, where grandfathered shares are involved, the loss available for carryback to the terminal return from the estate is not reduced by capital dividends received on the redemption or repurchase for cancellation. The problems associated with the stop-loss rule are thereby largely avoided with grandfathered shares. Both because one would expect fewer and fewer grandfathered shares to appear in tax planning, and because there is value in recognizing the potential consequences of the subsection 112(3.2) stop-loss rule, grandfathered shares have been deliberately excluded from the present analysis.

Distributions from a Mutual Fund Trust

The final point to be considered is what happens when capital gains are distributed from a mutual fund trust to a private corporation that is a unitholder of the trust. It used to be assumed, incorrectly, that the non-taxable portion of such capital gains could be added to a corporation's CDA. By 1996, however, it became apparent that the CCRA took the position that these non-taxable receipts were not to be added to the CDA and, accordingly, could not be distributed as capital dividends to a corporation's shareholders. This position could have become a significant problem for some corporations that had mistakenly paid out capital dividends in excess of the actual amounts in their CDAs. However, Parliament recently provided a remedy by amending the Act and making the relief associated with the amendment retroactive to capital dividends that became payable after 1997. For those corporations that have paid out capital dividends based on distributions from a mutual fund trust before 1998, and that still have an open assessment period with respect to those elected capital dividends, the potential of excess elections may still have to be addressed. Some suggestions for dealing with such a situation are provided later in this section.

The problem emerged when corporations diversified their investment holdings to include mutual funds of the type held by many resident individuals. As unitholders of such trusts, corporations began receiving distributions to which subsection 104(21) applies.[94] That subsection allows a trust to distribute net taxable capital gains to a particular beneficiary of the trust. Where the trust is a mutual fund trust, it must designate the amount in respect of a particular beneficiary, but that beneficiary need not be a resident of Canada.[95] (The beneficiary must be a resident of Canada if the designation is made by a trust that is not a mutual fund trust.)[96] If the designation in subsection 104(21) is made, the net taxable capital gain is deemed for the purposes of, inter alia, section 3 "to be a taxable capital gain for the year of the particular beneficiary from the disposition by that beneficiary of capital property."

Corporations receiving distributions from a mutual fund trust in excess of the designated amount proceeded to build up their CDAs with these excess amounts and, in turn, passed on the funds to their shareholders as capital dividends. Corporations that took this approach in the past confused the designation of the taxable capital gain with the realization of the entire capital gain. As the corporation was not deemed to have triggered the whole gain, there could be no addition of the non-taxable portion of the gain to its CDA.[97] According to the CCRA, the result would be the same (there would be no addition to the CDA) in the case of a designation by a mutual fund trust.[98] Moreover, there was no express inclusion of a portion of the subsection 104(21) designation in the CDA definition in subsection 89(1). The corporation still received the excess above the subsection 104(21) designation on a tax-free basis, but it was not permitted to pass along that tax-free portion to its shareholders by means of a capital dividend.

As a result of this misunderstanding, before the legislative changes, some corporations were inadvertently paying out capital dividends to shareholders in excess of the amounts in their CDAs, thereby risking part III assessments of tax on those dividends. As has been pointed out, there are ways of mitigating part III tax by effectively turning the excess amounts into taxable dividends, but this would hardly be the result that most corporations were counting on when they made the capital dividend elections in the first place.

The problem was remedied in 2001 by amendment of the CDA definition in subsection 89(1).[99] Where a distribution is made by a trust to a corporate unitholder in respect of a capital gain of the trust, paragraph (f) of the definition provides for an addition to the corporation's CDA of, basically, the non-taxable portion of the distribution.[100] As a result, not only will the corporation receive a tax-free distribution, but it will also be able to pass along that distribution through capital dividends to its shareholders. As noted above, Parliament also made the provisions of new paragraph (f) retroactive to capital dividends that became payable after 1997.[101]

For a corporation that paid out capital dividends to its shareholders based on a trust distribution before 1998, and in respect of which the assessment period is still open, it may yet be possible for the parties to avoid part III tax. Subsection 220(3.2) provides for the late filing[102] and revoking[103] of elections that are prescribed provisions pursuant to the Income Tax Regulations. Regulation 600(b) provides that both subsections 83(2) and 184(3) are prescribed provisions. It is therefore open to the corporation to attempt to revoke the subsection 83(2) election and take the position that it is void. If that submission were to succeed, no tax would be exigible on the dividend, since it would never have been paid. Alternatively, the corporation may take the position that a late-filed election pursuant to subsection 184(3) is appropriate, thereby converting the excess amount of the capital dividend into a taxable dividend to the shareholder. For the majority of corporations and shareholders that may have found themselves with a potential part III tax liability, however, the retroactive effect of Parliament's amendment removes the need for such solutions.

CONCLUSION

For private corporations, there is wide scope for tax planning using the CDA. As this article has shown, the CDA can be worked into efficient planning for, inter alia, divestitures of assets and shares, estate freezes, life insurance planning, and even ordinary dividend distributions where both non-residents and residents hold shares of a corporation.

The importance of the CDA to private corporations and their shareholders is matched by the care that must be exercised when using it in tax planning. For certain transactions, it is important to be aware of the specific anti-avoidance rules in section 83. With respect to potential excess elections, the penalty tax provisions in part III and the potential remedy to a part III tax liability are critical considerations in developing a workable tax structure. As with an increasing number of tax plans, possible exposure to the GAAR should be thoroughly addressed at the planning stage.

For taxpayers, the benefits of being familiar with the rules and clarifying the mechanics of certain provisions can be great. In the case of dispositions of ECP (such as goodwill) by a private corporation, in the right circumstances and with proper planning, shareholders can receive tax-free capital dividends sooner than is usually the case. Efficient streaming structures can be set up well in advance in order to maximize the value of the CDA to different shareholders. The CDA can be circulated when its balance is highest, so long as the implications of doing so are fully understood (that is, the choice between RDTOH and CDA is clear and the lack of future flexibility is acknowledged). In addition, when life insurance is advisable to fund a redemption or purchase for cancellation, a taxpayer can choose suitable insurance products and a level of funding that will optimize the amount received by his or her estate on the redemption or purchase. Finally, a careful reading of the rules can now provide some comfort about the mechanics associated with the receipt of certain distributions by a private corporation from a mutual fund trust. These concepts are certainly not an exhaustive inventory of the planning opportunities associated with the CDA. However, it is hoped that this article will provide practical guidance to the use of the CDA to maximize shareholder value in private corporations.

NOTES

1 See, for example, *Le Groupe Commerce Compagnie d'Assurances v. The Queen*, 97 DTC 537, at 542 (TCC), aff'd. 99 DTC 5491 (FCA); Joel Cuperfain, "Estate Planning and Life Insurance," in *Report of Proceedings of the Fifty-Third Tax Conference*, 2001 Conference Report (Toronto: Canadian Tax Foundation, 2002), 26:1-43, at 26:8-9; Joel Cuperfain, "Got Me Those 'Low Capital Gain, High Dividend Tax, Stop-Loss Rules, Estate-Planning' Blues," Personal Tax Planning feature (2001), vol. 49, no. 3 *Canadian Tax Journal* 764-800, at 779-80 (herein referred to as "Stop-Loss Rules Blues"); and Leonard Glass, "Sale of a Business—Purchaser and Vendor Issues," in *1999 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 1999), tab 7, 7:26.

2 Glass, ibid.

3 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

4 For example, subsection 112(3.2).

5 Subsection 89(1), definition of "capital dividend account," paragraphs (f) and (g).

6 Paragraph 38(a) and subsection 14(1).

7 Subsection 184(3).

8 Compare Robert E. Beam, Stanley N. Laiken, and James J. Barnett, *Introduction to Federal Income Taxation in Canada*, 22d ed., 2001-2002 (Toronto: CCH Canadian, 2001), 855; and Glass, supra note 1.

9 Subsection 89(1), definition of "capital dividend account," paragraph (a). For a short summary of the exclusions from paragraph (a), see Suzanne I.R. Hanson, "Planning for a Share Sale," in *Report of Proceedings of the Forty-Fourth Tax Conference*, 1992 Conference Report (Toronto: Canadian Tax Foundation, 1993), 27:1-26, at 27:13.

10 Subsection 89(1), definition of "capital dividend account," paragraph (b).

11 Ibid., paragraphs (c), (c.1), and (c.2).

12 Ibid., paragraph (d).

13 Ibid., paragraph (f).

14 Ibid., paragraph (g).

15 Typically, the directors will elect on the corporation's behalf.

16 However, paragraph 212(2)(b) imposes a withholding tax of 25 percent in respect of capital dividends received by non-resident persons. This provision will be discussed further below in the context of CDA streaming.

17 The penalty tax and excess elections will be addressed below in the section dealing with part III tax.

18 The rule generally applies to corporations resident in Canada, provided that subsection 84(2) does not apply.

19 Hanson, supra note 9, at 27:16.

20 Subsection 83(2).

21 *Interpretation Bulletin* IT-66R6, "Capital Dividends," May 31, 1991, paragraph 2.

22 Compare Peter L. Clark and Mark I. Jadd, "Taking a Family Business Public," in *Income Tax and GST Planning for the Purchase, Sale, and Canada-US Expansion of a Business*, 1996 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1996), 11:1-31, at 11:22-23.

23 Ibid., at 11:23.

24 Subsection 89(1), definition of "capital dividend account," subparagraph (a)(i).

25 Assuming that the anti-avoidance rules in subsection 83(2.1) and section 245 do not apply. These provisions will be discussed further below.

26 It is trite law that a public corporation can receive capital dividends tax-free. The only question here is whether it may receive them into its own CDA.

27 Subsection 89(1), definition of "capital dividend account," paragraph (b).

28 Subsection 89(1.1). This rule is consistent with what appears to be the Act's general policy against the accumulation of funds in CDAs when private corporations are controlled by non-residents. For example, pursuant to paragraph 83(2.2)(d), where all or substantially all of a corporation's CDA was made up of capital gains from dispositions of property that may reasonably be considered to have accrued when the property was the property of a corporation controlled, directly or indirectly, by a non-resident person, that CDA will be subject to the anti-avoidance rule in subsection 83(2.1). The latter provision generally disallows (tax-free) capital dividend treatment when a share of a corporation is acquired in a transaction one of the main purposes of which was to receive a capital dividend. Subsection 83(2.1) will be discussed further below.

29 "The purpose of sections 184 and 185 is to levy a punitive tax on a corporation when it has elected to make a distribution under subsection 83(2) . . . in excess of the amount available for such distribution standing to the credit of its capital dividend account." *Canada Tax Service* (Toronto: Carswell) (looseleaf), 184-108.

30 David M. Sherman, ed., *Income Tax Act, Department of Finance Technical Notes*, 13th ed. (Toronto: Carswell, 2001), 1934.

31 *Canada Tax Service*, supra note 29, at 184-111.

32 Paragraph 184(4)(a).

33 Douglas H. Matthew, "Bumper Bedding Limited Case Study: Part IV," in *1995 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 1995), 16:1-62, at 16:11.

34 Compare *Canada Tax Service*, supra note 29, at 184-111, wherein the editors state only that "[t]his result will *often* be advantageous" [emphasis added]. The editors go on to note, at 184-112, "It is not necessary that the election be filed in such a manner that all Part III tax be avoided; the corporation may choose any portion of the excess to be treated as a taxable dividend."

35 Regulation 2106(a)(ii)(B).

36 See *Canada Tax Service*, supra note 29, at 184-112.

37 Letter to D.E. Holtz, Clarkson Gordon, September 17, 1980. See also *Canada Tax Service*, supra note 29, at 184-112.

38 The analysis that follows assumes, for simplicity, that the disposition of ECP occurs in 2002 or later. It also assumes that no amounts in respect of bad debts have been deducted by the corporation pursuant to subsection 20(4.2) and that subsection 20(4.3) does not apply.

39 Technically, paragraph 14(1)(b) brings into income two-thirds of a formula-driven amount. Part of that formula includes the description of E in the determination of cumulative eligible capital in subsection 14(5). E in that definition is, generally, receipts from disposition multiplied by three-quarters.

40 The position outlined here was provided in informal discussions with the CCRA.

41 Karen Yull, "CDA on Sale of ECP" (2002), vol. 10, no. 1 *Canadian Tax Highlights* 6-7.

42 Paragraph 249(4)(a).

43 Subsection 256(9).

44 One might suppose that, as the amounts in respect of the goodwill disposition are added to Opco's CDA at the end of its taxation year—that is, at the very end of March 1, 2002—those amounts should be available for distribution at the end of Opco's taxation year and before the acquisition of control. However, it is the CCRA's position that any amounts added to a corporation's CDA in respect of the disposition of goodwill pursuant to paragraph 89(1)(c.1) or (c.2) in a taxation year may be paid out as capital dividends only in a subsequent taxation year: CCRA document no. 2001-0115265, March 21, 2002. In such cases, the administrative relief described above may apply.

45 Pursuant to paragraph 83(2.1)(b), such a recharacterized dividend is excluded from the application of paragraph 83(2)(b), which provides that no part of the capital dividend elected pursuant to subsection 83(2) is included in the dividend recipient's income. Paragraph 83(2.1)(a) does not recharacterize the dividend for purposes of computing the corporation's CDA. Accordingly, the CDA will still be reduced by the full amount of the dividend. Paragraph 83(2.1)(a) also does not recharacterize the dividend for purposes of part III of the Act; therefore, "the dividend retains the character of a capital dividend for the purposes of determining Part III tax liability." *Canada Tax Service*, supra note 29, at 83-255. However, if the penalty tax in part III applies only to the amount of a dividend in excess of what subsection 83(2) deems to be a capital dividend, and if the taxable dividend deemed by paragraph 83(2.1)(a) is still a capital dividend for purposes of part III, quaere whether the corporation or the dividend recipient is exposed to any part III tax liability as a result of the recharacterization of the dividend.

46 An entire paper could be written on a GAAR analysis of the examples in this section, but such a discussion is beyond the scope of this article. For present purposes, it is merely noted that the rule should be considered when this type of planning is contemplated.

47 Even here, however, the facts may save A from the application of the GAAR if, for example, Newco subscribes for supervoting shares to control Opco and carry on its business, but subsequently purchases the common shares primarily in order to gift them to a trust that will share in the growth in the value of Opco.

48 If the non-resident is the beneficiary of a Canadian-resident trust that receives the capital dividend, the trust may be able to subsequently distribute the capital dividend to the non-resident

free of withholding tax: CCRA document no. 5-7609, June 19, 1989. This planning point should be remembered in the structuring of arrangements whereby non-residents may receive capital dividends. Since it does little to illustrate the streaming concept, it will not be dealt with further in this article.

49 Paragraph 149(1)(f).

50 Paragraph 149(1)(l).

51 See generally CCRA document no. 2001-0112945, March 19, 2002.

52 See generally Hanson, supra note 9, at 27:17. Different classes of shares could also be created by amending the articles of the corporation. If a reorganization of the corporation's capital took place at the time that a capital dividend were contemplated, however, A would need to satisfy herself that the capital dividend she expects on the new class A shares would not be deemed by subsection 83(2.1) to be a taxable dividend.

53 "Revenue Canada Round Table," in *Report of Proceedings of the Forty-Third Tax Conference*, 1991 Conference Report (Toronto: Canadian Tax Foundation, 1992), 50:1-40, question 23, at 50:13.

54 CCRA document no. 2000-0026615F, November 30, 2000.

55 Subsection 89(1), definition of "capital dividend account," paragraphs (a), (c.2) (by reference to paragraph 14(1)(b)), and (d).

56 CCRA document no. 9729995, June 26, 1998.

57 Subsection 129(1). "Refundable dividend tax on hand" is defined in subsection 129(3). RDTOH can be seen as a prepayment of shareholder tax that is recovered by a corporation when it pays taxable dividends. The purpose of RDTOH is to prevent an undue deferral of shareholder tax on certain passive income earned through a corporation. Generally, the RDTOH account of a corporation accumulates two amounts:

1. all of the part IV tax paid by that corporation on its portfolio dividend income deductible in computing taxable income; and
2. for CCPCs, a percentage of aggregate investment income (other than deductible dividends) and taxable capital gains.

Norman C. Tobias, *Taxation of Corporations, Partnerships and Trusts*, 2d ed. (Toronto: Carswell, 2001), 242-43.

58 Norman C. Loveland and Jack A. Silverson, "The Purchase and Sale of Shares: Preserving Tax Basis and Other Planning Considerations," 1996 Corporate Management Tax Conference, supra note 22, 2:1-44, at 2:3-4; and Glass, supra note 1, at 7:28-29.

59 The cost basis of the policy excludes the net cost of pure insurance (NCPI): subsection 148(9), definition of "adjusted cost basis," description of L. For purposes of calculating Subco's CDA, it is assumed that the NCPI is zero. This is generally not the case—although there will often be some amount of cost basis, especially with policies that have been in effect for only a relatively short time—but the illustration is made simpler (and nothing is lost) by making this assumption. Note that the NCPI may, in fact, be zero, depending upon the particular facts: CCRA document no. 2001-0089935, September 5, 2001.

60 CCRA document no. 9415675, July 26, 1994.

61 CCRA document no. 9824645, December 15, 1998. See also CCRA document no. 7M12851, May 10, 1996.

62 CCRA document no. 9908430, June 30, 1999.

63 Ibid., question 3.

64 With respect, the CCRA's conclusion that two seemingly legitimate non-tax objectives in the split structure "initially appear" to be secondary to the obtaining of a tax benefit appears to be questionable.

65 Note that Opco's creditors can attack the proceeds when they are paid to Opco on the death of the insured shareholder.

66 Paragraph 70(5)(a).

67 Jack Bernstein, "Life-Insured Corporate Buy-Sell Arrangements," in 1996 Corporate Management Tax Conference, supra note 22, 10:1-43, at 10:1-2.

68 See, for example, Cuperfain, "Stop-Loss Rules Blues," supra note 1, at 779-84; Robin Goodman and Joel Cuperfain, "Life Insurance Planning," in *2001 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2001), tab 12, 12:25-28; Jack Bernstein, "Life Insurance Corporate Buy-Sell Arrangements" (2000), vol. 6, no. 11 *Tax Profiles*; and Gail Grobe, "Corporate Redemption Buy-Sell Arrangements and the '50% Solution'—Does It Make Sense?" (December 2000) *CALU Report* 1-8.

69 The assumptions in this example are modelled on those of Bernstein, supra note 68. See also Dale M. Ammeter, "Tax Planning for Closely Held Corporations: An Update," *1996 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 1996), tab 2, 2:13-18.

70 This nominal amount of PUC will be ignored for purposes of this example.

71 Paragraph 70(5)(a).

72 Paragraph 70(5)(b).

73 Subsection 84(1).

74 Paragraph 53(1)(b).

75 Paragraph 84(3)(a).

76 Section 54, definition of "proceeds of disposition," paragraph (j).

77 The sequence outlined above, in which a PUC increase is followed by a purchase of shares for cancellation, is described by Alan Shragie in "Non-Grandfathered Life Insurance and the Stop Loss Rules," (1998), vol. 20, no. 11 *The Canadian Taxpayer* 82-84, at 84. A structure that avoids the PUC increase and provides for a capital dividend election in respect of only part of the deemed dividend is not technically possible, since the subsection 83(2) election must be in respect of the full amount of the dividend. Also, if the PUC increase is avoided and the purchase for cancellation is simply split into two stages (that is, one purchase to be elected to be a capital dividend and the other to be a taxable dividend), the stop-loss rule in subsection 112(3.2) will apply to limit the capital loss that can be carried back in respect of the deemed dividend that is elected to be a capital dividend. Ibid., at 83.

78 Subparagraph 112(3.2)(a)(iii). In addition, the stop-loss rule in subsection 40(3.6) will not apply to limit the loss carryback because, immediately after the purchase for cancellation, the trust and Opco are not "affiliated persons" within the meaning of section 251.1.

79 Paragraph 164(6)(c).

80 See Bernstein, supra note 68.

81 Since neither individual knows who will die first, it may be reasonable to assume that A and B will seek to protect their respective interests no matter who dies first. For example, A might want a lower tax burden in respect of her combined terminal return and estate should she die first, but she might very well agree to the 50 percent solution in case B dies first. (If B dies first, Opco's CDA is left with $5 million, which Opco may be able to distribute tax-free to A.)

82 Since this article focuses on the CDA, only the briefest overview of permanent insurance will be given here. For more information about permanent insurance, see, for example, Goodman and Cuperfain, supra note 68, at 12:39-40.

83 The exempt policy requirements will be discussed further below.

84 A similar analysis can be applied to an individual and his or her spouse who both own shares of an operating company (or who provide for a transfer of one spouse's shares to the other on the

death of the first to die). In such a case, joint last-to-die insurance coverage would be purchased and would fund the buy-sell upon the death of the last of the spousal shareholders. Including a spouse in the scenarios described here would not add anything meaningful to the illustrations.

85 This nominal PUC will be ignored in computing any deemed dividends for purposes of this example.

86 It is assumed that, over the course of 40 years, all of the premiums in respect of the insurance policy will be attributable to the NCPI. Accordingly, it is assumed that there is no cost basis of the policy to Opco.

87 Note that the "PUC increase" version of the 50 percent solution is not viable here since a PUC increase would apply to all of the class A common shares held by the estate; that is, the PUC increase would be averaged over 10 million shares and not just the 4,033,198 shares being purchased by Opco. In order to confine the capital dividend to the shares being redeemed, a capital dividend election should be made in respect of all of the shares being purchased, followed by an excess election to cover the excess of $4,033,198 over the amount in Opco's CDA as a result of the death of A.

88 Definition of "proceeds of disposition," paragraph (j).

89 This figure has been rounded up. Because of rounding in the example, the difference between the total tax payable in respect of A's terminal return and estate and the death benefit received into Opco's CDA may equal $1.

90 As in scenario 1, numbers in this example have been rounded. Accordingly, although the difference in table 3 between the amount of benefit remaining after taxes and the costs associated with the basic life insurance premiums and permanent insurance investments may equal $1, the balance has been rounded to zero.

91 As there is a higher amount in the CDA than the amount of capital dividend desired, it will not do here to elect in respect of an entire $10 million deemed dividend and make an excess election. If a capital dividend election is made pursuant to subsection 83(2) in respect of a deemed dividend in the amount of $10 million when there is $10 million in Opco's CDA, there will be no excess amount in respect of which an election may be made; accordingly, Opco will be compelled to distribute all of the funds in its CDA to A's estate on the redemption of the class A common shares. As this result is not desirable because of the grind imposed by the subsection 112(3.2) stop-loss rule, the PUC increase version of the 50 percent solution is the preferred mechanism to use in scenario 3.

92 If A and B were to decide to implement similar structures with respect to non-funded and permanent insurance, it may be reasonable to assume that they would work out an agreement whereby the last to die would have the opportunity of obtaining the remaining portion of Opco's CDA. As with the amount remaining in the CDA after implementation of the 50 percent solution, above, this may be rational ex ante behaviour since neither A nor B knows which of them will die first.

93 See generally T.R. Burpee, "The New Stop-Loss Rules: Grandfathered Shares," Personal Tax Planning feature (1998) vol. 46, no. 3 *Canadian Tax Journal* 678-95.

94 As will become clear, subsection 104(21) does not provide for the distribution of amounts, per se; it provides for the designation of certain net taxable capital gains by the trust. It will be assumed for the purposes of this discussion that a distribution to the particular beneficiary of the trust accompanies the designation by the trust.

95 Subparagraph 104(21)(a)(i).

96 Subparagraph 104(21)(a)(ii).

97 CCRA document no. 2000-0047897, October 17, 2000; and CCRA document no. 9524995, February 12, 1996. The amounts mistakenly included in the CDA depended on the capital

gains inclusion rate at the time of the designation. For example, before the most recent change to the capital gains inclusion rate, one-third of the perceived total gain would have been included in the CDA of the corporation receiving the distribution from the trust.

98 CCRA document no. 9830585, June 1, 1999.

99 Canada, Department of Finance, Notice of Ways and Means Motion To Amend the Income Tax Act, the Income Tax Application Rules, Certain Acts Related to the Income Tax Act, the Canada Pension Plan, the Customs Act, the Excise Tax Act, the Modernization of Benefits and Obligations Act and Another Act Related to the Excise Tax Act, tabled March 16, 2001, resolution no. 67(3).

100 Pursuant to paragraph (f), the addition to the CDA is to be the lesser of two amounts: (1) the excess of the distribution over the amount designated pursuant to subsection 104(21) (that is, the excess over and above the amount of the taxable dividend); and (2) the product obtained when the reciprocal of the fraction in paragraph 38(a) applicable to the trust for the year, minus 1, is multiplied by the amount designated pursuant to subsection 104(21). These two amounts will generally be the same. For example, where the amount distributed is $100 and the designated amount is $50, the calculation under subparagraph (f)(i) equals $50 and that under subparagraph (f)(ii) equals the reciprocal of ½ (that is, 2), minus 1, multiplied by $50, or $50.

101 Notice of Ways and Means Motion, supra note 99, at resolution 67(6).

102 Paragraph 220(3.2)(a).

103 Paragraph 220(3.2)(b).