Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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Passive investment income in a private corporation

In 2017, the federal government released a consultation paper proposing changes that were intended to remove the perceived unfair tax advantages available to owners of private corporations. As a result of the consultation process, in 2018, the government enacted the following two measures to limit the tax deferral advantages related to private corporations:

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 these two measures are discussed in this article. These 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.

Please note that this article primarily refers to federal tax rules and rates. At the time of writing, Ontario and New Brunswick have confirmed they will not limit access to the SBD due to passive investment income in a corporation for provincial tax purposes. You should consult with a qualified tax advisor to determine the rules relating to a specific province/territory.

Limiting access to the SBD

There may be 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%. A Canadian corporation, on the other hand, is 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 can lower the federal tax rate on the first $500,000 of ABI (known as the "business limit").

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

This measure reducing the business limit applies to taxation years that begin after 2018. It operates alongside the rules related to taxable capital between $10 million and $15 million. The reduction in a corporation's business limit is the greater of the reduction based on taxable capital employed in Canada and the reduction based on passive investment income.

There may be a tax deferral advantage for business owners who retain after-tax income in their corporation.

For the purposes of calculating the reduction to the business limit, you need to determine the corporation's "adjusted aggregate investment income" (AAII), which consists of certain types of investment income earned by the corporation. AAII generally includes net taxable capital gains, interest income, portfolio dividends, rental income and income from savings in a life insurance policy that's not an exempt policy. AAII excludes 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 also excludes 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 based on AAII 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, it's 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 have applied to the CCPC until its taxation year ended October 31, 2020, because this was the first taxation year that began 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).

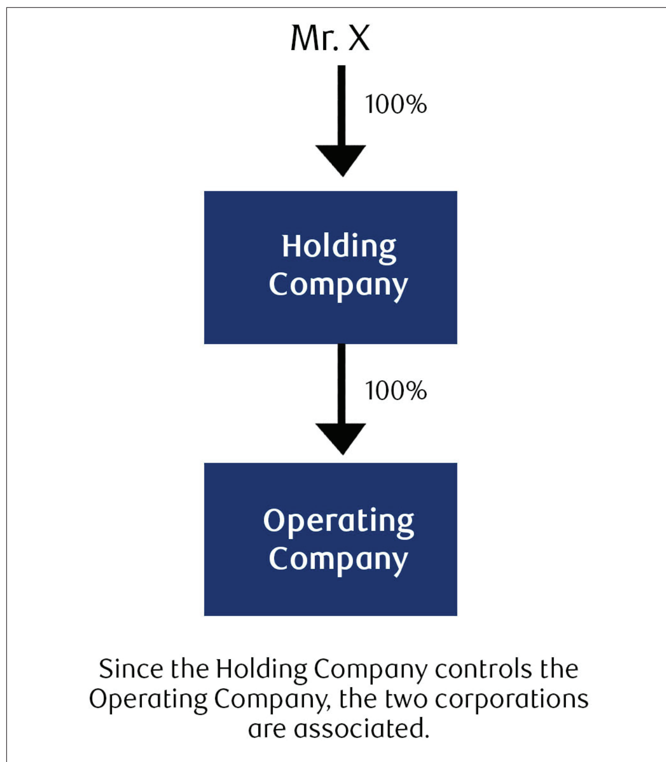
Since this is an annual test, it is possible that a corporation could regain access to the SBD if its passive investment income was high in one tax year but lower in another tax year.

Association rules

As mentioned, the reduction to the business limit for any particular corporation is based on the AAII of the corporation and any associated corporation. The concept

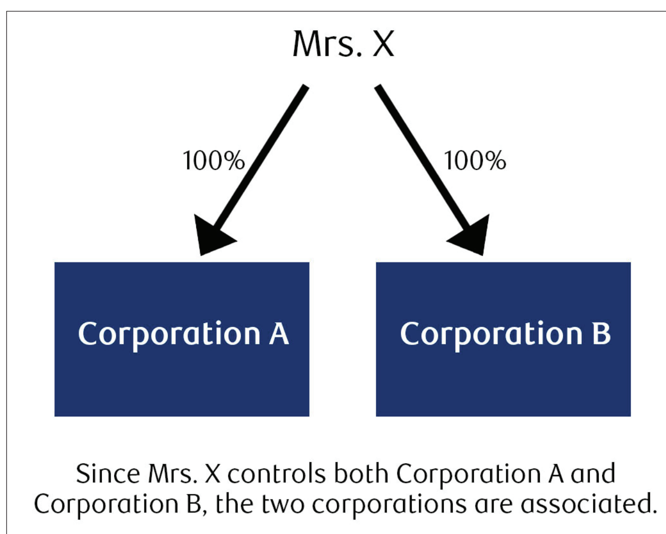
of associated corporations is defined in the Act. The test for determining whether corporations are associated relies on the control of the corporations. A detailed discussion of the association rules is beyond the scope of this article, but here are some examples of situations where two corporations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

Example A:



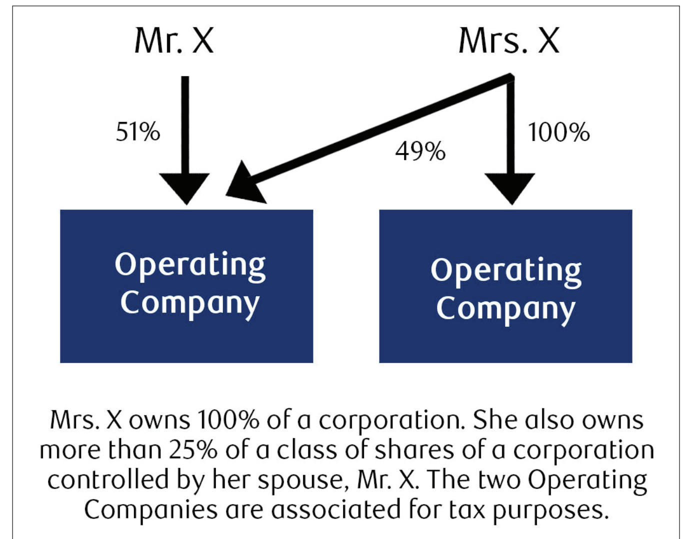
Since the Holding Company controls the Operating Company, the two corporations are associated.

Example B:



Since Mrs. X controls both Corporation A and Corporation 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 Operating Companies are associated for tax purposes.

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

Anti-avoidance rules were also introduced in 2018 to prevent transactions 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 measure limiting access to SBD

This measure only impacts CCPCs that earn ABI, seek to claim the SBD and have AAII over $50,000. Moreover, it only impacts 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 and a reduced business limit of $400,000 will not be affected by these rules. The corporation's ABI of $100,000 will still be taxed at the small business tax rate. This measure also does not impact a holding company earning only passive investment income.

Example: How these SBD rules may impact business owners

Joe is a doctor. He's 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% annualized investment return consisting of interest income and portfolio dividends ($120,000 of AAII).

If Joe's corporation earned less than $50,000 of AAII, 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. However, since Joe's corporation earned $120,000 of AAII, the corporation's access to the SBD will be limited. For every dollar of AAII earned in excess of $50,000, the business limit will be reduced by $5. So, the small business limit for Joe's corporation will be reduced from $500,000 by $350,000 [($120,000 - $50,000) x $5 = $350,000]. This means 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.

As a result of this measure, Joe will have fewer 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 assumes Joe does not need the funds personally now or in the near future.

Potential strategies and investment solutions

If you're the owner of a CCPC, consider how this measure impacts your corporation. If your corporation (together with any associated corporations) has significant passive assets and you're 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 of these securities with unrealized gains 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's 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 the corporation's AAII. When the investment is eventually sold, this may result 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. Income from a non-exempt life insurance policy is 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 measures.

All of these potential strategies have benefits and costs, which must be analyzed 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

When a CCPC earns passive investment income (not including taxable Canadian dividends), it's subject to a general rate of tax on this income that's close to the highest personal marginal tax rate. 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 2/3% of the investment income and is referred to as the "refundable portion of Part I tax".

Taxable Canadian dividends earned in a corporation are not subject to regular corporate income tax. Specifically, taxable Canadian dividends received by a private corporation are subject to special refundable tax rules. Dividends received by a private corporation from Canadian corporations, that are not connected, are subject to a

special refundable tax at 38 1/3%, called Part IV tax. This tax is refundable to the private corporation once taxable dividends are paid out to the shareholders. Dividends received from connected corporations are generally not subject to Part IV tax unless the paying corporation received a dividend refund when it paid the dividends.

The refundable portion of Part I tax and the Part IV tax are 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's a positive balance in the RDTOH account). The RDTOH is a notional account that keeps track of the refundable taxes paid by the corporation.

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 CCPC 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.

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 or territory of residence, an individual in the highest tax bracket receiving an eligible dividend in 2021 will pay between 28% and 43% combined federal and provincial/territorial tax on the dividend.

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 2021 will pay between 36% and 49% combined federal and provincial and territorial tax on the dividend, depending on their province or territory of residence.

In the past, when a corporation paid out a taxable dividend to its shareholder, the corporation could have potentially received an RDTOH refund (called a "dividend refund") regardless of whether the dividend paid was an eligible or non-eligible dividend. As such, a corporation could 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 was perceived by the government as an unfair tax deferral advantage.

To address this issue, the government introduced rules in 2018 that only allow a private corporation to receive a dividend refund on the payment of non-eligible dividends. An exception is provided where the RDTOH arises from eligible dividends received by the corporation on portfolio investments. In this case, the corporation is able to obtain a dividend refund upon the payment of eligible dividends.

In order to implement these rules, the corporation's previous RDTOH account became the "non-eligible RDTOH" account. This account tracks refundable taxes paid on passive investment income (excluding eligible dividends received by the corporation). It also tracks refundable taxes paid on non-eligible dividends received from non-connected corporations. A corporation is only able to obtain a refund from the non-eligible RDTOH account upon the payment of a non-eligible dividend.

A second RDTOH account known as the "eligible RDTOH" account was introduced and is used 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.

If a corporation obtains a dividend refund when it pays a taxable dividend to a connected corporation, the recipient corporation is subject to Part IV tax. This refundable Part IV tax is added to the same type of RDTOH account from which the payor corporation received the refund.

The measure enacted by the government in 2018 relating to the refundability of taxes on investment income applies to tax years beginning after 2018. Transitional rules were introduced to deal with a corporation's existing RDTOH balance at the time the measure first applied to the corporation. 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, would have been 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 would have been allocated to the CCPC's non-eligible RDTOH account. For any other corporation, all of the corporation's existing RDTOH balance would have been allocated to its eligible RDTOH account.

Conclusion

In light of these rules, you may want to review your corporation's investment portfolio with your 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.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.

Wealth Management

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