

Intercorporate Dividends, Safe Income and Life Insurance – News and views

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With the expansion of the potential application of subsection 55(2) to intercorporate dividends received after April 20, 2015, paying normal course dividends within a corporate group is not as simple as it once was. And now, in current audits, the CRA has been requesting more information about intercorporate dividends including safe income, adjusted cost base and paid-up capital calculations, as well as the purpose of intercorporate dividends paid.

Some background

Where 55(2) applies, a tax-deductible intercorporate dividend is recharacterized as a capital gain to the recipient, or, in the case of a redemption, additional proceeds of disposition. One of the exceptions provided is where the dividend does not exceed the safe income attributable to the shares on which the dividend is paid. This exception is only available to the extent of an accrued capital gain on the relevant shares.

Safe income is a tax calculation. In simple terms it represents a corporation's retained earnings calculated under tax rules, rather than accounting rules. The main guidance on how to calculate it is in CRA administrative positions and papers. Revisions and updates to these positions were presented at the Annual CTF Tax Conference in the fall of 2023 by way of an extensive paper.

If a dividend exceeds safe income, one of the purposes, and not necessarily a main purpose, of the dividend can not be to effect either of these triggering purposes:

- a significant reduction in a capital gain that, without the dividend, could have been realized on any share ;
- significant reduction in the fair market value of any share; or,
- a significant increase in the cost of property of the recipient.

Practical issues

Prior to the changes in 2015, in general, safe income calculations were only done at important points in time, for example, in sale of business situations. As a result of the changes, it is more likely that these calculations must be done annually. Because safe income calculations start at initial incorporation, keeping accurate corporate records, accounting records and doing these tax calculations annually is a best practice.

Life insurance and safe income calculations

At the time of the 2015 changes, the CLHIA CRA Roundtable asked for clarification regarding the treatment of life insurance premiums for purposes of safe income calculations and the consequences of the payment of a dividend in-kind of a life insurance policy in the context of a safe income dividend. 2015-0573821C6 confirmed non-deductible life insurance premiums reduce safe income to the extent that they are not reflected in the policy's cash surrender value. In respect of a dividend in-kind of a policy, any gain on the disposition of the policy would not contribute to safe income allocable to the dividend in-kind but should create safe income that's available for subsequent distributions.

Often, life insurance is purchased at a Holdco level - to fund tax liabilities on death, to fulfill buy-sell commitments of a shareholder's agreement, to name a few. A normal course dividend paid to a Holdco so that it can pay a premium on a life insurance policy held by it, would increase the cost of the life insurance policy such that a triggering purpose would appear to be present. Therefore, having sufficient safe income is really the only way to assure such an intercorporate dividend would be tax-free. If 55(2) applies to such a normal course dividend, the portion in excess of safe income would be recharacterized as a capital gain and result in a CDA credit for the non-taxable portion of the capital gain to the recipient.

Opportunities to consider life insurance on sale of business

In a sale of business context, often, a large one-time safe income dividend is paid to a Holdco, deferring tax of the vendor. Life insurance purchased by Holdco can fund the deferred tax liability arising on death of the shareholder of Holdco. Life insurance death benefits less the adjusted cost basis of the policy would credit the capital dividend account of Holdco and allow tax-free distribution of life insurance proceeds.

FOOTNOTE:

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