Taxation of corporate investment income

Successful businesses often accumulate excess profits in a corporation. Your corporation may not need the surplus for operations, so you look for options to invest the profits for retirement or estate planning purposes. After maximizing your RRSP and TFSA, investing within your corporation may allow you to accumulate more funds. However, when investing inside your corporation, it's important to understand the tax impact on investment returns. Different investment returns inside your corporation attract tax at varying rates. Your short-term and long-term goals may also play a role in choosing your investments from a tax perspective. Let's look at how the type of investment income within a corporation can impact your after-tax returns.

Investment returns

Investment returns come in a variety of income types. The most common forms include interest (or rental income), capital gains, Canadian dividends and return of capital (ROC). Each income type creates a different after-tax return inside your corporation based on the applicable tax rate. The return also affects the tax you personally pay when you eventually distribute the funds out of the corporation.

Interest

Fixed income type investments produce interest income. Examples of fixed income investments include guaranteed investment certificates (GICs), bonds, and accumulation and payout annuities. Mutual fund trusts and exchange traded funds (ETFs) may also distribute interest income as part of their return. Corporations report interest income on an accrual basis and therefore pay tax even when it hasn't received the interest yet. Whether your corporation receives a T-slip from the financial institution or not, your corporation still needs to report the interest earned for the year.

As an example, assume your corporation purchases a 3-year compounding GIC on July 1, 2024. The financial institution doesn't pay your corporation the interest until July 1, 2027. However, your corporation must report interest earned in 2025, 2026, and 2027. Each year your corporation should report the interest accrued up to that anniversary date. Since your corporation won't receive cash flows from the investment until 2027, this may create a cash flow issue. You'll want to ensure there is enough cash on hand for taxes.

Capital gains or losses

Capital gains or losses arise when your corporation disposes an investment, and the sale proceeds differ from its adjusted cost base (ACB). A capital gain occurs if the sale proceeds exceed the ACB. A capital loss occurs if the ACB exceeds the sale proceeds.

The ACB generally represents the amounts your corporation pays for an investment subject to adjustments. Although complex, some of the more common items that affect ACB include:

- Expenses associated with purchase of the investment (e.g., commissions) increase the ACB.
- Distributions received and reinvested increase the ACB.
- Return of capital (ROC) distributions decrease the ACB.
- Disposing of a portion of the investment generally decreases the ACB.

You may purchase the same stock, mutual fund, or ETF unit at different times at varying costs. The varying purchase price is important when you calculate the ACB. If your corporation disposes a portion of identical investments, you use the average ACB to determine the gain or loss. Identical investments include the same class of stock in a corporation. They also include the same units of a mutual fund or ETF. This is true even when your corporation owns them across several accounts. We recommend maintaining clear records for your corporation's investment account activities. This assists you in reporting gains or losses and can even reduce your corporation's taxes.

Your corporation generally claims investment capital gains in the year they occur. Your corporation can use capital losses incurred in the year first to offset capital gains incurred in the same year. It can then carry back unused capital losses three years, or forward indefinitely to offset future capital gains.

Mutual funds, ETFs or shares of corporations may produce a capital gain or loss on sale. Mutual funds and ETFs also trigger capital gains and losses inside the fund. Internal fund gains don't produce taxable gains to your corporation unless distributed. In certain situations, your corporation may receive a capital gain distribution known as capital gain dividend. A capital gain dividend isn't a dividend for tax purposes, instead your corporation reports it as a capital gain.

When your corporation incurs a capital gain or loss, only a portion of the amount is taxable or allowed as a loss. For the past few decades and up until June 24, 2024, the inclusion rate for capital gains and losses was 50%. However, Federal Budget 2024 increased the inclusion rate to 66 2/3% for some capital gains and losses realized on or after June 25, 2024.

For example, assume your corporation purchases an investment for $10,000 that grows to $12,000. Your corporation incurs a capital gain of $2,000 on sale. Under the current inclusion rate, $1,333.33 (or 66 2/3% of the capital gain) is a taxable capital gain your corporation reports.

A lower 50% inclusion rate continues to apply to the first $250,000 annually of capital gains and losses when you realize them personally. However, there is no $250,000 threshold for capital gains or losses your corporation realizes. The higher 66 2/3% inclusion rate applies to all capital gains and losses earned in your corporation on or after June 25, 2024.

Canadian dividends

Canadian public companies pay eligible dividends to their shareholders. Canadian mutual funds or ETFs may also pay eligible dividends through distributions. Non-eligible dividends generally come from private corporation distributions, which we won't focus on here. When your corporation invests in dividend paying investments, it pays tax on Canadian dividends at a flat tax rate of 38.33%. When your corporation receives eligible dividends, they retain this characteristic allowing your corporation to pay an eligible dividend to its shareholders.

This characteristic is important when your corporation pays a dividend to you, as it affects the tax you pay at the personal level. Eligible dividends receive preferential tax treatment and produce lower taxes to you personally compared to non-eligible dividends due to dividend tax credits. This preferential treatment occurs because eligible dividends come from after-tax corporate earnings taxed at the general corporate tax rate. Receiving preferential tax treatment at the personal level reduces the impact of double taxation. We show this below using examples.

Return of capital

Mutual funds and ETFs make periodic distributions through its own investment activity throughout the year. Funds classify the distributions as interest, capital gains, and dividends. However, some funds provide distributions known as ROC. ROC occurs when the fund makes a distribution that exceeds the fund's income for the year. ROC is a return of a portion of the original investment or capital.

An ROC distribution isn't income for corporate tax purposes. Therefore, your corporation doesn't pay tax on these cash distributions. This can initially produce a very tax-efficient annual return. However, receiving ROC decreases the investment's ACB which later increases capital gains inside your corporation. For example, assume your initial $10,000 corporate investment receives a $400 distribution classified as ROC. After receiving the ROC, the investment's ACB reduces to $9,600. As ROC distributions continue, the ACB adjustments continue. Finally, when your corporation sells the investment, the updated ACB determines your corporation's capital gain or loss. The ACB may decrease to nil and become negative. If this happens, the negative ACB produces an immediate capital gain and the ACB is reset to nil.

Corporate investment tax rates

Corporations across Canada pay varying combined corporate investment tax rates depending on the province and type of income. When combined, you have the tax rates applicable to investment income shown in the table below

	Interest	Capital gains (66 2/3% inclusion rate)	Canadian dividends
British Columbia	50.67%	33.78%	38.33%
Alberta	46.67%	31.11%	38.33%
Saskatchewan	50.67%	33.78%	38.33%
Manitoba	50.67%	33.78%	38.33%
Ontario	50.17%	33.45%	38.33%
Quebec	50.17%	33.45%	38.33%
New Brunswick	52.67%	35.11%	38.33%
Nova Scotia	52.67%	35.11%	38.33%
P.E.I.	54.67%	36.45%	38.33%
Newfoundland and Labrador	53.67%	35.78%	38.33%
Nunavut	50.67%	33.78%	38.33%
Northwest Territories	50.17%	33.45%	38.33%
Yukon	50.67%	33.78%	38.33%

When you look at the tax rates applicable to corporate investment income, note your corporation pays tax on:

- For interest income, the federal government levies a flat tax rate of 38.67%. Provinces and territories across the country have investment tax rates between 8% and 16%. Interest income at the highest rates across the country. This makes interest income the least desirable from a corporate tax perspective. Your corporation pays tax on net rental income at the same rate as interest.

- Capital gains at 66 2/3% of the rate applicable to interest income. This makes capital gains more desirable than interest income and Canadian dividends from a corporate tax perspective.

- Canadian dividends have the same flat tax rate of 38.33% across Canada. Canadian dividend income is more desirable from a corporate tax perspective than interest income.

- Earning ROC inside your corporation doesn't have a tax rate, since ROC isn't taxable for income tax purposes. This initially makes

ROC the most desirable from a corporate tax perspective.

The above rates only show part of the analysis. Taxation of corporate investment income also involves reviewing tax pools and what happens when you distribute funds to shareholders.

Tax pools generated by investment income

Your corporation initially pays tax on corporate investment income that is quite high. Individuals have graduated tax rates that may be lower than these higher corporate tax rates. However, the corporate tax rates generally resemble the highest marginal tax rates on the same form of income you earn personally.

If your corporation may pay higher tax on investment income than when you earn it personally, why invest corporately? Well, the Income Tax Act (ITA) creates a system that attempts to equalize taxes between corporations and its shareholders. This system is known as integration and arises when your corporation distributes the funds to you as a shareholder. In theory, the total tax paid by a corporation and its shareholders should be equal to an individual earning the same income directly. To achieve integration, the ITA creates notional corporate tax pools. Your corporation generates an addition to these tax pools when it earns certain investment income. Your corporation then either recoups a portion of the corporate tax or can pay a tax-preferred dividend to shareholders. We explore this below.

Refundable Dividend Tax on Hand (RDTOH)

Without RDTOH, your corporation would pay the higher investment tax rate and you could also pay high personal tax rates on the same amount. To avoid the potential for double taxation, the ITA creates a refundable tax account - RDTOH. Your corporation recoups the RDTOH when it pays a taxable dividend to its shareholder.

Since January 1, 2019, the ITA separates RDTOH into two different accounts. These accounts track the two different types of tax your corporation pays on investment income. The two RDTOH accounts track the following:

- Eligible RDTOH (ERDTOH) tracks the amount of tax paid on eligible Canadian dividends received by your corporation.
- Non-eligible RDTOH (NERDTOH) tracks a portion of the tax your corporation pays on other investment income earned within the corporation. This includes interest and the taxable portion of capital gains.

When your corporation receives Canadian eligible dividends, it adds 38.33% of the taxable dividend to the ERDTOH account. When your corporation earns interest income, it adds 30.67% of the taxable amount to your corporation's NERDTOH account. The same occurs if your corporation earns income from property such as rents or royalties. Your corporation pays tax on 66 2/3% of capital gains. Therefore, when your corporation has a capital gain, your corporation adds 66 2/3% of 30.67%, being 20.45%, to its NERDTOH.

Your corporation receives an RDTOH refund only when it pays a taxable dividend to a shareholder. The corporation needs to pay $2.61 in taxable dividends to receive $1 of refund from an RDTOH account. This dividend refund lowers the corporate tax burden. Shareholders then pay tax at the personal level when they receive the dividend. The NERDTOH refund lowers your corporation's tax rate on interest income to a range of 16% to 24% across Canada. The ERDTOH refund reduces your corporation's tax to zero on eligible dividends.

Your corporation receives a refund from the NERDTOH pool only when it pays a non-eligible dividend. Your corporation can receive a refund from the EDRTOH pool when it pays eligible dividends. If your corporation depletes the NERDTOH pool, it can receive a refund from the ERDTOH pool when it pays non-eligible dividends. To ensure integration works, the ITA gives you a dividend tax credit personally on dividends you receive. You receive an enhanced dividend credit on eligible dividends you personally receive. We illustrate this in the examples below.

General Rate Income Pool (GRIP)

The GRIP account is a notional account that tracks eligible dividends received by a corporation for investment income purposes. Your corporation may also receive a credit to the GRIP account for a portion of active business income it earns. That is, your corporation may pay tax on business income taxed at the general business income tax rate. This rate applies to income not subject to the small business deduction and ranges from 23% -31% across Canada. However, we'll focus on the GRIP associated with investment income here.

If your corporation has a positive balance in the GRIP account, it can pay eligible dividends to shareholders. Paying an eligible dividend reduces the GRIP balance dollar for dollar. Further, eligible dividends retain their form when flowed through your corporation. Without tracking eligible dividends using the GRIP account, your corporation couldn't pay eligible dividends. As a shareholder, you then couldn't receive eligible dividends with the enhanced dividend tax credit. This results in lower personal taxes compared to non-eligible dividends.

Capital Dividend Account (CDA)

The CDA tracks certain tax-free amounts your corporation receives, like the non-taxable portion of net capital gains. As of June 25, 2024, your corporation includes 66 2/3% of capital gains in income. Meaning only a portion of the gain is taxable, and the other portion is not taxable. A similar result occurs for individuals who realize capital gains.

To get the non-taxable amounts out to shareholders, your corporation uses the CDA to pay a capital dividend. The CDA allows you to extract the non-taxable portion of capital gains to the shareholder tax-free.

The CDA is a complex calculation. The major components of the CDA include:

- Non-taxable portions of net capital gain (net of capital losses) on the sale of a capital asset. For gains and losses that occur on or after June 25, 2024 the non-taxable portion is 1/3 of the gain.
- Capital dividends your corporation receives. For example, a capital dividend distribution your corporation receives on shares it owns of other Canadian corporations.
- The proceeds of a life insurance policy your corporation receives as beneficiary. Your corporation receives a CDA credit for the death benefit amount less the adjusted cost basis for the policy.

It is important to note that integration no longer applies to the first $250,000 of capital gains earned annually. This arises because of the lower 50% inclusion rate on the first $250,000 you earn personally which isn't available inside your corporation. This creates more complexity when planning between your personal and corporate investments. Personally, if you experience a gain of $100, you pay tax on $50 and retain $50 tax-free assuming your total capital gains for the year remain below $250,000. However, if your corporation experiences a gain of $100, your corporation pays tax on $66.67 and only $33.33 is non-taxable for your corporation. A similar result occurs personally if you realize capital gains of more than $250,000 in the year. However, the discrepancy exists for the first $250,000 of capital gains causing a mismatch in integration. Your tax advisors may review planning to reduce the effect of this discrepancy.

Integration in action

The RDTOH, GRIP, and CDA attempt to balance corporations and its shareholders to reduce the potential for double taxation. However, the system of integration isn't perfect. Let's look at an example of how integration works. Assume Nazem and Sarah live in Alberta and own shares of their corporation equally. The corporation has excess retained earnings to invest. Nazem and Sarah would like to use the corporate investment income for personal retirement purposes. They decide to diversify and produce various types of investment returns, Let's look at the taxes they would owe on this income assuming all transactions occur on or after June 25, 2024.

	Interest	Capital gains (66 2/3% inclusion rate)	Eligible dividend	Return of capital
Income amount	$1,000	$1,000	$1,000	$1,000
Corporate tax rate	46.67%	31.11%	38.33%	-
NERDTOH produced	(30.67%)	(20.45%)		-
ERDTOH produced	-	-	(38.33%)	-
GRIP produced	-	-	$1,000	-
CDA produced	-	$333.33	-	-
Net corporate tax	16.00%	10.66%	0.00%	0.00%

The above chart shows the tax pools produced by the various taxable income streams. To use the tax pool, the corporation needs to pay a dividend. This reduces the corporate taxes to a net amount. If the corporation doesn't pay a dividend, it can't use the tax pool. Assuming the corporation pays a dividend, interest income remains more taxable than capital gains. Eligible dividends have a net tax of NIL. ROC isn't a taxable income and therefore, doesn't produce any corporate taxes or tax pools. To see integration in action, we look at the taxes to Nazem and Sarah as they remove the funds from the corporation. They'll pay tax personally based on the type of dividend they receive. Let's look at their personal taxes on these investment returns and what is left after taxes.

	Interest	Capital gains (66 2/3% inclusion rate)	Eligible dividend	Return of capital
Available taxable dividend amount to recoup RDTOH	$840	$560	$1,000	$1,000
Personal tax rate	42.31%	42.31%	34.31%	42.31%
Personal after-tax amount	$484.60	$323.06	$656.90	$576.90
Non-taxable CDA received	-	$333.33	-	-
Total after-tax cash flow	$484.60	$656.39	$656.90	$576.90

Capital gains and eligible dividends produce the most after-tax cash flow. To show the effect of integration, if Nazem and Sarah had the funds to invest personally in a non-registered account, they would have paid the following taxes:

	Interest	Capital gains (66 2/3% inclusion rate)	Eligible dividend	Return of capital
Personal tax if earned directly	$480.00	$320.00	$343.10	-
Combined corporate and personal tax (from above)	$515.40	$343.61	$343.10	$423.10
Difference in tax (cost)	($35.40)	($23.61)	-	($423.10)
Total combined tax rate	51.54%	34.36%	34.31%	42.31%

After integration, we see that it costs more to produce interest and capital gains through a corporation. Eligible dividends are perfectly integrated, and ROC extracted from a corporation has a large cost. This doesn't make ROC a bad investment inside a corporation. However, if you compare earning ROC personally versus inside a corporation and flowing it out, it has a cost. The good news is that the cost is the same combined tax of non-eligible dividends.

The above comparison assumes a personal inclusion rate for capital gains of 66 2/3%. How does the comparison fare if Nazem and Sarah had the funds to invest personally in a non-registered account, subject to the 50% inclusion rate?

	Capital gains (66 2/3% personal inclusion rate)	**Capital gains** (50% personal inclusion rate)
Personal tax if earned directly	$320.00	$240.00
Combined corporate and personal tax (from above)	$343.61	$343.61
Difference in tax (cost) $	($23.61)	($103.61)
Difference in tax (cost) %	(2.36%)	(10.36%)

In this case, there is an even larger tax cost to earning capital gains inside the corporation when you're eligible for the lower personal inclusion rate. This doesn't make earning capital gains inside the corporation a bad thing as it still results in a lower or comparable combined tax rate compared to other income types. However, it does produce disintegration and may require allocating among your personal and corporate investments to maximize after-tax returns. For more on this, see our article The corporate tax deferral. Also, keep in mind that to invest personally, you need to have removed the funds from the corporation and paid tax personally. This means you could have less to begin with for purposes of investing than if retained inside your corporation.

Other factors

Nazem and Sarah's goal is to produce a tax-efficient income stream using their corporate funds. The tax impact of their choices may lead them to choose investments that produce more income after-tax. However, investment decisions require reviewing more than just the tax impact. Investment decisions involve considering factors such as risk, diversification, and your short-term and long-term goals. If you want to reinvest your returns in your corporation, an investment that produces ROC may be better suited since there is no initial tax on ROC if it isn't extracted from the corporation.

Investing inside your corporation may only be part of your total investment portfolio. You may have investments personally in registered and non-registered accounts. Understanding corporate and personal taxation allows you to allocate investments between your accounts to create tax efficiency. For more information on taxation of personal investment income, see our article Taxation of personal investment income. Speak with your financial advisor to determine which income streams fit within your financial plan.

A note about foreign dividend income inside your corporation

You can also invest in foreign dividend paying investments outside of Canada as a method of diversifying your portfolio. However, investing in foreign dividend paying investments inside your Canadian corporation may be punitive. Your corporation pays tax on foreign income at the same rate as interest income noted above. However, many foreign countries also impose a withholding tax on dividends paid to a Canadian investor (subject to treaty). As a result, your corporation receives a lower net amount from the dividend distribution. The lower amount then reduces the corporation's credit to the NERDTOH account. Therefore, your corporation may pay more total tax than interest income, which is already highly taxed. One solution to gain foreign exposure is to invest in Canadian corporate class mutual funds with underlying foreign investments. Corporate class mutual funds don't distribute interest or foreign income. Rather, they distribute Canadian dividends and capital gains, allowing your corporation to benefit from the tax pools and integration.