Practice 16 – Corporation Tax: Investment Income

Part 1 – Interest Income and rental income

ABC Inc. earned **$10,000 of interest income** during the year.

Step 1 – Enter the interest income

Open **Schedule 125 (S125)** in FutureTax.

Enter:

Interest income: $10,000

At this point, FutureTax shows approximately:

Corporate tax owing: $1,220

This is because the $10,000 has not yet been identified as investment income and is initially being treated like income eligible for the small-business rate.

Do not stop here.

Step 2 – Identify the investment income

Open **Schedule 7 Worksheet (S7WS)**.

Enter:

Interest income: $10,000

FutureTax will now recognize the amount as investment income.

Review the T2.

You should see approximately:

Corporate tax: $5,017
Refundable portion: $3,067 (T2 page 6 line 450)

The $10,000 is now being taxed under the corporate investment-income rules rather than the small-business rate.

Step 3 – Record the dividend

Assume ABC Inc. pays a dividend to David.

Open **Schedule 100 (S100)** and record the dividend in the balance sheet/retained earnings information.

Simply recording the dividend on Schedule 100 will **not** trigger the dividend refund.

Step 4 – Report the taxable dividend

Open **Schedule 3 (S3)**.

On the taxable-dividend-paid section, enter:

Dividend paid: $8,000 (S3 Line 450)

Review the T2 again.

FutureTax should now show approximately:

Initial corporate tax: **$5,017**
Dividend refund: **$3,067**
Final corporate tax: $1,950

An $8,000 dividend is enough to recover approximately the full refundable tax in this example.

If you enter a **$10,000 dividend**, the refund remains approximately $3,067 because the corporation does not have more refundable tax available.

How the Numbers Are Calculated

1. Initial tax

Investment income is subject to a much higher initial corporate tax rate than active small-business income.

On $10,000:

Initial tax ≈ $5,017

or approximately:

50.17%

Federal portion: 38⅔%

For CCPC investment income:

28% basic federal corporate tax after the 10% federal abatement
+ 10⅔% additional refundable tax
= 38⅔% federal tax

Finance Canada confirms that CCPC investment income is subject to a **38⅔% federal rate**, of which **30⅔% is refundable**. Canada

Ontario portion: 11.5%

Investment income does not qualify for Ontario's small-business rate, so the Ontario general corporate rate applies:

11.5%

Therefore:

38.6667% federal + 11.5% Ontario = 50.1667%

2. Refundable portion

The refundable portion generated in this example is:

$10,000 × 30⅔% = approximately $3,067

This amount is added to the corporation's **NERDTOH** account.

30⅔% is essentially a fixed statutory federal percentage in the refundable-tax calculation for a CCPC's aggregate investment income, subject to the detailed limits in the calculation.

3. Dividend refund

The dividend refund on non-eligible dividends is generally limited to approximately:

38⅓% of the taxable dividend paid

For an $8,000 dividend:

$8,000 × 38⅓% ≈ $3,067

Therefore the corporation can recover the entire $3,067 NERDTOH balance.

4. Final corporate tax

$5,017 initial tax
– $3,067 dividend refund
= $1,950 final corporate tax

So:

$10,000 interest income	**Amount**
Initial corporate tax	$5,017
Refundable tax / NERDTOH	$3,067
Dividend required for full refund	~$8,000
Dividend refund	$3,067
Final corporate tax	**$1,950**

Why Is Investment Income Taxed This Way?

Investment income is initially taxed at a high corporate rate to reduce the tax-deferral advantage of earning passive investment income inside a private corporation.

Part of that tax is refundable when the corporation pays taxable dividends.

The simple logic is:

Investment income → high initial corporate tax → refundable tax builds in NERDTOH → pay taxable dividend → receive dividend refund

The dividend itself is **not an expense** and does not reduce the $10,000 investment income. It simply allows the corporation to recover refundable tax that was previously generated.

Part 2 – Capital Gains

ABC Inc. sold shares on the stock market and realized a **$10,000 capital gain**.

For simplicity, assume there is no cost or selling expense in this exercise.

What to Do in FutureTax

Step 1 – Enter the accounting gain

Open **Schedule 125 (S125)**.

Enter:

Realized gain on sale of investments – GIFI code 8211: $10,000

At this point, the capital gain has been recorded in the corporation's accounting income, but the tax calculation is not complete.

Step 2 – Complete Schedule 6

Add **Schedule 6 – Summary of Dispositions of Capital Property**.

Enter:

Proceeds of disposition: **$10,000**
Adjusted cost base: **$0**
Outlays and expenses: **$0**

Capital gain:

$10,000

FutureTax calculates the taxable portion of the capital gain and the T2 tax.

In this example:

Tax owing ≈ $2,508

How the Tax Is Calculated

For this exercise, the capital gain is $10,000 and the applicable inclusion rate is 50%:

$10,000 × 50% = $5,000 taxable capital gain

The $5,000 taxable portion is treated as investment income and taxed in the same general manner as the interest income in Part 1:

$5,000 × approximately 50.17% = $2,508

So:

Capital gain	**$10,000**
Taxable portion	$5,000

Capital gain	**$10,000**
Initial corporate tax	~$2,508
Refundable portion	~$1,533
Non-taxable portion	$5,000

The taxable investment-income portion also generates **NERDTOH**:

$5,000 × 30⅔% ≈ $1,533

If ABC Inc. pays sufficient taxable dividends, the corporation can recover this refundable tax in the same manner as the interest-income example.

Capital Dividend Account – CDA

Now click **Forms**, search **CDA**, and open the **Capital Dividend Account worksheet**.

You should see approximately:

CDA balance = $5,000

Why?

The $10,000 capital gain has two parts:

$5,000 taxable portion → subject to corporate investment-income tax
$5,000 non-taxable portion → added to the CDA

CRA confirms that one of the main amounts added to the CDA is the tax-free portion of capital gains, net of the applicable non-deductible portion of capital losses. Canada

What can ABC Inc. do with the $5,000 CDA?

ABC Inc. can elect to pay up to **$5,000 as a capital dividend** to a Canadian-resident shareholder.

A properly elected capital dividend:

- is generally **tax-free to the shareholder**
- does **not** use the normal taxable-dividend/T5 treatment
- reduces the corporation's CDA balance

CRA requires the corporation to make the capital-dividend election using **Form T2054**. The election generally must be filed by the earlier of the date the dividend becomes payable and the date any part of it is paid. Canada

When the $5,000 capital dividend is paid, the accounting records will also reflect the dividend distribution, reducing retained earnings/equity as appropriate.

Why Does the CDA Exist?

The simple logic is:

If David owned the shares personally, only the taxable portion of the capital gain would be subject to income tax; the non-taxable portion would not become taxable merely because he withdrew the cash.

The CDA helps preserve similar treatment when the investment is owned through a private corporation.

So remember:

Capital gain → taxable portion → corporate investment tax + NERDTOH

Non-taxable portion → CDA → can potentially be paid to shareholder tax-free

This is the main difference between **Part 1 interest income** and **Part 2 capital gains**: interest generates investment income and NERDTOH, while a capital gain can generate **both NERDTOH and CDA**.

Part 3 – Canadian Dividends

A. Eligible Dividend

Eligible dividends are commonly received when the corporation owns shares of Canadian public companies such as banks. They are normally reported on a **T5**, with the actual eligible dividend shown in **Box 24**.

Assume ABC Inc. receives a **$10,000 eligible dividend from TD shares**.

What to Do in FutureTax

Step 1 – Schedule 125

Enter:

Dividend from Canadian source – GIFI code 8096: $10,000

Step 2 – Schedule 3

Open **S3 – Dividends Received**.

Enter:

- Connected corporation: **No**
- Type: **s.112**
- Taxable dividend: **$10,000**
- Eligible dividend: **$10,000**

FutureTax calculates:

Part IV tax: approximately $3,833

Step 3 – Check ERDTOH and GRIP

The $10,000 eligible dividend creates approximately:

ERDTOH: $3,833
GRIP: $10,000

GRIP means ABC Inc. now has the ability to pay up to approximately **$10,000 as an eligible dividend** to its shareholder, assuming there are no other GRIP adjustments. CRA includes eligible dividends received by a CCPC in its GRIP calculation. CRA – GRIP and eligible dividends

How It Works

The $10,000 dividend is generally deductible to ABC Inc. under **s.112**, so it is not taxed like interest income.

Instead:

$10,000 × 38⅓% = approximately $3,833 Part IV tax

The $3,833 is refundable and tracked in **ERDTOH**.

At the same time, because ABC Inc. received an eligible dividend:

$10,000 eligible dividend received → $10,000 GRIP

ABC Inc. can later pay David an eligible dividend. When sufficient taxable dividends are paid:

- the corporation can recover its **ERDTOH**
- the eligible dividend paid uses the corporation's **GRIP**
- David reports the dividend and pays personal dividend tax

Simple Way to Remember

Eligible dividend received → Part IV tax → ERDTOH

Eligible dividend received → GRIP

Eligible dividend paid → dividend refund + shareholder pays personal tax

The purpose is to allow eligible dividends to flow through a corporation without simply taxing the same corporate profit again at each corporate level.

B. Non-Eligible Dividend

A **non-eligible dividend from a non-connected Canadian corporation** works similarly to the eligible dividend above.

Assume ABC Inc. receives:

$10,000 non-eligible dividend from another CCPC

In **Schedule 125**, enter the $10,000 Canadian dividend income.

In **Schedule 3**, enter:

- Connected corporation: **No**
- Type: **s.112**
- Taxable dividend: **$10,000**
- Eligible dividend: **$0**

FutureTax calculates:

$10,000 × 38⅓% = $3,833 Part IV tax

The main difference from an eligible dividend is the refundable account:

Eligible dividend → $3,833 ERDTOH
Non-eligible dividend → $3,833 NERDTOH

When ABC Inc. later pays sufficient taxable dividends to its shareholder, the NERDTOH can generate a dividend refund.

Simple Rule

Non-connected eligible dividend → Part IV tax → ERDTOH

Non-connected non-eligible dividend → Part IV tax → NERDTOH

The immediate Part IV tax is the same; **the RDTOH account is different**.

C. Dividend from a Connected Corporation

Assume ABC Inc. owns **100% of CDE Inc.** and receives a **$10,000 taxable dividend** from CDE.

In **Schedule 3**:

- Connected corporation: **Yes**
- Type: **s.112**
- Taxable dividend received: **$10,000**
- Enter CDE's business number and tax year-end

The dividend is generally deductible under **s.112**, so ABC normally pays **no additional corporate income tax** on the dividend.

This allows dividends to **flow between connected corporations without being taxed again at each corporate level**.

Exception – CDE receives a dividend refund

If paying the dividend causes CDE to receive an **RDTOH dividend refund**, ABC may have corresponding **Part IV tax**.

The basic rule is:

Connected corporation pays dividend → normally no additional tax

If payer receives an RDTOH refund → Part IV tax may flow to the receiving corporation

So for a simple parent/subsidiary structure with no dividend refund involved, the $10,000 can generally flow from **CDE → ABC without additional corporate tax**.

I would change the title from **“reserve”** to **“How to Use Corporate Tax Accounts and Losses”**, because RDTOH, CDA and losses are different things.

Part 4 – How to Use Corporate Tax Accounts and Losses

1. NERDTOH

NERDTOH (Non-Eligible Refundable Dividend Tax on Hand) represents refundable corporate tax.

To recover it, the corporation generally pays **non-eligible taxable dividends** to its shareholders.

The dividend refund rate is:

38⅓% of the dividend paid, limited by the available NERDTOH.

Example:

If NERDTOH = **$1,000**:

$1,000 ÷ 38⅓% = approximately $2,609

Therefore, ABC Inc. needs to pay approximately:

$2,609 non-eligible dividend

to recover the full $1,000 NERDTOH.

Report the dividend on the shareholder's **T5 Box 10**.

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2. ERDTOH and GRIP

ERDTOH (Eligible Refundable Dividend Tax on Hand) works similarly.

If ERDTOH = **$1,000**:

$1,000 ÷ 38⅓% = approximately $2,609

ABC Inc. needs to pay approximately:

$2,609 eligible dividend

to recover the $1,000 ERDTOH.

Report the eligible dividend on **T5 Box 24**.

The corporation must also have sufficient **GRIP** to designate the dividend as eligible.

ERDTOH = refundable tax available

GRIP = how much eligible dividend the corporation can generally pay

CRA's dividend-refund rules use the 38⅓% rate and separate ERDTOH and NERDTOH balances. Canada

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3. Capital Dividend Account – CDA

CDA can allow the corporation to pay a **tax-free capital dividend** to a Canadian-resident shareholder.

Before paying the capital dividend:

- confirm the CDA balance
- complete the required corporate resolution/election
- file **Form T2054**

The capital dividend is generally **not taxable to the shareholder** and is not reported like a regular taxable dividend on a T5. Canada

CDA balance → capital dividend → generally tax-free to shareholder

Be careful not to pay more than the available CDA balance.

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4. Non-Capital Loss

Use **Schedule 4** to track and apply corporate losses.

A non-capital loss can generally:

Carry back 3 years
Carry forward 20 years

It can generally be used against taxable income, subject to the applicable rules. CRA confirms the 3-year carryback and 20-year carryforward periods. Canada

This can generate a refund if a current-year loss is carried back against taxable income from a previous year.

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5. Net Capital Loss

A net capital loss is more restricted.

It can generally only be used against **taxable capital gains**, not regular business or investment income.

It can generally:

Carry back 3 years
Carry forward indefinitely Canada

Simple Summary

Account / Loss	How to use it
NERDTOH	Pay non-eligible dividend → corporate tax refund
ERDTOH	Pay eligible dividend → corporate tax refund
GRIP	Allows eligible dividend designation
CDA	Pay capital dividend → generally tax-free to shareholder
Non-capital loss	Against taxable income; back 3 / forward 20 years
Net capital loss	Against taxable capital gains; back 3 / forward indefinitely