RETURN CHARACTER & AAII · FOR INCORPORATED ALBERTA PROFESSIONALS

Same Return. Different Tax Bill.

If your corporation invests its retained earnings, the character of those returns can materially change the corporation's current tax result. Here is how, in one number.

CORP. INVESTMENT ACCOUNT · A — STMT OF RETURN	
Return type	Interest income (illustrative)
Portfolio value	$1,500,000
Annual return	5.0%
Dollar return	$75,000
RETURN CHARACTER · INTEREST	
CORPORATE TAX THIS YEAR	$105,000

= RETURN ≠ TAX

CORP. INVESTMENT ACCOUNT · B — STMT OF RETURN	
Return type	Realized capital gain (illustrative)
Portfolio value	$1,500,000
Annual return	5.0%
Dollar return	$75,000
RETURN CHARACTER · CAPITAL GAIN	
CORPORATE TAX THIS YEAR	$72,500

Same **$75,000** *return on the same* **$1.5M** *— yet Account A pays* **$105,000** *in tax and Account B pays* **$72,500**. *In this simplified illustration, the variable being isolated is the* **tax character** *of the $75,000 return.*

+$32,500
MORE CURRENT CORPORATE TAX FOR ACCOUNT A, BEFORE ANY POTENTIAL DIVIDEND REFUND

WHO THIS MATTERS TO MOST

Incorporated business owners and professionals whose company holds investments. The more retained earnings invested inside the corporation, the larger the potential effect on its **current tax result.**

Illustrative composite — a fictional Alberta incorporated practice, simplified to isolate one variable: the **character** *of the same $75,000 return. Assume each corporation generated the same return character in the preceding year — which sets its current-year business limit — and earns it again this year for the passive-tax comparison. Both corporations also earn* **$500,000** *of active business income otherwise eligible for the 11% small-business rate. Figures are educational estimates, not a forecast; capital-gain returns cannot be guaranteed. Full assumptions and sources on page 4.*

PAGE 2 → *So why does one identical return cost more? It begins with a figure your statement never prints — your corporation's AAII, the number the tax system actually watches.*

01 The return is not the figure the tax system sees

A corporate statement reports one number at the top — the return. The tax system reads something else: how much of that return became **taxable investment income** this year.

That figure is the corporation's **adjusted aggregate investment income** — AAII — and it does not simply copy the headline return. The same $75,000 can enter AAII in full, in half, or not at all this year, depending only on its character and whether it was realized.

EXHIBIT 1 · ONE $75,000 RETURN, THREE TAX CHARACTERS

$75,000 economic return on the $1.5M portfolio — the same dollar figure in every case

IF INTEREST	IF REALIZED CAPITAL GAIN	IF UNREALIZED GROWTH
$75,000	**$37,500**	**$0**
enters AAII in full — fully taxable as earned	one-half inclusion — only the taxable half enters AAII	nothing enters AAII this year
		DEFERRED — NOT TAX-FREE

– Why the AAII figure matters: the $50,000 line

Once a corporation's AAII passes **$50,000**, its $500,000 small-business limit begins to shrink — **$5** of low-rate room lost for every **$1** of AAII above the line. By **$150,000** of AAII, the small-business deduction is gone entirely. This reduction sets the **current year's** limit and is based on the **preceding year's** AAII; here, each year is assumed the same.

EXHIBIT 2 · WHAT EACH RETURN CHARACTER LEAVES OF THE $500,000 SMALL-BUSINESS LIMIT

● INTEREST · AAII $75,000	● CAPITAL GAIN · AAII $37,500
$375,000	**$500,000**
limit remaining — $125,000 ground away ($75K − $50K × 5)	*full limit intact — AAII stays under the $50,000 line*

→ Where does that lost room go? The **$125,000** of business income that no longer qualifies for the small-business rate is taxed at **23% instead of 11%** — an additional **$15,000** of combined federal and Alberta corporate income tax on the operating business itself, on top of the tax on the investment income.

The point is not that one asset class is universally better. It is that return **character** *and* **realization timing** *change how much of the same return the tax system counts this year — and that figure reaches past the portfolio to the operating business itself.*

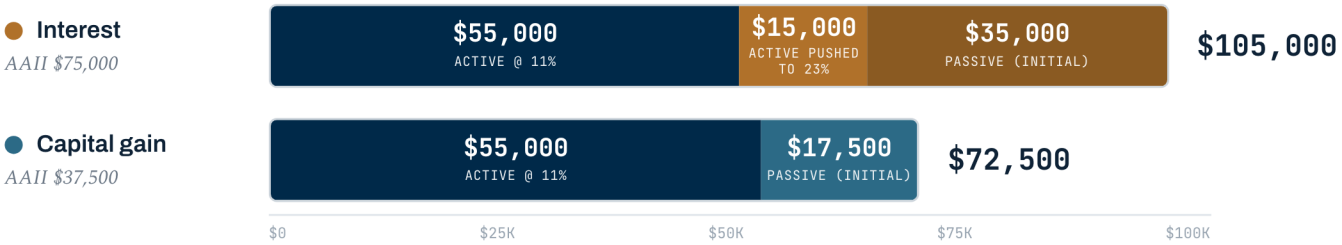
PAGE 3 → *That lost room is not abstract. Next we turn it into dollars — the tax on the investments, and the tax on the business itself.* →

02 The same return, two tax bills

The interest example pays more for two reasons at once. Its passive income carries a higher initial rate — and, because its AAII crossed the $50,000 line, **$125,000** of business income is pushed from the 11% small-business rate to the 23% general rate, adding **$15,000** of tax on a separate source: the operating business. In this illustration, the capital-gain example faces a smaller initial passive-tax amount and does not trigger the business-limit grind.

Each bar below is a corporation's **total current tax**, built up by source. The longer the bar, the more tax; the gap between them is the additional current corporate tax the interest example carries.

EXHIBIT 3 · CURRENT CORPORATE TAX, BUILT UP BY SOURCE — DRAWN TO SCALE

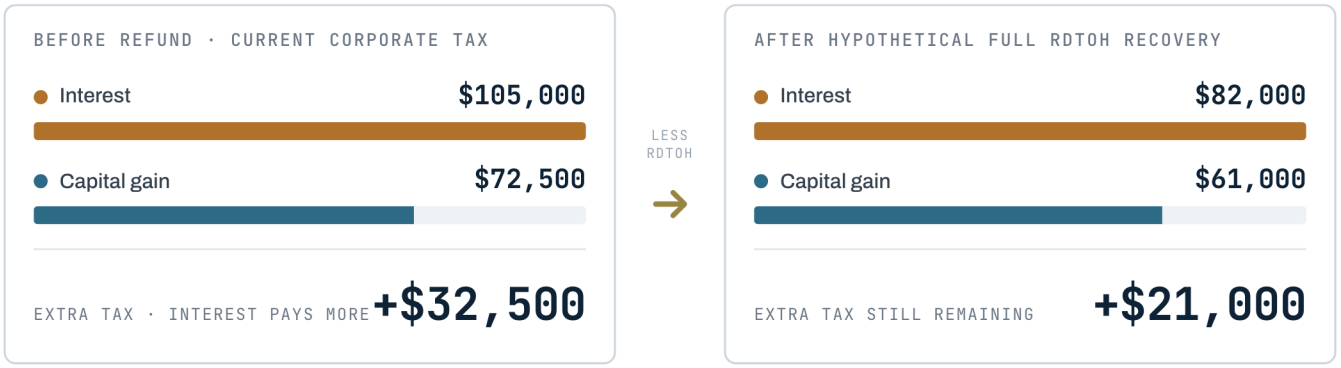


+$32,500 **more tax** for the interest example this year — additional current corporate tax before any potential dividend refund — on the same $1.5M portfolio earning the same 5%. Of that gap, **$15,000** falls on the operating business (the lost small-business room) and **$17,500** on the investment income itself.

– But part of that initial tax comes back

The high initial rate on passive income is not the whole story. A portion is **refundable** — set aside and returned to the corporation when it later pays enough taxable dividends to shareholders. The mechanism is **RDTOH**, and it narrows, but does not close, the gap.

EXHIBIT 4 · THE GAP BEFORE, AND AFTER A HYPOTHETICAL FULL REFUND OF REFUNDABLE TAX



Both figures are **extra tax the interest corporation pays**, *not the capital-gain one. Read two numbers, not one:* **+$32,500** *is the current cash gap before any refund;* **+$21,000** *is what still remains after assuming all refundable tax is recovered — neither including the personal tax on dividends. The non-taxable half of the gain (up to $37,500) may also add to the corporation's capital dividend account, subject to its full CDA calculation.*

PAGE 4 → *A similar gap can recur in years with comparable income, return character and realization patterns — and it is manageable. Here is the* **annual review** *that helps identify the trade-offs.* →

04 The annual corporate-portfolio review

The takeaway is not to chase capital gains or avoid interest — returns cannot be manufactured, and suitability, diversification, liquidity, and risk come first. It is that the corporate portfolio deserves a tax-character review alongside its performance review. Five questions frame that conversation each year.

01 **How much AAII** did the corporation — and any associated companies — generate last year? The grind generally uses the preceding year's figure.

02 **What was the return made of?** How much came from interest, dividends, realized gains, and unrealized growth?

03 **How much small-business-limit room** will remain next year at the current AAII level?

04 **What RDTOH balances exist,** and when might they realistically be recovered through taxable dividends?

05 **Does the portfolio's tax character** still fit the owner's liquidity, retirement, and distribution needs?

Two corporations, the same return — we help identify how return character, AAII and shareholder distributions interact.

This is exactly what Cochrane Wealth Management does for incorporated Alberta professionals: we review how the corporate portfolio's return character interacts with AAII, RDTOH, liquidity and planned shareholder withdrawals. We run the analysis on these pages against your real numbers and coordinate it with your accountant. **Cochrane Wealth Management does not provide tax or legal advice.**

RETURN CHARACTER | AAII | BUSINESS LIMIT | RDTOH | CORPORATE LIQUIDITY | SHAREHOLDER DRAWS

Greg Wood, CIM®
PARTNER · FINANCIAL ADVISOR · COCHRANE WEALTH MANAGEMENT

REQUEST A PORTFOLIO REVIEW →

SOURCE BASE

CRA — Corporation tax rates (federal general & small-business)

Government of Alberta — Corporate income tax guidance

CRA — T2 Corporation Income Tax Guide, Chapters 4 & 6

Income Tax Act — s. 38 (taxable capital gain), s. 123.3 (additional refundable tax), s. 129 (dividend refund / RDTOH)

IMPORTANT INFORMATION

This material is for general informational and educational purposes only and is not investment, tax, legal, insurance, or accounting advice. The corporation described is a hypothetical, anonymized composite created to illustrate how the character and timing of corporate investment income affect adjusted aggregate investment income (AAII) and the small-business limit; it does not represent any actual client, account, transaction, or typical result. All figures are illustrative approximations using simplified, single-corporation, top-of-structure assumptions with no investment expenses, losses, foreign income, or associated-corporation AAII.

AAII is calculated across associated corporations, and the business-limit reduction generally uses the preceding taxation year's AAII. Actual AAII and corporate tax depend on expenses, losses, dividends received, foreign income, and other adjustments. The ~46⅔% rate is an initial corporate rate on ordinary taxable investment income, part of which (the additional refundable tax and related amounts) may be recovered through the dividend refund when sufficient taxable dividends are paid; the ~30⅔% and refundable figures shown are illustrative. Capital gains cannot be manufactured or guaranteed, and tax-managed investing can alter the timing or character of taxable distributions but cannot eliminate investment risk. Personal tax payable by shareholders on dividends is outside this illustration. Capital dividend account additions are subject to the corporation's complete CDA calculation. The current one-half capital-gains inclusion rate is assumed throughout. Confirm every figure and structure with qualified tax and accounting advisors before acting. Raymond James advisors are not tax or legal advisors.

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