Budget 2018

Legislation affecting private corporations and the passive investment income measures

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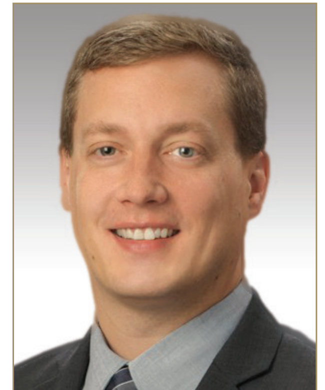

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On February 27, 2018 the Government of Canada presented its 2018 budget. Along with the spending plans, the Government also presented the next round of legislation to address their concerns with perceived advantages of using private corporations. As anticipated, the 2018 Budget includes provisions to address the Government's concerns with "passive investments" in a corporation.

Tax changes to address "advantages" of passive investments in private corporations

The Government has introduced legislation which would make two significant changes to reduce the advantages of investing in passive investments in a corporation:

1. The small business deduction ("SBD") will be reduced when an associated group of corporations is earning more than $50,000 of passive investment income and will be eliminated after $150,000.
2. There will be an eligible and ineligible refundable tax pool ("RDTOH") which will reduce the ability of a corporation to obtain a refund of RDTOH through paying eligible dividends.

Subject to some anti-avoidance provisions, both changes will apply starting in tax years that begin in 2019.

Reduction of SBD – New legislation

The normal tax rate for active business income earned by a private corporation is 27% in Alberta (all tax rates are combined Federal and Alberta provincial rates). The SBD allows active business income of up to $500,000 to be taxed at 12%. This allows a larger tax deferral while the earnings remain in the corporation. The policy behind this deferral is that it allows greater reinvestment in the small business. The Government was concerned that this deferral was often used instead to invest in passive investments.

There are already numerous limits to when a corporation qualifies for the small business deduction, and how much it qualifies for. Notably, "associated" corporations must share the SBD and the SBD is reduced when the "taxable capital employed in Canada" exceeds $10,000,000 (to fully eliminate it at $15,000,000).

The Government proposes to add an additional reduction mechanism, now reducing the SBD by the greater of the reduction for more than $10,000,000 of taxable capital employed in Canada or by $5 for every $1 of "adjusted aggregate investment income" ("AAII") above $50,000 within the associated group of corporations. This would result in the SBD being eliminated completely at $150,000 of AAII.

AAII is essentially aggregate investment income

- less capital gains on capital assets used in the active business or a share of a connected corporation where substantially all the fair market value of its assets is attributable to assets used in an active business;
- plus dividends from non-connected corporations; and
- plus income from a life insurance policy that is not otherwise exempt.

Note, while the Government indicated in its October 2017 announcements that "all past investments and the income earned from those investments will be protected" there is nothing to suggest that investment income earned on current passive investments would be excluded from the definition of AAII (i.e. there are no grandfathering provisions for current passive investments).

Reduction of SBD – What it means

These measures will not impact corporations that are unable to claim the SBD or which do not have more than $50,000 of AAII.

However, for associated corporate groups earning more than $50,000 of AAII which were able to claim the full SBD, their SBD will be reduced and potentially eliminated.

This will reduce the tax deferral available as more business income will be taxed at 27% as opposed to the 12% SBD rate. Business income taxed at 27% results in an addition to the corporation's general rate income pool ("GRIP") which allows a corporation to pay eligible dividends (taxed at 31.71% top tax rate) as opposed to non-eligible dividends (41.64% top tax rate). However, this still results in an increase of net tax as the net effective tax rate of the combined SBD rate plus non-eligible dividends is 48.6% where the net effective tax rate of the combined general business rate plus eligible dividends is 50.1%.

RDTOH – New Legislation

Canadian-controlled private corporations are required to pay a refundable tax on most investment income, which includes items such as interest, capital gains, and dividends on marketable securities. The purpose of the refundable tax is to eliminate the incentive to make investments through holding corporations, by taxing the resulting income at a rate comparable to the highest personal tax rate. This refundable tax is either 30.67% or 38.33% depending on the type of investment income received, and is refundable by paying taxable dividends to individual shareholders. For every $100 of taxable dividends paid, $38.33 of refundable tax is recovered.

Currently, both eligible dividends and non-eligible dividends result in a recovery of refundable tax when paid. In the case of eligible dividends, this means that a $100 dividend results in $31.71 of tax at the top rate and recovers $38.33 of refundable tax, giving a net refund. A non-eligible dividend would result in $41.64 of tax and a $38.33 refund, giving a net tax liability.

Budget 2018 will change how refundable tax is recovered by creating two RDTOH pools. Most types of investment income earned after 2018 will give rise to a "non-eligible" refundable tax that can only be recovered by paying non-eligible dividends. Paying eligible dividends will no longer result in a refund of this "non-eligible" refundable tax. In contrast, eligible dividends received by a corporation and subject to Part IV Tax will give rise to an "eligible" refundable tax, which can be refunded by paying either eligible or non-eligible dividends.

As a transitional rule, a Canadian-controlled private corporation will have an opening "eligible" RDTOH equal to the lesser of its existing RDTOH or 38.33% of its GRIP balance. The balance (if any) of its RDTOH will become "non-eligible" RDTOH.

RDTOH – What it means

This change will impact taxpayers who own corporations that earn both investment income and active business income that generates GRIP (i.e. that does not qualify for the small business deduction). In these corporations, a decision will need to be made whether to pay eligible dividends (at a preferential tax rate) or non-eligible dividends (to recover the non-eligible refundable tax). Depending on the taxpayer's marginal tax rate, it may make sense to effectively abandon the refundable tax in the corporation as it will cost more to recover than the refund is worth.

Where all a corporation's active business income is eligible for the SBD these provisions will have no effect as such a corporation generally cannot pay eligible dividends in any event.

Conclusion

These proposed changes achieve the Government's stated purpose of reducing the advantages of investing business after corporation income in passive investments in a corporation if the corporation

- earns more than $50,000 of AAII, or
- regularly pays eligible dividends

The combination of these two new changes along with the "income sprinkling" provisions introduced in December will require most private corporations (or at least their accountants) to review their current tax plans.

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