Manulife

Last updated: March 2019

The Capital Dividend Account and Life Insurance

Introduction

As a notional tax account that tracks tax-free amounts received by Canadian resident private corporations, the capital dividend account ("CDA") includes proceeds received as a death benefit from a life insurance policy. This Tax Topic will focus on the specific rules, issues and interpretations relating to life insurance and the CDA.

The Capital Dividend Account in General

The taxation of private corporations in Canada is based upon the fundamental principle of tax integration. Under this principle, income earned by a private corporation and distributed to its shareholders should be subject to approximately the same amount of tax as if the income had been earned by the shareholders directly. Integral to the principle of tax integration is the recognition that an amount which would have been tax-free if received directly by a shareholder should not be subject to tax if received by a private corporation and then flowed through to the shareholder.

The purpose of the CDA is to track certain tax-free surpluses (in addition to amounts related to the proceeds of a life insurance policy, amounts including: non-taxable portion of capital gains/losses; non-taxable portion of gains realized from the disposition of eligible capital property; and capital dividends received from other corporations) accumulated by a private corporation. The calculation of the CDA is described in the definition of "capital dividend account" in subsection 89(1) of the Income Tax Act (the "Act"). These surpluses may be distributed in the form of tax-free capital dividends to the shareholders of the corporation. The Canada Revenue Agency's ("CRA") views on the CDA and capital dividends are contained in Income Tax Folio S3-F2-C1 – Capital Dividends (referred to here as "the Folio").

All private corporations' resident (i.e. mind and management) in Canada qualify for a CDA. There is no requirement that the corporation be Canadian-controlled. Public corporations do not qualify for a CDA.

Life insurance proceeds received by a private corporation

Life insurance proceeds constitute a key component of the CDA. The CDA is credited by life insurance proceeds received by a private corporation in consequence of the death of any person, in excess of the "adjusted cost basis" (ACB) of the policy immediately prior to death, subject to certain adjustments.

Note that paragraphs 1.61-1.62 of the Folio also deal with what was known as the life insurance capital dividend account ("LICDA") which was repealed effective 1985. Any credit that existed in the corporation's LICDA was added to the corporation's CDA following the 1985 changes.

A discussion of the requirements and issues relating to life insurance proceeds and the CDA follows.

"Proceeds of a *life insurance policy*"

Life vs. non-life policies

A life insurance policy is defined for purposes of the Act to include annuities and segregated funds (see subsection 138(12) definition of "life insurance policy" which the definition of this term in subsection 248(1) refers to for purposes of the Act). Under provincial Insurance Acts or regulations enacted under provincial Insurance Acts, "life insurance" is generally defined to mean: an undertaking by an insurer to pay insurance money, on death; or on the happening of an event or contingency dependent upon human life; or at a fixed or determinable future time; or for a term dependent on human life. Accident or sickness insurance products like critical illness insurance, disability insurance or long-term care insurance are not life insurance. The proceeds of accident or sickness products do not, therefore, credit the CDA of a private corporation. (For more information on the taxation of these products see: Taxation of Stand-Alone Critical Illness Insurance in the Corporate Context; Taxation of Disability Insurance; Taxation of Long-Term Care Insurance).

Exempt vs. non-exempt policies

For income tax purposes, a life insurance policy will either be considered exempt or non-exempt. If the policy qualifies as an exempt policy, the investment earnings associated with the cash value accumulation in the policy are not subject to annual taxation. (For more information on exempt policies see The Exempt Test). On the other hand, non-exempt policies are subject to annual taxation on the amount by which the accumulating fund (AF) exceeds the ACB of the policy. The calculation of the AF of a non-exempt policy is prescribed by Regulation 307 and in general is a measure of the accumulation of value within the contract. The accumulation of value could be obvious, such as accrued investment returns, or intrinsic, such as an implicit pre-funding of future mortality risks embedded in the cost structure of the policy. A life insurance policy need not be an exempt policy to create a credit to the CDA on the death of the life insured. However, practically speaking, the credit to the CDA may not be significant for non-exempt policies due to the fact that a non-exempt life insurance policy's ACB (which would reduce the CDA credit) is generally higher due to the fact that there is annual taxation on the accumulation of value, which increases the ACB. Virtually all life insurance contracts currently available in Canada are structured to be exempt life insurance policies. The discussion below assumes the policy is an exempt policy.

Foreign life insurance policies

Although the "life insurance policy" for purposes of the capital dividend account must be within the meaning of subsection 138(12) of the Act, the residence of the insurer or the insured person is irrelevant. This means that private corporations in receipt of foreign life insurance policy proceeds may calculate a CDA credit in respect of such proceeds. However, the challenge in relation to a life insurance policy issued by a non-resident insurer is in determining the ACB of the policy. CRA indicated that it is the corporation's responsibility to demonstrate that the ACB for the policy is being calculated in accordance with the definition of that expression in subsection 148(9) of the Act (see Technical Interpretation, 2005-0132331C6, dated October 7, 2005). Many foreign policies may well be non-exempt policies. Whether exempt or non-exempt it would be the policyholder's responsibility to determine the policy's ACB and indeed the policy's AF. Independent actuarial professional advice is recommended.

"Other than a LIA policy"

A private corporation's CDA is not increased by any amount it receives in a taxation year as death benefit proceeds of a "LIA policy" (leveraged insured annuity). This term is defined in subsection 248(1) of the Act as a life insurance policy where there is a borrowing after March 20, 2013 and the lender is assigned an interest in the policy and a life annuity in respect of a particular individual. Policies existing on or before March 20, 2013 that would otherwise meet the definition are "grandfathered" from LIA policy rules. It is important to determine if a policy that would otherwise meet the definition of a LIA policy has retained grandfathering at the time of death to ensure that a CDA credit is available. (See: Triple Back-to-Backs before March 21, 2013).

“*Proceeds* of a life insurance policy”

Net of policy loans outstanding

The proceeds of a life insurance policy received by a private corporation as a beneficiary will generally equal the death benefit amount payable to the corporation under the contract terms. Where, at the time of death, there is an outstanding policy loan against the policy, the contract would provide that the death benefit paid is reduced by the amount of the policy loan. For purposes of the credit to the CDA, the death benefit net of policy loans outstanding would be the starting point for the calculation.

CRA Technical Interpretation #2004-0089141C6 – (Question 5 APFF Conference) confirmed the following result:

ACB	$200,000
Outstanding policy loan	(150,000)
ACB immediately prior to death	$50,000
Death benefit	$1,000,000
Credit to CDA (Death benefit proceeds – policy loan – ACB immediately before death)	$800,000

Proceeds of a life insurance policy in excess of ACB and other adjustments

As was mentioned previously, a private corporation’s CDA is credited by an amount equal to the excess of the proceeds of a life insurance policy over the ACB of the policy immediately before death received by the corporation following the death of the life insured. The reduction of the credit to the CDA for the ACB of the policy is intended to account for the fact that, if the corporation had distributed amounts to the shareholders to pay for life insurance, such amounts would have been taxable to the shareholders. The ACB roughly represents the cost of the savings accumulation within the policy.

The ACB of an exempt life insurance policy

The calculation of the ACB of a life insurance policy is detailed in the definition of “adjusted cost basis” in subsection 148(9) of the Act. Briefly, premiums or deposits made into the policy (including premiums for term riders) increase the ACB of the policy. The ACB is reduced by the “net cost of pure insurance” (NCPI) at the end of the calendar year. The ACB is reduced by taking policy loans, paying dividends under a participating policy and partial dispositions. The ACB is increased by repaying policy loans, purchasing paid-up insurance, purchasing term enhancements and policy gains.

The NCPI, as the name suggests, is the pure mortality cost under the policy each year. The NCPI is calculated in accordance with Regulation 308 of the Act. Mortality rates are obtained from a prescribed table - the CIA 86-92 table for policies issued after December 31, 2016 (“G3” policies) and the Canadian Institute of Actuaries (CIA) 1969-75 Select and Ultimate Mortality Tables for “G2” policies (generally, policies issued after December 1, 1982 and prior to January 1, 2017). The NCPI calculations are based on mortality factors obtained from the relevant mortality table, applied to the net amount at risk. For G3 policies, the calculation of the net amount at risk is prescribed and uses the AF that is defined for the policy. For G2 policies, the net amount at risk is the difference between the total death benefit and the AF or cash surrender value of the policy depending on the method regularly followed by the life insurer in calculating NCPI. Most insurers use the cash surrender value of the policy in this computation for G2 policies.

The NCPI increases each year after a policy is issued, primarily because of the increase in mortality factors as the life-insured ages. The NCPI has a profound effect on the calculation of the ACB of the policy and, by definition, the credit to the CDA. The lower the ACB, the higher the CDA credit. Because the G3 regime uses a more modern mortality table and the net amount at risk is generally lower due to the prescribed calculation of the AF, NCPI’s will generally be lower under the current regime, resulting in higher ACB’s that remain positive for a longer period of time. Higher ACB’s will generally be advantageous to policyholders with respect to withdrawals and other policy dispositions but will generally be disadvantageous to the CDA credit. (For a detailed discussion of the ACB of a life insurance policy, refer to Dispositions of Life Insurance Policies.) However, the ACB of a policy will eventually reduce over time and normally, eventually, to zero in later years when the NCPI can be in excess of the premium. For G3 policies issued on older aged individuals (age 70+), the ACB may never reduce to zero over time. Life insurers normally provide product illustrations that show the projected ACB, NCPI and resulting CDA credit in the particular case.

The ACB of multi-life policies

A multi-life policy has only one ACB. Thus, at the death of a life insured under the policy, the full amount of the ACB is deducted from the proceeds receivable by the corporation as a consequence of the death of a life insured. For G3 policies the ACB of multi-life policies is reduced as death benefits are paid. This was not the case for G2 policies which had no adjustment to the ACB as death benefits were paid in respect of separate coverages under a multi-life policy. The relevant ACB calculation also applies for multi-life and joint last-to-die life insurance policies that include a feature that pays out fund values in consequence of the first death of an insured person or on each death of an insured person. (For further discussion see Dispositions of a Life Insurance policy).

ACB of "a policyholder" vs. "to the corporation"

The amount added to a corporation's CDA in respect of the receipt of life insurance proceeds in consequence of death after March 22, 2016 will be limited to the amount by which the proceeds exceed the ACB of "a policyholder's" interest in the policy regardless of whether the particular corporation is the policyholder. Prior to this amendment, the wording required that the ACB "to the corporation" reduce the CDA credit to a corporation in receipt of life insurance proceeds.

The prior wording led to planning where one corporation (e.g., a holding company) owned the insurance policy and another corporation (e.g., an operating company) being named the beneficiary. On receiving the insurance proceeds, the beneficiary corporation was not required to reduce the CDA for the ACB of the policy. The credit to the CDA was not reduced for the ACB of the policy because the ACB belonged to the policy owner, not the beneficiary. This maximized the credit to the CDA. The CRA took the position that structuring the ownership and beneficiary designations in this manner could be challenged as an avoidance transaction under the general anti-avoidance rule (GAAR). In any structure where the beneficiary of a corporate owned policy is not the owner, there is also potential for CRA to assess a taxable benefit to the recipient corporation or its shareholder.

The amendments ensure that the ACB of the policy will reduce the CDA credit to a corporate beneficiary no matter who owns the policy. However, this has caused inequities in some situations. The CRA has stated that the calculation allows for no prorating of the ACB so that if there are two corporate beneficiaries of a policy the entire ACB will reduce each of the CDA credits to the corporations. This is true whether or not the corporations owned and paid for interests in the policy. For further discussion of these issues see Corporate Owned Life Insurance Tax Considerations.

Adjustment for "10/8 policies"

If the life insurance policy is a "10/8 policy" as defined in subsection 248(1) the amount added to the CDA in consequence of death of a person after 2013 is reduced by the amount outstanding immediately before death in respect of the 10/8 policy. For more information on 10/8 policies see As a Matter of Tax, 10/8 Plan Measures Tabled. Due to the fact that there was no grandfathering for 10/8 policies when these measures were put in place, most 10/8 policies were collapsed and replaced so it is unlikely that there are many 10/8 policies in existence and therefore the application of this adjustment may be very limited.

Adjustment for policies that were transferred to the corporation after 1999 and before March 22, 2016

For prior transfers by individuals to a corporation after 1999 and before March 22, 2016 there are two "grinds" or reductions calculated where fair market value consideration was given by the corporation to the shareholder on the transfer. These grinds reduce the CDA for deaths occurring after March 21, 2016. These may be described as:

1. "The Hard Grind" = FMV of consideration given in respect of the prior transfer less the greater of CSV and ACB immediately before the disposition. This hard grind is permanent.
2. "The Soft Grind" = the amount, if any, by which the lesser of the FMV of the consideration given in respect of the transfer and the ACB immediately before the disposition exceeds the CSV minus any "negative ACB" at the time of death. (Generally, due to reductions to the ACB for the NCPI, a "negative ACB" can result. In calculating any taxable policy gain, the negative ACB is ignored.) This "soft grind" can be eroded over time.

An example follows:

Shareholder A owned a life insurance policy with a $1 million death benefit, an ACB of $100,000, a CSV of $60,000 and a FMV of $200,000. On March 21, 2016, he transferred the policy to ACo for $200,000. On that transfer the proceeds of the disposition of the policy was deemed to be $60,000 and the ACB to ACo, also $60,000. Mr. A dies in 2020, at which time the ACB of the policy is negative $20,000. ACo's CDA credit at the time of death will be calculated as follows:

- $1 million (death benefit) less the ACB of the policy (deemed zero, even though negative);
- Applying the hard grind: $1 million is reduced by $200,000 less the greater of ACB and CSV at the time of the transfer (in this case $100,000). The permanent reduction will equal $100,000 making the CDA credit $900,000.
- Applying the soft grind: A further reduction to the CDA is made for lesser of FMV consideration given and ACB at the time of the transfer (in this case $100,000) minus the CSV at that time ($60,000) = $40,000. But, since the policy now has a negative ACB, the grind is reduced by the negative ACB ($40,000 - $20,000). Thus, the soft grind is $20,000.
- The end result is an all-in CDA credit of $880,000, in our example.

Meaning of received

In order to obtain a credit to the CDA, the recipient corporation must be the beneficiary under the policy and not simply the policy owner. As beneficiary, a corporation receives the life insurance proceeds. What happens when a corporate-owned policy is collaterally assigned to a lender as security for a loan to the corporation? Creditor insurance is another type of life insurance product commonly used in business lending situations. In these situations, the life insurance proceeds are paid directly to the creditor as either the policyholder of a creditor's group life insurance policy or beneficiary of a life insurance policy owned by the debtor as policyholder. Slightly different results to the CDA arise from each type.

Collateral assignment of corporate-owned insurance policies

When corporate-owned insurance policy has been assigned to a lending institution as collateral for a bank loan to the corporation or is the subject of a hypothecary claim by a creditor and a death occurs, the insurer generally makes a payment to the lending institution in satisfaction of the collateral assignment and to the extent of any excess proceeds, to the named beneficiary under the policy. If the beneficiary of the policy is a private corporation, the full amount of the proceeds are included in the calculation of the CDA under subsection 89(1) of the Act, notwithstanding the fact that a portion of the proceeds may be paid directly to the lending institution. This treatment is confirmed by the CRA in paragraphs 1.66-1.67 of the Folio.

Creditor insurance

It had long been CRA's administrative policy that a private corporation was not entitled to a credit to its CDA when proceeds of a life insurance policy were paid directly to a creditor as a beneficiary under life insurance to repay the debtor's business loans (i.e., commonly referred to as "creditor insurance").

This long-standing position was successfully challenged in the case of Innovative Installation Inc. v. The Queen (2009 TCC 580). The Federal Court of Appeal (2010 FCA 285) upheld and confirmed the Tax Court of Canada's finding that the debtor corporation should receive a CDA credit for creditor insurance paid on the death of a key person to retire the corporation's business loan. The court stated that: "Paragraph 89(1)(d) does not require that the corporation receive the proceeds directly from the insurer or that it be named as the beneficiary of the policy. It only had to have 'received' them in consequence of … death." In the case of creditor insurance, the debtor corporation constructively receives the proceeds that retire the business debt. The CRA reflects this position in paragraph 1.68 of the Folio.

In a technical interpretation (#2012-0447171E5 dated March 25, 2013) the CRA confirmed that the full amount of the death benefit would be added to the debtor's CDA, without a reduction for the adjusted cost basis (ACB). The rationale for this conclusion was as follows:

> …creditor's group life insurance products are generally 'pure' insurance products, in that they are generally term and non-participating insurance products with no cash surrender value, typically designed to pay the outstanding balance of a loan upon death of the life insured. Moreover, it is our understanding that premiums payable with respect to a particular debtor for this type of products are generally calculated to cover the cost of insurance over the term of the certificate, that is, the term of the loan. It is therefore our understanding that if an ACB calculation was effected with respect to each particular certificate holder, the result would generally be a very low figure, if not nil.

A similar response was received to the same question at the 2012 APFF Conference in October of 2012. The CRA also confirmed (APFF Q 7) in situations where a debtor names a creditor as an irrevocable beneficiary under an individual insurance policy in addition to making a collateral assignment of the policy to the creditor, the debtor would be permitted an addition to its CDA. (This is a common practice amongst lenders in Quebec because of differences in the law under the Civil Code.) An unofficial translation of the response stated as follows:

> …we are of the opinion that the same position could reasonably be applied in such circumstances, provided that the debtor corporation is able to demonstrate that the life insurance proceeds paid directly to the lending institution were used to reduce the debt owed by the corporation to the lending institution, as per the contractual relationship between the parties.

The CRA also stated that the CDA credit would be reduced by the debtor's ACB, if any, as owner of the insurance policy. It is clear that CRA comments about not having to reduce the CDA by the ACB are confined to creditor insurance products as described. These positions are reflected in paragraphs 1.69-1.71 of the Folio.

Proceeds received by a trust

The CRA indicated in a 1986 technical interpretation that proceeds received by a trust (other than a bare trust) and distributed to a corporation are not credited to the corporation's CDA because the funds do not represent proceeds of a life insurance policy. Instead, the proceeds represent distributions of property from the trust in satisfaction of an interest in the trust. See Trusts and Life Insurance – The Basics. Therefore, the proceeds are not credited to the corporation's CDA.

> CRA more recently confirmed this position in Technical Interpretation, 2011-0399771C6, dated May 20, 2011 after the Innovative Installations case confining the "constructive receipt" argument just to creditor insurance situations. The CRA stated that the case: did not extend the concept of constructive receipt or create a new, broader meaning of the word "received" under which a taxpayer could be considered as having received an amount to which he is not otherwise entitled under the terms of a life insurance policy. More specifically in that case, the judge concluded that the proceeds of the policy had been constructively received by Innovative Installation Inc. since the bank was contractually bound by the terms of the group creditor life insurance policy to credit the taxpayer by discharging the balance of the loan.

Proceeds received by a Partnership

Where a partnership receives death benefit proceeds of a life insurance policy, subparagraph 53(1)(e)(iii) of the Act provides for an addition to the adjusted cost base of a partnership interest for the net amount (death benefit less ACB of the policy) of life insurance proceeds allocated to a partner. For corporate partners that are private corporations, there is an addition to the corporation's CDA for the net amount of life insurance proceeds so allocated. This treatment is confirmed in paragraph 1.65 of the Folio which also refers to Archived Interpretation Bulletin IT-430R3 Life Insurance Proceeds Received by a Private Corporation or a Partnership as a Consequence of Death.

Payment of a capital dividend

A dividend (including a capital dividend) is declared by the directors of the corporation and is made payable to the shareholders of record as of a certain date. The resolution of the directors declaring the dividend is recorded in the minutes of the corporation.

Typically, dividends paid by a corporation are taxable dividends. However, if a credit balance exists in the CDA prior to the declaration of the dividend and the directors elect in prescribed manner and form, an otherwise taxable dividend will be a tax-free capital dividend pursuant to subsection 83(2) of the Act.

Note that even though the individual components of the CDA calculation cannot be negative, because of the cumulative nature of the calculation it is possible to have a negative CDA balance. Consider the following scenario. A Corporation realizes a $1,000,000 capital gain in year one resulting in a $500,000 credit to the CDA. At the end of the year, a capital dividend of $500,000 is declared and paid. The balance of the CDA at the end of year one is zero (+$500,000–$500,000). In year two, the corporation realizes a capital loss of $400,000. The CDA balance at the end of year two is now negative $200,000 (+$500,000–$500,000–$200,000). Although a negative CDA has no immediate tax consequences, it may prevent the distribution of all of the CDA credit arising from a subsequent receipt of life insurance by A Corporation. Continuing the example above, if in year three, the corporation receives a death benefit of $500,000 from a life insurance policy with a nil ACB, the credit to the CDA will be $500,000, but only $300,000 may be paid out as a capital dividend. The CDA balance is calculated as follows:

Excess of non-taxable portion of capital gains over non-deductible portion of capital losses (+$500,000-$200,000)	$300,000
Excess of life insurance proceeds over the ACB of the policy	$500,000
Less capital dividends paid by the corporation	($500,000)
CDA Balance	$300,000

In order to qualify as a tax-free capital dividend under subsection 83(2) of the Act, certain steps must be followed concurrent with the declaration of the dividend and prior to payment of the dividend to the shareholders. The steps are set out in Regulation 2101 of the Act, which provides that the election must be made on a prescribed form (CRA Form T2054, "Election in respect of a capital dividend under subsection 83(2)") and lists the various documents that must be filed with the election including the directors' resolution authorizing the election and schedules showing the amount of the corporation's CDA. The CRA has asked insurers to confirm the following information in respect of CDA Elections which have been filed by taxpayers:

- Name of insured
- Breakdown of proceeds received
- ACB
- Beneficiary(ies) in receipt of the proceeds under the policy
- Date proceeds received
- Name of the policyholder, if other than the corporation

With the many legislative changes relating to the life insurance component of the CDA, it is not surprising that the CRA is scrutinizing corporate taxpayers to ensure they are properly determining the CDA credit on receipt of insurance proceeds.

The election must be filed with CRA no later than the day on which the dividend becomes payable or the first day on which any part of the dividend is paid, whichever is earlier. Late-filed elections will generally be accepted by CRA subject to filing the proper forms and paying a late filing penalty. It is extremely important to calculate the CDA correctly; an election that exceeds the corporation's CDA credit can result in a harsh 60% penalty assessed to the corporation calculated on the excess amount.

CDA Anti-avoidance Provision – Sale of Business with CDA arising from life insurance proceeds
In a recent technical interpretation (#2017-0704221E5) the CRA confirmed that CDA arising from life insurance proceeds could be preserved and used by an arm's length purchaser. The question involved the following fact pattern:

- Mr. X, a 100% shareholder of Canco, dies.
- Canco is and always has been the owner and beneficiary of a life insurance policy on Mr. X.
- The life insurance had an adjusted cost basis (ACB) of nil and was neither a leveraged insured annuity (LIA) nor a 10/8 policy.
- Canco receives life insurance proceeds of $500,000.
- Canco uses $200,000 of the insurance proceeds to repay corporate debt and $250,000 to pay a capital dividend to Mr. X's estate.
- $50,000 of the life insurance proceeds remained in Canco
- Mr. X's estate sells his Canco shares to an arm's-length party, Ms. Y.

The CRA confirmed that the CDA balance in Canco before and after the sale of its shares to Ms. Y would be $250,000. Because the life insurance had an ACB of nil and was not a LIA or 10/8 policy, and Canco always owned (and was the beneficiary of) the policy, there were no adjustments to the CDA credit relating to the policy. Regarding the CDA after the sale to Ms. Y, the CRA stated, "The ability of a corporation to elect pursuant to subsection 83(2) and its CDA balance determined under subsection 89(1) are generally not impacted by an acquisition of control of the corporation."

However, the CRA went on to analyze if the CDA anti-avoidance rule in subsection 83(2.1) would apply and recharacterize any future capital dividend Ms. Y receives into a taxable dividend. This rule applies when one of the main purposes of acquiring the shares was to receive the dividend. However, the rule would not apply if one of the exceptions is met.

A key exception looks at the origin of the CDA credit or how the capital dividend being paid arose. Subsection 83(2.2) of the Act provides if all, or substantially all, of the CDA immediately before the capital dividend becomes payable did not arise:

a) from a capital dividend received on another corporation's share that is acquired in a transaction or series of transactions with one of the main purposes being to receive the dividend (other than a capital dividend paid from the other corporation's CDA arising from life insurance proceeds);
b) from an addition to the CDA that results from certain amalgamations or wind-ups;
c) while the corporation was controlled directly or indirectly, in any manner, by a non-resident; or
d) from a capital gain that accrued on property of the corporation that was controlled directly or indirectly, in any manner, by a non-resident,

then the CDA anti-avoidance rule would not apply.

The CRA confirmed that in the scenario where the shares sold are Canco shares, the CDA balance would not be from any of a) to d) above because the CDA balance was only attributable to life insurance proceeds. That means that a capital dividend Ms. Y receives -- up to $250,000 -- would not be recharacterized under the CDA anti-avoidance rule in subsection 83(2.1) as a taxable dividend.

The CRA confirmed that in the scenario where the shares sold are Holdco shares, the capital dividend Canco pays to Holdco would not be subject to the CDA anti-avoidance rule. Because Holdco did not acquire Canco's shares, the main purpose test is not met.

In this same scenario, another exception from the CDA anti-avoidance rule applies to capital dividends paid between related corporations. This exception provides that the CDA anti-avoidance rule will not apply to capital dividends paid through a corporate chain unless all, or substantially all, of the CDA immediately before the dividend becomes payable consists of amounts listed in paragraphs 83(2.4)(a)-(e). Three of these amounts parallel b) to d) discussed above. The other amounts involve CDA or gains accrued while the corporations were not related. In this scenario though, Canco and Holdco were always related. In summary, this means that the CDA anti-avoidance rule would not apply to the dividend paid from Canco to Holdco.

The CRA then confirmed that the capital dividend Holdco pays to Ms. Y would also not be subject to the CDA anti-avoidance rule since Canco's CDA balance immediately before a dividend is paid to Ms. Y would not consist of any amounts described in a) to d) above. Specifically, not a) because Holdco did not acquire the Canco shares to receive the dividend from Canco. The CRA also confirmed that, even if the capital dividend were paid to Ms. Y after there is a winding up of Canco into Holdco, or an amalgamation of Canco and Holdco, the capital dividend Holdco pays to Ms. Y would not be subject to the CDA anti-avoidance rule. In essence, this means that Canco's CDA balance of $250,000 can be transferred to Holdco or to the new corporation resulting from an amalgamation and be paid in the future to Ms. Y in these circumstances.

Despite this, GAAR *could* still apply and would depend on the facts and circumstances of a series of transactions in any particular situation.

As a final comment, the CRA also suggested that another exception could apply. Subsection 83(2.3) provides that the CDA anti-avoidance rule will not apply to a dividend paid by a corporation "in order to distribute life insurance proceeds which were received by it and included in its capital dividend account as a consequence of death of a person."

Because the exception for life insurance proceeds is built right into the exception from the CDA anti-avoidance rule (in subsection 83(2.2) (a)), the CRA confirmed that the CDA anti-avoidance rule will not apply where a capital dividend funded by life insurance proceeds is paid to an individual either directly or through a holding company. This exception appears to be limited to the actual amount of proceeds available for distribution, which in this case was less than the CDA balance in question. The CRA concluded that "thus, assuming that Canco's assets consist only of $50,000 cash which is funded by life insurance proceeds, the provision 83(2.3) could apply to a capital dividend equal to this amount."

In summary then, the specific exception for life insurance would only relate to the amount available for distribution from life insurance proceeds. However, the other exceptions allow for a distribution of the rest of the CDA credit produced by life insurance since the CDA balance is permitted to be distributed without the CDA anti-avoidance rule applying. That means, if the corporation does have other assets or gets other assets, this distribution can be done at a later time without fear of the CDA anti-avoidance provision applying, subject to GAAR.

Conclusion

A corporation may own life insurance for any number of reasons, including funding a buy-sell agreement, business loan protection, key person protection, etc. Life insurance proceeds received by a private corporation create a credit to the CDA of the corporation that may be distributed as tax-free dividends to the shareholders. The credit to the CDA is often a fundamental component of the overall plan and represents a key advantage of life insurance strategies over alternative strategies that might be considered.

Tax, Retirement & Estate Planning Services at Manulife writes various publications on an ongoing basis. This team of accountants, lawyers and insurance professionals provides specialized information about legal issues, accounting and life insurance and their link to complex tax and estate planning solutions.

These publications are distributed on the understanding that Manulife is not engaged in rendering legal, accounting or other professional advice. If legal or other expert assistance is required, the service of a competent professional should be sought.