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What is RDTOH?

Many Canadian small business corporations can earn two kinds of income:

- Active business income eligible for the lower small business tax rate.
- Investment income in the form of interest, dividends and capital gains, taxed at high rates.

Refundable Dividend Tax on Hand (RDTOH) is an important tax concept that applies to investment income earned in a corporation. It's referred to in many of our life insurance concepts, such as the Corporate Retirement Strategy and the Corporate Investment Shelter. This article discusses what RDTOH is, why our tax system has it, and how it's calculated.

What is RDTOH?

RDTOH is a notional account produced when a Canadian private corporation earns "aggregate investment income"¹ and dividends from "unconnected" corporations (discussed in more detail below). Only a private Canadian corporation can generate an RDTOH account. Public corporations and non-resident corporations cannot.

Subsection 129(3) of the Income Tax Act (ITA) provides an extensive and complex definition of RDTOH. The Canada Revenue Agency (CRA) also publishes a guide, IT-243, "Dividend Refunds to Private Corporations", that helps explain RDTOH.

26.67% of a corporation's investment income plus an amount equal to the tax the corporation pays on dividends received from "unconnected" corporations are posted to the corporation's RDTOH account.

Investment income consists of taxable capital gains² minus business investment losses, plus income from property, such as interest, rent and royalties. This type of income is taxed to the corporation at high rates, approximately 50% (combined federal/provincial marginal rate) depending on the province where the corporation carries on business.

¹ For simplicity's sake, we'll use the term "investment income" throughout this bulletin instead of "aggregate investment income".

² Taxable capital gains are what you get from the sale of a capital asset, minus what you originally paid for it, minus any expenses you incurred in selling it, divided by two. Capital losses are calculated in a similar way and may be used to offset taxable capital gains.

Dividends from “unconnected” corporations are dividends received on the shares of corporations that the recipient corporation owns as an investment. A “connected” corporation, on the other hand, is a corporation that:

- owns the corporation receiving the dividend, or
- is owned by the corporation receiving the dividend, or
- has the same owner as the corporation receiving the dividend.

It's possible for dividends to flow tax-free between connected corporations, but whether a particular dividend being paid from one connected corporation to another is in fact tax-free should be discussed with a tax advisor.

Dividends from “unconnected” corporations are taxed to the recipient corporation at approximately 35% (combined federal/provincial marginal rate), again depending on the province, after grossing up the dividend and applying the federal and provincial dividend tax credits. An amount equal to the tax the recipient corporation pays on that dividend may be posted to that corporation's RDTOH account.

Integration

Corporations create RDTOH accounts to track the “extra” tax they are paying on investment income, and to preserve their right to claim a tax credit when they pay a taxable dividend to a shareholder. Why do they go to this trouble, and why do they get a tax credit? In a word, integration.

Integration is an important goal of Canada's tax system. When a tax system is perfectly integrated, the tax authorities will not care whether a shareholder earns income personally or as dividends from their corporation. They will collect the same amount of tax from taxing the corporation on its business earnings (and then taxing the shareholder on the dividends received from that corporation) as they would if the shareholder had earned the money personally.

A second goal is to discourage using corporations as tax shelters for investment income. Canada's tax system achieves that goal by taxing corporate earned investment income at high rates. If it were otherwise, investors could move money into corporations, benefit from the low tax rates generally available to small businesses, and partially defer taxes on their investment income.

But having a high corporate tax rate on investment income inhibits integration when a corporation distributes after-tax investment income to its shareholders. Consider what happens when a corporation pays its after-tax investment income as dividends. \$10,000 taxed at a 50% rate inside the corporation leaves \$5,000 to distribute to the shareholder as a dividend. If that \$5,000 dividend is taxed at 35% in the shareholder's hands (after the gross up and dividend tax credit), only \$3,250 remains after-tax for the shareholder. That amounts to a combined 67.5% tax rate on the original \$10,000. RDTOH tax treatment provides a tax credit for the corporation to help reduce that overall rate.

How RDTOH works

As discussed above, when a corporation earns investment income, it can post an amount equal to 26.67% of that income to its RDTOH account. Also, if a corporation earns a dividend from an unconnected corporation, and pays tax on that dividend, it can post an amount equal to the tax it has paid on that dividend to its RDTOH account.

If the corporation never pays a taxable dividend to its shareholders, the RDTOH account grows each year as the corporation earns investment income or dividends from unconnected corporations, and pays tax on those earnings. But having an RDTOH account only confers a benefit on the corporation if it pays a taxable dividend.

If the corporation pays a taxable dividend to its shareholders, it can claim a tax credit equal to \$1 for every \$3 it pays, up to the limit of its RDTOH account. There's no need for the dividend income to come from the corporation's investment earnings. As long as the dividend is taxable in the shareholder's hands, the corporation may claim the RDTOH credit.

The table at the end of this article shows the varying tax treatments that apply in the following situations (tax rates shown are approximations), and helps show how the RDTOH credit works:

- Personally-earned income from salary.
- Business income earned by a corporation to which the small business tax rate applies.
- Business and investment income earned by a corporation that benefits from the small business tax rate and uses the RDTOH credit.

Even though each scenario shows different types of income subject to different tax rates, there is nearly perfect tax integration, with each scenario showing nearly the same after-tax income and overall tax rate. In the far right column, corporate investment income is taxed at high rates, and the dividend is taxed at the same rate as the dividend paid by the corporation earning only small business income. But the RDTOH credit returns some of the money the corporation paid in high taxes on its investment income, so that the overall tax rate approximates that of the individual and the small business corporation.

Of course, the income mixes and tax rates shown in the table are well chosen. If you changed them across the three scenarios, you would reach different results, with greater or less tax integration. But the goal of integration is not to achieve perfectly equal tax rates in all scenarios, but to instead reduce the discrepancies that inevitably result from applying different tax rates to different types of income.

The lower rows in the table show what would happen if we removed the RDTOH tax credit. Overall after-tax income for the scenario showing corporate investment income (the far right column) falls from \$112,700 to \$96,500, while the overall tax rate on that income jumps from 44% to 52%. The two other scenarios are not affected by this change. High corporate investment tax rates therefore help discourage investors from using their corporations as investment shelters. For corporations that do earn investment income, though, the RDTOH tax credit reduces the overall level of taxation to a level comparable to that paid by those earning personal and business income, but only when the corporation pays a taxable dividend.

Summary

Canada's tax system tries to deter shareholders from using corporations as investment shelters by taxing corporate investment income at similar rates to those that a shareholder would pay. It also tries to integrate that income to negate the tax difference between money earned inside or outside of a corporation. The RDTOH account is an important tool that helps the tax system achieve both goals.

Every effort has been made to ensure the accuracy and currency of the information provided. However, any examples presented in this article are for illustration purposes only. No one should act upon these examples or information without a thorough examination of the tax and legal situation with their own professional advisors after the facts of the specific case are considered.

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Impact of RDTOH tax treatment			
	Personal income	Corporate business income – no RDTOH account	Corporate investment income – RDTOH account
INCOME			
Business		\$200,000	\$100,000
Personal	\$200,000		
Interest			\$33,000
Capital gains			\$34,000
Dividends			\$33,000
Total income	\$200,000	\$200,000	\$200,000
TAX			
15% on business income		\$30,000	\$15,000
45% on personal income	\$90,000		
50% on corporate interest income			\$16,500
50% on corporate capital gains (50% inclusion rate)			\$8,500
35% on dividends			\$11,550
Total tax	\$90,000	\$30,000	\$51,550
RDTOH ACCOUNT			
On investment income (26.67%)			\$13,335
On dividends			\$11,550
Total RDTOH account			\$24,885
PAID AS DIVIDEND			
35% tax on dividends		\$59,500	\$51,958
RDTOH tax credit (\$1 for every \$3 in dividends paid to a maximum of total RDTOH account)			\$24,885
RDTOH credit paid as dividend			\$24,885
35% tax on dividends			\$8,710
RDTOH credit			
Total after-tax income	\$110,000	\$110,500	\$112,668
Overall tax rate	45%	45%	44%
After-tax income without RDTOH	\$110,000	\$110,500	\$96,493
Overall tax rate without RDTOH	45%	45%	52%

Life's brighter under the sun

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