Wealth Management

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Passive investment income in a private corporation

On July 18, 2017, the government released a consultation paper proposing changes that were intended to remove the perceived unfair tax advantages available to owners of private corporations. One of the proposed changes targeted passive investments inside a corporation.

In October 2017, after a consultation period, the government announced that they were moving forward with the measures to limit the tax deferral benefits of holding passive investments within private corporations and that draft legislation for these measures would be included in the 2018 federal budget (the budget).

On February 27, 2018, the government released the budget. The government departed from their proposals originally outlined in the consultation paper and instead proposed two new measures to limit the tax deferral advantages:

1. Limiting access to the small business deduction (SBD) based on the amount of passive investment income earned in a corporation and any corporations associated with it.
2. Limiting access to a refund of high corporate taxes paid on passive investment income where dividends are paid from income taxed at lower corporate tax rates on active business income (ABI).

The details of the two new proposed measures are discussed in this article. These proposed measures do not directly impact taxes on passive investment income earned in a corporation. The tax rates applicable to investment income, refundable taxes and dividends remain unchanged.

Since, at the time of writing, the provinces have not yet announced whether they will apply the measure limiting access to the SBD for provincial tax purposes, the article primarily refers to federal tax rates.

Please contact us for more information about the topics discussed in this article.

Limiting access to the small business deduction

Currently, there is a tax deferral advantage for business owners who retain after-tax income in their corporation. This is because corporate business income is generally taxed at lower rates than business income earned personally. If an individual is in the highest marginal tax bracket and earns business income, this income is subject to tax at a federal tax rate of 33%. Canadian corporations, on the other hand, are subject to a general federal corporate tax rate of 15% on its ABI. In addition, if a corporation is a Canadian Controlled Private Corporation (CCPC) throughout a tax year, it may benefit from the SBD which lowers the federal tax rate on the first $500,000 of ABI (known as the "business limit"). The government announced in October 2017, and confirmed in the budget, that it intends to decrease the small business rate (the rate applicable on the first $500,000 of ABI) from 10.5% to 10% effective January 1, 2018 and to 9% effective January 1, 2019.

The business limit must be allocated among all corporations that are "associated". The concept of association is defined in the Income Tax Act (the Act) and will be explained in more detail later. Also, the business limit is reduced on a straight-line basis for a CCPC and its associated corporations where the group has between $10 million and $15 million of total taxable capital employed in Canada. The concept of taxable capital employed in Canada is beyond the scope of this article.

As a result of the lower corporate tax rates for ABI, incorporated business owners may have more after-tax money to invest inside their corporation. Due to the larger amount of starting capital to invest, a business owner may realize after-tax returns that exceed what an individual investor saving in a personal investment account can achieve. The longer the funds are left in the corporation, the higher the value of this "tax deferral advantage".

The government is concerned with this tax deferral advantage. As a result, the government is proposing to restrict access to the SBD for CCPCs that have significant income from passive investments. The government proposes to reduce the business limit on a straight-line basis where the CCPC and its associated corporations have between $50,000 and $150,000 of investment income in a year. The proposed measure would reduce the business limit by $5 for every $1 of passive investment income above the $50,000 threshold. The business limit would be eliminated if a CCPC, and its associated corporations, earn at least $150,000 of passive investment income in a year.

This proposed reduction to the business limit will apply to taxation years that begin after 2018. It will operate alongside the existing rules related to taxable capital between $10 million and $15 million. The reduction in a corporation's business limit will be the greater of the reduction based on taxable capital employed in Canada and the reduction based on passive investment income.

For the purposes of calculating the reduction to the business limit, investment income earned by a corporation will be measured by a new concept, known as "adjusted aggregate investment income" (AAII). AAII will generally include net taxable capital gains, interest income, portfolio dividends, rental income and income from savings in a life insurance policy that is not an exempt policy. AAII will exclude certain taxable capital gains (or losses) realized from the disposition of active business assets and shares of certain connected CCPCs. Corporations are connected to each other if one corporation controls the other or one owns more than 10% of the fair market value and voting shares of the other corporation. AAII will also exclude net capital losses carried over from other tax years and investment income that pertains to and is incidental to an active business (e.g. interest on short-term deposits held for operational purposes, such as payroll or to purchase inventory).

The test for accessing the SBD is an annual test that is based on passive investment income earned by a CCPC and any associated corporation in the taxation year that ended in the preceding calendar year. As a simple example, to determine a CCPC's SBD for its taxation year ended December 31, 2019, the corporation's AAII for its 2018 taxation year would need to be calculated. In this example we have assumed that the CCPC is not associated with any other corporations.

In a more complex situation, where a CCPC has an October 31 year end and an associated corporation has a June 30 year end, these rules would not apply to the CCPC until its taxation year ended October 31, 2020 because this is the first taxation year that begins after 2018. In determining its SBD for the taxation year ended October 31, 2020, it would need to calculate its AAII for the taxation year ended October 31, 2019 and the AAII for its associated corporation for its taxation year ended June 30, 2019 (even if this associated corporation is not a CCPC).

Since this is an annual test, it is possible that a corporation could regain access to the SBD if its passive investment income was high in one tax year but lower in another tax year.

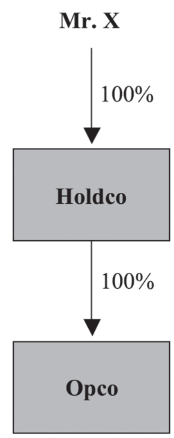
Association rules

As mentioned, the proposed reduction to the business limit for any particular corporation is based on the passive investment

The proposed reduction to the business limit for any particular corporation is based on the passive investment income of the corporation and any associated corporation.

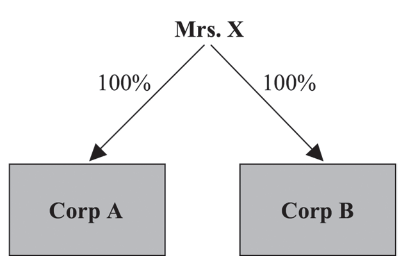
income of the corporation and any associated corporation. The concept of associated corporations is defined in the Act. The test for determining whether corporations are associated relies on the control of the corporations. A detailed discussion of the association rules is beyond the scope of this article but here are some examples of situations where two corporations may be associated:

Example A:



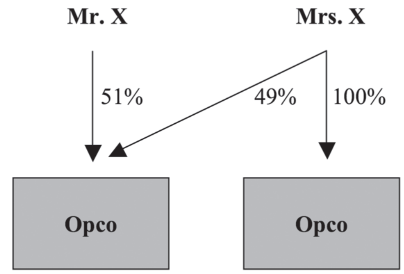
Since Holdco controls Opco, the two corporations are associated.

Example B:



Since Mrs. X controls both Corp A and Corp B, the two corporations are associated.

Example C:



Mrs. X owns 100% of a corporation. She also owns more than 25% of a class of shares of a corporation controlled by her spouse, Mr. X. The two Opcos are associated for tax purposes.

Mrs. X owns 100% of a corporation. She also owns more than 25% of a class of shares of a corporation controlled by her spouse, Mr. X. The two Opcos are associated for tax purposes.

Since the corporations in the examples above are associated, investment income earned in one corporation will impact the associated corporation's ability to access the business limit. As well, under existing tax rules, since they are associated, they will have to share the business limit.

Anti-avoidance rules have also been introduced in the budget to prevent transactions that are intended to avoid this measure, such as transferring or lending property to a related but unassociated corporation. If you or your family members own shares of different corporations, speak to a qualified tax advisor to determine whether these corporations are associated.

Implications of proposed measure limiting access to SBD

The proposed measure will only impact CCPCs that earn ABI, seek to claim the SBD and have passive investment income over $50,000. Moreover, it will only impact CCPCs to the extent that their ABI exceeds the reduced business limit. If the reduced business limit is still greater than the ABI earned by a corporation, the ABI will continue to be taxed at the small business tax rate. For example, a CCPC that has ABI of $100,000 but their reduced business limit is $400,000 will not be affected by this proposal. Their ABI of $100,000 will still be taxed at the small business tax rate. The proposed measure will not impact a holding company earning only passive investment income.

Appendix I provides a comparison under the current rules and the proposed rules of the federal taxes payable by a CCPC earning ABI below the business limit as well as passive investment income at various levels. As the proposed measures do not come into effect until the CCPC's first taxation year beginning in 2019, we have used the proposed federal small business rate of 9% for the purpose of this comparison.

Example of how the new SBD rules may impact business owners

Joe is a doctor. He is the sole shareholder of a medical professional corporation. Joe's corporation is not associated with any other corporations and the taxable capital employed in Canada does not exceed $10 million. The corporation earns $700,000 of ABI annually. Joe has also accumulated a $2 million portfolio of investments in his corporation, which generates a 6% investment return consisting of interest income and portfolio dividends ($120,000 of annual investment income).

Under the current tax rules, the first $500,000 of ABI earned in Joe's corporation would have been taxed at the federal small business tax rate of 9% resulting in $45,000 of federal taxes payable. Based on the proposed measure, beginning in 2019, the corporation's access to the SBD will be limited because of the passive investment income being generated in his corporation. For every dollar of passive investment income earned in excess of $50,000, the business limit will be reduced by $5. So if Joe's corporation earns $120,000 of passive investment income in the preceding tax year, the business limit for the current tax year will be reduced by $350,000 (reduction of business limit -- ($120,000-$50,000) x $5 = $350,000). This means that only $150,000 of ABI will be taxed at the small business rate. The remaining ABI will be taxed at the general federal corporate tax rate of 15%. As a result, Joe's corporation will pay $21,000 more in federal taxes on the first $500,000 of ABI.

Based on the proposed measure, Joe will have less after-tax dollars to invest in his corporation. However, Joe may still decide to leave the profits of his business inside his corporation to be taxed at the general federal corporate tax rate of 15% versus taking it out as a salary or bonus to be taxed at 33%, assuming Joe is subject to the highest federal personal tax rate. This is still a significant tax deferral. This also assumes that Joe does not need the funds personally now or in the near future.

Potential strategies and investment solutions

If you are the owner of a CCPC, consider how this proposed measure will impact your corporation. If your corporation (together with any associated corporations) has significant passive assets and you are concerned that the annual passive investment income earned on these assets will exceed $50,000 and impact your corporation's ability to claim the SBD, speak to a qualified tax advisor about any actions you should take as well as potential investment and asset allocation strategies going forward.

If your corporation has long-term investments with accrued gains or engages in a buy and hold strategy, it may make sense to dispose of these investments slowly over time to avoid a grind to the business limit. Alternatively, your corporation may want to dispose of all these securities with unrealized gain in one particular tax year. This may impact your corporation's ability to access the SBD in the following tax year; however, you may be able to regain access to the SBD in a future tax year as the $50,000 threshold is an annual test and your corporation may have less investment income in a future year.

In terms of choosing passive investments, your corporation may want to consider investing in a portfolio of investments that produce deferred capital gains (e.g. non-dividend paying stocks) as opposed to interest income. Only half of a capital gain is taxable and would be included as part of the $50,000 threshold. Your corporation may also wish to consider exchange traded funds or mutual funds that do not make annual distributions or that generate tax-free return of capital (ROC) distributions. Generally from a tax perspective, it is better to hold ROC investments personally. However, if your passive investment portfolio is already inside your corporation, earning non-taxable ROC on your passive investments would not be included in your AAII. When the investment is eventually sold, it results in a capital gain, only half of which would be included in the calculation of AAII. ROC distributions are not withdrawn from your corporation tax-free.

Another option may be to invest in a permanent life insurance policy, if you have an insurance need and will likely never need these assets in your lifetime. The government has stated that income from a non-exempt life insurance policy will be included as part of the $50,000 passive investment income threshold. Income earned in an exempt life insurance policy, however, is not included in the calculation of AAII.

In certain circumstances, it may make sense for your corporation to set up a registered pension plan, such as an Individual Pension Plan (IPP). Funds contributed to an IPP are held separate from the corporation's assets. Income earned in the IPP is tax-deferred until withdrawn and would not be subject to these proposed measures.

All of these potential strategies have benefits and costs which must be analysed before implementing. Speak to a qualified tax advisor to determine if any of these strategies or investment solutions makes sense for you.

Refundability of taxes on investment income

Under the current tax regime, when a private corporation (not just a CCPC) earns passive investment income, it is subject to tax on this income at a rate that is higher than the rate applicable to ABI. The federal tax rate on investment income is currently 28%. A private corporation is also subject to an additional refundable tax of $10\frac{2}{3}\%$ on this investment income for a total federal tax of $38\frac{2}{3}\%$. A portion of the total tax paid is refundable to the corporation when taxable dividends are paid out to the shareholders. The refundable portion is calculated as $30\frac{2}{3}\%$ of the investment income.

Canadian dividends earned in a corporation are not subject to regular corporate tax. However, they are subject to special refundable tax rules. Dividends received from Canadian corporations that are not connected are subject to a special refundable tax at $38\frac{1}{3}\%$. This entire tax is refundable to the corporation once taxable dividends are paid out to the shareholders. Dividends received from connected corporations are generally not subject to this special tax unless the paying corporation received a dividend refund when it paid the dividends.

The refundable portion of tax paid by a private corporation is added to the corporation's refundable dividend tax on hand (RDTOH) account and is refundable at a rate of $38.33 for every $100 of taxable dividends paid to its shareholders (to the extent there is a positive balance in the RDTOH account). The RDTOH is a notional account that keeps track of the refundable taxes paid by the corporation which are on deposit with the Canada Revenue Agency.

The purpose of the refundable tax mechanism is to discourage individuals from using a corporation to earn passive investment income and defer tax. The tax paid by a private corporation on passive investment income approximates the amount of tax an individual subject to tax at the highest marginal tax rate would pay personally on investment income.

When a corporation pays out a taxable dividend to its shareholder, the corporation may receive an RDTOH refund (called a "dividend refund") regardless of whether the dividend paid is an eligible or non-eligible dividend.

An eligible dividend can only be paid by a private corporation to the extent the corporation has ABI that has been taxed at the general corporate tax rate or to the extent that it received eligible dividends from another corporation. Depending on their province of residence, an individual in the highest tax bracket receiving an eligible dividend in 2018 will pay between 29% and 43% combined federal and provincial tax on the dividend.

An eligible dividend can only be paid by a private corporation to the extent the corporation has ABI that has been taxed at the general corporate tax rate or to the extent that it received eligible dividends from another corporation.

A taxable dividend that cannot be designated as an eligible dividend is paid as a non-eligible dividend. Generally, ABI that was taxed at the small business tax rate or passive investment income (excluding eligible dividends received from other corporations) would give rise to income that would be paid as a non-eligible dividend. An individual in the highest tax bracket receiving a non-eligible dividend in 2018 will pay between 36% and 48% combined federal and provincial tax on the dividend, depending on their province of residence. Appendix II provides a table of the 2018 combined federal and provincial tax rates on eligible and non-eligible dividends for individuals in the highest tax bracket.

Under current tax rules, a corporation can receive a dividend refund upon the payment of a preferentially taxed eligible dividend out of income that was not subject to the refundable tax mechanism, where the corporation's RDTOH was generated from investment income that would normally need to be paid out as a non-eligible dividend. This is perceived by the government as an unfair tax deferral advantage.

To address this issue, the government is proposing that a private corporation only receive a dividend refund on the payment of non-eligible dividends. An exception will be provided where the RDTOH arises from eligible dividends received by the corporation on portfolio investments. In this case, the corporation will still be able to obtain a dividend refund upon the payment of eligible dividends.

In order to implement this proposal, the current RDTOH account will now be referred to as the "non-eligible RDTOH" account and will track refundable taxes paid on passive investment income (excluding eligible dividends received by the corporation). This account will also track non-eligible dividends received from non-connected corporations. A corporation will only be able to obtain a refund from the non-eligible RDTOH account upon the payment of a non-eligible dividend.

A new RDTOH account known as the "eligible RDTOH" account will be introduced to track refundable taxes paid on eligible portfolio dividends. Any taxable dividend (eligible or non-eligible) paid by a corporation will entitle the corporation to a refund from its eligible RDTOH account. However, an ordering rule requires that a private corporation paying a non-eligible dividend must exhaust its non-eligible RDTOH account before claiming a refund from its eligible RDTOH account.

Currently, if a corporation obtains a dividend refund when it pays a taxable dividend to a connected corporation, the recipient corporation is subject to a special refundable tax. Under the proposed measure, this special refundable tax will be added to the same RDTOH account from which the payor corporation received the refund.

The proposed measure relating to the refundability of taxes on investment income will apply to tax years beginning after 2018. Transitional rules have been introduced to deal with a corporation's existing RDTOH balance. For a CCPC, the lesser of its existing RDTOH balance and an amount equal to 38 1/3% of the balance of its general rate income pool, if any, will be allocated to its eligible RDTOH account. The general rate income pool is a pool that keeps track of ABI that was taxed at the general corporate tax rate. Any remaining balance in its existing RDTOH account will be allocated to the CCPC's non-eligible RDTOH account. For any other corporation, all of the corporation's existing RDTOH balance will be allocated to its eligible RDTOH account.

If your corporation is not impacted by the proposed measure limiting the SBD, investing in securities that pay eligible dividends is still the most tax neutral. This is because the tax paid by the corporation on eligible dividends is fully refundable to the corporation when the dividends are paid out to a shareholder. The shareholder then pays personal tax on the dividend received, resulting in only one level of tax.

Conclusion

In light of these proposed measures, you may want to review your corporation's investment portfolio with an RBC advisor and a qualified tax advisor. If you hold significant passive investments inside your CCPC, your investment strategy may change to one that has the least impact on the reduction to the SBD.

Appendix I

Federal Corporate Income Tax Payable on Active Business Income

This table illustrates the federal taxes payable by a CCPC in 2019 on its active business income where the corporation is earning various amounts of passive investment income under the current rules and the proposed rules. This is a proposed federal tax measure and, at the time of writing, the provinces have not yet announced whether they will apply the measure limiting access to the business limit for provincial tax purposes. Therefore, this illustration provides only the federal tax payable and does not include provincial taxes.

	Passive Income					
	$50,000		$100,000		$150,000	
Active Business Income	Current Rules	Proposed Rules	Current Rules	Proposed Rules	Current Rules	Proposed Rules
$50,000	$4,500	$4,500	$4,500	$4,500	$4,500	$7,500
$100,000	$9,000	$9,000	$9,000	$9,000	$9,000	$15,000
$150,000	$13,500	$13,500	$13,500	$13,500	$13,500	$22,500
$200,000	$18,000	$18,000	$18,000	$18,000	$18,000	$30,000
$250,000	$22,500	$22,500	$22,500	$22,500	$22,500	$37,500
$300,000	$27,000	$27,000	$27,000	$30,000	$27,000	$45,000
$350,000	$31,500	$31,500	$31,500	$37,500	$31,500	$52,500
$400,000	$36,000	$36,000	$36,000	$45,000	$36,000	$60,000
$450,000	$40,500	$40,500	$40,500	$52,500	$40,500	$67,500
$500,000	$45,000	$45,000	$45,000	$60,000	$45,000	$75,000

Notes:

- assumes the corporation has less than $10 million of taxable capital
- small business rate is 9%
- general corporate rate is 15%
- passive investment income of $50,000 results in no reduction to the business limit
- passive investment income of $100,000 results in a reduction to the business limit of $250,000
- passive investment income of $150,000 or more results in an elimination of the business limit

Appendix II

Combined Federal and Provincial Tax Rates on Eligible and Non-Eligible Dividends

Please contact us for more information about the topics discussed in this article.

This table illustrates the combined federal and provincial personal tax rates for eligible and non-eliglble dividends for 2018. The tax rates assume an individual is subject to tax at the highest marginal tax rate in their province of residence.

	Eligible	Non-Eligible	Difference
Alberta	31.71%	41.64%	9.93%
British Columbia	34.20%	43.73%	9.53%
Manitoba	37.78%	45.92%	8.13%
New Brunswick	33.51%	46.88%	13.38%
NL and Labrador	42.61%	43.81%	1.20%
Nova Scotia	41.58%	47.34%	5.76%
Nunavat	33.08%	36.78%	3.70%
NWT	28.33%	35.98%	7.65%
Ontario	39.34%	46.84%	7.50%
PEI	34.22%	44.25%	10.03%
Quebec	39.83%	43.94%	4.11%
Saskatchewan	29.64%	39.76%	10.11%
Yukon	28.93%	41.42%	12.50%

Wealth Management