



CAPITAL DIVIDEND ACCOUNT

A powerful tax tool for Canadian
owner-managed businesses

A capital dividend account (CDA), combined with capital gains-generating investments, may provide tax-efficient income for Canadian business shareholders.

What is it?

A CDA, as defined by the *Income Tax Act* (Canada),¹ is a notional account that keeps track of various tax-free surpluses accumulated by a private corporation. These amounts are eligible for distribution to shareholders as tax-free dividends, referred to as capital dividends.

The intent of the CDA is to preserve the concept of integration, which is designed to ensure the taxes paid by an individual are the same whether the income was earned directly by the individual or was earned by a corporation and later distributed to the individual. Both individuals and corporations are subject to tax, and are taxed on only 50% of capital gains. In the case of a corporation, the remaining non-taxable 50% can be added to a CDA and distributed to the shareholder as a tax-free capital dividend. Capital losses, in turn, reduce the CDA.

Only Canadian-controlled private corporations (CCPCs) are eligible, and the shareholder must be a Canadian resident. Capital dividends paid to non-residents are subject to withholding tax.

CDAs and investment products

Corporations should seek investments that generate primarily capital gains if they wish to take advantage of the tax benefits of a CDA. Capital gains distributions from mutual fund trusts and capital gains dividends from mutual fund corporations (corporate class funds) both qualify as capital gains for the purpose of funding a CDA.

Paying a tax-free capital dividend

Before a capital dividend can be paid, the corporation must file an election with the Canada Revenue Agency (CRA),² on or before the earlier of

- the day the dividend becomes payable; or
- the day it was paid.

If an election is filed late it could be subject to a late-filing penalty. The election form should be submitted with a certified directors' resolution authorizing the election and a schedule showing that the calculation of the tax-free capital dividend was made immediately before the election.

Tax-efficient options

To fund the CDA, the corporate treasurer should seek investments that generate capital gains. Capital gains are conventionally driven by the appreciation of equity investments. But with Fidelity's corporate class products businesses can fund their CDA and distribute gains in a tax efficient way.

- **Corporate class funds** can grow in a tax-efficient manner, primarily because the income and expenses of the funds are pooled. This means that corporate classes can share income, gains, losses, expenses and loss carry-forwards from other classes to reduce distributions generated by the overall structure. When distributions are made, they are generally tax-efficient Canadian dividends and, on a more limited basis, capital gains dividends. As a result, corporate class investments can potentially accumulate maximum growth while minimizing taxable distributions during the investment term. Upon redemption, the investment will realize a capital gain or loss.

Tax-planning strategies

There are several ways that shareholders can use these tax-efficient options to take full advantage of a CDA. Here are some examples:

Tax-free shareholder dividends

Many business owners accumulate after-tax profits in the company to facilitate growth. Investing that pool of capital in corporate class funds may be an attractive alternative to money market or fixed-income funds, which provide interest earnings that are taxed at the highest corporate rate.

The non-taxable portion of realized capital gains is added to the CDA balance, which can be paid as a tax-free capital dividend, maximizing after-tax returns for shareholders. This strategy reduces the corporate tax liability by replacing investment income (taxed at approximately 50%³) with capital gains (taxed at 25%, because only 50% of the gain is taxable), while funding the CDA to distribute tax-free dividends to shareholders.

Capital expenditures

Many operating companies need capital assets to support their business, but capital expenditures can be a challenge to budget. One possible budgeting technique is to fund capital expenditures by saving money in corporate classes. Investments can be redeemed at any time to purchase a new asset. The redemption will trigger a capital gain or loss, and the non-taxable portion of a gain will be added to the CDA.

With a wide array of corporate class products to choose from, backed by a leading investment process, Fidelity offers investments to suit almost every risk profile.

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¹ Subsection 89(1).

² File Form T2054 – Election for a Capital Dividend under subsection 83(2) of the Income Tax Act.

³ 2016 national average corporate tax rate on investment income for a CCPC.