STEPUP

Sales Tax Estate Planning Underwriting & Product Newsletter

The Taxation of Corporately owned Investments

The objective of this newsletter is to provide the readers with some guidance regarding the taxation of investment income in a corporation including an overview of the capital dividend account. For a more complete explanation of the capital dividend account, please consult our newsletter "The Capital Dividend Account". For a detailed explanation about tax issues regarding corporately owned segregated funds, please consult our newsletter "Taxation of Corporately Owned Segregated Funds".

The Canadian income tax system is primarily designed to integrate corporate and personal income taxation, so that individuals who make investments using Canadian private corporations face similar net income tax consequences as individuals who make the same investments personally. Let's look at the practical consequences of this integration principle for different sources of investment income.

Investment income

Investment income is referred to as "aggregate investment income" at ss 129(4) of the Income Tax Act (Canada) (ITA). It includes the taxable portion of capital gains realized in the year as well as income from property other than dividends. This means that interest, rents and royalties are included in the definition of "aggregate investment income".

In 2021, investment income earned by a Canadian-controlled private corporation (CCPC) is subject to a 38.67% federal tax rate. The provincial tax rate applicable to investment income varies between provinces and ranges from a low of 8.0% in Alberta to a high of 16.0% in Prince Edward Island. In Ontario and Quebec, the combined federal and provincial tax rate on investment income is 50.17%.

A portion of the tax paid by a corporation on its aggregate investment income is added to the notional tax account called the "non-eligible refundable dividend tax on hand" (NERDTOH) account. This portion represents 30.67% of the aggregate investment income realized by the CCPC. Therefore, in provinces such as Ontario and Quebec, the taxes paid by a CCPC on aggregate investment income it realizes includes a refundable portion (30.67%) and a non-refundable portion (19.50%).

The refundable portion of taxes paid on investment income will be refunded to the corporation at a rate of 38,33% of non-eligible dividends paid.

To illustrate this with an example, we'll look at a situation where an Ontario CCPC with a sole individual shareholder realizes $100 of aggregate investment income during its financial year. In this situation, the

Peter A. Wouters,
Director, Tax Retirement & Estate Planning Services

Peter works with independent advisors and other professionals raising awareness on issues and concerns faced by affluent individuals, professionals and business owners. He supports efforts in researching and developing optimal solutions for clients aimed at improving their financial well-being and supporting their personal wishes and lifestyles. He has provided 1000s of workshops, seminars and technical support throughout the country on tax, retirement income and estate planning issues, concepts and strategies to both advisors and consumers. As an accredited Registered Financial Gerontologist, a good deal of his time is spent on building awareness and educating people of all professions who work with or specialize in the needs, expectations and issues of elders. Comprehensive lifestyle planning is an important element of these processes.

The Sales, Tax, Estate Planning, Underwriting & Product (STEPUP) team provides internal and broker support, including seminars, education, advanced concept illustrations & Client case technical consultations.

Peter can be reached at peter.wouters@empire.ca

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CCPC would have to pay $50.17 in taxes for the financial year when the income is realized. However, $30.67 of the taxes paid could be refundable if the CCPC pays non-eligible dividends. To benefit from a full refund of the $30.67, the CCPC would have to pay $80.02 ($30.67 / 38.33% = $80.02) of non-eligible dividends to its sole shareholder. If such dividend is paid, the corporation would benefit from a refund of the full $30.67 but the receipt of the dividend would be taxable for the individual shareholder.

Capital Gains

For a capital gain or a capital loss to be realized for tax purposes, there has to be a disposition of the capital property. The most common type of disposition occurs when a capital property is sold, but the concept of disposition is broader than a sale. For instance, a disposition also occurs when the ownership of any capital property is transferred (including gifts) or when any capital property is exchanged for other property.

Similarly, as is the case for capital gains realized by an individual, a portion of capital gains realized by a corporation is taxable while a portion is non-taxable. The percentage of capital gains included in taxable income has varied over the years and the inclusion rate is currently 50% of the capital gains realized.

If a taxpayer realizes capital losses in excess of capital gains in a year, currently 50% of these net capital losses may be carried back up to three years prior to the year when they are realized to reduce taxable capital gains the corporation realized during those years. They may also be carried forward indefinitely and applied to reduce taxable capital gains realized in the future.

If a taxpayer realizes capital gains in excess of capital losses in a year, currently 50% of these net capital gains will be taxable capital gains and 50% will be non-taxable capital gains. For a corporation, taxable capital gains realized are included in the definition of "aggregate investment income" provided at ss129(4) ITA.

Non-taxable capital gains realized by a corporation should be distributed on a tax-free basis to its shareholders to ensure that the principle of integration discussed hereinabove is respected. The capital dividend account (CDA) solves that problem by allowing these surpluses to be distributed tax-free in the form of capital dividends declared to the corporation's Canadian-resident shareholders. An overview of the capital dividend account is provided hereinafter.

Dividend income

The taxation of dividend income realized by a private Canadian corporation may be different depending on whether the payer corporation is connected or not with the receiving corporation. Since the purpose of this newsletter it to analyze the consequences of investment income, we'll look only at situations where dividend income is received from non-connected corporations such as public corporations.

When a private Canadian corporation receives dividends from a non-connected Canadian corporation, it is subject to a 38.33% Part IV tax on dividends received. Part IV tax paid by a corporation is added to its RDTOH account which will be refunded to the corporation at a rate of 38.33% of eligible dividends paid. Therefore, the private corporation does not have any net paid taxes on dividend income that is flowed out to its shareholders.

To illustrate this with an example, we'll look at a situation where a Quebec CCPC with a sole individual shareholder receives $100 of dividends from a Canadian public corporation. In this situation, the CCPC would have to pay $38.33 in Part IV taxes for the financial year when the dividend is received. However, the full amount of Part IV taxes could be refundable if the CCPC pays eligible dividends. To benefit from a full refund of the $38.33 of Part IV taxes, the CCPC would have to pay $100.00 ($38.33 / 38.33% = $100) of eligible dividend to its sole shareholder. If such dividend is paid, the corporation would benefit from a refund of the full $38.33 but the receipt of the dividend would be taxable for the individual shareholder.

Dividend from foreign companies

If a resident of Canada receives a dividend on shares of a corporation which is resident in a foreign country, the dividend will normally be recognized as being from a source in that foreign country.

Dividends received by a Canadian resident corporation from foreign corporations (including US corporations) are often subject to tax levied in the country of the foreign corporation. If a tax treaty exists between Canada and the foreign country, the treaty usually limits the rate of tax levied by the other country.

The Canadian corporation could then claim a foreign tax credit which consists of a credit against its Canadian taxes payable for the foreign taxes paid on foreign income that is reported in its tax return. Separate foreign tax credit calculations are prescribed on a country-by-country basis.

The calculation of the foreign tax credit is complex. Please seek independent tax counsel to determine how these rules may apply to your investments.

Return of capital

Certain investments, such as certain mutual funds, may have as objective to provide the investor with a regular income stream. Such income stream often includes a distribution of non-taxable payments referred to as "return of capital" (ROC). A ROC is a payment from the capital of the fund. Unlike other forms of investment income, it is generally not taxable for the investor. However, it will generally reduce the investor's adjusted cost base thereby having an impact on the capital gain or loss realized at disposition of the fund.

Impact of passive income on small business deduction

The 2018 federal budget introduced new rules which may restrict the small business deduction for a CCPC which is part of a group of associated corporations that earned more than $50,000 of passive investment income. Those changes are beyond the scope of this newsletter.

Capital Dividend Account

The capital dividend account is a notional account used to keep track of various tax-free surpluses accumulated by a private corporation. One of the components of the CDA is the non-taxable portion of capital gains in excess of the non-deductible portion of capital losses.

Other components that are added to the CDA balance also include:

- capital dividends received from other corporations like a subsidiary company
- life insurance proceeds received by the corporation as the result of the death of an insured person, net of the Adjusted Cost Basis of a policyholder's interest
- The non-taxable portion of capital gains distributed by a trust to the corporation in respect of capital gains of the trust or capital dividends received by the trust

Subtracted from these are:

- total amount of capital dividends payable by the corporation

The capital dividend account does not appear on the company's balance sheet but the balance may be reported in the notes to the financial statements for information purposes only.

The balance in the capital dividend account at any point in time determines how much can be paid out as a tax-free capital dividend to Canadian shareholders. A capital dividend declared in favour of a non-resident shareholder will likely be taxable for that shareholder and the corporation will have to withhold the necessary taxes. Be very conscious of events that can reduce the balance in the account or the ability to elect or receive a capital dividend. For instance, a sale of capital property may trigger a capital loss and, in such a situation, the non-deductible portion of capital losses would reduce the CDA balance. Look at paying out capital dividends before the sale.

The computation of the balance in that capital dividend account is very complex, and subject to many special rules. Again, please seek independent tax counsel before paying out a capital dividend.

How we can help

Our tax retirement and estate planning team can assist you and your client's other professional advisors in your tax planning involving corporately owned investments. Also, for a more complete explanation of the capital dividend account and for a deep dive on tax issues regarding corporately owned segregated funds, please consult our newsletters "The Capital Dividend Account" and the "Taxation of Corporately Owned Segregated Funds".

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Empire Life Investments Inc.
165 University Ave., 9th Floor, Toronto, ON M5H 3B8

Insurance & Investments – Simple. Fast. Easy.®
empire.ca info@empire.ca 1 877 548-1881

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