Taxation of investment income within a corporation

INVESTMENT INSIGHT

For individuals with cash or investments within their corporation the tax cost of withdrawing these funds or winding up the corporation can be quite high. In order to defer these taxes, these individuals often choose to keep the corporation going and concentrate on maximizing its investment returns.

Having the corporation invest in a tax-efficient manner can make a big difference to its net after-tax return; unfortunately the taxation of investment income within a corporation is often not well understood.

Let's review the taxation of corporate investment income[1].

Corporate investment income is taxed as passive income at a fixed rate that varies by province. There are no graduated tax rates for corporate investment income. The corporate tax rate on investment income is usually higher than the highest personal marginal tax rate and approaches 50 per cent in some provinces.

Interest income and foreign income, including foreign dividends, are taxed as regular income at the passive income tax rate. A portion of the tax is refundable and added to the Refundable Dividend Tax on Hand account (RDTOH).

Capital gains are a more tax efficient form of income as only half are taxable (the "taxable capital gain") and they are taxed at the passive income tax rate. A portion of the tax is also refundable and added to the RDTOH account. The non-taxable half of the capital gain is added to the Capital Dividend Account ("CDA").

Dividends received from taxable Canadian corporations are subject to a 33.33 per cent refundable tax which is all added to the RDTOH account.

[1] This assumes the corporation is a Canadian Controlled Private Corporation (CCPC). The taxation of investment income within a corporation can be complex. Please consult with your tax advisor about the application of the rules to your specific situation.

CAPITAL DIVIDEND ACCOUNT (CDA)

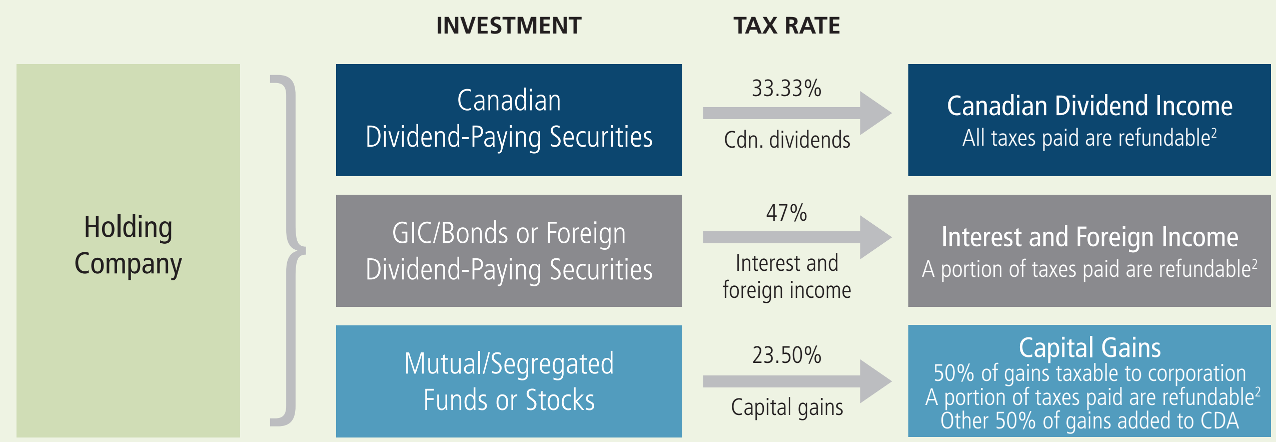
No money is actually paid into the CDA. It is a notional account that includes the non-taxable 50 per cent of all capital gains. Corporations can elect to pay a "capital" dividend up to the balance in the CDA and the dividend is received tax-free by the shareholder. This is very attractive to shareholders.

TIP
Where a corporation realizes an increase in the CDA it is usually a good idea to pay out the CDA balance promptly (via a tax-free "capital" dividend). If the CDA balance is not paid out, 50 per cent of any subsequent capital losses will reduce the CDA and potential "capital" dividend.

REFUNDABLE DIVIDEND TAX ON HAND (RDTOH) ACCOUNT

The RDTOH account is also a notional account. It includes all of the 33.33 per cent tax on dividends received from a taxable Canadian corporation. For all other investment income (i.e. interest and foreign income and taxable capital gains) 26.67 per cent of that income is also added to the RDTOH account. When the corporation pays a taxable dividend to shareholders it will receive a tax refund of $1 for every $3 of dividends paid, up to the balance of the RDTOH account. The taxable dividend received by the shareholder is included on their tax return and will be subject to a dividend gross-up and dividend tax credit.

The taxation of investment income within a Canadian corporation



[2]All taxes paid on Canadian dividend income and 26.67 per cent of interest and foreign income and taxable capital gains is refundable (added to RDTOH). Assumes corporate tax rate of 47 per cent.

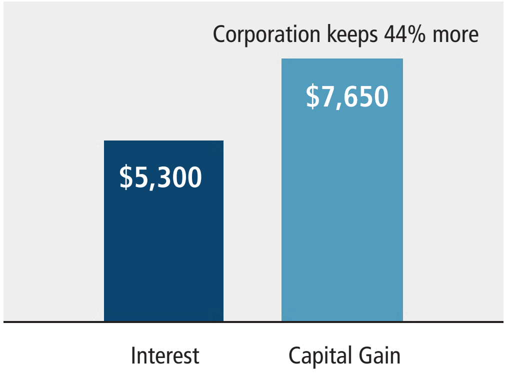
COMPARING THE TAXATION OF INTEREST INCOME VERSUS CAPITAL GAINS WITHIN A CANADIAN CORPORATION

Taxation of investment income within a Canadian corporation

	Interest ($)	Capital gain ($)
Amount	10,000	10,000
Taxable income	10,000	5,000
Tax payable (47%)	4,700	2,350
Net income	5,300	7,650
RDTOH (26.67% Of taxable income)	2,667	1,333
CDA (50% of capital gain not taxable)	**–**	**5,000**

Assumes corporate tax rate of 47 per cent.

Corporation's after tax income



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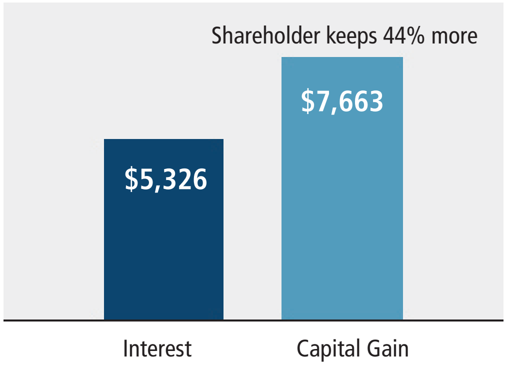
COMPARING THE TAXATION OF THE INVESTMENT INCOME FLOWED OUT TO A SHAREHOLDER

Taxation of investment income within a Canadian corporation flowed out to a shareholder

	Interest ($)	Capital gain ($)
Net income (a)	5,300	7,650
Capital dividend (b) (received tax-free)	–	5,000
Dividend tax refund (c) (RDTOH)	2,650	1,325
Taxable dividend (d) (a) - (b) + (c)	7,950	3,975
Tax on dividend (e) (33%)	2,624	1,312
After tax income (b) + (d) - (e)	**5,326**	**7,663**

Assumes corporate tax rate of 47 per cent.
Assumes dividend is a non-eligible dividend with a tax rate of 33 per cent.

Shareholder's after tax income



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CONCLUSION

Money that's invested in a corporation, regardless of the source, should be invested as tax efficiently as possible to mitigate the high corporate tax rates that apply to investment income in a corporation. Just as with individuals, all other things being equal, capital gains are tax preferred over interest income, whether the corporation leaves the income invested in the corporation to grow or pays it out to a shareholder via a dividend. Understanding the taxation of investment income with a corporation can have a significant impact on the corporation's and owner's bottom line.

For more information on corporate taxation or corporate investments see our related pieces entitled Investments *Owned by Private Corporations* (MK2206E), *Earning Income Inside a Corporation* (MK2609E) and *Professional Corporations Offer Tax Breaks* (MK2435E).

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