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INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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Taxation of investment income in a corporation

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.

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. The tax rates referenced in this article are current as of July 2018 and are based on federal and provincial legislation.

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 dividend 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.

Tax on investment income (excluding Canadian dividends)

When a private corporation (not just a CCPC) earns passive investment income (excluding Canadian dividends), it is currently subject to a federal tax at a rate of 28%. A private corporation is also subject to an additional refundable tax of 10 ⅔% on this investment income for a total federal tax of 38 ⅔%. A portion of the total tax paid is refundable to the corporation when taxable dividends are paid out to the shareholders. The refundable portion is calculated as 30 ⅔% of the investment income. The refundable portion is reduced if the corporation earns foreign investment income and claims a foreign tax credit for the non-resident withholding tax paid. 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 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.

Tax on Canadian dividends

Canadian dividends earned in a corporation are not subject to regular corporate tax. Instead, they are subject to special tax rules depending on whether the dividends are received from a connected or non-connected corporation. A payer corporation is connected to the corporation that receives the dividends if:

- the recipient corporation owns more than 10% of the voting shares and more than 10% of the fair market value of all of the issued shares of the payer corporation, or
- the recipient corporation controls the payer corporation.

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.

For the purposes of determining whether two corporations are connected, the normal concept of control is expanded and provides that one corporation is controlled by another if more than 50% of its shares (that have full voting rights) belongs to the other corporation, persons that do not deal at arm’s length with the other corporation, or a combination of the other corporation and persons that do not deal at arm’s length with the other corporation.

Dividends received from Canadian corporations that are not connected are subject to a special refundable tax at 38 ⅓%. This entire tax is refundable to the corporation once taxable dividends are paid out to the shareholders. Dividends received from connected corporations are generally not subject to this special refundable tax unless the paying corporation received a refund of its taxes when it paid the dividends. 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 refundable portion of tax paid by a private corporation on passive investment income, including Canadian dividends, is added to the corporation’s RDTOH account. The RDTOH account is a notional account that keeps track of the refundable taxes paid by a private corporation to the Canada Revenue Agency (CRA).

To the extent there is a positive balance in the RDTOH account, when a corporation pays out a taxable dividend to its shareholder, the corporation will receive an RDTOH refund (called a “dividend refund”) at a rate of 38 ⅓% of the taxable dividend paid. In other words, the dividend refund is equal to the lesser of the RDTOH balance at the end of the year or 38 ⅓% of the taxable dividends paid in the year.

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 tax paid (30 2/3%)	$307		$153
Refundable tax paid (38 1/3%)		$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 the refundable taxes paid on all of the investment income). If 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.

Changes to the RDTOH account and the dividend refund

A dividend refund may be available when a corporation pays out a taxable dividend to its shareholder. A taxable dividend may be designated as an eligible or non-eligible dividend.

An eligible dividend can only be paid by a private corporation to the extent the corporation has active business income (ABI) that has been taxed at the general corporate tax rate or to the extent that it received eligible dividends from another corporation. An individual in the highest tax bracket receiving an eligible dividend in 2018 will pay between 29% and 43% combined federal and provincial tax on the dividend, depending on their province of residence.

A taxable dividend that cannot be designated as an eligible dividend is paid as a non-eligible dividend. Generally, ABI that was taxed at the small business tax rate or passive investment income (excluding eligible dividends received from other corporations) would give rise to income that would be paid as a non-eligible dividend. An individual in the highest tax bracket receiving a non-eligible dividend in 2018 will pay between 36% and 48% combined federal and provincial tax on the dividend, depending on their province of residence.

A taxable dividend may be designated as an eligible or non-eligible dividend.

For tax years prior to 2019, a corporation could receive a dividend refund upon the payment of a preferentially taxed eligible dividend out of income that was not subject to the refundable tax mechanism, where the corporation's RDTOH was generated from investment income that would normally need to be paid out as a non-eligible dividend. This was perceived by the government as an unfair tax deferral advantage.

To address this issue, the government introduced rules where for tax years after 2018, a private corporation could only receive a dividend refund on the payment of non-eligible dividends. An exception will be provided where the RDTOH arises from eligible dividends received by the corporation on portfolio investments. In this case, the corporation will still be able to obtain a dividend refund upon the payment of eligible dividends.

The existing RDTOH account will now be referred to as the "non-eligible RDTOH" account and will track refundable taxes paid on passive investment income (excluding eligible dividends received by the corporation). This account will also track non-eligible dividends received from non-connected corporations. A corporation will only be able to obtain a refund from the non-eligible RDTOH account upon the payment of a non-eligible dividend.

A new RDTOH account known as the "eligible RDTOH" account will be introduced to track refundable taxes paid on eligible portfolio dividends. Any taxable dividend (eligible or non- eligible) paid by a corporation will entitle the corporation to a refund from its eligible RDTOH account.

However, an ordering rule requires that a private corporation paying a non-eligible dividend must exhaust its non-eligible RDTOH account before claiming a refund from its eligible RDTOH account.

If a corporation obtains a dividend refund when it pays a taxable dividend to a connected corporation, the recipient corporation is subject to a refundable tax. For tax years beginning after 2018, this refundable tax will be added to the same RDTOH account from which the payer corporation received the refund.

Transitional rules have been introduced to deal with a corporation's existing RDTOH balance. For a CCPC, the lesser of its existing RDTOH balance and an amount equal to 38 ⅓% of the balance of its general rate income pool, if any, will be allocated to its eligible RDTOH account. The

general rate income pool is a notional account that keeps track of ABI that was taxed at the general corporate tax rate and eligible dividends received by the corporation. Any remaining balance in its existing RDTOH account will be allocated to the CCPC's non-eligible RDTOH account. For any other corporation, all of the corporation's existing RDTOH balance will be allocated to its eligible RDTOH account.

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 the 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 reduces 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 an 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 that is distributed as an ineligible dividend (or eligible dividend where eligible dividends are earned in the corporation) to a shareholder; and,
3. the personal tax rates on various types of investment income earned personally.

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.

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 when earned through a corporation than foreign dividends that are earned personally.

There is no tax rate difference between earning Canadian eligible or ineligible dividends personally or through a corporation. The corporate taxes paid on dividends from non- connected corporations are refunded to the corporation when a taxable dividend is paid to shareholders.

Tax deferrals or prepayments

Where investment income earned in a corporation is retained in the corporation and not paid out to shareholders immediately, there is a deferral or prepayment of taxes. This is because corporate tax rates differ from personal tax rates. 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 refundable tax of 38 ⅓% and your personal marginal tax rate on dividend income.

Currently, in many 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 a qualified tax advisor to see if this makes sense in your circumstances.

Other considerations for earning investment income in your corporation

For tax years that begin after 2018, passive investment income earned by a corporation or any of its associated corporations may impact a corporation's ability to claim the small business deduction (SBD) on its ABI. The concept of association is defined in the Income Tax Act and is beyond the scope of this article. The SBD lowers the federal tax rate on the first $500,000 of ABI (the "business limit") earned by a CCPC from 15% (the general corporate tax rate on ABI earned by a private corporation) to 10%.

Under this measure, the business limit will be reduced on a straight- line basis where the CCPC and its associated corporations have between $50,000 and $150,000 of investment income in a year. The business limit will be reduced by $5 for every $1 of passive investment income above the $50,000 threshold and be eliminated if a CCPC, and its associated corporations, earn at least $150,000 of passive investment.

For the purposes of calculating the reduction to the business limit, investment income earned by a corporation will generally be measured by a new concept, known as "adjusted aggregate investment income" (AAII). AAII will generally include net taxable capital gains, interest income, portfolio dividends, rental income and income from savings in a life insurance policy that is not an exempt policy. AAII will exclude certain taxable capital gains (or losses) realized from the disposition of active business assets and shares of certain connected CCPCs. As well, AAII will exclude net capital losses carried over from other tax years and investment income that pertains to and is incidental to an active business (e.g. interest on short-term deposits held for operational purposes, such as payroll or to purchase inventory).

The test for accessing the SBD under this measure will be an annual test based on passive investment income earned by a CCPC and any associated corporation in the taxation year that ended in the preceding calendar year.

Under current rules, the business limit is only reduced based on the corporation's taxable capital employed in Canada. The reduction in a corporation's business limit will be the greater of the reduction based on taxable capital employed in Canada and the reduction based on passive investment income.

If you are the owner of a CCPC, consider how these rules will impact your corporation. If you are concerned that your corporation, together with any associated corporations, will have annual passive investment income in excess of $50,000 and impact your corporation's ability to claim the SBD, speak to a qualified tax advisor about any actions you should take as well as potential investment and asset allocation strategies going forward.

For tax years that begin after 2018, passive investment income earned by a corporation or any of its associated corporations may impact a corporation's ability to claim the small business deduction (SBD) on its ABI.

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 may contain several strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax, or insurance 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, legal, and/or insurance advisor before acting on any of the information in this article.

Wealth Management

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