IG PRIVATE WEALTH MANAGEMENT

Passive income Q&A

Canada's Federal Department of Finance (Finance) in 2018 introduced measures aimed at reducing access to the Small Business Deduction once passive income earned by the Canadian Controlled Private Corporation (CCPC) exceeded a $50,000 threshold. These measures apply for corporations whose year end begins on or after January 1, 2019.

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The following highlights frequently asked questions resulting from the release of the measures relating to passive income earned within a private corporation.

Does the corporation actually have a problem?

Understanding a corporation's projected **adjusted aggregate investment** income as well as its projected **active business income** will be key in determining whether it will be impacted by these measures. Simply being a Canadian Controlled Private Corporation (CCPC) which carries on an active business and holds a corporate investment portfolio, will not necessarily result in a negative impact.

Understanding current limitations on the corporation's ability to access the small business deduction (SBD) is a key first step. The SBD limit must be shared amongst associated corporations (generally under common control). Secondly, if the corporation (and its associated corporations) has taxable capital in excess of $10 million, the SBD limit begins to grind down by $1 for every $10 of taxable capital over the $10 million threshold, with it being fully eliminated when taxable capital reaches $15 million. Generally, taxable capital is the sum of retained earnings plus debt less investments.

Additionally, rules introduced in 2016 have further restricted access to the SBD. Corporations that are members of a partnership or that are deemed to be a designated member of a partnership share the SBD limit with respect to business income earned from the partnership.

A corporation that derives more than 10% of its income from a corporation, of which a non-arm's length person holds an interest in that corporation, may be required to share its SBD limit with that corporation as well. This rule has affected many medical practices who may have had a master practice corporation which then billed separate medical corporations for services provided.

What is the extent of the corporation's problem?

Assuming a corporation has access to the SBD limit, the next step is understanding the impact that passive income over $50,000 will have on the SBD limit. For every $1 of passive investment income earned in excess of $50,000, the SBD limit the following year will be reduced by $5, resulting in no SBD limit once investment income exceeds $150,000.

ACTIVE BUSINESS INCOME QUALIFYING FOR THE SMALL BUSINESS TAX RATE UNDER NEW BUSINESS LIMIT ($)

BUSINESS INCOME	INVESTMENT INCOME				
	50,000	75,000	100,000	125,000	150,000
50,000					0
75,000					0
100,000		NOT AFFECTED			0
200,000				125,000	0
300,000			250,000	125,000	0
400,000		375,000	250,000	125,000	0
500,000		375,000	250,000	125,000	0

Source: equality + growth: a strong middle class, department of finance, FEB. 27, 2018.

The following example illustrates the above:

If the adjusted aggregate investment income in fiscal 2020 is $120,000, then the excess over the $50,000 threshold is $70,000. Five times the excess of $70,000 is $350,000. The SBD limit of $500,000 for fiscal 2021 will be reduced by $350,000 to only $150,000. If the active business income earned in fiscal 2021 is $151,000, $150,000 will be taxed at the small business rate with the remaining $1,000 being taxed at the general rate.

In Ontario, for example, the small business rate is 12.5% while the general rate is 26.5%. If the business limit had not been reduced to $150,000, that additional $1,000 of business income would incur tax at a rate of only 12.5%, which is $125. But in reality, that $1,000 of business income will be subject to tax at a rate of 26.5% which is $265. The difference of $140 in this example is a 14% increase in corporate taxation on the active business income that would normally have been included within the available business limit but is now excluded.

It is always important to note that when the general tax rate applies to active business income, this results in an increase in the corporate General Rate Income Pool (GRIP). GRIP enables a CCPC to pay to its shareholders an eligible dividend. Eligible dividends are more favourably taxed to individuals, than non-eligible dividends, due to an enhanced dividend tax credit applicable to eligible dividends. As such, when corporate and personal taxes are combined, generally the effect of these new rules will be an increase of tax of (on average) 2%. But it is the loss of tax deferral while the funds remain in the corporate structure that garners the majority of our attention with respect to these new provisions.

It is important to note (as the chart above shows) the corporation is not adversely affected if the reduction to the SBD limit of $500,000 leaves a balance which is greater than, or equal to, the active business income earned.

Another key factor to consider is the age and intention of the shareholder. If they are currently running an active business but will be retiring shortly, accumulating passive assets may become less of a concern, as access to the SBD limit will be needed for only a short period of time, whereas the access to the tax deferral by leaving profits within the corporate structure may be more lucrative.

Don't forget the most obvious question - "Is the corporation even carrying on an active business?" For a corporation that is simply an investment company, it will see no impact as a result of these measures unless it begins to carry on an active business in the future.

What is aggregate investment income? What is adjusted aggregate investment income? Do advisory fees reduce aggregate investment income?

Let's start with aggregate investment income, which forms the starting point of adjusted aggregate investment income. Aggregate investment income is defined as taxable capital gains net of taxable capital losses plus income for the year from a source that is a property. Interest, rents, royalties, taxable income generated by life insurance policies, as well as foreign income, would all be included in a calculation of aggregate investment income. Aggregate investment income **does not** include Canadian sourced dividends.

Advisory fees, interest expense and other expenses relating to investment income reduce aggregate investment income. It is important to note that salaries are not an expense which reduce aggregate investment income. Salaries must be applied to reduce active business income. If the salary expense exceeds active business income and is reasonable, such an expense will produce a loss that will reduce overall taxable income, which can reduce the amount of tax applicable on the aggregate investment income.

As part of creating adjusted aggregate investment income, Finance added Canadian sourced dividends to aggregate investment income to ensure this type of income would be included for the purposes of determining the grind on the SBD limit. However, in an effort to ensure that transactions relating to the active business did not negatively affect the SBD limit, taxable gains and losses resulting from the disposition of assets which were used in an active business carried on by the corporation or a corporation related to it are not included in adjusted aggregate investment income. The preceding is not an exhaustive summary of inclusions and exclusions which comprise adjusted aggregate investment income.

It is important to once again highlight that adjusted aggregate investment income will be a notional account calculated simply for the purposes of determining any potential grind to the SBD limit. The taxation of passive income remains as it was before. Therefore, Canadian sourced dividends will continue to only be subject to fully refundable Part IV tax, whereas other passive income, including foreign dividends, will be taxed under Part I, of which a portion remains refundable.

Are unrealized gains included in adjusted aggregate investment income?

Unlike some accounting standards which may require unrealized capital gains to be reportable as income, only realized gains are subject to taxation in Canada. As such, unrealized capital gains were never reportable as aggregate investment income and will not be reportable under the adjusted aggregate investment income rules.

In the context of corporate owned life insurance policies, realized gains from a disposition of an interest in an exempt life insurance policy has not in the past been required to be included in the calculation of aggregate investment income but normally has been in practice. Going forward any taxable income generated by an exempt or non-exempt life insurance policy must be included as part of adjusted aggregate investment income. But as in the past, unrealized gains within an exempt life insurance policy due to growth in the cash value will not form part of adjusted aggregate investment income.

Why were there no grandfathering provisions?

Finance provided comments on October 18, 2017, in which they indicated that past investments would be protected from new passive income measures they would introduce. However, the budget in fact did not contain any such measures. Finance did however acknowledge this and justified it this way:

> The proposal represents an important departure from the July approach. Importantly, the design does not directly affect taxes on passive investment income. Under this proposal, the tax applicable to investment income remains unchanged—refundable taxes and dividend tax rates will remain the same, unlike the July 2017 proposal. No existing savings will face any additional tax upon withdrawal, thereby maintaining the Government's commitment to protect the tax treatment of all past savings and investments.
>
> The new approach will be much simpler to comply with, will not require the tracking of new and legacy pools of passive investments, and will target only private corporations with more than $50,000 in passive investment income per year..."

For business owners who do not rely upon the SBD to reduce the corporate tax paid on active business income, the lack of grandfathering is not an issue since, as noted above, the taxation of passive income itself has not and will not be affected. However, for those corporations that do generate active business income and therefore rely upon the SBD, income that was retained within the corporation under previous legislation could result in the potential loss of some or all of the SBD limit without a way to fix the problem that doesn't result in immediate personal taxation.

The $50,000 adjusted aggregate investment income limit has to be shared amongst associated corporations. What makes corporations associated?

The concept of associated corporations was originally enacted to prevent an individual from setting up a number of corporations to multiply access to the small business deduction. Although the rules can be complex in some instances, association revolves around the concept of common control (i.e., where corporations are controlled by the same person or group of persons, either directly or indirectly). A simple example of associated corporations would be where an individual owns all of the shares of a holding company which in turn owns all of the shares of an operating company. In this instance, the holding company and the operating company would be associated and therefore, must share one SBD.

The 2018 federal budget reduces the availability of the SBD if a corporation and its associated corporations, in total, earn more than $50,000 of passive investment income in a year. Once passive investment income exceeds the $50,000 threshold, the SBD limit of the associated group for the following year would be reduced by $5 for every $1 of investment income in excess of this threshold. As a result, the SBD limit would be fully eliminated once $150,000 of investment income is earned in the year.

As the $50,000 passive income threshold and the SBD limit are both shared among an associated group, transferring assets from one company in the group to another would not be beneficial from a tax perspective.

Furthermore, rules have been instituted to deem corporations to be associated where a corporation lends or transfers property, directly or indirectly, to a related corporation for the purpose of minimizing the reduction to the small business limit. Any tax benefit from this type of transaction would be negated.

EXAMPLE

XYZ Co. and Holdco are both CCPCs with December 31st year-ends. Sam owns all of the shares of Holdco, which in-turn owns all of the shares of XYZ Co.

In its 2019 taxation year, XYZ Co. earned $80,000 of portfolio dividend income and $40,000 of interest income. Holdco earned no income during its 2019 year. As the $120,000 of passive income of the associated group of companies is above the $50,000 threshold, the SBD limit of the group for its 2020 year will be reduced by $350,000 (($120,000) - $50,000) x 5). As a result, the SBD limit for the group reduces to only $150,000. Whether or not the underlying investments which produced the dividend and interest income were kept in XYZ Co. or loaned or transferred to the holding company, the business limit reduction would be the same.

EXAMPLE

Sam owns all of the shares of XYZ Co. which holds $2,000,000 of mutual funds. His brother Joe owns ABC Co. which holds no passive investments. In an effort to reduce the passive income in his corporation, Sam has XYZ Co. loan $1,000,000 of the investments (interest free) to Joe's company. In this instance, the corporations would be deemed to be associated for purposes of calculating whether there is a reduction in the SBD limit and passive income on the full $2,000,000 would be used for determining the SBD limit for XYZ Co.

EXAMPLE

Looking back at the previous example, instead of moving the funds to his brother's corporation, Sam decides to incorporate three additional companies and have XYZ Co. loan $500,000 to each company, with no interest payable to the creditor corporation. As these companies would all be controlled by Sam, they would be associated corporations and the combined passive income in all four corporations would be assessed against the $50,000 passive income threshold to determine if there is a reduction of the group's SBD limit.

How should a corporation invest to avoid or minimize the reduction in the small business deduction limit?

For corporations earning active business income eligible for the SBD, the emphasis will be on designing portfolios that, for a given risk tolerance, maximize tax deferral. Historically, in terms of IG Wealth Management managed solutions, Corporate Class portfolios have been the option of choice for maximizing tax deferral. However, Corporate Class has declared dividends in recent years and as more shareholders within Corporate Class move to mutual fund series with unbundled advisory fees, the expenses within Corporate Class will continue to decline. As a result, dividend distributions are likely to continue.

Investors should also be reminded that Corporate Class has the potential to declare capital gains dividends which, along with ordinary dividends, would be included in the definition of aggregate investment income.

It appears that only non-exempt life insurance policies are impacted. Is that right?

As explained below, the majority of life insurance policies issued in Canada are exempt policies. As a result, the income which accrues in these policies will not be included in adjusted aggregate investment income. However, policy gains may be triggered by an exempt policy as a result of the removal of all or a portion of the cash surrender value, or the transfer of ownership of a policy from a corporation to an employee or shareholder will continue to result in a taxable amount being reportable by the corporation. Such policy gains would therefore be part of the adjusted aggregate investment income calculation.

WHAT MAKES A POLICY EXEMPT?

Exempt vs. Non-exempt – Life insurance policies issued after December 1, 1982 are subject to an “exemption test”. The exempt or non-exempt status of a life insurance policy with respect to accrual taxation on policy gains is determined by reference to this test. The purpose of the test is to distinguish between life insurance policies that emphasize benefits at death (exempt) and life insurance policies that offer potential for sizeable lifetime benefits consistent with an “investment” (non-exempt). Non-exempt policies are subject to annual taxation on the growth in the cash value excluding premium payments; however, life insurance companies generally take appropriate action to preserve exempt status of life insurance policies.

Many life insurance policies with a cash value are designed by the issuing life insurance company to qualify as exempt policies under the Income Tax Act by setting a fixed premium payment schedule. If the premium is flexible then the issuer puts in place an administrative procedure to ensure the accumulating fund does not exceed the allowable amount beyond the allowable grace period. On this basis, income which accrues under the accumulating fund (actuarial reserve) which often equals the cash surrender value of a permanent life insurance policy, is not subject to annual accrual tax. The complexities of the test used to determine the exempt status for a policy, and the related information required to implement the test, means the policyholder will rely on the insurance company to ensure the policy is exempt and the status is maintained.

Is permanent life insurance a solution to try to limit a corporation’s passive income?

Cash value life insurance is not a short or medium term investment. For many years the sum of the premiums will exceed the cash value, and thus generate a negative internal rate of return. First and foremost there must be a demonstrable need for the coverage, whether the purchase is personal or corporate. There are other considerations, such as creditor protection, which must be reviewed before putting personal needs life insurance within a corporation. For the right situation, a corporate owned life insurance policy can be an effective estate planning tool, but such policies are not a blanket solution to the new passive income measures.

What is RDTOH and its purpose?

The rate of tax paid by a corporation on investment income and portfolio dividends earned by the corporation in most provinces approximates top personal rates of tax. To compensate for the fact that when the after-tax profits are paid out to the shareholder personally and subject to another level of personal tax, some of the corporate tax paid is refundable to the corporation. The refundable tax is added to what is called a refundable dividend tax on hand (RDTOH) account.

The RDTOH account balance of a CCPC is increased at a rate of 30.67% on investment income (i.e. interest, foreign dividends, taxable capital gains, rents) and 38.33% on portfolio dividend income from Canadian corporations. A CCPC recovers its RDTOH balance when paying taxable dividends at a rate of 38.33%.

What concern is the government trying to address with the changes to the refundable tax rules?

Under previous rules, a corporation could accelerate the recovery of refundable tax by using after-tax earnings from its active business activities to pay lower taxed eligible dividends. This can be done to the extent the corporation has a General Rate Income Pool (GRIP) balance.

The GRIP balance of a CCPC is equal to its cumulative Canadian portfolio dividend income plus 72% of its active income before tax that was not subject to the SBD, minus cumulative eligible dividends paid. Taxable dividends paid from the GRIP account are designated as eligible dividends, and as such, are subject to reduced personal tax as compared to dividends not paid from the GRIP account (i.e., non-eligible dividends).

Under previous rules, recovery of the RDTOH balance occurred at the same rate on all taxable dividends – non-eligible and eligible. As such, you could have a situation whereby RDTOH was created from the receipt of interest income, but that RDTOH was recovered through the payment of an eligible dividend, resulting in a lower personal tax obligation than would have applied if a non-eligible dividend were paid.

How have the refundable tax rules been impacted by the 2018 federal budget?

The 2018 federal budget enacted legislation does not change the rate of tax on investment and portfolio dividend income, or the rate at which the RDTOH is calculated. The new rules are in effect for corporations whose year end begins on or after January 1, 2019. What the new rules do is separate the RDTOH account into two accounts:

01 | The non-eligible RDTOH account relates to investment income and non-eligible dividends received; and

02 | The eligible RDTOH account relates to Canadian portfolio dividend income and eligible dividends received from connected corporations who received a dividend refund from their eligible RDTOH account.

To illustrate, assume an Ontario CCPC earns $100,000 of investment income (i.e., interest and/or taxable capital gains), $50,000 of portfolio dividends from Canadian corporations, and $800,000 of active income before tax of which $500,000 is eligible for the SBD. Also assume that a GRIP dividend of $100,000 is paid to shareholders. The CCPC's tax position is as follows under the previous and enacted changes:

	PREVIOUS	CURRENT
Tax on $100,000 of investment income		
Permanent tax@19.5%	$19,500	$19,500
Refundable tax@30.67%	$30,670	$30,670 [1]
Tax on $50,000 of portfolio dividends		
Refundable tax – 38.33%	$19,165	$19,165 [2]
Tax on $800,000 active income		
$500,000@12.5%	$62,500	$62,500
$300,000@26.5%	$ 79,500	$ 79,500
Total tax	**$211, 335**	**$211, 335**
Total RDTOH	$49,835	$49,835
Addition to GRIP-$300,000 x .72	$216,000	$216,000
RDTOH recovery on payment of a $100,000 Eligible dividend		
$100,000@38.33%	$38,333	$19,165 [3]
RDTOH balance after recovery	$11,502	$30,670

[1] Allocated to non-eligible RDTOH. [2] Allocated to eligible RDTOH. [3] RDTOH recovery is equal to the lesser of 38.33% x $100,000 and eligible RDTOH balance.

As a result of the enacted changes, the RDTOH paid on the investment income may only be recovered on the payment of a non-eligible dividend. In the above illustration, if a non-eligible dividend of $100,000 were paid rather than an eligible dividend, the RDTOH recovery would be $38,333 under both the previous and new system. The effect of the changes is to limit the RDTOH recovery of non-eligible RDTOH balances to only when non-eligible dividends are paid.

CHECKLIST: POTENTIAL IDEAS FOR ADVANTAGEOUSLY REDUCING CORPORATE INVESTMENT INCOME

The following is a high level checklist (not in any particular order) of possible methods for the reduction of corporate investment income. Depending on the actual situation, some may apply while others may not. Consideration must be given to additional passive investment income that may be generated upon the redemption of corporate investments to carry out any of the following.

01 | Portfolios designed to maximize tax deferral: For corporations earning active business income eligible for the small business deduction, the emphasis will be on designing portfolios that, for a given risk tolerance, maximize tax deferral.

02 | Repayment of corporate debt: Apply corporate investment funds to repay corporate debt.

03 | Active business assets: Apply corporate investment funds to acquire needed active business assets such as inventory, machinery, equipment and buildings.

04 | Repayment of shareholder loans: Apply corporate investment funds to repay shareholder's loans to individual shareholders. These repayments are received tax-free by the shareholder.

05 | Capital dividends: Apply corporate investment funds to pay tax-free capital dividends to individual shareholders to the extent of the capital dividend account (CDA). An equal dividend must be paid on each share of the class of shares on which the dividend is declared.

06 | Eligible dividends: Apply corporate investment funds to pay eligible dividends to the extent of the GRIP balance. This will be particularly tax-advantageous to the extent there is a balance in the Eligible RDTOH account.

07 | Non-eligible dividends: Apply corporate investment funds to pay non-eligible dividends to the extent of the Non-eligible RDTOH account and, subsequently, the Eligible RDTOH account.

08 | Exempt cash value life insurance: The corporation allocates corporate investments to fund a life insurance policy having a cash value. The cash value of a whole life or universal life insurance policy will accumulate on a tax-deferred basis subject to the condition the policy remains tax-exempt, meaning the cash value remains below the maximum tax actuarial reserve and no partial cash withdrawals or change of ownership occur.

A cash value life insurance policy should never be undertaken as a good short-term investment, since for many years the sum of the premiums paid will exceed the cash surrender value, and during this time period a negative internal rate of return results, unless death occurs. A need for life insurance must be demonstrated before such coverage is purchased. Some unique aspects to consider with respect to life insurance policies which are corporately held:

- 'Policy loans' to the corporation not exceeding the adjusted cost basis (ACB) would be received tax-free by the corporation. Each new policy loan reduces the ACB of the policy.
- Annual 'cash dividends' paid by the insurer directly to the policy owner (and not applied to purchase additional life insurance) not exceeding the ACB would be received tax-free by the corporation. Each 'cash dividend' will reduce the ACB of the policy.

If a partial cash withdrawal from the cash surrender value occurs at a time when the cash surrender value exceeds the ACB, a portion of the partial cash withdrawal would be taxable to the corporation as aggregate investment income. However, it is likely the cash surrender value of the policy will not be accessed to supplement income until after the shareholder has retired and the corporation is no longer generating active business income. Therefore, a reduction to the business income limit may then be irrelevant.

09 | Establish an individual pension plan (IPP) for selected employees: The allowable contributions will be tax deductible by the corporation and will be removed from the corporation, and therefore no longer generate investment income for the corporation. This is particularly advantageous for individuals over age 40 whose earned income (i.e., salary) exceeds that required for a maximum contribution to a RRSP.

10 | Establish a retirement compensation arrangement (RCA) for selected employees: The allowable contributions will be tax deductible by the corporation and will be removed from the corporation, thus no longer generating investment income for the corporation.

11 | Group Benefits: Apply corporate investment funds to pay for group benefits for employees to attract and retain good employees and build morale, such as health and dental reimbursement plans, as well as short-term and long-term income replacement plans in the event of disability.

12 | Charitable donations: Use corporate investment funds to make donations to charity if the shareholders are devoted to one or more charities, recognizing charitable donations will reduce the net worth of the corporation. The donations are tax deductible by the corporation to the extent there is taxable income but do not reduce adjusted aggregate investment income.

13 | Critical illness insurance with return of premium on cancellation (ROPC): If the shareholders require critical illness insurance, the corporation acquires the insurance by accessing corporate investments. The policy is issued with a refund of premium upon cancellation rider. The funds applied to pay the premiums would no longer generate investment income.

In the event of a critical illness claim, the corporation would receive the claim proceeds tax-free but a credit to the CDA would not occur.

The claim proceeds would far exceed the sum of the premiums paid. If the policy is maintained and cancelled on a date when 100% of the premiums would be available for refund, those funds would be received by the corporation tax free but again no credit would occur to the CDA. The ROPC amount would far exceed the cost for the ROPC rider. If a CI claim occurs, the ROPC benefit would not be paid.

Which strategies will not be successful in reducing corporate investment income?

- **Guaranteed investment funds (GIF)**. Although GIF's (otherwise known as segregated funds) are technically life insurance policies in the common-law provinces, non-registered funds do not accumulate on a tax-deferred basis.
- **Life annuities:** Although a life annuity has no cash surrender value (under most circumstances), any annuity contract acquired by a corporation will have an accrual tax status. This means for the first year or perhaps two, no portion of the annuity payout will be taxable but then in subsequent years the taxable portion will be higher than a prescribed annuity and gradually reduce year by year.

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