
Wealth Management

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

# Taxation of investment income in a corporation

**On July 18, 2017 the federal government released a consultation paper proposing a number of strategies which target private corporations with regards to income splitting, multiplication of the lifetime capital gains exemption, holding a passive investment portfolio inside a private corporation, and converting a private corporation's regular income to capital gains.**

**Generally, effective for 2018 and later taxation years, the government has proposed to limit income sprinkling to family members receiving "reasonable" compensation from a private corporation. The proposed measures extend the tax on split income rules (often known as "kiddie tax") to adults and limit the multiplication of claims to the lifetime capital gains exemption.**

**The government is also seeking input on possible measures to eliminate the tax advantage of investing undistributed earnings from an active business in a private corporation. If enacted, these measures may result in a disincentive for investing passively within a corporation.**

**The strategies discussed in this article may be affected by the proposed measures in the consultation paper and the accompanying proposed legislation. If you are an owner of a private corporation you should consider the potential impact of the proposed measures and discuss the implications with your qualified tax advisor.**

As a business owner, you may have surplus cash accumulating in your corporation. Perhaps you have been setting aside funds for a large future business purchase or perhaps you received a cash inflow from a major sales contract. Either way, you should determine how to maximize the value of this surplus cash. One method of increasing the value of the surplus is investing the funds within your corporation. This article discusses the taxation of passive investment income in a corporation should you decide to invest the surplus cash.

Please contact us for more information about the topics discussed in this article.

It is important to note that in the 2017 federal budget, the government identified certain strategies involving private corporations that they believe provide an unfair tax advantage to high-income individuals. One of these strategies involves holding a passive investment portfolio inside a private corporation. This strategy may be financially advantageous for owners of private corporations because corporate tax rates are generally much lower than personal rates so private corporations can accumulate earnings that can be passively invested. The government intends to release a paper in the coming months setting out the nature of these issues in more detail as well as proposed policy responses.

The tax rates referenced in this article are current as of May 2017 and are based on federal and provincial legislation.

The terms 'corporation' and 'company' are used interchangeably to refer to a Canadian-controlled private corporation (CCPC) in this article. In simple terms, a CCPC is a Canadian corporation that is not controlled by a non-resident of Canada or a public corporation or a combination of both. In addition, no class of shares of a CCPC can be listed on a prescribed stock exchange. This article does not apply to public corporations or to businesses operating as a partnership or a sole proprietor.

## Taxation of investment income in a corporation

When you have surplus cash in your corporation, the first step is to determine if the business will need the funds in the near future. Perhaps your corporation will need the excess cash to pay tax instalments or make a major business acquisition. If you decide to invest the surplus cash accumulating in your corporation, the income generated might be considered incidental to your business and may be taxed as active business income. Please refer to the article titled "Taxation of Business Income in a Corporation" for more details on how active business income is taxed.

If it is determined that the income generated from investing the surplus cash is not incidental to your business, it would be taxed as passive investment income. Passive investment income may include interest income, foreign income, rental income, royalty income and taxable capital gains. This is the case whether the investment income is earned in your operating company or your holding company. Although the taxation of passive investment income earned in a corporation is far from straightforward, the following are some basic concepts and key terms that you may find helpful.

### Part I tax and the refundable portion of part I tax

A Canadian corporation is subject to a general rate of tax on its investment income under Part I of the Income Tax Act (Act). If the corporation is a CCPC, it is subject to an additional tax of 30 ⅔% on this investment income which is referred to as the "refundable portion of Part I tax". The refundable portion of Part I tax is recoverable by the CCPC when it pays a taxable dividend to its shareholders. The mechanism for the refund is explained in greater detail in the dividend refund section.

The purpose of this pre-payment and refund of tax is to achieve an important principle of the Canadian tax system commonly referred to as "integration". When a tax system is perfectly integrated, an individual will be indifferent to earning investment income in a corporation versus earning it personally. Without the refundable portion of Part I tax on investment income, a corporation would pay less tax on investment income than an individual (with a high marginal tax rate) and this advantage would encourage individuals to earn investment income in a corporation as a way to defer tax.

### Part IV tax

Although Canadian source dividends are not subject to Part I tax, they are considered passive income and subject to special tax rules.

Canadian source dividends received from corporations that are **not connected** are subject to Part IV tax of 38 ⅓%. Corporations are connected to each other if one corporation controls the other or one owns more than 10% of the fair market value and voting shares of the other corporation. Like the refundable Part I tax, Part IV tax is refundable to the corporation when a taxable dividend is paid to a shareholder.

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. Therefore, in certain circumstances, inter-corporate dividends between connected corporations may be able to be paid tax-free. Speak to your qualified tax advisor for more information about the tax implications of inter-corporate dividends.

Unlike dividends received by individuals, there is no gross-up or dividend tax credit for dividends received by a corporation.

### Refundable Dividend Tax on Hand (RDTOH) and the Dividend Refund

The RDTOH is a notional account for private corporations. It keeps track of the refundable portion of Part I tax plus the Part IV tax that has been paid to the Canada Revenue Agency (CRA) but has not yet been refunded. If there is a positive balance in the RDTOH account, the corporation will receive a refund when it pays a taxable dividend to a shareholder. The corporation receives a dividend refund at a rate of 38 ⅓% of the taxable dividends it pays. The dividend refund is limited to the balance in the RDTOH account.

### Example

The following is an example of how the dividend refund works:

Assume the corporation earned $1,000 each of interest income, dividend income, and capital gains in the year.

| | Interest Income | Dividend Income | Capital Gain |
|---|---|---|---|
| Income | $1,000 | $1,000 | $1,000 |
| Refundable Part I Tax (30 ⅔%) | $307 | | $153 |
| Part IV Tax (38 ⅓%) | | $383 | |

Assuming the prior year's RDTOH closing balance is nil, the RDTOH balance at the end of the current year would be $843 (which is the total of refundable Part I tax of $307 and $153 as well as the Part IV tax of $383). The corporation then decides to pay taxable dividends of $3,000 to its shareholders. The dividend refund is equal to the lesser of:

i) The RDTOH balance at the end of the year of $843; or

ii) 38 ⅓% of the taxable dividends paid in the year of $1,150 (38 ⅓% x $3,000).

In this example, the full RDTOH balance of $843 would be recovered by the corporation as a dividend refund. The RDTOH balance would then be reduced to nil.

### Capital Dividend Account (CDA)

The CDA is another notional account for private corporations. It keeps track of the non-taxable portion of capital gains and non-allowable portion of capital losses as well as other amounts such as capital dividends received or paid by the corporation and certain life insurance proceeds received in excess of the policy's adjusted cost base. It is intended that the tax-free character of these amounts be transferable to shareholders. As such, when there is a positive balance in the CDA, a tax-free capital dividend can be paid out to the company's shareholders. Once a capital dividend is distributed, the CDA is reduced by the amount of the capital dividend paid.

The CDA does not appear on your company's financial statements, nor does it have to be disclosed anywhere. However, you should maintain an annual balance of the account and closely monitor it to allow you to take advantage of any tax-free capital dividends. As a planning strategy, since the non-allowable portion of capital losses immediately reduce the CDA, it may be beneficial to pay a capital dividend when the CDA is positive so that the opportunity is not lost in cases where the corporation realizes a capital loss in the future.

## Tax rates and tax-deferrals or prepayments

### Tax rates

Investment income earned within a corporation is ultimately taxed at two levels – once at the corporate level and again at the personal level when the income is distributed to shareholders. For the current combined corporate and personal tax rates on investment income, please ask your RBC advisor for the tax tables titled "Combined Corporate and Personal Tax Rates". The tables illustrate the following:

1) the corporate tax rates on various types of income earned and retained in a corporation;

2) the combined corporate and personal tax rates on various types of investment income earned in the corporation and is distributed as an ineligible dividend to a shareholder; and,

3) the personal tax rates on various types of investment income earned personally.

These tables assume that the shareholder is at the top marginal tax rate.

The tables show that integration is not quite perfect. Currently, there is a tax rate disadvantage to earning interest income, foreign income and capital gains inside a corporation for all provinces and territories (although this may change from year to year depending on the current year's tax rates and your province or territory of residence). Further, if the corporation is subject to non-resident withholding tax and entitled to a foreign tax credit, the amount that is added to the RDTOH account is reduced. Thus, foreign dividends that are subject to withholding tax may be taxed more heavily in the corporation than foreign dividends earned personally.

There is no tax rate difference between earning Canadian eligible or ineligible dividends personally or through a corporation. All of the corporate taxes paid on dividends from non-connected corporations are refunded to the corporation when a taxable dividend is paid to shareholders. Consequently, Canadian dividend income is ultimately only taxed at a personal level.

### Tax deferrals or prepayments

There is a deferral or prepayment of taxes with respect to all types of investment income earned in a corporation where the corporate and personal tax rates differ and the corporate tax is paid in one year but personal tax on a dividend distribution is paid in a future year. For example, in the case where your 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 calculated as the difference between the Part IV tax of 38 ⅓% and your personal marginal tax rate on dividend income. Currently, in most provinces and territories, there would be a prepayment of tax when eligible dividend income is earned in a corporation and is not paid out in the same taxation year. Accordingly, you may want to consider paying out eligible dividend income earned in the corporation in the same taxation year in which it is earned to avoid the prepayment of tax. Speak with your qualified tax advisor to see if this makes sense in your circumstances.

## Conclusion

As a business owner with surplus cash accumulating in your corporation, you first need to consider the funding requirements of the business and the timing of when certain obligations need to be satisfied. If you decide to invest the surplus cash in your corporation, it is important to understand the tax implications of doing so.

The taxation of investment income in a corporation is fairly complicated but essentially it is designed to eliminate any tax advantage of earning investment income through a corporation versus earning the income personally. Currently, there is a tax disadvantage to earning investment income inside a corporation for all provinces and territories (although this may change from year to year depending on the current year's tax rates and your province or territory of residence).

With that in mind, if you instead decide to withdraw the surplus cash from your corporation and invest it personally, there are different tax implications associated with doing so. These tax implications should be considered in conjunction with the taxation of investment income in your corporation. For more details on the tax implications withdrawing funds from your corporation, please refer to the article titled "Withdrawing Surplus Cash from a Corporation." It is also recommended that you discuss these decisions with your qualified tax advisor prior to proceeding with any action.

*This article outlines several strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal or tax advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax advisor before acting on any of the information in this article.*