CORPORATE INVESTMENTS AND THE ROLE OF RDTOH

Advisors should understand the needs for a client's investment capital in order to recommend the most appropriate investment solution. When considering a corporate client's investments, advisors have two additional aspects to consider, namely:

- An additional layer of tax – the corporation and its shareholders are separate taxpayers; and
- Tax-efficient options for paying out income to shareholders when the need arises.

HOW IS INVESTMENT INCOME TAXED IN A CORPORATION?

Corporate tax rates are determined largely by the nature of income reported for tax purposes, while an individual is subject to a marginal tax rate system and, to a certain extent, to the nature of income being reported.

Investment income (interest, other income, dividends, capital gains) earned by a corporation is passive in nature and attracts a higher corporate tax rate than active business income. The higher corporate tax rates are due to:

- Refundable income tax; and
- The inability to claim the small business tax deduction or general rate reduction.

When working with a corporate client, advisors should consider the following:

1. *If distributions are needed from the corporate investments to support ongoing corporate operations or for a shareholder who requires funds for personal lifestyle needs.*

Corporation

If distributions from the corporate investments are not required for ongoing operations or for shareholders, consider investing on account of capital, namely using CI's Corporate Class funds, which seek to minimize income distributed to investors. Unnecessary income generates unnecessary income tax, which represents tax leakage from investment capital.

If the corporation does require distributions for ongoing operations, consider CI T-Class mutual funds (trust or corporate class options) which distribute return of capital (ROC) and/or income on a regular basis. ROC distributions represent cash flow which is not taxable, whereas income is a taxable receipt.

T-Class mutual funds are useful in a limited set of circumstances for a corporate client. T-Class funds result in ROC payments, where cash is transferred from the corporation's investment capital to its bank account. Where the corporation itself requires regular cash flow for operations or to fund a particular corporate expense, (e.g., life insurance premiums, a bank interest payment or the repayment of a shareholder loan), T-Class funds generate tax-free cash flow at the corporate level.

Personal shareholder

Where shareholders needs access to corporate investments to support personal lifestyle needs, there are a variety of ways to realize income or extract funds from a corporation, namely:

- Compensation (salary) – generally, where the corporation is an operating company, generating active income
- Dividends from shares – either eligible, ineligible or capital dividends
- Cash flow – repayment of a shareholder loan.

Consider the following scenario: An individual shareholder needs to access corporate investments to support lifestyle needs; there is no shareholder loan, and the corporation is not an active, operating company. Declaring and paying taxable dividends is the primary means to distribute income and get cash out of the corporation into the hands of the shareholder. Dividends are paid with after-tax corporate dollars, and the dividend is an income receipt for the shareholder.

2. *What role do dividends play in distributing from a corporation tax efficiently? What means, if any, are available to reduce overall taxes paid by the two taxpayers – the corporation and its shareholder(s)?*

When considering the payment of taxable dividends, corporate decision-makers should consider the corporation's Refundable Dividend Tax on Hand Account (RDTOH). The premise behind RDTOH is to prevent a tax deferral on investment income at the corporate level, or gain a tax advantage by incorporating a corporation to hold investments.

As mentioned above, corporate investment income is passive in nature and is subject to refundable tax. For example, for every $1 a Canadian corporation reports of:

- Interest or other investment income, it will pay 30.67% Part I refundable tax;
- Capital gains, it will pay 15.34% Part I refundable tax; or
- Canadian dividends, it will pay 38.33% Part IV refundable tax.

The tax is "refundable" as it is reimbursed when the corporation pays out taxable dividends to its shareholders. A dividend refund of 38.33% ($1 dividend refund for every $3 of taxable dividends paid) is generated and is refunded to the corporation, to the extent the corporation has a RDTOH balance.

If an individual shareholder anticipates the need to access corporate investments, creating RDTOH to generate a dividend refund when paying taxable dividends can be tax advantageous. By realizing capital gains in a corporate portfolio, or receiving dividends or other income distributions from investments, RDTOH is created. To the extent the corporation does not have a RDTOH balance, no dividend refund nor other form of tax relief to the corporation for declaring and paying dividends is realized, and thus, a double tax scenario occurs.

CONSIDERATIONS		Investment solution recommendations	TAXPAYER CONSIDERATIONS: Corporation	TAXPAYER CONSIDERATIONS: Individual shareholder
Is income or cash flow needed from corporate investments? → NO		Consider CI GAM Corporate Class, which aims to minimize income distributions.	Minimal taxable distributions and tax liability. Where taxable distributions are paid, corporate investor can declare a taxable dividend to shareholders to create dividend refund and clear out RDTOH.	Normally a taxable dividend when paid to shareholders. Tax-free capital dividend from CDA might also be available.
YES	By the corporation	Consider CI GAM Corporate Class T-Class	Tax-free ROC distributions can be used to pay certain expenses, such as corporate-owned life insurance, bank loan interest, or repay shareholder loan.	Normally a taxable dividend to shareholders. Tax-free capital dividend from CDA might also be available upon sale of corporate investments.
YES	By the corporation	Consider CI GAM trust pools, which distribute income on a regular basis.	Sufficient income required to pay corporate operating expenses. Will generate RDTOH and corporate investor may declare dividend to generate dividend refund and clear out RDTOH.	Normally a taxable dividend to shareholders. Tax-free capital dividend from CDA might also be available upon sale of corporate investments.
YES	By the shareholder	Consider CI GAM trust pools or CI GAM Corporate Class to generate RDTOH and CDA.	Sufficient income required to generate RDTOH, 50% of realized capital gains will be added to CDA.	Normally a taxable dividend to shareholders. Tax-free capital dividend from CDA might also be available upon sale of corporate investments.

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