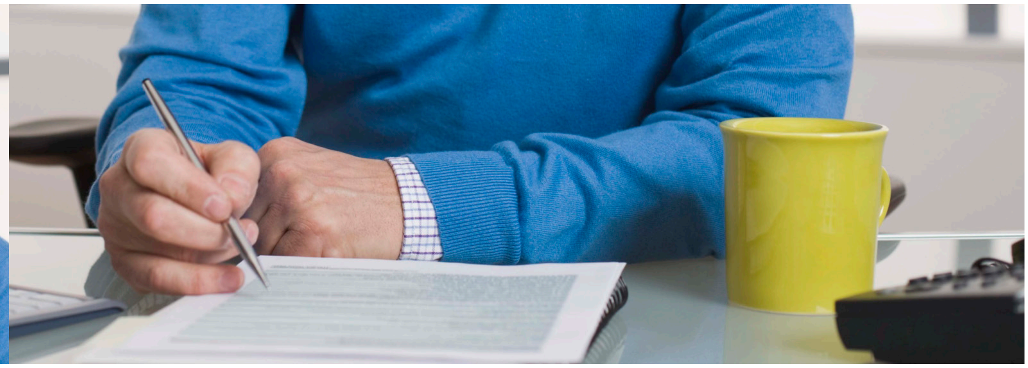

Garrett Watson, CFA, CMT
Investment Advisor

333-7th Ave SW, Suite 1400,
Dome Tower
Calgary, AB T2P 2Z1
t: (403) 299-7368
e: garrett.watson@rbc.com

www.garrettwatson.ca

Capital Dividend Account and Refundable Dividend Tax On Hand

When individuals receive salary or bonus from a corporation the amount is fully taxable. But if they choose to receive their income as dividends, only approximately two thirds of the amount is taxable.

When discussing dividends paid by private corporations to its shareholders, it is important to be aware of two "notional" accounts: the Refundable Dividend Tax On Hand (RDTOH) and the Capital Dividend Account (CDA).

RDTOH

The federal government levies a tax on any investment income earned by a corporation. This includes interest income, capital gains income and most income from property. The tax goes into the company's RDTOH account with CRA and is refunded to the corporation when it pays a taxable dividend.

- The amount that is added to the RDTOH is 26 2/3% of any aggregate investment income (other than dividends) and taxable capital gains
- Dividends received from certain taxable Canadian corporations are subjected to a special tax calculated at 33 1/3%, and added to the company's RDTOH
- For every $3 in taxable dividends that are paid to shareholders, the company is refunded $1 from its RDTOH

When you earn income through a corporation, there are two levels of taxation: one at the corporate level and one at the individual level upon distribution of the corporation's after-tax income as a dividend. RDTOH was created to help ensure that the total income tax (corporate and personal) incurred by using a corporation would be the same as the personal tax resulting if the income were earned directly by the individual.

CDA

The Capital Dividend Account is the other part of this integration process. It allows private corporations to pay tax-free dividends to its shareholders.

RBC Wealth Management

Generally, a corporation's CDA consists of the following:

- The non-taxable portion of the excess of capital gains over capital losses
- Capital dividends received from another corporation
- The proceeds of a life insurance policy received by the corporation in excess of the Adjusted Cost Basis (ACB) of the policy

The last amount plays a major role in the estate and business continuation planning for private business owners. Ordinarily, any capital taken out of the corporation as income is done so as a taxable dividend. The CDA credit, created by the receipt of insurance proceeds, allows the shareholders to withdraw at least a portion of that capital, if not all of it, tax-free.

By using life insurance, the business owner may not only have protected the company against potential losses, but created the ability to pass the value of its assets out of the corporation in the most tax-effective way possible.

To learn more, contact us today.

The following is an illustration to help you understand the elements of these accounting concepts. For more detailed information or explanations, please speak with your tax advisor.

Life Insurance Proceeds
$100,000

Corporation receives $200,000 of income from two sources: investments and a life insurance policy

Investment Income
(Interest, Capital Gains, etc)
$100,000

Private Corporation

Proceeds less ACB equals credit in CDA

Refundable portion (26 2/3%) of eligible income is created to RDTOH

Corporation decides to pay a $150,000 dividend. They would exhaust the credit in the CDA first, then pay the rest as a taxable dividend. The corporation is refunded $1 for every $3 it pays in taxable dividend. In essence $16,666 ($50,000/3) is paid from ROTOH through the corporation to the shareholder.

CDA Credit
$100,000[1] (tax-free)

RDTOH Credit
$26,666 – $16,666 =
$10,000 remaining

$100,000 tax-free

Total Taxable Dividend $100,000 from CDA + $16,666 from RDTOH + $33,334 from corporation =

$50,000 pre-tax
+ $36,666

$150,000 dividend becomes
$136,666 after tax*

The remaining shareholders, or the shareholder's estate, benefit from having received at least a portion of the corporation's assets tax-free via the CDA. The RDTOH ensures that some of the tax that the corporation previously paid is reallocated to the shareholder to be taxed in his/her hands.

[1] Assumes the ACB has reached zero   * Using a 40% Personal Tax Rate