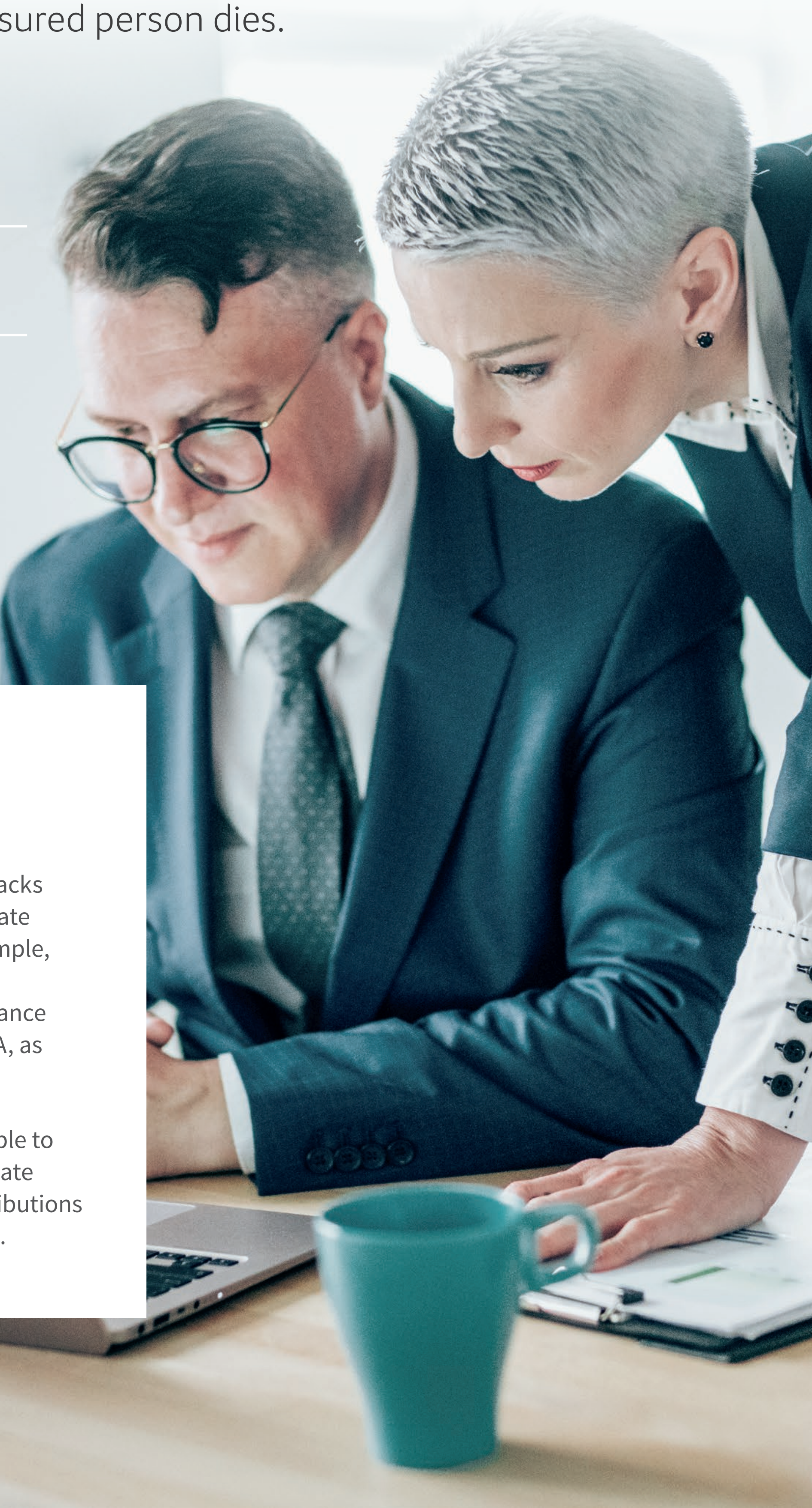
Life Insurance and the Capital Dividend Account

A corporation may buy a life insurance policy so that money is available when the insured person dies.

Funds may be needed for:

- Funding a buy/sell agreement
- Debt coverage for a business line of credit or loan
- Estate planning, including funding a shareholder's tax liability on death

Once a life insurance death benefit is paid to a corporation, the capital dividend account (CDA) can be used to distribute all or a portion of the insurance proceeds on a tax-free basis to its Canadian resident shareholder(s).



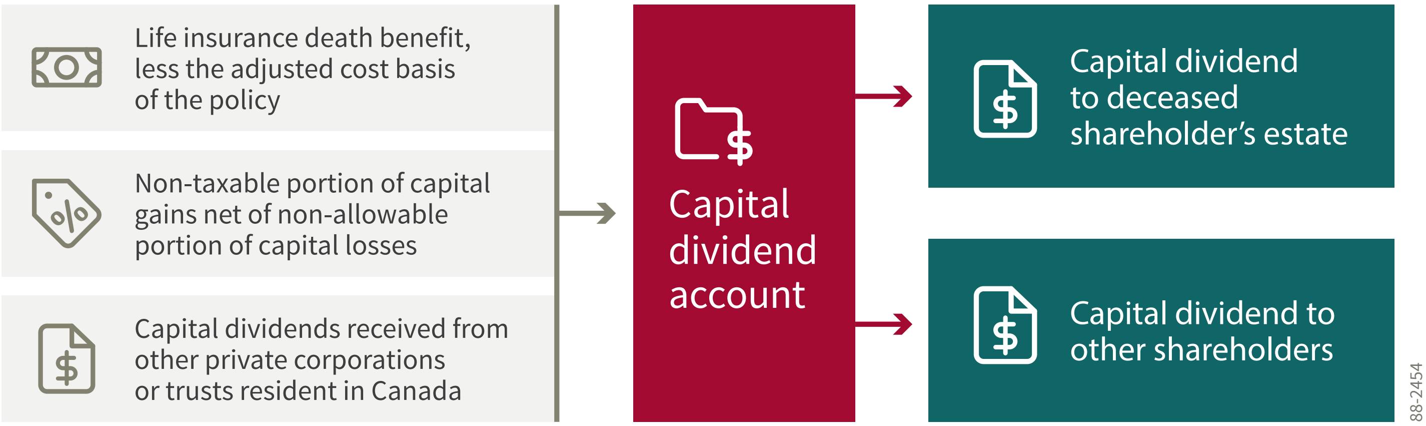
The capital dividend account

The CDA is a notional tax account that tracks certain types of income earned by a private corporation resident in Canada. For example, the non-taxable portion of a capital gain realized by a corporation and a life insurance death benefit credits a corporation's CDA, as described in more detail below.

A corporation's CDA is particularly valuable to Canadian resident shareholders of a private corporation as it allows for tax-free distributions of funds in the form of capital dividends[1].

[1]Tax withholding is required if a capital dividend is paid directly or indirectly (through a trust or estate) to a non-resident.

What determines a capital dividend account balance[2]?



Life insurance and capital dividends – how it works

When a corporation owns a life insurance policy, it's also typically the beneficiary of the policy as well for tax reasons.

When the insured dies, the corporation receives the death benefit, which credits its CDA by an amount that's generally equal to the death benefit less the adjusted cost basis of the insurance policy.

If the policy is used to secure the indebtedness of the corporation, the corporation receives a credit to its CDA on the same basis, even when the death benefit is paid directly to the creditor[3].

Capital dividends are paid by the corporation using a special tax form[4] to elect that that a dividend be treated as a capital dividend. Since detailed knowledge of tax legislation is required for the election process, it's recommended that the corporation's tax accountant be involved.

Corporations have the flexibility to determine when they elect to pay capital dividends. The CDA may be affected by subsequent transactions, so it's a good practice to pay a capital dividend at the earliest opportunity. For example, CDA may be reduced by the capital losses realized by the corporation after receiving the death benefit.

canada life™

[2]In 2016 rules changed to the CDA calculation for non-arms length transfer of life insurance policy that occurred between January 1, 2000 and March 21, 2016, and additional rules may need to be considered when determining the CDA balance.

[3]Court rulings have confirmed the corporation only needs to have 'constructively received' the death benefit proceeds and the discharging of the corporate debt qualifies as receiving the death benefit for purposes of the credit to the corporation's CDA. Refer to Canada Revenue Agency Income Tax Folio S3-F2-C1, Capital Dividends paragraph 1.67.

[4]Prescribed form T2054

The information provided is based on current laws, regulations and other rules applicable to Canadian residents. It is accurate to the best of our knowledge as of the date of publication (January 2021). Rules and their interpretation may change, affecting the accuracy of the information. The information provided is general in nature, and should not be relied upon as a substitute for advice in any specific situation. For specific situations, advice should be obtained from the appropriate legal, accounting, tax or other professional advisors.