30 YEARS INVESTED IN CANADA

Is your private corporation taking advantage of the

Capital Dividend Account?

by Bob Leeming CFA, CFP, CIM, FCSI
Director, Client Solutions

Much like individual investors, shareholders of Canadian Controlled Private Corporations ("CCPC") need to be concerned with minimizing taxes and maximizing the capital that eventually will be distributed to them.

The use of corporate class funds and a corporation's Capital Dividend Account ("CDA") are increasingly effective ways to achieve these complementary goals and Russell Investments offers several corporate class solutions which, when held by private corporations, may help shareholders achieve the following:

- Minimize taxable income and defer taxes payable
- Generate a return in the form of capital gains
- Offset capital losses with capital gains dividends
- Grow the Capital Dividend Account balance

While there are differences in the methods of calculation and the tax rates that apply to individuals and businesses, there are some consistencies in the tax implications for various sources of income:

- **Interest** – interest income is taxed at the highest marginal rate
- **Foreign dividends** – dividends from foreign corporations are taxed as regular income at the highest marginal tax rate
- **Eligible Canadian dividends** – benefit from the gross-up / tax credit mechanism
- **Capital Gains** – a 50% inclusion rate on capital gains means that for every dollar of realized gains only $0.50 is taxed at the taxpayer's marginal rate.

From a tax perspective, it may be beneficial for a corporation to realize capital gains rather than income, to determine when capital gains are recognized, and to have the gains flow through the Capital Dividend Account. Corporate class funds may provide private corporations with the potential to take advantage of these benefits.

What is the Capital Dividend Account?

The CDA is a notional account created as part of the federal government's approach to 'integrate' the taxes payable between private corporations and individuals. The intention is to permit a private corporation to realize income that is partially or wholly exempt from tax and then pass it on tax-free to its Canadian-resident shareholders. In this manner, an individual utilizing a CCPC to earn investment income should be subject to approximately the same tax burden as an individual who makes the investment directly.

1936
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Data and AUM are as of September 30, 2015.

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One of the primary uses of the CDA is to pay out the untaxed portion of a capital gain to shareholders. When a CCPC realizes a capital gain, 50% of that gain is taxed. The untaxed portion can be added to the corporation's CDA. Similarly, 50% of a capital loss would reduce the balance in the CDA. Since the CCPC can elect to pay out any positive balance in the CDA to its Canadian-resident shareholders by way of a tax-free capital dividend it is advisable to consider making the election to pay out a capital dividend soon after the account has a positive balance.

Why might a Corporate Class Fund be an attractive investment for a Private Corporation?

Many CCPCs are established by the owner of an active business as a personal holding company for the common shares of the active business. As such, the CCPC may receive tax-free intercorporate dividends from the active business. Transferring assets to the CCPC by way of intercorporate dividends may provide the owner of the active business with benefits such as creditor-proofing the active business and creating an income-splitting opportunity.

Regardless of the reason for creating a CCPC, once the corporation has excess funds to be invested it is important for the shareholder(s) of the CCPC to consider investment opportunities that can enhance after-tax returns for both the CCPC and the shareholder(s). As we have indicated above, capital gains are the most efficient type of income for a CCPC and its shareholders from a tax perspective since the Capital Dividend Account permits the flow-through of the untaxed portion of a gain from the CCPC to shareholders.

So, the question becomes "how does a CCPC generate income in the form of a capital gain"? While publicly traded equity securities tend to be the traditional investment choice to generate capital gains, a CCPC may realize gains from many other investments including real estate, private businesses, foreign currencies, derivatives, equity-oriented mutual funds and corporate classes. It's important to recognize, however, that any investment that offers the ability to realize a capital gain also offers the ability to experience a capital loss. If an investor is not willing to assume the risk associated with the type of investment required to generate a capital gain then it may be best to consider adding interest-bearing investments to the discussion as these typically carry a lower level of risk.

Fortunately, corporate class solutions are structured such that a variety of investment choices of varying degrees of risk can provide investors with the potential to realize income in the form of capital gains. For example, Russell Investments' family of corporate classes offers a CCPC the opportunity to realize capital gains while investing in fixed income or income-oriented balanced solutions that tend to fall to the conservative end of the risk scale. Alternatively, Russell Investments offers equity or equity-oriented balanced solutions that offer the opportunity to realize capital gains and tend to carry more risk.

How do the Shareholders of a Private Corporation benefit?

Since interest income does not qualify as an eligible addition to the CDA, private corporations that invest in interest-bearing securities may be forgoing an opportunity to utilize the CDA.

The ability of Russell Investments' corporate classes to offer investors the potential to realize returns in the form of capital gains means that investors will include only 50% of realized capital gains in income for tax purposes. If a CCPC is an investor in a Russell Investments' corporate class, the CCPC will enjoy the benefit of the lower tax rate associated with capital gains plus the CCPC can flow-through the non-taxable portion of capital gains to its shareholders via a tax-free capital dividend from the CCPC's CDA.

Summary

Corporate classes offer shareholders of CCPCs two very significant advantages:

- Generate income in the form of capital gains; and
- Provide investors with the potential to defer tax on investment income until shares are sold.

Because expenses can be aggregated across all of the classes in the mutual fund corporation they can be used to offset or eliminate income that would otherwise be taxable within the corporation or would be distributed to shareholders. This benefit was reduced with the federal government's announcement in March 2013 to abolish transactions that had allowed certain classes of the mutual fund corporation to eliminate taxable interest income by effectively converting the income to capital gains. Despite the decision to end these conversion transactions the corporate class structure continues to offer a tax-effective way in which to build wealth by reducing and deferring taxable distributions. So long as the mutual fund corporation has sufficient expenses from its classes to offset taxable income, shareholders can benefit from owning corporate classes.

The ability to realize return in the form of capital gains offers a specific benefit to shareholders of CCPCs. These shareholders are able to utilize the corporation's Capital Dividend Account to extract the non-taxable portion of capital gains realized by the corporation by way of a tax-free capital dividend.

It's important to note the additional impact of dividends from a tax perspective. Regular dividends received by an investor would be grossed-up and included in the investor's taxable income. During the grossing up process, it is quite common that investors who would have otherwise been eligible for certain government benefits such as Old Age Security (OAS) may no longer qualify because the dividend gross-up has put them into an income range that triggers the OAS clawback. Since capital dividends paid out of the CDA to CCPC shareholders are tax-free, it may be possible to substantially increase the shareholder's overall income by permitting them to remain eligible for OAS and other government benefits.

While corporate classes are designed to appeal to taxable investors and those individuals looking to minimize taxable income, it is possible that the mutual fund corporation may not be able to shelter all of the income generated within the structure and it may be necessary to distribute taxable income annually in the form of eligible dividends and capital gains. This may make corporate classes less appealing to taxable investors who are not anticipating distributions from their investment. Although corporate classes are eligible for registered accounts, non-taxable investors are not able to take full advantage of the tax-efficient features of the corporate class structure. Corporate classes share many of the risks associated with mutual fund investing and several risks, such as forward agreement risk, multi-class risk and multi-series risk, may be more common to corporate classes, which may make them unsuitable for you, depending on your investment objectives and risk tolerance.

To find out more about Russell Investments' investment solutions and the various series available, please ask your advisor, or contact us at 1-888-509-1792 or visit us at www.russell.com/ca.

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