Passive income taxation for Canadian-controlled private corporations

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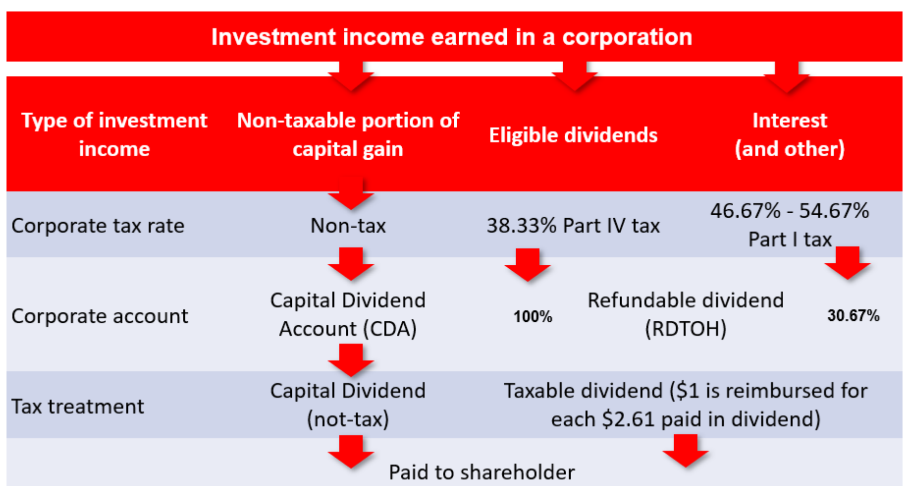
Businesses may generate income from various sources and generally, it is divided into two categories: passive income and active income. Passive income is income earned from property (i.e. rental, interest income, royalties, etc.) and active income is generated through active business activities. This article will outline the taxation specifically related to passive income earned in a Canadian-controlled private corporation (CCPC).

Corporate taxation

Passive income earned in a CCPC is taxed around 50% across Canada and business income earned by a CCPC is taxed as such: (a) first $500,000 is subject to a small business tax rate and (b) amounts over $500,000 are subject to a general tax rate (see chart 1 in Appendix). Starting in 2019, when the CCPC and its associated corporation(s) make over $50,000 in passive income, this will reduce the amount of business income that is eligible for the lower small business deduction rate. Note that investment income earned in an associated holding company will be included for passive income rule calculation and may trigger a reduction in income qualified for the small business deduction. For more details, please refer to our tax article *Take action on passive income rules*.

Investment income taxation

When investment income is taxed on a corporate level and then subsequently paid out as shareholder dividends, a certain amount of corporate tax is refunded back to the corporation. There is a $1 corporate tax refund when you pay $2.61 of taxable dividends. This is commonly known as Refundable Dividends Tax on Hand (RDTOH).



Refundable Dividends Tax on Hand

RDTOH is a notional account that is increased when a CCPC pays corporate tax on its investment income (e.g. taxable capital gains, interest, rents, etc.) and any dividends from unconnected Canadian corporations. 30.67% of the investment income and the Part IV tax payable by the recipient corporation of the dividend income are added to the RDTOH account. For taxation years beginning after 2018, the RDTOH is divided into eligible and non-eligible accounts and refundable based on the nature of the dividends paid by the CCPC.

It simply represents a prepayment of an estimated amount of personal tax at the corporate level. This exists to eliminate any tax deferral opportunity for investment income and integrate the system when the money flows out to the shareholder personally.

Capital Dividend Account (CDA)

Capital gains realized within the corporation is taxable at a tax rate equal to 50% of the investment income rate because only 50% of a capital gain is taxable. The non-taxable portion of the capital gains is added to the CDA, which is a notional account that accumulates the non-taxable receipts of the corporation.

Life insurance proceeds (net of the adjusted cost basis) are also commonly added to the CDA. These amounts can be flowed out to the shareholder by way of a capital dividend, which is tax free to the shareholder. The CCPC must file an election with the Canada Revenue Agency to declare these tax-free dividends. For more details, please refer to our article *Capital Dividend Account (CDA).*

Capital investments are tax-efficient since the growth is not taxable until realized. Once the gains are realized, it increases the CDA and the balance can be distributed tax free. Hence, a CDA is generally considered a valuable tool in the estate tax planning for shareholders of CCPCs.

Personal taxation on dividends

When dividends are declared from the company, the shareholder will also have to pay personal tax on dividends received. The personal tax rates that the shareholder would be subject to on dividends from a Canadian corporation depends on (a) the shareholder's total taxable income, and (b) if the income is paid from the corporation's general rate income pool or other sources. General rate income pool (referred to as GRIP) is corporate business income that was taxed at the general corporate rate; dividends paid from this pool are considered eligible dividends (see chart 2 in appendix). Dividends that are not paid from the GRIP pool are taxed as non-eligible dividends.

Understanding the tax implications of investment income within a CCPC is critical to structure tax-efficient investments. For further information on opportunities to maximize your net-of-tax portfolio return, please contact your Scotia Wealth Management relationship manager.

Speak with your tax advisors about your own tax situation when evaluating and before implementing any tax planning strategies.

Appendix

Chart 1: 2021 Canadian-controlled private corporations tax rate
(Combined federal and provincial tax rates as of August 30, 2021)

Province	Active business income (ABI)	
	Small business rate (ABI to $500,000)	General rate (ABI>$500,000)
AB	11.0%	23.0%
BC	11.0%	27.0%
MB	9.0%	27.0%
NB	11.5%	29.0%
NL	12.0%	30.0%
NT	11.0%	26.5%
NS	11.5%	29.0%
NU	12.0%	27.0%
ON	12.2%	26.5%
PE	11.0%	31.0%
QC	12.38%	26.5%
SK	9.0%	27.0%
YT	9.0%	27.0%

Chart 2: 2021 Investment income taxes for CCPC and top personal marginal tax rate
(Combined federal and provincial tax rates as of August 30, 2021)

Province	Interest income		Capital gain		Eligible dividend	
	CCPC	Personal	CCPC	Personal	CCPC	Personal
AB[1]	46.67%	48%	23.34%	24.00%	38.33%	34.31%
BC	50.67%	53.50%	25.34%	26.75%	38.33%	36.54%
MB	50.67%	50.40%	25.34%	25.20%	38.33%	37.78%
NB	52.67%	53.30%	26.34%	26.65%	38.33%	33.51%
NL	53.67%	51.30%	26.84%	25.65%	38.33%	42.61%
NT	50.17%	47.05%	25.09%	23.53%	38.33%	28.33%
NS	52.67%	54%	26.34%	27.00%	38.33%	41.58%
NU	50.67%	44.50%	25.34%	22.25%	38.33%	33.08%
ON[2]	50.17%	53.53%	25.09%	26.76%	38.33%	39.34%
PE	54.67%	51.37%	27.34%	25.69%	38.33%	34.22%
QC	50.17%	53.31%	25.09%	26.65%	38.33%	40.11%
SK	50.67%	47.50%	25.34%	23.75%	38.33%	29.64%
YT[3]	50.67%	48%	25.34%	24.00%	38.33%	28.93%

1. Top personal marginal tax rate for incomes over $314,928
2. Top personal marginal tax rate for incomes over $220,000
3. Top personal marginal tax rate for incomes over $500,000