Wealth Management

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Taxation of business income in a corporation

On July 18, 2017 the federal government released a consultation paper proposing a number of strategies which target private corporations with regards to income splitting, multiplication of the lifetime capital gains exemption, holding a passive investment portfolio inside a private corporation, and converting a private corporation's regular income to capital gains.

Generally, effective for 2018 and later taxation years, the government has proposed to limit income sprinkling to family members receiving "reasonable" compensation from a private corporation. The proposed measures extend the tax on split income rules (often known as "kiddie tax") to adults and limit the multiplication of claims to the lifetime capital gains exemption.

The government is also seeking input on possible measures to eliminate the tax advantage of investing undistributed earnings from an active business in a private corporation. If enacted, these measures may result in a disincentive for investing passively within a corporation.

The strategies discussed in this article may be affected by the proposed measures in the consultation paper and the accompanying proposed legislation. If you are an owner of a private corporation you should consider the potential impact of the proposed measures and discuss the implications with your qualified tax advisor.

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

As a business owner, you most likely rely on the income generated by your corporation's business to fund your lifestyle. You may also hope that your business accumulates sufficient capital to meet your income needs in retirement. As a starting point, you may want to be familiar with the rules governing the taxation of business income inside your corporation. Understanding how business income is taxed will provide you with the insight for making informed decisions about what to do with any surplus cash resulting from your business. The purpose of this article is to review the benefits of operating a business inside a corporate structure, describe the various facets of business income and explain how business income is taxed in a corporation.

The terms 'corporation' and 'company' are used interchangeably to refer to a Canadian-controlled private corporation (CCPC) in this article. In simple terms, a CCPC is a Canadian corporation that is not controlled by a non-resident of Canada or a public corporation or a combination of both. In addition, no class of shares of a CCPC can be listed on a prescribed stock exchange. This article does not apply to public corporations or to businesses operating as a partnership or a sole proprietor.

The tax rates referenced in this article are current as of May 2017 and are based on federal and provincial legislation.

The small business deduction

Canadian corporations are subject to a general federal corporate tax rate of 15% on its active business income (ABI) earned in Canada. If your corporation is a CCPC throughout the tax year, it may benefit from the small business deduction (SBD) which lowers the federal tax rate to 10.5% on the first $500,000 of ABI. All provinces and territories also have a small business limit of $500,000, except for Manitoba which has a limit of $450,000. Both the federal and provincial small business limits must be shared by associated CCPCs. Associated corporations are defined in the Income Tax Act (Act), but the definition is complex and is beyond the scope of this article.

> Here is an example of how a CCPC benefits from the small business deduction. Let's assume a CCPC earns ABI of $750,000 for its fiscal period ending on December 31. For federal purposes, the taxable income eligible for the SBD of $500,000 will be taxed at the small business rate of 10.5%. The $250,000 balance will be taxed at the federal general rate of 15%.

The small business limit is reduced for larger CCPCs whose taxable capital employed in Canada (generally equal to a company's retained earnings, share capital and long-term debt) exceeds $10 million for the preceding year. If the company's taxable capital is between $10 million and $15 million, the taxable income eligible for the small business rate is proportionately reduced. If a company's taxable capital exceeds $15 million, it does not qualify for the SBD. This means that all of the company's income would be taxed at the higher general corporate tax rate. These limits are also determined on an associated group basis.

Tax rate advantage or disadvantage

One important principle of the Canadian tax system is a concept commonly referred to as "integration". Integration is the idea that an individual should pay the same amount of tax whether the income is earned personally or through a corporation. Under the current tax rates, integration is not quite perfect and there is currently an advantage or disadvantage to earning business income in a corporation and then paying a dividend you, the shareholder versus you earning the business income personally. This tax rate advantage or disadvantage depends on whether the business income was taxed at the small business rate or at the general rate as well as your province or territory of residence.

For the current tax rates across all provinces and territories, please ask your RBC advisor for the tax tables titled 'Corporate, Integrated and Personal Tax Rates on Active Business Income'. The tables show the corporate tax rates on ABI, both below and above the small business limit, and include the integrated corporate and personal tax rates when the income is distributed to the shareholders as a dividend. For comparative purposes, these tables also provide the tax rate for income if it was earned personally and assumes that the individual shareholders are taxed at the top marginal tax rate. Therefore, you can use these tax tables to determine the tax rate advantage or disadvantage in your province or territory of residence.

The tax rate advantage or disadvantage will also differ depending on whether salary or dividends are paid from the corporation. Salary is generally taxable to you as income and is deductible for the corporation. In essence, salary income is taxed as if you earned the business income personally. For example, using the previously mentioned tax tables, it can be determined that for income above the small business limit, paying a salary from the corporation rather than dividends would result in lower overall taxes in every province and territory.

Tax-deferral

Perhaps the most significant advantage of operating your business within a corporation is the ability to defer taxes. This is because business income earned within a corporation is taxed at two levels – once at the corporate level and then again at the personal level when the income is distributed. You can defer personal taxation on the after-tax business income until the time you withdraw it from your corporation. The low tax rates on ABI provide a significant advantage since it allows more funds (the deferred taxes) to accumulate within your corporation, which can then be used to invest and earn additional income. The longer you can leave the funds in your corporation, the higher value of the deferral advantage. If you had operated your business personally, you would be taxed on all of the business income at your marginal tax rate, which would likely be substantially higher than the small business rate or the general corporate tax rate.

It is important to note that in the 2017 federal budget, the government identified certain strategies involving private corporations that they believe provide an unfair tax advantage to high-income individuals. One of these strategies involves holding a passive investment portfolio inside a private corporation. The government intends to release a paper in the coming months setting out the nature of these issues in more detail as well as proposed policy responses.

Active business income

ABI is income that is generated from a business source and includes any income incidental to your business. For example, if you own a CCPC that operates an ice skates manufacturing business, any income derived from selling the ice skates or replacement parts is considered ABI. If you sell your ice skates on credit and earn interest on your accounts receivables, the interest would be considered incidental to the business and be ABI as well.

When you have surplus cash in your corporation and you have determined the business will need the funds at some point in the short-term (e.g. working capital), you may consider investing the excess funds within your corporation in order to maximize the value of your surplus cash. The investment income generated from this surplus cash may be considered incidental to your business and therefore be taxed as ABI since the cash is required for a business purpose.

ABI could also include profits earned from an adventure or concern in the nature of trade. This is a general principal that if a person or corporation usually performs an activity which could generate a profit, then they are carrying on a trade or business even if these activities may be separate and apart from their ordinary business. Using the previous example, if your corporation's main business is manufacturing ice skates but it habitually buys and sells real estate, its real estate endeavours may be considered an adventure or concern in the nature of trade and the gains derived from buying and selling real estate will be considered ABI.

ABI typically does not include investment income since investment income is generally considered passive income. ABI also generally does not include income from a specified investment business (SIB), or income from a personal services business (PSB). Each of these terms are discussed more in detail in the following sections.

Investment income

In general, investment income (which includes dividend income, interest income, foreign income, rental income, royalty income and taxable capital gains) earned in a corporation is taxed as passive income. This is especially the case where funds accumulated in the corporation are invested from after-tax profits that are in excess of what is required to operate the business. Whether this surplus cash is invested in your operating company or your holding company, it would be taxed as passive income. For an explanation of how passive income is taxed inside a corporation, please refer to the article on the "Taxation of Investment Income in a Corporation".

Specified investment business

In general, income from a SIB is not considered to be ABI. A SIB is a corporation whose principal purpose is to generate income from property (including interest, dividends, rents, and royalties). For example, a company with two employees that owns a property and rents out the property to tenants could be considered a SIB if the company's sole purpose is to earn rental income. If a corporation carries on a SIB, any SIB income it earns is taxed as investment income and not eligible for the SBD.

Not all corporations that earn solely investment income are considered an SIB. A corporation would not be an SIB and its income could be considered ABI and eligible for the SBD if:

- the corporation employs more than five full-time employees in the business throughout the year; or
- an associated corporation provides managerial, financial, administrative, maintenance, or other similar services to the CCPC while carrying on an active business and the CCPC would have to engage more than five full-time employees to perform these services if the associated corporation were not providing them.

Personal services business

In general, income from a PSB is not considered to be ABI. A PSB is where you provide personal services through a corporation to another entity (such as a person, corporation or a partnership) that an officer or employee of that entity would usually perform. You are an "incorporated employee" in substance. Consider John, an IT consultant who has incorporated under his own name. John works independently but does not have his own office since he spends the majority of his time at W&C Company and works out of their office. W&C Company provides John with a laptop computer and John uses their software and office support to carry out his work. John's corporation could be considered a PSB.

Any income your corporation derives from providing the services is considered PSB income if:

- you would, if it were not for the existence of your corporation, reasonably be considered an officer or employee of the entity receiving the services; and
- you, or any person related to you, is a specified shareholder of the corporation. A specified shareholder is someone who owns at least 10% of the issued shares of the corporation or a related corporation.

Income from a PSB can be considered to be ABI and eligible for the SBD if:

- your corporation employs more than five full-time employees throughout the year; or
- your corporation provides the services to an associated corporation.

If a corporation carries on a PSB, there are two main tax consequences:

1. The corporation is not eligible to claim the SBD, either federally

or provincially. Also, the corporation would not qualify for the general corporate rate reduction. When taking money out of the corporation, the ultimate combined personal and corporate tax rate will be much higher than if you earned the money personally as an unincorporated employee or self-employed individual, even if you were subject to tax at the highest marginal tax rate. This creates a significant disincentive to operating a PSB corporation.

2. The corporation is limited in deducting expenses. When calculating the income of the PSB, your corporation is allowed to deduct your salary, wages or other remuneration plus any benefits or allowance. Your corporation can also deduct any amount you incurred in connection with selling or negotiating contracts for the corporation, as long as the amount would have been deductible if you had incurred it under a contract of employment that required you to pay the amount.

If there is a risk that you may be considered to be operating a PSB, you should consult with your qualified tax advisor to help you review your situation.

Conclusion

You may be operating your business through a CCPC for a variety of reasons, some of which may be tax-driven. One of the most compelling tax reasons would be to take advantage of the SBD and reduce your corporation's tax liability. To benefit from the SBD, it is very important to ensure that income generated from your business is considered ABI and not income from a SIB or a PSB. You should consult with your qualified tax advisor to help you determine the correct classification of your corporate income.

If you do not need to withdraw all of the surplus cash for personal use, there is also a significant tax deferral advantage by leaving the after-tax corporate income inside your corporation. This tax-deferral allows for surplus cash to accumulate within your corporation, which can be used to invest and earn extra income. If you find your corporation has built up surplus cash, ask your RBC advisor for additional articles on the options for dealing with surplus cash in your corporation.

This article outlines several strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal or tax 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 advisor before acting on any of the information in this article.