Just leave it! Corporate versus personal capital gains investing

October 2024

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If you operate your business through a corporation,[1] you can choose either to invest after-tax business income within your corporation, or to withdraw the after-tax income, pay personal tax, and then invest the remaining funds yourself. With the changes to the capital gains inclusion rate effective June 25, 2024, the decision has become more complex since two-thirds of capital gains are now taxed in a corporation, whereas for individuals only one-half of the first $250,000 of annual capital gains are taxed.

This report will explore whether you should consider withdrawing after-tax business income from your corporation, so you can personally benefit from the lower, one-half inclusion rate on the first $250,000 of annual capital gains personally, or just leave it in the corporation and invest corporately.

[1] It is assumed that you are the sole shareholder of a private corporation and that you pay personal tax at the highest marginal tax rate.

How much of your corporation's business income could be invested?

After your corporation pays tax on its business income, the remaining amount (after corporate tax) can be used as starting capital for corporate investments (Corporate Capital). Alternatively, your corporation can distribute the after-tax amount to you as dividends and, after you pay personal tax, the remaining amount (after corporate and personal taxes) can be used as starting capital for personal investments (Personal Capital).[2]

Let's look at an example of how this works if your corporation earns $10,000 of business income, assuming you live in Ontario. You can find additional tax information, including tax rates for other provinces or territories, in the CIBC Tax Toolkit.

Small Business Deduction income (SBD Income) is the first $500,000 of active business income earned in your corporation in a year.[3] The first column of Figure 1 below shows that if your Ontario corporation earned $10,000 of SBD Income, after paying tax of $1,220 there would be $8,780 of Corporate Capital to invest within your corporation. Alternately, your corporation could distribute its after-tax SBD Income to you as dividends, and you'd pay $4,190 of personal tax. You'd then have $4,590 of Personal Capital to invest personally. Note that with SBD income, the starting Corporate Capital is nearly double the starting Personal Capital.

General Income is business income over $500,000[4] that's earned in your corporation. The second column of Figure 1 below shows that if your Ontario corporation earned $10,000 of General Income, after paying tax of $2,650 there would be $7,350 of Corporate Capital. Alternately, your corporation could distribute its after-tax General Income to you as dividends, and you'd pay $2,900 of personal tax. You'd then have $4,450 of Personal Capital. Note that with General Income, the starting Corporate Capital is nearly two-thirds larger than starting Personal Capital.

Figure 1: Taxes on $10,000 of SBD Income or General Income that is earned in your corporation using Ontario tax rates

Description	SBD Income	General Income
Corporate business income	$10,000	$10,000
Corporate tax	(1,220)	(2,650)
Corporate after-tax income (Corporate Capital)	**$8,780**	**$7,350**
Personal tax on dividend distributions	$4,190	$2,900
Personal after-tax income (Personal Capital)	**$4,590**	**$4,450**

Source: Tax Templates Inc. August 2024

SBD Income used as starting capital for investments

Corporate investing

The CIBC report In good company: Earning investment income in your corporation describes how investment income is taxed in a corporation. The corporate tax on the investment income includes refundable tax. When your corporation pays dividends, it generally recovers the refundable tax and may also pay that amount to you as dividends. After you pay tax on the dividends, you get to keep the remaining Net Proceeds (after both corporate and personal tax) from the investment income that was originally earned in your corporation.

[2] It may be possible to distribute corporate income as salary or bonus, though payroll taxes may also apply and may lead to other benefits. To simplify the analysis and keep calculations consistent, it is assumed that corporate funds are distributed as dividends. For more information about distributing dividends versus salary, please see the CIBC report Bye-bye bonus! Why business owners may prefer dividends over a bonus.

[3] The small business deduction (SBD) is available for active business income earned in Canada, up to the SBD limit, which is $500,000 federally and in all provinces and territories except Saskatchewan (where it is $600,000).

[4] Ibid.

Continuing with the example above, suppose your Ontario corporation earned $10,000 of SBD Income, so there would be $8,780 of Corporate Capital. If the investment grows by a 5% rate of return, after one year there would be a capital gain of $439 ($8,780 × 5%) before tax.

Figure 2 shows your Net Proceeds when $439 of capital gains are earned in your corporation and funds are distributed from your corporation to you. As you can see, with the new two-thirds inclusion rate on capital gains earned in a corporation as of June 25, 2024, you'd have $269 after-tax.

Figure 2: Net Proceeds after one year when starting capital for corporate investments comes from $10,000 of SBD Income, and investments earn capital gains with a 5% rate of return using Ontario tax rates

Description	Amount
SBD Income	$10,000
Corporate tax	(1,220)
Corporate Capital for investment	**$8,780**
Corporate capital gains (5% return)	$439
Corporate tax (refundable and non-refundable)	(147)
Corporate after-tax capital gains	$292
Recovery of refundable tax	90
Total available to distribute as dividends	**$382**
Consisting of:	
Non-taxable capital dividends (33% × $439)	$146
Taxable non-eligible dividends	236
Personal tax on taxable non-eligible dividends	(113)
Net Proceeds	**$269**

Personal investing

As shown in Figure 1, if $10,000 of SBD Income was earned in your corporation, you'd have Personal Capital of $4,590 to invest personally. If your investments earned a 5% rate of return, after one year you would have a capital gain of $230 ($4,590 × 5%) before tax. (See Figure 3) Assuming one-half of capital gains are included in income (because your annual capital gains personally is below $250,000), after paying tax of $62, your Net Proceeds would be $168.

Figure 3: Net Proceeds after one year when starting capital personal investments comes from $10,000 of SBD Income, and investments earn capital gains with a 5% rate of return using Ontario tax rates

Description	Amount
Corporate business income	$10,000
Corporate tax	(1,220)
Corporate after-tax income (Corporate Capital)	**$8,780**
Personal tax on dividend distributions	$4,190
Personal after-tax income (Personal Capital)	**$4,590**
Capital gain (5%)	230
Tax on capital gain (50% inclusion rate, gains under $250,000)	62
Net Proceeds	$168

Corporate investing versus personal investing

You may have noticed that after one year, your $269 Net Proceeds with corporate investing is substantially higher than your Net Proceeds of $168 with personal investing. This seems counterintuitive, since two-thirds of capital gains are taxed in a corporation, but only one-half of capital gains are taxed personally. So, how can corporate investing give you more Net Proceeds than personal investing, when the fully integrated corporate tax rate on capital gains (38.62% in Ontario) is much higher than the personal tax rate on capital gains with one-half inclusion rate (26.77% in Ontario)[5]?

The answer lies with the starting capital. When $10,000 of SBD Income is used for investment, the Corporate Capital of $8,780 is about 90% higher than the Personal Capital of $4,590. This creates a huge advantage for corporate investments over personal investments because 90% more investment income can be earned. Even though tax on corporate capital gains is quite a bit higher than for personal capital gains, the extra corporate investment income outweighs the higher corporate tax.

Figure 4 expands on previous calculations, to show the Net Proceeds when $10,000 of SBD income is used to invest in a corporation or personally over periods of up to 30 years, with capital gains realized at the end of the period. We assume that all funds are distributed from the corporation at the end of the period and that you'd pay tax on one-half of personal capital gains.

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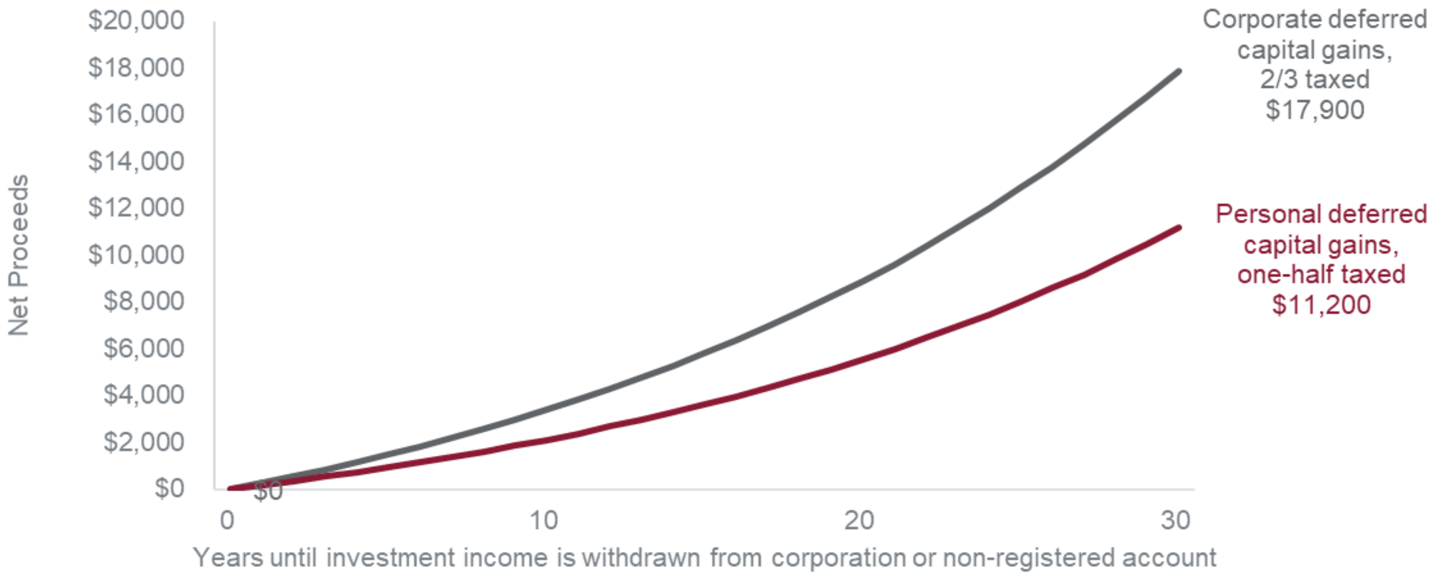
[5] In Ontario, the:

- Highest personal tax rate on capital gains with one-half inclusion is 26.77%.
- Integrated (combined personal and corporate) taxes on capital gains earned in a corporation and distributed to a shareholder who pays tax at the top marginal rate is 38.62%.

Figure 4: Net after-tax proceeds when $10,000 of SBD Income is used as starting capital for investments that earn 5% capital gains that are taxed at two-thirds in a corporation or one-half personally using Ontario tax rates



After 30 years, you'd have Net Proceeds of $17,900 with corporate investing when SBD Income is used as the starting capital for investment, which is about 60% more than the $11,200 of Net Proceeds with personal investing in a non-registered account.

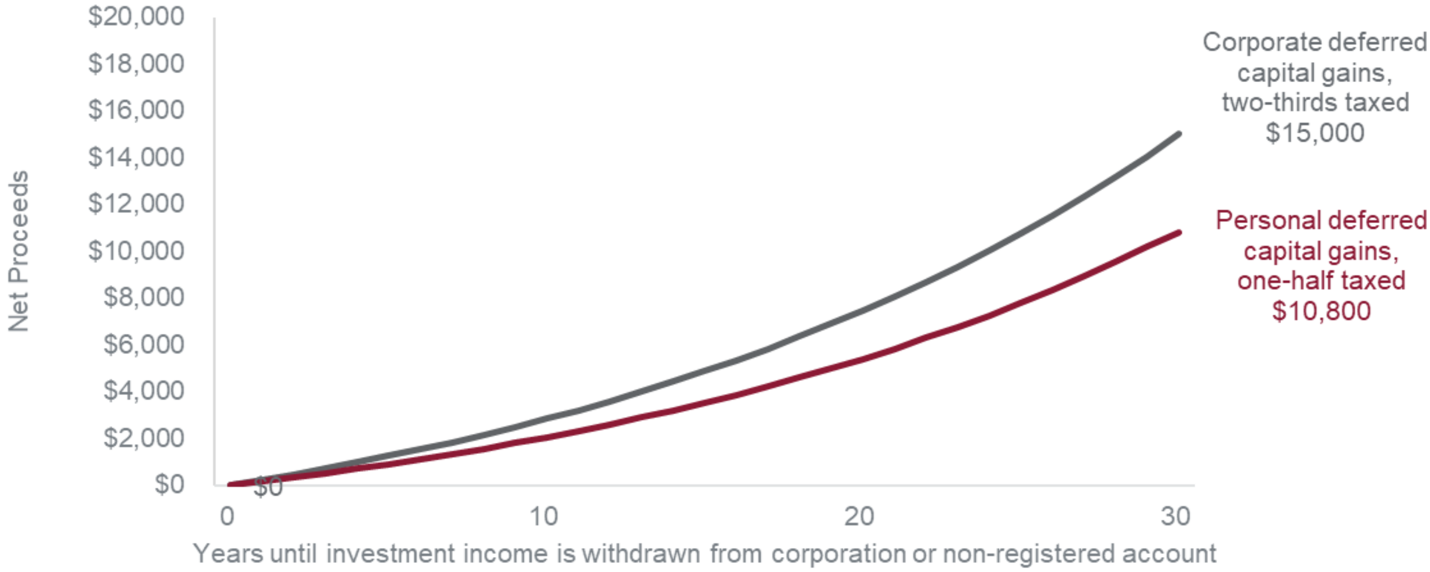
As indicated above, this is because Corporate Capital of $8,780 is about 90% higher than Personal Capital of $4,590, so almost twice the capital gains can be earned in a corporation compared to personally. Even though tax for corporate capital gains is quite a bit higher than tax on personal capital gains[6], the extra capital gains more than outweigh the higher corporate tax.

General Income used as starting capital for investments

When the same calculations are run for General Income (See Figure 5), we've found you'd still have about 40% more Net Proceeds with corporate investing than personal investing This is because starting Corporate Capital of $7,350 is about 65% higher than Personal Capital of $4,450, and the extra corporate capital gains outweigh the higher corporate tax.

[6] Assuming one-half of capital gains are included in personal income and two-thirds of capital gains are included in corporate income.

Figure 5: Net after-tax proceeds when $10,000 of General Income is used as starting capital for investments that earn 5% deferred capital gains that are taxed at two-thirds in a corporation or one-half personally using Ontario tax rates



Other considerations

The calculations in the examples assume that you always pay tax at the top marginal rate. If you don't pay tax at the top rate, or you think your tax rates may change in the future, perhaps upon retirement, the outcome may be quite different.

The outcome may also differ if you are able to split income with family members, perhaps by paying dividends to a spouse or common-law partner once you reach age 65. Additional information on income splitting is available in the CIBC report The great divide: Income splitting strategies can lower your family's taxes.

The federal SBD Limit may be decreased when your company earns passive income, typically from investments.[7] If your corporation had over $50,000 of passive income last year, some (or all) of your corporation's business income may be taxed as General Income, rather than SBD Income, so that the Corporate Capital and Personal Capital available for investment may be reduced.[8]

Apart from the Net Proceeds that you may receive with corporate or personal investing, there are other factors to consider. For example, leaving after-tax income in your corporation may expose the funds to creditors of the business and affect your ability to claim the lifetime capital gains exemption to eliminate tax on up to $1,250,000 of capital gains when you sell shares of your corporation.[9] The CIBC reports Making the leap from employee to owner: some tax considerations and Professional Inc. Tax Benefits of Professional Incorporation outline some of the factors to consider.

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7 The federal SBD Limit for CCPCs is reduced by $5 for each $1 of "adjusted aggregate investment income" (AAII) that exceeded $50,000 in the previous year, and reaches zero once $150,000 of AAII is earned in the previous year. AAII includes passive income such as interest, rent, royalties, dividends and taxable capital gains.

8 In Ontario and New Brunswick, the provincial SBD Limit is not reduced with AAII, so income affected by the reduction of the federal SBD Limit would not be taxed in the same way as General Income in these provinces.

9 You may claim the lifetime capital gains exemption (LCGE) to eliminate tax on capital gains from the disposition of qualified small business corporation shares, to a maximum of $1,250,000 for dispositions starting on June 25, 2024, as proposed in the 2024 Federal Budget.

Conclusion

When business income that's earned in your corporation is used as starting capital for investment, you may ultimately have a lot more cash in your pocket with corporate investing than personal investing, due to the lower tax rates on corporate business income that leave funds for corporate investing than for investing. Even though the integrated tax rate for corporate capital gains is quite a bit higher than the top tax on personal capital gains that are only one-half taxed (below $250,000), the extra corporate investment income more than outweighs the higher corporate tax.

Before choosing to either invest after-tax business income within your corporation, or to withdraw the after-tax income and invest the remaining funds personally, be sure to consult with your investment, accounting, tax and legal professionals about both the financial and non-financial considerations involved when choosing to leave funds in your corporation.

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