Sun Life

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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 it for retirement or estate planning purposes. After removing funds to maximize your RRSP/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. Finally, the return also affects the tax you personally pay when you eventually distribute the funds out of the corporation. 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). We'll look at each in detail below.

Interest

Fixed income type investments produce interest income. Examples of fixed income investments include guaranteed investment certificates (GICs), bonds, and accumulation/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. Whether your corporation receives a T-slip from the financial institution or not, it 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, 2025. The financial institution doesn't pay the interest to your corporation until July 1, 2028. However, your corporation must report interest earned in 2026, 2027, and 2028. Each year your corporation will report the interest accrued up to that anniversary date. Since your corporation won't receive cash flows from the investment until 2028, this may create a cash flow mismatch. You'll want to ensure your corporation has 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 investment's 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 also purchase the same stock, mutual fund, or ETF unit at different times at varying costs. The fluctuating 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 reports investment capital gains or losses in the year they occur. It 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 may also incur capital gains and losses inside the fund. Internal fund gains don't produce taxable gains to your corporation unless distributed by the fund to your corporation. In certain situations, your corporation may receive a capital gain distribution known as a 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, the inclusion rate for capital gains and losses has been 50%. However, the capital gains inclusion rate has fluctuated in the past and could change in the future.

As an 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 a 50% inclusion rate, $1,000 (50% of the $2,000 capital gain) is a taxable capital gain your corporation reports.

Canadian dividends

Canadian public companies pay eligible dividends to their shareholders. Canadian mutual funds or ETFs may also pay eligible dividends through distributions. When your corporation invests in dividend-paying investments, it pays tax on Canadian dividends at a flat tax rate. Non-eligible dividends generally come from private corporation distributions, which we won't focus on here. We also won't focus on tax-free intercorporate dividends.

Return of capital

Mutual funds and ETFs make periodic distributions based on 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 income 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

Once you know the type of income your corporation's investments produce, you can determine the applicable tax rate. Corporations across Canada pay a flat combined corporate investment tax rate 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 (50% inclusion rate)	Canadian dividends
British Columbia	50.67%	25.34%	38.33%
Alberta	46.67%	23.34%	38.33%
Saskatchewan	50.67%	25.34%	38.33%
Manitoba	50.67%	25.34%	38.33%
Ontario	50.17%	25.09%	38.33%
Quebec	50.17%	25.09%	38.33%
New Brunswick	52.67%	26.34%	38.33%
Nova Scotia	52.67%	26.34%	38.33%
P.E.I.	53.67%	26.84%	38.33%
Newfoundland and Labrador	53.67%	26.84%	38.33%
Nunavut	50.67%	25.34%	38.33%
Northwest Territories	50.17%	25.09%	38.33%
Yukon	50.67%	25.34%	38.33%

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

- For interest income, the federal government charges a flat tax rate of 38.67%. Provinces and territories across the country charge investment tax rates between 8% and 15%. This makes interest income initially the least desirable from a corporate tax perspective. Your corporation pays tax on passive net rental income at the same rate as interest.

- Capital gains incur taxes at 50% 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.

However, 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 corporate investment income

The flat corporate tax rates generally resemble the highest marginal tax rates on the same form of income you earn personally. If your corporation pays a high flat tax on investment income and you then pay personal tax on dividends your corporation pays to you, why invest corporately? Well, the Income Tax Act (ITA) includes a system that attempts to equalize taxes between corporations and its shareholders. This system is known as integration and occurs when your corporation distributes the funds

to 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 when it earns certain forms of income. The tax pools track various types of corporate income that allow it to recoup a portion of the corporate tax when it distributes a dividend to its shareholder(s). Some tax pools may also allow your corporation to pay a tax-preferred or tax-free dividend to shareholders. We explore the main tax pools generated by corporate investment income below.

Refundable Dividend Tax on Hand (RDTOH)

Without RDTOH, your corporation initially pays the high flat tax rate on investment income. You could also pay high personal tax rates on the same amount when the corporation distributes it to you as shareholder. To avoid the potential for double taxation, the ITA generates a credit to a refundable tax account - RDTOH. 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 your corporation pays on eligible Canadian dividends it receives. When your corporation receives Canadian eligible dividends, it adds 38.33% of the taxable dividend to the ERDTOH account.

- 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 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. When your corporation has a capital gain, your corporation adds 50% of 30.67%, being 15.34%, to its NERDTOH.

Your corporation recoups RDTOH from the CRA 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 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 personal dividend tax credit (DTC) on dividends you personally receive. This accounts for the corporate tax paid by the corporation. 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. When your corporation receives an eligible dividend, it receives a credit to the GRIP equal to 100% of the eligible dividend. Your corporation may also receive a credit to the GRIP account for a portion of active business income it earns. For example, your corporation receives an addition to the GRIP equal to 72% active business income taxed at the general business income tax rate. This rate applies to corporate income not subject to the small business deduction. 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, so you personally receive an eligible dividend. 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 an enhanced DTC. Eligible dividends result 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. Meaning only a portion of the gain is taxable – 50%- and the other portion is not taxable. A similar result occurs for individuals who realize capital gains. To flow the non-taxable amounts out to shareholders, your corporation uses the CDA to pay a tax-free capital dividend. Therefore, 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 gains (net of capital losses) on the sale of a capital asset or the receipt of a capital gain dividend.

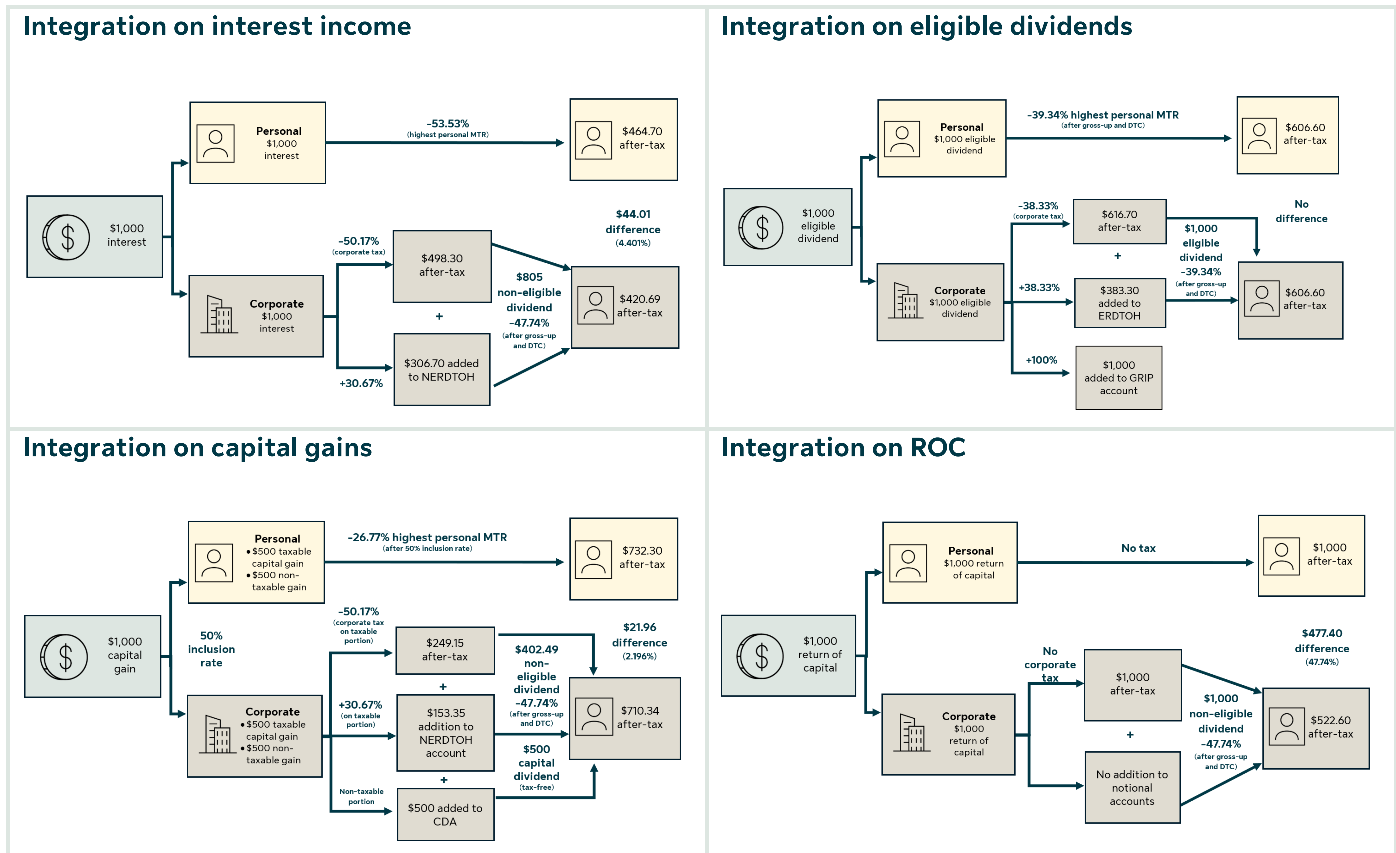
- Capital dividends your corporation receives. For example, a capital dividend your corporation receives on shares it owns of other Canadian corporations.

- 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.

Integration in action

How does this all come together? 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 lives in Ontario and own all shares of his corporation. The corporation has excess retained earnings to invest. Nazem wants to know the how the corporation initially pays tax. He also wants to know the personal tax when he distributes the money. Let's look at the combined corporate and personal taxes he would owe on this income to earn it inside a corporation and distribute to him personally. We'll also look at the tax rate if he had earned that type of income personally. This allows us to see if integration is working to reduce the potential double taxation.

To use a tax pool, the corporation pays a dividend. This reduces the corporate taxes by recouping RDTOH where available. The tax pool also determines the type of distribution and the applicable personal tax rates. Recouping RDTOH also increases the amount available for distribution. If the corporation doesn't pay a dividend, it can't use the tax pool.



Initially, it costs more to produce interest through a corporation than if you earn the same amount personally. It is a similar result for capital gains. This doesn't mean investing in interest or capital gain producing investments inside your corporation is bad. Remember, your corporation likely accumulated the surplus funds from lower-taxed active business income, benefitting from a tax deferral. 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. It simply shows how various investment choices inside your corporation affect the combined corporate and personal taxes.

Eligible dividends are perfectly integrated, and ROC extracted from a corporation has a large cost. This also doesn't make ROC a bad investment inside a corporation. It highlights that ROC may be tax-efficient for funds retained and used inside the corporation. However, ROC to the corporation doesn't mean tax-free to the shareholder. 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.

Other factors

The tax impact of Nazem's choices may lead him to choose investments that produce more income after-tax inside his corporation. However, investment decisions require reviewing more than just the immediate tax impact. They 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 if it isn't extracted from the corporation since there is no initial tax on ROC.

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. 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 that country's tax treaty with Canada). As a result, your corporation receives a lower net amount from the dividend distribution. While the corporation may claim a foreign tax credit for the withholding tax, this credit reduces the addition to NERDTOH. 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.

The bottom line

Choosing investments inside your corporation starts with determining your goals and use/need for the funds. You can then choose your investments within your overall risk tolerance profile and in conjunction with personal investments. When doing so, keep the above in mind and consider allocating amongst your personal and corporate investments to create tax-efficiency. Keep in mind that taxes inside the corporation will affect the taxes to you personally when you ultimately remove the money.

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