Manulife Investments

For your future™

Earning income inside a corporation

TRS | TAX & RETIREMENT SERVICES

INVESTMENT INSIGHT

If you own your own business, you may be considering whether or not it makes sense to incorporate your business. The answer to this question depends upon a number of factors; the most important being the type of income that will be earned inside the corporation. In most cases, it makes sense to incorporate a business that earns active business income. Based upon current tax rates, however, if a taxpayer is thinking of incorporating to earn investment income, it's best to think twice.

EARNING ACTIVE BUSINESS INCOME

Active business income is income that's generated by actively doing "something." That is, your business provides some type of goods or service, or is involved in manufacturing or sales. This can be compared to passive income, which is typically investment income.

So does it make sense to earn active business income inside a corporation? Owners/managers wondering if they should incorporate their business typically ask this question.

One of the biggest advantages of earning active business income inside a corporation is the ability to claim the small business deduction (SBD). The SBD allows a Canadian-controlled private corporation (CCPC) to claim a reduced tax rate on active business income, up to a certain threshold. (This threshold is $500,000 for federal purposes and for most provinces and territories).

Consider this example: Assume Jane owns a business in Ontario that earns $100,000 of active business income in 2011. She's wondering whether or not it makes sense to incorporate. Assume that Jane also earns taxable income of $30,000 outside of her business.

If Jane incorporates, she'll have a significant tax deferral opportunity up front due to the small business rate that is applied to active business income. When the corporation pays her out a dividend, Jane is somewhat better off through incorporation rather than earning business income directly. However, although there is some tax savings in this scenario, Jane also will incur fees to set up and maintain the corporation, adding to the total cost of incorporating a company which could offset any benefit.

For 2011, the first $500,000 of active business income will attract a reduced federal tax rate of 11 per cent. Combined with the provincial and territorial small business deduction, the average tax rate on active business income up to $500,000 is approximately 15 per cent. If this income was earned personally, an individual in the top tax bracket could pay tax as high as 50 per cent, depending upon his/her province or territory of residence.

As you can see, this gives a business owner the opportunity to defer as much as 35 per cent tax if active business income is earned and the after tax income is retained inside the corporation.

The chart on the next page shows the tax benefit(s) for 2011, by province, of earning active business income inside a corporation. If the income is retained inside the corporation (that is, it's not paid out to the shareholder as salary or dividend), there's an overall tax deferral. Even when the corporation pays the shareholder the after-tax earnings in the form of a dividend, there's still generally a tax savings, albeit small. As such, it makes the most sense to incorporate if the corporation is going to earn a profit and some or all of those profits can be left inside the corporation for a period of time.

	Don't Incorporate ($)	Incorporate ($)
Income inside corporation	–	100,000
Corporate tax	–	15,500[1]
After-tax dividend (non-eligible)	–	84,500
Total personal income	130,000[2]	135,625[3]
Personal taxes payable	39,707[4]	22,326[4]
Total tax	39,707	37,826[5]
Tax deferral by incorporating	**24,207[6]**	
Tax savings by incorporating	**1,881[7]**	

For illustration purposes only

[1]Combined Federal/Ontario small business rate is 15.50 per cent [2]$100,000 business income plus $30,000 other income [3]Dividend of $84,500, grossed up by 1.25 per cent plus other income of $30,000 [4]Based on 2011 marginal tax rates in Ontario [5]Total tax = $15,500 plus $22,326 [6]Tax deferral = $39,707 less $15,500 if dividend not paid to shareholder [7]Tax savings = $39,707 less $37,826 if dividend paid to shareholder

	Small Business Rate Up to $500,000[8] (%)	Income Earned Personally[9] (%)	Tax Deferral (%)	Total Taxes When After-tax Profits Paid as Dividend[10] (%)	Tax Savings / (Cost)[11] (%)
British Columbia	13.50	43.70	30.20	42.66	1.04
Alberta	14.00	39.00	25.00	37.83	1.17
Saskatchewan	14.25	44.00	29.75	41.76	2.24
Manitoba	11.00	46.40	35.40	45.84	0.56
Ontario	15.50	46.41	30.91	43.02	3.39
Quebec	19.00	48.22	29.22	48.44	(0.22)
New Brunswick	16.00	43.30	27.30	41.90	1.40
Nova Scotia	15.50	50.00	34.50	46.10	3.90
PEI	12.00	47.37	35.37	48.23	(0.86)
Newfoundland	15.00	42.30	27.30	40.47	1.83
Yukon	15.00	42.40	27.40	40.85	1.55
Northwest Territories	15.00	43.05	28.05	40.20	2.85
Nunavut	15.00	40.50	25.50	39.62	0.88

Rates are current as of September 1, 2011.

[8]Manitoba & Nova Scotia's small business threshold is $400,000. All other provinces and territories small business threshold is $500,000 which is equivalent to the federal amount. As well, the benefit of the SBD (federal, provincial or territorial) may be reduced (or eliminated) for larger corporations, along with those corporations that leave income greater than the SBD limit to be taxed in the corporation. [9]Assumes individual is in the top marginal tax bracket for his or her province/territory. [10]Assumes tax is paid in corporation, and then all after-tax profits are paid out to the individual as a non-eligible dividend. Assumes individual is in top marginal tax bracket for his or her province/territory. [11]This represents the total tax savings/(cost) of earning active business income inside a corporation, and then flowing all after-tax profits out to the shareholder in the form of a non-eligible dividend vs. the shareholder earning that business income personally.

Assume John, who lives in Ontario in 2011, owns investments that earn $10,000 of taxable interest income annually. This investment income is earned in addition to his regular salary of $130,000 per year. John has no deductions from this salary income. He's considering incorporating and transferring his investments to this new corporation.

If John incorporates, he'll essentially pay the same amount of tax upfront in the corporation than if he earned it personally due to the 26.67 per cent refundable tax the corporation must pay on its investment income. When the corporation pays him out a dividend and receives the refundable tax back, John is slightly better off by $52 through incorporation rather than earning the investment income directly. However, although there are some tax savings in this scenario, John also will incur fees to set up and maintain the corporation, adding to the total cost of incorporating a company to hold his investments which could offset any benefit.

EARNING INVESTMENT INCOME

In the past, it was advantageous to earn investment income inside a corporation rather than earning it personally if you were already paying personal tax at the top marginal rate. However, as a result of an increase in corporate tax rates on investment income – and a reduction in personal tax rates over the years – there's no longer any tax deferral and/or tax savings advantage to earning investment income inside a corporation. In fact, in most cases, a tax cost results. The actual cost to you depends upon your province or territory of residence, your level of personal tax, and the type of income you earn.

There are two reasons why passive investment income isn't taxed as favourably as active business income in corporations. The first is investment income isn't eligible for the small business deduction, as discussed earlier, as is the case with active business income. The second reason is investment income is subject to "refundable tax." There's a refundable tax of 26.67 per cent on most investment income earned by a corporation, as well as 33 1/3 per cent Part IV tax on portfolio dividend income, which is a "prepayment" of tax. This refundable tax is later refunded when taxable dividends are paid out of the corporation to its shareholders ($1 is refunded to the corporation for every $3 of taxable dividends paid out). A private corporation keeps track of and receives its refundable tax from its Refundable Dividend Tax on Hand Account ("RDTOH").

	No Corporation ($)	Corporation ($)
Investment income inside corporation	–	10,000
Corporate tax	–	4,642[12]
After-tax dividend	–	8,025[13]
Total investment income	10,000	–
Personal taxes payable	4,641[14]	2,614[15]
Total tax	4,641	4,589
Prepayment of tax by incorporating	**1[16]**	
Tax savings by incorporating	**52[17]**	

For illustration purposes only

[12]Corporate tax rate on investment income in Ontario is 46.42% in 2011 [13]Includes refundable tax of $2,667 [14]Top marginal tax rate in Ontario on interest income is 46.41% [15]Top marginal tax rate in Ontario on non-eligible dividends is 32.57% [16]Prepayment of tax = $4,642 less $4,641 [17]Tax savings = $4,641 less $4,589

The integration theory behind refundable tax is there should be no difference between earning investment income inside a corporation and then paying it out to the shareholder as a dividend, or the shareholder earning the investment income personally. However, there are two levels of tax when a corporation is involved: income is taxed once at the corporate level and then at the shareholder level, but only when income or dividends are paid to the shareholder. Refundable tax is, therefore, required to be prepaid at the corporate level to minimize any deferral by leaving investment income inside a corporation, and not paying it out as a dividend.

The chart below shows both the prepayment of tax and the ultimate tax cost of earning interest income inside a corporation vs. earning it personally, assuming the individual is in the top marginal tax bracket for 2011. The results for each province are shown.

	General Corporate Tax Rate (%)	Income Earned Personally[18] (%)	Tax Deferral (Prepayment) (%)	Total Taxes When After-tax Profits Paid as Dividends[19] (%)	Tax Savings / (Cost)[20] (%)
British Columbia	44.67	43.70	(0.97)	45.64	(1.94)
Alberta	44.67	39.00	(5.67)	40.72	(1.72)
Saskatchewan	46.67	44.00	(2.67)	45.66	(1.66)
Manitoba	46.67	46.40	(0.27)	51.32	(4.92)
Ontario	46.42	46.41	(0.01)	45.89	0.52
Quebec	46.57	48.22	1.65	49.02	(0.80)
New Brunswick	45.17	43.30	(1.87)	43.63	(0.33)
Nova Scotia	50.67	50.00	(0.67)	51.52	(1.52)
PEI	50.67	47.37	(3.30)	55.29	(7.92)
Newfoundland	48.67	42.30	(6.37)	45.37	(3.07)
Yukon	49.67	42.40	(7.27)	46.42	(4.02)
Northwest Territories	46.17	43.05	(3.12)	43.37	(0.32)
Nunavut	46.67	40.50	(6.17)	43.17	(2.67)

Rates are current as of September 1, 2011.

[18]Assumes investments earn interest income, and the individual is in the top marginal tax bracket for his or her province/territory. [19]Assumes tax is paid in corporation, and then all after-tax profits (including RDTOH) are paid out to an individual as a non-eligible dividend. Assumes individual is in the top marginal tax bracket for his or her province/territory. [20]This represents the total tax savings/(cost) of earning interest income inside a corporation, and then flowing all after-tax profits out to the shareholder in the form of a non-eligible dividend vs. the shareholder earning that interest income personally.

As you can see, in most situations earning investment income inside a corporation doesn't allow for a deferral of tax and, when the income is flowed through to the shareholder in the form of dividends, there's actually a tax cost of earning this type of income in a corporation. So, does it make sense to incorporate for the sole purpose of earning investment income? Purely from a tax standpoint, the answer is no. However, there may be other benefits to incorporation for you to consider. This is something you should discuss with your advisor.

If you already have a corporation that holds investments, generally speaking, it doesn't make sense to collapse or "wind-up" this corporation – the immediate tax liability may be too great. Your tax accountant can help you calculate how much tax exposure you and the corporation may have, based upon the particular circumstances. In many cases, in order to defer the current tax liability on a wind-up, you may prefer to leave the corporation intact, and concentrate on keeping the taxes in the corporation as low as possible going forward.

THE BOTTOM LINE

Whether or not it makes sense for you to incorporate can depend a lot upon the type of income the business earns. From a tax point of view, it generally makes the most sense to incorporate your business when you're earning active business income and it's profitable to the point where you can leave some of the after-tax profits in the corporation. If you simply want to earn investment income in the corporation, though, you'll probably find that the tax costs of doing so are prohibitive. That being said, there may be other reasons why you want to incorporate. Before making any decisions, it's best to speak to your advisor who can help you decide if earning income inside a corporation is right for you.

FOR MORE INFORMATION, CONTACT YOUR ADVISOR OR VISIT MANULIFE.CA/INVESTMENTS

MK2609E 11/11 TMK1246E