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In Good Company: Retaining investment income in your corporation

by Jamie Golombek

When it comes to earning investment income inside your corporation, the amount of taxes paid depends on the type of income earned, such as interest income, Canadian dividends or capital gains. Similarly, the amount you get to keep will depend on how well the corporate tax system is "integrated" with the personal tax rates in your province of residence. This report will examine how investment income that is earned in a private Canadian corporation is taxed and show that, due to an "investment advantage" for most types of investment income in the majority of provinces, it may be best to retain after-tax investment income in your corporation.

BACKGROUND

Our previous reports, Bye Bye Bonus[1] and The Compensation Conundrum[2], looked at whether to maintain surplus after-tax business income in your corporation or distribute the funds as dividends or bonus. For active business income up to the small business deduction limit ($500,000 federally and in most provinces), there is a significant tax deferral advantage that ranges from 25% to 36%, depending on the province. For active business income exceeding the small business deduction limit, the tax deferral advantage is slightly lower and ranges from 13% to 23%. This means that by leaving after-tax business income in your corporation, there is more money that can be invested than if you were to withdraw the funds from your corporation and invest them personally. If you're a business owner who has left surplus funds in your corporation, now is the time to look at the taxes that arise when the corporate funds are invested and what to do with the funds that remain after taxes are paid on the investment income.

When investment income is earned in your corporation, it is initially taxed at the applicable corporate tax rate. The after-tax income may then be left in your corporation to be reinvested or, alternatively, it may be distributed to you (the shareholder)[3] as a dividend, on which you would pay personal tax. Since tax is levied at both the corporate and personal levels, two mechanisms are available to prevent double taxation: some or all of the initial corporate tax may be refunded[4] to your corporation when a dividend is paid and you may be able to claim a dividend tax credit to reduce taxes payable on the dividend.

Based on our analysis, there is an investment advantage for most types of investment income in 2014. Accordingly, if you do not need funds personally, after-tax corporately-earned interest income, capital gains and dividends should generally be retained in your corporation, with a few exceptions.[5] In all provinces, the non-taxable portion of capital gains should be distributed as capital dividends as soon as possible, as will be discussed in the section titled "Capital gains and losses".

Jamie Golombek
Managing Director, Tax & Estate Planning CIBC Wealth Advisory Services
Jamie.Golombek@cibc.com

Due to these two levels of tax (corporate and personal), there is often a difference between the after-tax income that is initially available to the corporation and the amount that will ultimately be left when paid out to the shareholder. We will call this the "investment advantage".

THE INVESTMENT ADVANTAGE: DECIDING WHETHER TO RETAIN INVESTMENT INCOME IN YOUR CORPORATION

An ***investment advantage*** occurs when the after-tax investment income that is available by retaining funds in your corporation is greater than the after-tax investment income that is available by distributing funds to yourself as a dividend. When there is an investment advantage, it is better to retain after-tax investment income in your corporation since there will be a greater amount for re-investment. Conversely, if there is an investment disadvantage, less after-tax investment income is available to your corporation, so you should distribute the after-tax investment income as dividends in the year it is earned and re-invest the resultant after-tax funds personally.

INVESTMENT INCOME & THE INVESTMENT (DIS)ADVANTAGE

Let's look at the specific details of how some common types of investment income are taxed when earned through your corporation and how the investment (dis)advantage is determined for each type of income.

Interest income

Figure 1 illustrates how $1,000 of interest income would be taxed if it were earned through your corporation in Ontario in 2014.[6]

The left bar in Figure 1 represents the cash position if interest income were earned inside your corporation and retained there (i.e. not yet distributed as a dividend), while the bar to the right represents what would happen if the after-tax income were distributed to you as a dividend.

The left bar of Figure 1 shows that non-refundable tax of $195 and refundable tax of $267 would be paid by your corporation when the income was initially earned, leaving $538 available within your corporation for investment. When a taxable dividend is paid, the refundable tax would be returned to your corporation, so that a total of $805 could be distributed to you as a taxable dividend. The right bar of Figure 1 shows that you would pay tax of $324, thus leaving $481 in your hands for investment.

If the after-tax interest income were retained in your corporation, there would be $57 (i.e. $538 - $481) of additional funds available for investment, compared to the amount that would be available for you to invest personally if funds were distributed to you. As a result, in Ontario in 2014, there is an investment advantage that amounts to 5.7% of corporately-earned interest income.

Capital gains and losses

Only 50% of a capital gain is included in your corporation's taxable income. The remaining 50% of the capital gain is not taxed in your corporation and may be distributed as a capital dividend that is completely tax-free to you.[7]

Figure 1 – Interest income earned in a corporation in Ontario in 2014

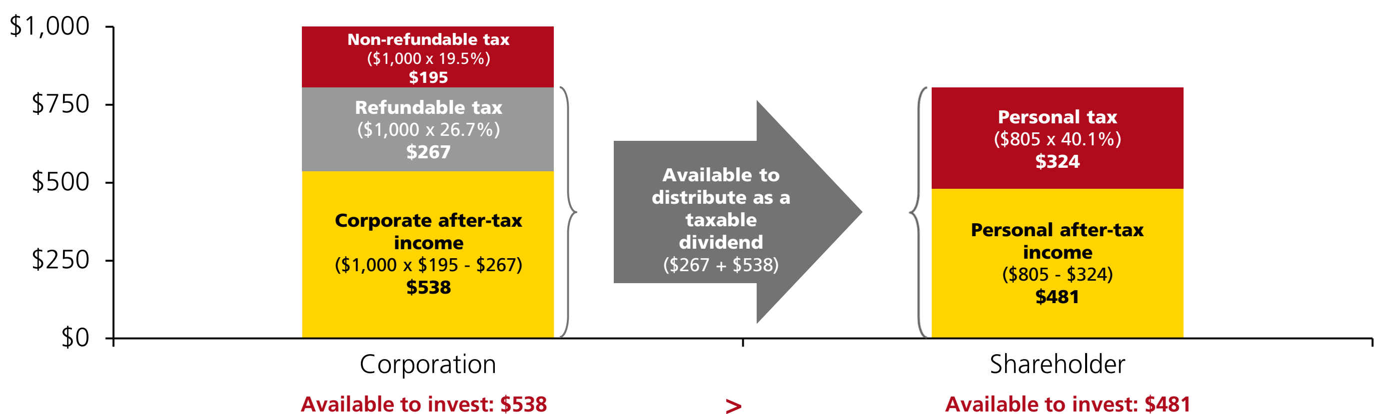


Figure 2 shows how $1,000 of net capital gains would be taxed if earned through your corporation in Ontario in 2014.[8]

First we will look at the non-taxable portion of the capital gain, which is shown in the bottom half of Figure 2. 50% of the capital gain ($500) is not taxable in your corporation and may be distributed to you as a capital dividend, on which you would pay no tax. It is important to note that as capital losses are incurred, they may decrease the capital dividends that can be paid until additional capital gains are realized. You may, therefore, wish to pay capital dividends as soon as possible.

Now let's look at the taxable portion of the capital gain, which is the other 50% of the capital gain ($500) shown in the top half of Figure 2. The left bar shows that your corporation would pay non-refundable tax of $98 and refundable tax of $133, leaving $269 after tax that could be invested within your corporation. When a taxable dividend is paid, the refundable tax of $133 would be refunded to your corporation and could be distributed to you, along with the after-tax corporate income of $269. You would, therefore, receive a taxable dividend of $402. The right bar shows that you would pay personal tax of $161, leaving $241 in your hands.

If the $269 of after-tax income (i.e. the after-tax portion of the taxable capital gain) were retained in your corporation, there would be an investment advantage of $28 (2.8%) compared to the $241 that would be available for you to invest personally if the after-tax income were distributed to you.

Capital losses that are incurred in your corporation offset your corporation's capital gains, resulting in a net capital gain (or loss) in the current year. Any net capital loss can only be claimed within the corporation and cannot be claimed by you personally. If there is an unused net capital loss in the current year, it may either be carried back and applied against your corporation's net capital gains in the prior three taxation years, or may be carried forward and applied against capital gains in any future year. As noted previously in this section, capital losses may reduce or eliminate the capital dividends that may be paid.

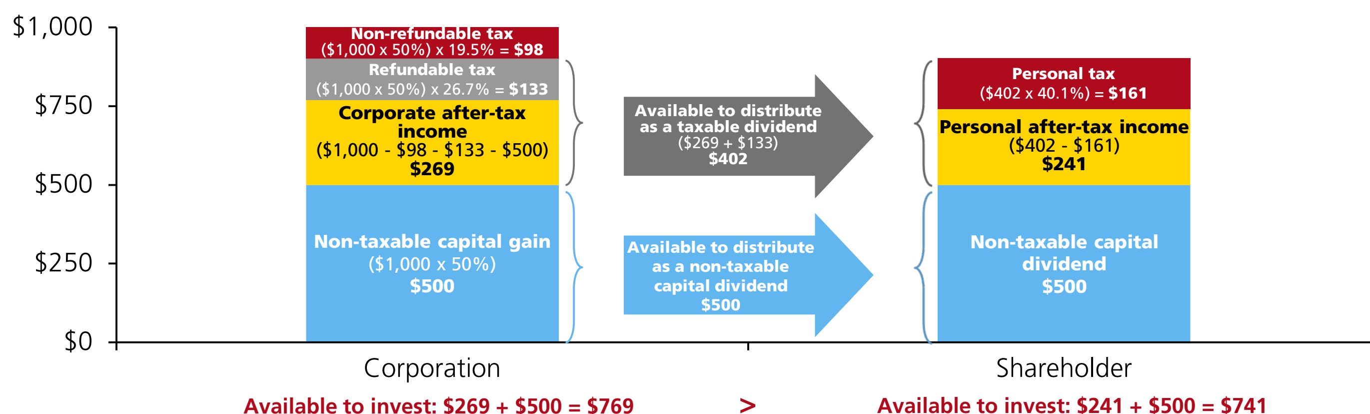
Canadian dividends

Canadian dividends are typically classified as either eligible or non-eligible. Eligible dividends are most commonly received from Canadian publicly-traded companies or mutual funds that hold Canadian dividend-paying equities. An enhanced dividend tax credit is available to an individual who receives eligible dividends to compensate for the high rate of tax that was paid when income was initially earned in a corporation. Non-eligible dividends would typically be received from a private Canadian corporation that paid tax on its corporate income at the low small business rate. Because tax is paid at a low rate in the corporation, a lower dividend tax credit is available to an individual for non-eligible dividends.

Eligible dividends

Let's look at how $1,000 of eligible dividend income would be taxed if it were earned through your corporation in B.C. in 2014, as illustrated in Figure 3.[9]

Figure 2 – $1,000 net capital gain earned in a corporation in Ontario in 2014



The left bar in Figure 3 shows that refundable tax of $333 would be paid by your corporation, leaving $667 in your corporation to be invested. When a taxable dividend is paid, the refundable tax would be refunded to your corporation so that a total of $1,000 could be distributed to you as a taxable dividend. The right bar in Figure 3 shows that you would pay tax of $286 on the dividend, leaving $714 to be invested personally.

You would have $667 available to invest when funds remain in your corporation. In comparison, you would have $714 available for personal investment after distributing funds from your corporation. Consequently, there is a 4.7% investment disadvantage when eligible dividend income is retained in your corporation.

Non-eligible dividends

Corporate taxation of non-eligible dividends is exactly the same as eligible dividends; however, personal taxation differs. You would pay a higher rate of personal tax on non-eligible dividends that are distributed to you since there is a lower gross-up and tax credit mechanism than for eligible dividends, which are subject to a higher gross-up and enhanced dividend tax credit.

Let's consider how $1,000 of non-eligible dividend income would be taxed if it were earned through your corporation in B.C. in 2014.

As with eligible dividends, refundable tax of $333 would be paid by your corporation, leaving $667 in your corporation to be invested. When a taxable dividend is paid, the refundable tax would be refunded to your corporation so that a total of $1,000 could be distributed to you as a taxable dividend. You would pay tax of $380 on the non-eligible dividend, leaving $620 to be invested personally.

While you would have $667 available to invest when funds remain in your corporation, in comparison you would have only $620 available for personal investment after distributing funds from your corporation. Consequently, there is a $47 (4.7%) investment advantage when non-eligible dividend income is retained in your corporation.

Foreign dividends

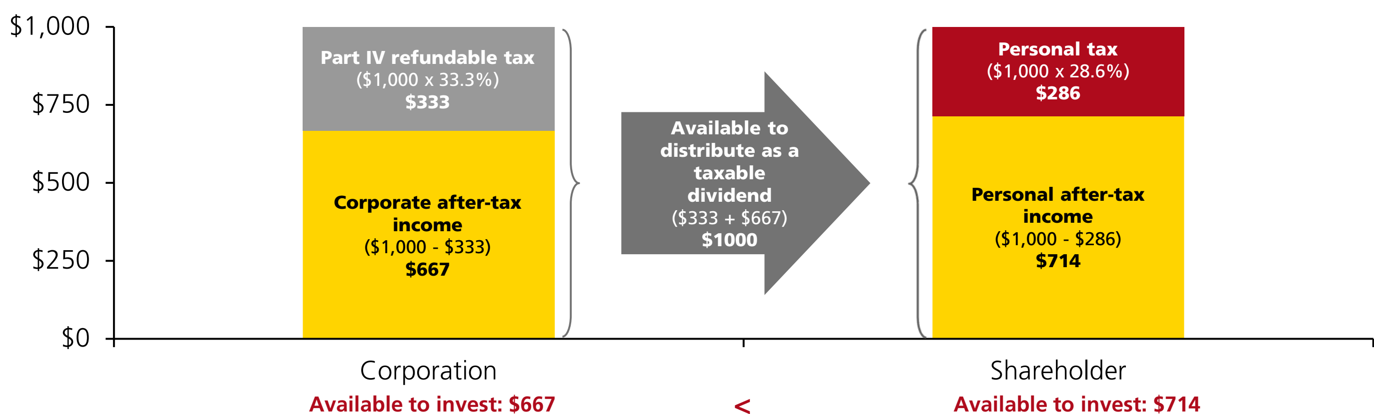
Foreign dividends are taxed in the same way as interest income except for one key difference: a lower portion of the corporate tax is refundable for foreign dividends.

Let's consider how $1,000 of foreign dividends would be taxed if they were earned through your corporation in Ontario in 2014.[10]

Non-refundable tax of $309 and refundable tax of $152 would be paid by your corporation when the income was initially earned, leaving $539 available within your corporation for investment. When a taxable dividend is paid, the refundable tax would be repaid to your corporation, so that a total of $691 could be distributed to you as a taxable dividend. You would then pay tax of $277, yielding $414 in your hands for investment.

Given that $539 is available when funds are retained and invested in your corporation but only $414 is available for personal investment when funds are distributed, there is an investment advantage of $125 (12.5%) in Ontario in 2014. This makes it more favourable to retain after-tax foreign dividends earned in your corporation than to distribute them.

Figure 3 – Canadian dividend income earned in a corporation in B.C. in 2014



Although there is a benefit to retaining after-tax foreign dividends that are earned through a corporation, it may be better not to earn foreign income in your corporation in the first place due to the "tax rate disadvantage" that is described below.

The tax rate disadvantage on foreign dividends

Until this point, we have only considered the investment (dis)advantage, which fundamentally assumes that after-tax business income is left in your corporation as capital for investment. For some types of income, however, there is a substantial "tax rate disadvantage" when income is earned in a corporation rather than personally, making it more costly to earn income through a corporation in the first place.

For example, you may have noticed that when $1,000 of foreign dividends is earned through your corporation in Ontario in 2014, only $414 would remain in your hands after tax. This means that combined corporate and personal taxes amount to $586, which is 58.6% of the $1,000 of foreign dividends. If, instead, you earned $1,000 of foreign dividends personally, you would only pay tax of 49.5%. Consequently there is a tax rate disadvantage of 9.1% (i.e. you pay 9.1% additional tax when income is earned through your corporation).[11] It may, therefore, be more tax effective to hold foreign investments that pay interest or dividends personally, rather than in your corporation.

One exception, however, may be for U.S. securities. If you are not a U.S. person (such as a U.S. citizen or green card holder) and your worldwide estate exceeds US$5.34 million,[12] you may face a U.S. estate tax liability if you die owning U.S. situs property, including shares of U.S. corporations. Holding these securities within your Canadian corporation may provide protection from U.S. estate tax that could arise if you hold the securities personally upon your death. Given that U.S. federal estate tax rates for 2014 range from 18% to 40% of the fair market value of your U.S. situs assets, it may be worthwhile to pay higher tax on the U.S. income and avoid the more punitive U.S. estate tax. You should consult with Canadian and U.S. tax professionals to determine how taxes may apply in your particular circumstances.

Return of capital

A return of capital (ROC) most frequently occurs when a mutual fund makes a distribution in excess of its income. When your corporation receives a ROC, there is no immediate tax payable; however, unlike the non-taxable portion of a capital gain, the ROC cannot be distributed tax-free from your corporation to you. Instead, the ROC amount is deducted from the adjusted cost base of the investment and will give rise to a capital gain (or decreased capital loss) when the investment is sold in your corporation. Treatment of the capital gain (or loss) is described in the section of this report titled *Capital gains and losses*, above.

SUMMARY: THE INVESTMENT (DIS)ADVANTAGE

Figure 4 shows the investment (dis)advantage as a percentage of investment income for each of the provinces in 2014. When there is an ***investment advantage*** (positive value), after-tax investment income should be retained in your corporation for re-investment provided that you do not need the funds for personal use. The larger the investment advantage, the larger the benefit from leaving after-tax investment income in your corporation for re-investment. When there is an ***investment disadvantage*** (negative value), after-tax investment income should be distributed to shareholders in the year it is earned. The larger the investment disadvantage, the larger the benefit from distributing after-tax investment income from your corporation and re-investing personally.

Figure 4 – Investment (dis)advantage of retaining various types of income in a corporation in 2014, by province[13]

	Interest	Capital Gains	Eligible Dividends	Non-Eligible Dividends	Foreign Dividends
BC	4.1%	2.1%	(4.7%)	4.7%	11.2%
AB	(2.6%)	(1.3%)	(14.0%)	(4.0%)	5.5%
SK	1.2%	0.7%	(8.5%)	1.6%	8.7%
MB	5.9%	3.0%	(1.1%)	7.4%	12.7%
ON	5.7%	2.8%	0.5%	6.8%	12.5%
QU	5.2%	2.6%	1.9%	6.5%	12.1%
NB	2.2%	1.1%	(6.0%)	2.7%	9.5%
NS	4.2%	2.1%	2.7%	5.7%	10.0%
PE	4.0%	2.0%	(4.6%)	5.4%	9.8%
NL	(1.0%)	(0.5%)	(3.1%)	(1.3%)	6.1%

Due to the investment advantage for most types of investment income, it may be beneficial to retain the after-tax income in your corporation when you don't need funds for personal use. Finally, although it is not reflected in Figure 4, the non-taxable portion of capital gains should be distributed as capital dividends on a timely basis, to prevent future capital losses from reducing the tax-free capital dividends that may be paid.

Jamie Golombek, CPA, CA, CFP, CLU, TEP is the Managing Director, Tax & Estate Planning with CIBC Wealth Advisory Services in Toronto.

Jamie.Golombek@cibc.com

1. The report *Bye Bye Bonus* is available online at https://www.cibc.com/ca/pdf/jg-dividends-bonus-en.pdf.
2. The report *The Compensation Conundrum* is available online at https://www.cibc.com/ca/pdf/small-business/compensation-conundrum-nov-13-en.pdf.
3. Throughout this report, it is assumed that you are the sole shareholder of a Canadian-controlled private corporation and that funds would be distributed from your corporation to you as dividends, rather than salary or bonus. It is also assumed that you pay tax at the highest personal marginal tax rate.
4. Refundable taxes are levied to increase the corporate tax paid initially to the approximate level that would be paid if an individual earned the income personally. Refundable taxes include a portion of tax on "aggregate investment income" (see endnotes 6, 8 and 10) and the Part IV tax on Canadian dividends (see endnote 9). These refundable taxes are notionally tracked in the Refundable Dividend Tax on Hand (RDTOH) account and are refunded at a rate of $1 for every $3 of taxable dividends distributed to the shareholder.
5. In all provinces, after-tax corporately-earned interest income, capital gains and dividends should generally be retained in your corporation, with the following exceptions:
   - In B.C., Manitoba, New Brunswick, P.E.I. and Saskatchewan, after-tax eligible dividend income should be distributed to you in the year it is earned.
   - In Alberta and Newfoundland, after-tax interest, capital gains, and Canadian dividends should be distributed to you in the year income is earned (i.e. only after-tax foreign income should be retained in your corporation).
6. In 2014, the combined federal/provincial corporate tax rate on aggregate investment income (which includes interest income) is 46.2% in Ontario, and ranges from 44.7% to 50.7% across the provinces. This tax rate includes a 26.7% refundable tax (see endnote 4), so that the "non-refundable tax rate" in Ontario for 2014 is 19.5%. Both the after-tax income and refundable tax may be distributed to the shareholder as non-eligible dividends. In 2014, the highest personal marginal tax rate on non-eligible dividends is 40.1% in Ontario, and ranges from 29.4% to 40.8% across the provinces.
7. 50% of net capital gains and losses are added to a corporation's notional Capital Dividend Account (CDA). Dividends may be designated as capital dividends if they do not exceed the balance of the CDA. Net capital losses will decrease the CDA and will, therefore, reduce or eliminate the capital dividends that may be paid. If there is a negative balance in the CDA, net capital gains must be generated to offset the negative balance before capital dividends can be paid. Capital dividends are not taxable to an individual who is resident in Canada.
8. 50% of capital gains are not taxable to a corporation and may be distributed as a non-taxable capital dividend to the shareholder (see endnote 7). The remaining 50% of capital gains is taxable. In 2014, the combined federal/provincial corporate tax rate on aggregate investment income (which includes taxable capital gains) is 46.2% in Ontario, and ranges from 44.7% to 50.7% across the provinces. This tax rate includes a 26.7% refundable tax (see endnote 4), so that the "non-refundable tax rate" in Ontario for 2014 is 19.5%. Both the after-tax income and refundable tax may be distributed to the shareholder as non-eligible dividends. In 2014, the highest personal marginal tax rate on non-eligible dividends is 40.1% in Ontario, and ranges from 29.4% to 40.8% across the provinces.
9. Federal tax of 33.3% is levied under Part IV of the *Income Tax Act* on dividends that a Canadian private corporation receives from another non-connected Canadian corporation. There is no provincial corporate tax on Canadian dividends. The "Part IV tax" is fully refundable (see endnote 4). Both the after-tax income and refunded tax may be distributed to the shareholder, either as eligible or non-eligible dividends, according to the type of dividends originally earned. In 2014, the highest personal marginal tax rate on eligible dividends is 28.6% in B.C. and ranges from 19.3% to 36.1% across the provinces. The highest personal marginal tax rate on non-eligible dividends in 2014 is 38.0% in B.C. and ranges from 29.4% to 40.8% across the provinces.
10. It is assumed that a 15% foreign withholding tax applies to foreign dividends. In 2014, the combined federal/provincial corporate tax rate on aggregate investment income (which includes foreign dividends) is 46.2% in Ontario, and ranges from 44.7% to 50.7% across the provinces. Due to a limitation related to the foreign tax credit, the refundable portion of the tax on foreign dividends in Ontario is 15.2% (see endnote 4), so that the "non-refundable tax rate" in Ontario for 2014 is 31.0%. Both the after-tax income and refundable tax may be distributed to the shareholder as non-eligible dividends. In 2014, the highest personal marginal tax rate on non-eligible dividends is 40.1% in Ontario, and ranges from 29.4% to 40.8% across the provinces.
11. The tax rate (dis)advantage is more fully described in our Reports, *Bye Bye Bonus* (see endnote 1) and *The Compensation Conundrum* (see endnote 2). In all provinces in 2014, there is a tax rate disadvantage for U.S. dividends that ranges from 8.7% to 13.1%.
12. In 2014, the maximum U.S. estate tax exemption that can be claimed by a Canadian is $5.34 million, or $10.68 million if all assets are left to a surviving spouse upon death.
13. It is assumed that the shareholder pays tax at the highest personal marginal tax rate.

Disclaimer:

As with all planning strategies, you should seek the advice of a qualified tax advisor.

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