Manulife

Case studies

Tax, Retirement & Estate Planning Services

Corporate Class Mutual Funds in a Corporation

Scenario

For the past 10 years, Mike has owned and operated a local construction company that has become highly successful. Due to this success, Mike has built up significant after-tax profits within his corporation and finds himself facing a decision – withdraw these funds now and invest them personally or leave the funds in the corporation and find an attractive corporate investment.

Although Mike believes withdrawing the funds and investing them personally is a viable alternative, his advisor warns him he would have to deal with the immediate tax consequences of removing excess cash from the corporation which leads to having less cash in hand to make a lump sum investment.

Therefore, exploring alternatives for his corporation to make an investment with a larger lump sum deposit is an appealing option. This becomes even more significant if a corporation's annual passive income is $50,000 or more. For each additional $1 of passive income, the corporation's small business deduction (SBD) is reduced by $5. The SBD would reach $0 when passive income reaches $150,000. This effectively increases the amount of tax a corporation would pay on its first $500,000 of active business income.

Solution

Having Mike's corporation invest in corporate class mutual funds can defer taxes owing while helping to minimize the amount of investment income that is subject to the high passive corporate income tax rates.

How does it work?

The tax efficiency that a corporate class mutual fund can provide comes from the fact that a corporation cannot flow through income to investors, but only Canadian dividends, capital gains dividends or return of capital. From a tax perspective, it is generally beneficial for a corporation to realize capital gains rather than income. Furthermore, when capital gains dividends are received by a corporate investor, the non-taxable portion will be added to the corporation's Capital Dividend Account ("CDA") where money can be extracted by the shareholder tax-free.

What is the Capital Dividend Account?

The CDA is a notional account which assists in integrating the taxes payable between private corporations and individuals. The CDA allows a private corporation to accumulate certain tax-free receipts which can then be passed on tax-free to its shareholders.[1]

When a private corporation realizes a capital gain only 50 per cent of that gain is taxed. The untaxed portion can be added to the corporation's CDA. Similarly, 50 per cent of a capital loss would reduce the balance in the CDA. Since a private corporation can elect to pay out any positive balance in the CDA to its shareholders by way of a capital dividend, it is advisable to make the election to pay out a capital dividend soon after the account has a positive balance.

While some business owners recognize that life insurance proceeds may be paid out to shareholders tax-free through the CDA, they tend to be less aware of the opportunity to pay out the non-taxable portion of capital gains added to the CDA.

How do shareholders of a private corporation benefit from an investment in a corporate class mutual fund?

Since interest income does not qualify as an eligible addition to the CDA, business owners may be losing an opportunity to build their capital dividend account.

The ability of Manulife corporate class mutual funds to distribute income by way of capital gains dividends allows shareholders to include only 50 per cent of realized capital gains in income for tax purposes. With a private corporation investing in corporate class mutual funds, it will benefit from the lower tax rate associated with capital gains as well as flowing through the non-taxable portion of capital gains to its shareholders tax-free by way of the CDA.

[1] The CDA can be used to track the following: a) The excess of the non-taxable portion of capital gains realized by a corporation over the non-deductible portion of its capital losses, b) Capital dividends received by the corporation from other corporations, c) Non-taxable capital gains and capital dividend distributions from a trust, d) Proceeds of life insurance received by the corporation in excess of the adjusted cost base, and e) The non-taxable portion of the gains realized by the corporation on the disposition of eligible capital property (i.e. goodwill).

Example: Fixed Income Investment vs. Manulife Corporate Class Mutual Fund

The following example illustrates the after-tax cash to Mike comparing an investment in a fixed income investment vs. a Manulife corporate class mutual fund:

	Fixed Income Investment	Manulife Corporate Class Mutual Funds[2]
Investment	1,000,000	1,000,000
Estimated Rate of Return	2.5%	2.5%
Annual Income	25,000	25,000
Tax Treatment	Interest	Capital Gains
Corporate Taxes[3]	12,750	6,375
Cash Available for Taxable Dividend to Shareholders of Private Corporation	12,250	18,625
Capital Dividend Declared	n/a	(12,500)
Dividend Refund	7,667	3,834
Total Available Cash to be Paid as Taxable Dividend to Shareholders of Private Corporation	19,917	9,959
Personal Taxes[4]	7,967	3,984
Net Cash to Shareholders before CDA	11,950	5,975
Tax-Free Dividend from CDA	n/a	12,500
Net Cash to Shareholder after CDA	11,950	18,475
Difference / Percentage Increase		6,525 or 54.6%

The example illustrates how $25,000 of annual income is taxed differently in each scenario. In the case of the traditional fixed income investment, the income is taxed as interest, while the income generated by a Manulife corporate class mutual fund is taxed as a capital gain.

Outcome

Since the non-taxable portion of the capital gains dividends received from the corporate class investment can be added to the CDA and paid out as a tax-free capital dividend, the amount available as a taxable dividend to Mike is reduced by $12,500 before calculating the applicable dividend refund. This leaves $9,959 available as an ineligible dividend to be paid to Mike as the sole shareholder of the private corporation. In the scenario where the corporation invests in a traditional fixed income investment there is no opportunity to add funds to the CDA.

Once personal taxes on the resulting dividend are considered and the $12,500 tax-free capital dividend from the CDA is included, the result is a net distribution to Mike from the Manulife corporate class mutual fund investment that is 54.6 per cent higher than the net distribution that would have been received from a traditional fixed income investment.

Some benefits to consider when investing in a corporate class mutual fund include:

The pooling of expenses: A mutual fund corporation can offset the income and capital gains of one fund with the expenses and capital losses of another thereby potentially reducing or deferring taxable distributions to investors.

Tax efficient income: Since a corporation cannot flow through ordinary income (i.e. interest or foreign income), any net income or capital gains generated within a corporate fund may be paid out as tax efficient distributions to investors either in the form of an ordinary Canadian dividend, or a capital gains dividend (which is taxed at 50 per cent as a taxable capital gain).

[2] Assumes corporation is invested in a corporate class mutual fund that is not expected to distribute ordinary Canadian dividends
[3] Assumes 51% corporate tax rate.
[4] Assumes 40% personal tax rate on ineligible dividends paid from corporation to shareholder.

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For more information on Manulife's corporate class mutual funds and how they can help, speak to your advisor or refer to our related piece Tax Managed Strategy #21: Ideal Candidates For Mutual Fund Corporations (MK2529).

For more information contact your advisor or visit manulife.ca/investments

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