Investing Inside Your Corporation: What the Passive Income Rules Mean for Business Owners

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Many incorporated business owners in Ontario hold the view that keeping money inside the corporation and investing it there is always the better choice. It is an understandable assumption. Active business income inside a corporation is generally taxed at a lower rate than most owners pay personally, so leaving profits in the company can feel like the natural way to build wealth.

In our experience, however, the picture may change once those retained earnings start generating investment income. The tax rules treat passive investment income very differently from active business income, and a corporate investment approach that suited your circumstances a few years ago may no longer be the right fit.

There is no universal answer. Investing inside a corporation is not inherently good or bad, but it generally works best as a deliberate strategy rather than a default.

How investment income is taxed inside a corporation

Canada's tax system is built around a concept called integration: the tax paid by a corporation, combined with the tax paid personally when that money is paid out as dividends, is intended to roughly equal the tax you would have paid earning the same income personally.

For active business income, the small business deduction generally allows the first $500,000 a year to be taxed at a lower rate. In Ontario, that combined federal and provincial rate is 11.2% from July 1, 2026, after Ontario reduced its small business rate from 3.2% to 2.2%.[1]

Investment income is treated differently. Interest, foreign dividends and most rental income earned by a Canadian-controlled private corporation in Ontario are taxed at a combined federal and provincial rate of up to approximately 50%.[2] A portion of that tax is refundable, meaning it may be recovered when the corporation later pays taxable dividends to its shareholders. Other types of investment income follow their own rules:

- **Capital gains.** Generally only half of a capital gain is taxable. The untaxed half may be added to the corporation's capital dividend account, from which tax-free capital dividends may be paid to shareholders.
- **Canadian portfolio dividends.** Dividends from Canadian public companies are generally subject to a refundable tax of 38⅓%, which may be recovered when the corporation pays taxable dividends.

Because part of the tax on investment income is refundable, how and when dividends are paid out of the corporation can matter as much as the investments themselves.



The $50,000 passive income threshold

The federal government also limits access to the small business deduction for corporations that earn significant passive income. When a corporation, together with any associated corporations, earns more than $50,000 of adjusted aggregate investment income in a year,

its federal small business limit for the following year is reduced by $5 for every $1 above $50,000. At $150,000 of passive income, the federal small business limit is eliminated.[3]

Where that happens, the federal tax rate on the affected active business income may rise from 9% to the general rate of 15%.[2] Two details are often overlooked:

- **Associated corporations are counted together.** Moving investments into a holding company that is associated with your operating company generally does not avoid the rule, because the investment income of associated corporations is combined.
- **Ontario does not follow the federal rule.** Ontario does not reduce its own $500,000 small business limit for passive income, so only the federal portion of the tax on active business income is affected.

When retained cash becomes a cost

Earnings that sit in a corporate bank account, or in GICs and high-interest savings accounts, generally produce interest income. Interest is taxed at the corporate investment income rate described above, and it counts toward the $50,000 passive income threshold.

There may be other considerations as well:

- **The lifetime capital gains exemption.** For shares of a qualifying small business corporation to be eligible, generally at least 90% of the corporation's assets must be used in an active business at the time of sale, and at least 50% throughout the preceding 24 months.
- **Exposure to business risks.** Assets held inside an operating company may be exposed to claims against that business.

The goal is not to empty the corporation. Many business owners keep a cash reserve for sound reasons. The question is whether the amount held, and how it is invested, still fits your plan.



Signs your approach may need revisiting

There are a few practical indicators that suggest your current arrangement may no longer be the right fit:

- Your corporate bank balance consistently exceeds six months of operating expenses
- Most of your corporate investments sit in savings accounts, GICs or money market funds
- You have never had a formal conversation about corporate investment allocation
- Your passive corporate investment income is approaching or exceeding $50,000 a year
- You may be considering selling your business in the coming years

In addition to the above, there may be additional tax and non-tax considerations which can affect how and where retained earnings are invested.

Questions worth discussing

A review of your corporate investments may consider:

- The type of income your investments generate, since interest, dividends and capital gains are each taxed differently inside a corporation
- Where investments are held, whether in the operating company, a holding company or personally, including any registered plan room you have available
- How and when dividends are paid, which affects when refundable taxes may be recovered

- How your salary and dividend mix interacts with your corporation's investment income
- Whether the operating company's assets may need attention ahead of a possible future sale

Each of these depends on your specific circumstances, and a change to one can affect the others.

Where to start

If you have not reviewed your corporate investments alongside your tax position in the last two years, that is where we would suggest beginning. It is a conversation best had with your accountant and your Sun Life advisor together, so that tax, investments and your longer-term plan are considered as one.

Over-investing inside the corporation and accumulating too much retained cash are two of seven areas incorporated business owners commonly overlook. All seven are covered in our commentary, The Costliest Corporate Mistakes. To request a copy, email Chanelle Lindegaard at chanelle.lindegaard@sunlife.com.

If you would prefer to talk it through, we offer a complimentary 45-minute discovery call. We will help identify which of the seven areas may apply to your situation, whether or not we end up working together.

To arrange one, contact Chanelle Lindegaard at chanelle.lindegaard@sunlife.com or call the Ajax and Toronto office at 905-428-9996 ext. 2229.

Sources

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Rates cited are combined federal and Ontario rates current as of November 2026 and may change.

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