TAX ALERT

TAX ALERT is a commentary on topics of current interest – usually topics relating to recent changes in tax law, new CRA administrative practices or current interpretations arising from tax cases. Professional advice should be obtained before acting on any of this information.

HOLDING COMPANIES AS INCOME CONDUITS

Small business corporations are used most often to run the family business. But some taxpayers use companies to own all or part of an investment portfolio – which often happens after a family business shuts down or individuals set up a personal holding company as part of a financial planning strategy.

There can be significant tax savings if individuals use a corporation to carry on an active business (corporate rate of 16.5% and declining) but investments are usually held by corporations for other reasons. This article will review the use of a corporation to hold investments and will discuss in less detail the advantages of using a corporation to carry on an active business.

Investments are usually owned by a corporation as some component of an estate plan, to split income amongst family members, as a holding company for an operating company or to do an estate freeze – but not for lower rates. Putting a portfolio in a corporation can in some cases avoid the OAS clawback which in itself could pay the extra administrative costs. A good example of using a corporation for estate planning is found on our website, www.personalwealthstrategies.net, on the Newsletters and Publications page under the title, *Holding Companies For Wealth Transfer*.

Personal and Corporate Tax Integration

At the time of tax reform in Canada in the 1970s, it was recommended by the Carter Royal Commission that corporate and personal income taxes be integrated so there would be the same total tax (personal and corporate) whether you received investment income directly or flowed it through a corporation. That gave rise to the dividend gross up and refundable corporate taxes which were additions to the already existing dividend tax credit and exist to this day.

Let's look at a hypothetical example of tax integration assuming a corporate tax rate of 25%, a personal tax rate of 40% and a dividend gross up of 33%. The corporation earns $100 of investment income and pays out the $75 after tax amount out as a dividend.

Corporate income	$100
Corporate income tax	25
Corporate income available for dividends	$ 75

Under the gross up and tax credit mechanism, there would be a gross up on the dividend paid (to bring it back to the corporate pretax income) making a taxable dividend of $100. There would also be a personal tax credit of 25% of the $100 grossed up amount to account for corporate taxes paid. Let's follow the trail.

Taxable Dividend	
Dividend received	$ 75
Dividend gross up (33.33%)	25
Taxable income	100
Income Tax	
Personal income tax	40
Dividend tax credit	25
Tax after credit	15
Personal after tax income ($75 less $15)	$ 60

The $60 of after tax income (after flowing income through a corporation) is the same as what a taxpayer would have gotten had the individual received the $100 of investment income directly. The flow through mechanism, in the end, is designed to integrate personal and corporate taxes on all forms of corporate income except foreign source income. Canada does not provide a tax credit for taxes paid to another country nor do dividends from foreign companies receive refundable tax treatment.

The integration mechanism has always worked reasonably well except for dividends originating from Canadian public corporations and a corporation's own business income taxed at the general rate. In those cases, the tax credit mechanism failed because integration did not give a full credit for higher taxes paid at the corporate level. This was corrected in 2006 with the *eligible dividend* tax credit which has a different gross up and credit amount.

As mentioned earlier, lower tax rates apply to business income of a corporation because of government policy to encourage business formation with lower tax rates. The government is not willing, however, to allow this same low rate on investment income. That would simply allow individuals to lower personal income taxes by putting their investments into a corporation. To prevent this, a refundable tax is added to the basic corporate tax bringing total tax up to and beyond the top personal rate. Corporations get back this refundable tax when they pay out investment income as dividends and it is taxed at the personal level. Seems fair!

Although the gross up and dividend tax credit mechanism now work quite well, there are two areas that taxpayers need to consider.

- Are corporate tax rates on investment income more favourable than personal rates
- Is there a penalty for flowing income through a corporation

Illustrations below are for the top personal tax bracket only – to provide examples for lower brackets would add an inordinate amount of detail and the principles are the same.

Personal and Corporate Tax Rates

In order to make personal and corporate tax rate comparisons, we first need to know what those rates are. The rates shown below are the personal tax rates (rounded) in Ontario. Corporate tax rates have been declining in the past few years so we are also looking at a moving target.

Business Income	**Advantage Corporation**	**Personal**	**Corporate**
Business - small business rate	30.5%	46%	15.5%
Business – general rate	19.5%	46%	26.5%
Investment Income			
Interest		46%	46%
Eligible dividends	(10%)	23%	33%
Non eligible dividends	(2%)	31%	33%
Capital gains		23%	23%

It is interesting to note from the above chart that corporate tax rates for business income are considerably lower than rates at the personal level. This certainly helps the decision whether to incorporate a business. Because of the new integration mechanism, there is now less of an inclination to bonus out corporate income taxed at the general rate.

Contrary to business rates, corporate tax rates on investment income are in some cases higher than personal rates. It is obvious that it is not a good idea to put investments into a holding company just to save immediate taxes. But there are estate planning and other reasons to do that. The bottom line – there can sometimes be an extra tax cost to hold investments in a corporation but this can be mitigated by paying dividends in certain situations. Financial and estate planning issues can justify or not justify the use of a corporation to hold investments.

Does Integration Really Work?

There are two ways of taking money out of a corporation – as a salary or bonus (if it can be justified to CRA) or as a dividend. It is always better to pay a dividend than a bonus to get the lower personal tax rates plus a refund of corporate taxes. If you pay a bonus, refundable taxes sit in the corporation and may never be recovered. There is not exact integration of personal and corporate taxes but it is reasonable.

Conclusion

The tax integration mechanism works well but there may be an extra tax on incorporating a portfolio until dividends are paid. Other financial planning considerations will determine whether a corporation should be used to hold a portfolio. While the decision is complex, use of a corporation for high wealth individuals is well worth the investigating.

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