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Taxation of Investment Income in a Corporation

Surplus cash in a corporation - Part 2

As the owner-manager of your operating company, you may have surplus profits accumulating in your corporation. This surplus cash could be in your operating company or it could be in your holding company. In either case it is still a corporate structure and the tax implications are the same.

Your first reaction may be to figure out how to withdraw the funds from the corporation and pay as little income tax as possible. While this might seem like the best solution, other options might be more appropriate depending on your situation and your personal and business needs.

There are many issues to consider when deciding what to do with your corporation's surplus funds. What do you need the money for most? What options are available? And what are the tax implications of those options?

Part 2 of this four-part series on surplus cash discusses a few scenarios where your corporation might need the surplus cash and reviews how investment income is taxed in a corporation.

This four-part series takes you through some of the key issues to consider when you have surplus cash in your corporation:

Part 1: Decision tree for addressing surplus cash in a corporation
Part 2: Taxation of investment income in a corporation
Part 3: Taxation of business income and methods of withdrawing cash from a corporation
Part 4: Retirement and estate solutions using excess funds in a corporation

The terms 'corporation' and 'company' are used interchangeably to refer to a Canadian-controlled private corporation (CCPC). This means that the corporation is not controlled by a non-resident of Canada or a public corporation and no class of shares of the corporation is listed on a prescribed stock exchange. This four part series does not apply to public corporations or to businesses operating as a partnership or a sole proprietor.

The content is for information purposes only and does not provide tax or legal advice. It is imperative that you obtain professional advice from a qualified tax or legal advisor before you act on any of the information provided in this article. This will ensure that your own circumstances have been properly considered and that action is taken on the latest information available.

When there's a business need for the surplus cash

Surplus Cash in a Corporation – Part 2

The first step when you realize that you have surplus cash in the corporation is to determine if the business will need the funds at some point in the short to medium term (one to two years). There are many reasons why your corporation may need the excess cash.

Income tax

A profitable business may be required to pay regular income tax instalments. These instalments most often will equal the amount of income tax paid in prior years. It is important to pay these instalments on time in order to avoid penalties and interest charges. Missing these tax instalments can be costly.

In addition, if the corporation is more profitable this year than last year and you calculated your instalments to equal the previous year's income tax, the corporation may owe more tax at the end of the year when you file its income tax return.

Harmonized sales tax (HST)/Goods & Services Tax (GST)

Similar to income tax, HST/GST is paid on an instalment basis and penalties and interest are incurred if instalment payments are late or missed. Instalments are based on the amount of HST/GST owed in the previous year.

HST/GST is calculated when the HST/GST return is prepared. This is done on a monthly or quarterly basis, but small businesses have the option of filing on an annual basis. Once again, you should keep track of additional amounts owing when you file your company's HST/GST return.

Low cash-flow periods

Depending on the type of business you have, there may be slow periods when you will need to supplement your business's operating cash. You should anticipate these periods so that you'll have the funds you need in the corporation to meet your operating requirements.

Corporate debt

Your corporation may have incurred debt to fund prior cash-flow deficiencies or major purchases. Analyze whether paying down the debt with the excess funds is your best choice.

Major purchases

If you need to replace old machinery and equipment to improve or update your processes or expand your operations, etc., consider developing a financial plan with spending timelines. Part of the plan might be to use business profits to pay part or all of these expenses.
If profits are required for business purposes, make sure your business's investment solutions can give you the funds you need, when you need them. If investment income is earned on assets that are required for business purposes and that are incidental to the business, it may be taxed as revenue generated from business operations.

However, usually income earned on funds accumulated in the corporation in excess of what is required for operating your business (passive income) is taxed very differently than income generated from business operations (active business income).

Taxation of investment income in a corporation

The taxation of investment income (or passive income) earned in a corporation is far from straightforward. For purposes of this article, investment income includes interest, foreign income, rental income, royalty income and taxable capital gains. Canadian dividends, although not subject to Part I tax, are considered passive income and are generally subject to Part IV tax as discussed below. Here are some key terms explained:

Refundable portion of Part I tax

In addition to regular corporate income tax, interest income, foreign income, rental income, royalty income and taxable capital gains earned by a corporation are subject to an additional tax referred to as the "refundable portion of Part I tax". Part I is the Part in the Income Tax Act that relates to tax on this type of income. The refundable portion of Part I tax is recoverable by the corporation when it pays a taxable dividend to its shareholders. This is explained in greater detail in the dividend refund section. The refundable Part I tax is $26^{2/3}$% of investment income.

The purpose of the refundable portion of Part I tax is to eliminate any tax advantage of earning investment income in a corporation. Without this refundable portion of tax, a corporation would pay less tax on this type of income than an individual. This would encourage individuals to earn investment income in a corporation as a way to defer tax. The intention of the refundable tax system is to attempt to make someone indifferent to earning investment income in a corporate structure versus earning it personally.

Part IV tax

Canadian source dividends from corporations that are not connected to the shareholder corporation are subject to Part IV tax. The Part IV tax rate is $33^{1/3}$%. Corporations are connected to each other if one owns more than 10% of the issued share capital (having full voting rights) of the other corporation and it also owns more than 10% of the fair market value of all of the issued shares of the capital stock of the other corporation (i.e., more than 10% of the votes and the fair market value of all share capital). Part IV tax is fully refundable to the corporation when a taxable dividend is paid to the shareholders.

Dividends received from connected corporations are generally not subject to Part IV tax unless the paying corporation received a dividend refund when it paid the dividends.

Refundable dividend tax on hand (RDTOH)

The RDTOH is a notional account that keeps track of the amount of refundable Part I tax plus the Part IV tax that has been paid to the Canada Revenue Agency (CRA) but not yet recovered.

Dividend refund

This is the amount of the RDTOH that is recovered in the current year (i.e. the amount of refundable tax that is claimed by the corporation). The corporation must pay a taxable dividend to its shareholder to claim a dividend refund. The corporation is able to claim a dividend refund of $1 for every $3 of taxable dividends that it pays to its shareholders in the current year. The dividend refund is limited to the balance in the RDTOH account.

The following is an example of how the refundable tax works:

	Interest income	Dividend income	Capital gain
Income	$1,000	$1,000	$1,000
Refundable Part I tax	$267		$133
Part IV tax		$333	

RDTOH balance = $267 + $333 + 133 = $733

The corporation then pays $3,000 in taxable dividends to its shareholders.

Dividend refund = the lesser of:

i) The RDTOH balance of $733; or
ii) The taxable dividends paid divided by 3 ($3,000 ÷ 3 = $1,000).

In this example, the full RDTOH balance of $733 would be recovered as a dividend refund in the current year.

Capital dividend account (CDA)

Among other things, the CDA accumulates the non-taxable/non-allowable portion of capital gains and capital losses. A positive balance in the CDA can be paid out to the shareholders as a tax-free capital dividend. This is discussed in greater detail in Part 3 of this series of articles.

Tax rates

To see the corporate tax rates on investment income for the current year, see the tax tables in the separate link provided. The tables illustrate the combined federal and provincial tax rates in all cases and also assume that the shareholder is at the top marginal tax rate.

In general, the tables illustrate that it may be very slightly better to earn interest and capital gains personally than through a corporation. This is true for most provinces, but you should review the rates in your province to determine if this is the case.

There is no difference between earning Canadian dividends personally or through a corporation since all of the corporate taxes paid are refunded to the corporation when a taxable dividend is paid to the shareholders. Consequently, Canadian dividend income is only taxed at a personal level.

However, where a corporation earns Canadian dividend income but does not pay out that income in the same taxation year, there may be a prepayment or deferral of tax equal to the difference between the Part IV tax of $33^{1/3}$% and the shareholders' personal marginal tax rate on dividend income. Currently in most provinces, there would be a prepayment of tax when Canadian eligible dividend income is earned in a corporation and is not paid out in the same taxation year it is earned. Accordingly, it may be advisable to distribute Canadian dividend income earned in the corporation in the same taxation year that it is earned to avoid the prepayment of tax. Ensure that this is true for your province of residence.

The taxation of investment income in a corporation is fairly complicated, but it was designed to eliminate any tax advantage of earning investment income through a corporation. In fact, there is currently a slight tax disadvantage to earning investment income inside a corporation in most provinces, but there are exceptions. However when the surplus assets are already inside the corporation, there may be tax implications when getting them out of the corporation to invest personally. These tax implications should be considered in conjunction with the taxation of investment income in the corporation.

Conclusion

It is important to understand the tax implications of investing in your corporation as this may affect your decision to hold investments inside your corporation. In addition, you need to consider the funding requirements of the business and the timing before you withdraw excess cash from your corporation. You, along with your qualified tax advisor, may decide that even if the corporation needs the excess funds, it may be better to pay the excess revenue out first in the form of a salary or a bonus and then loan it back to the corporation. It is recommended that you discuss these decisions with your qualified tax advisor prior to implementing any plan.