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CCPC Tax Planning for Passive Income

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In 2018, the government enacted new tax legislation governing Canadian-controlled private corporations (CCPCs), including incorporated professionals. As we enter the final months of 2018, one new measure is of particular concern – the potential looming loss of the small business deduction (SBD) in 2019 for corporations with more than $50,000 of passive investment income in 2018. This Report will review the new rules, the potential financial impact of a loss in the SBD on your long term savings, and what you can do about it.

Background

Income from your CCPC can be distributed to you as salary (or bonus) if you are an employee, or dividends as a shareholder. If you receive salary, your corporation will receive a tax deduction for the salary paid so no corporate tax would be payable on the income. You would simply pay personal tax at the graduated personal tax rates on any salary you receive from your corporation.[1] If you don't take out all your corporation's net income as salary, the net income remaining will be subject to corporate tax and the after-tax income can then be distributed to you as a dividend, either immediately or in the future. You would pay personal income tax on dividends you receive in the year, at your graduated marginal tax rates.

The theory of tax integration looks at how closely the personal income tax you would pay on salary compares to the combined corporate/personal income tax that would be paid on dividends. If there is perfect tax integration, you should be indifferent between earning salary or dividends because the same amount of total tax will be paid either way. There is no Tax Savings (or Tax Cost), which refers to the tax that is saved (or additional tax that is paid) if business income is earned in your corporation and distributed to you as a dividend, rather than salary. There may, however, still be a significant Tax Deferral (or Tax Prepayment), which refers to the tax that is deferred (or paid in advance) if business income is distributed to you as a dividend in a later year, rather than salary in the current year. This Tax Deferral (or Tax Prepayment) could be advantageous (or disadvantageous) if you defer payment of a dividend and the related personal tax to a future year. More information is available in our report, Bye Bye Bonus.[2]

In 2018, assuming you pay tax at the top marginal tax rate,[3] there is near-perfect integration for business income in most provinces, so there is little Tax Savings (or Tax Cost) if distributions are made as dividends, rather than salary. But as top personal tax rates have increased and corporate tax rates have decreased in recent years, the Tax Deferral (which is the difference between the personal and corporate tax rates) has become quite significant.

1 Payroll taxes, such as premiums for the Canada/Quebec Pension Plan, Employment Insurance or provincial health taxes, that may be payable when income is distributed as salaries have not been considered.
2 The report Bye Bye Bonus is available online at https://www.cibc.com/content/dam/personal_banking/advice_centre/tax-savings/jg-dividends-bonus-en.pdf
3 Throughout this report, it is assumed that you are the shareholder of a CCPC (your corporation) and you pay tax at the highest marginal tax rate on income distributed from your corporation.

Tax Deferral

In 2018, the top personal marginal tax rate that you would pay on ordinary income, including salary or bonus, ranges from 47.5% in Saskatchewan to 54% in Nova Scotia.

The SBD is available if your CCPC earns active business income up to the annual small business limit (SBD Limit), which in 2018 is $500,000 federally and in most provinces.[4] Income that is eligible for the small business deduction (SBD Income) is taxed inside your corporation at a lower, small business deduction tax rate (SBD Rate) that ranges from 10% in Manitoba to 17% in Quebec in 2018 when federal and provincial taxes are combined. Associated corporations must share the SBD.

In 2018, if your corporation earns active business income (ABI) that is not eligible for the SBD, there is a higher, general corporate tax rate that ranges from 26.5% in Ontario to 31% in Nova Scotia and Prince Edward Island when federal and provincial taxes are combined.

As a result, in 2018 there is significant Tax Deferral of federal and provincial taxes, ranging from 35.3% to 41% for SBD Income as shown in Figure 1 and ranging from 20.4% to 27% for ABI as shown in Figure 2.

Figure 1: Combined federal/provincial Tax Deferral on SBD Income left in the corporation for all provinces in 2018

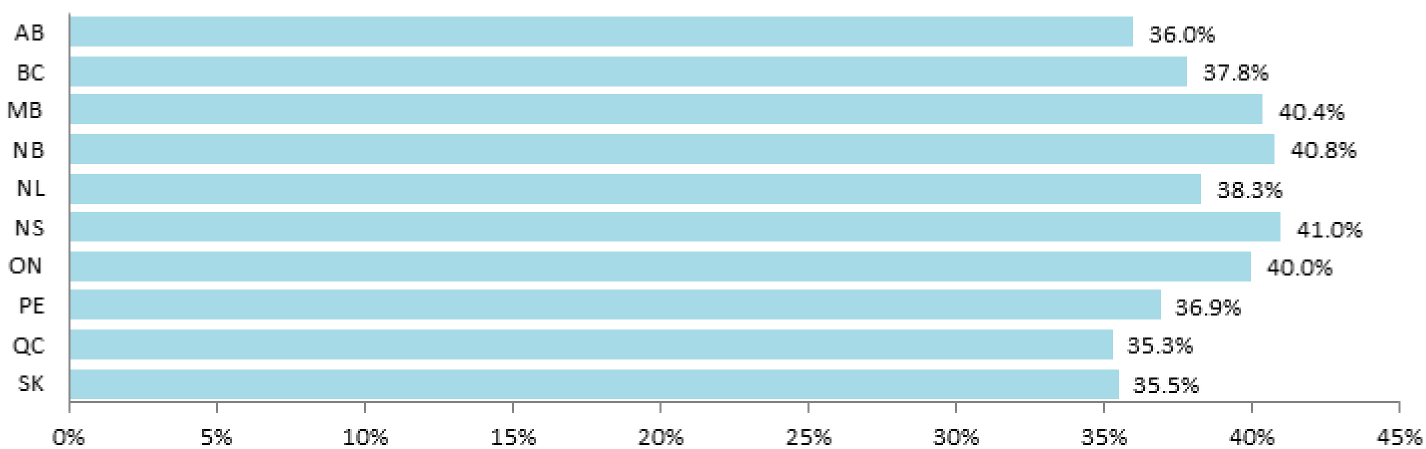
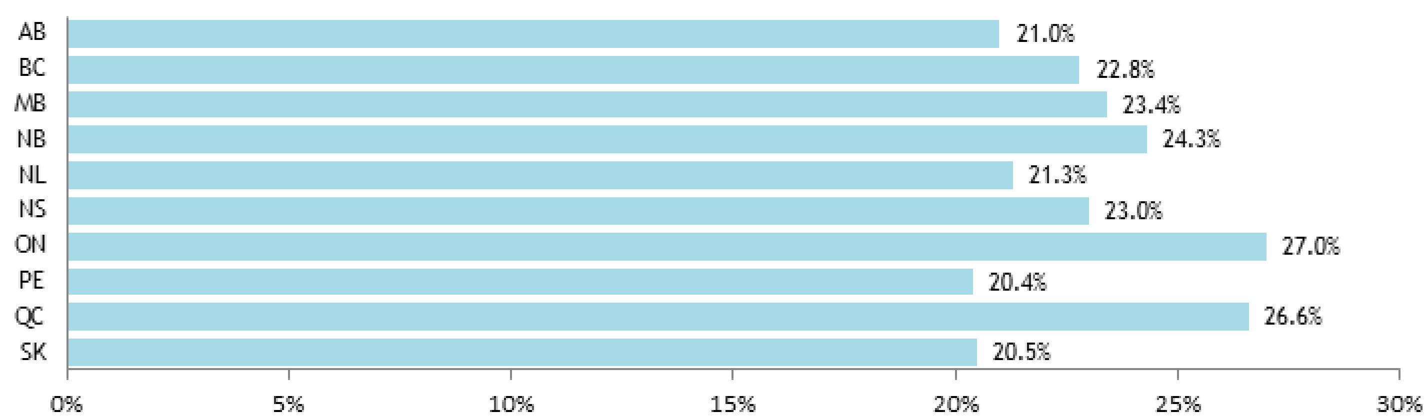


Figure 2: Combined federal/provincial Tax Deferral on ABI left in the corporation for all provinces in 2018



4 For large CCPCs, the federal and provincial SBD Limit is reduced on a straight-line basis for CCPCs that, in the prior tax year, had taxable capital between $10 million and $15 million. In Saskatchewan, the SBD Limit is $600,000. In Manitoba, the SBD Limit is $450,000 in 2018 but will rise to $500,000 in 2019.

The New Rules for Passive Income

When business income is distributed as salary (or when an unincorporated business owner earns business income personally), the business owner must pay full personal tax in the year the income is earned. When business income is distributed as dividends, the corporate tax on the business income is lower than the personal tax rate on salary, and personal tax on the dividend is only payable when the dividend is paid. If dividend payments are deferred to a future year, additional funds are available to invest in the corporation in the interim, which may yield more investment income over time compared to a business owner who invests after-tax salary personally.

The government thought that this provided an unfair benefit for owners of CCPCs who chose to defer personal taxes by delaying the payment of dividends and build up significant funds in their corporations. With particularly low SBD Rates, the potential benefit from the large Tax Deferral with SBD Income (Figure 1) was of most concern. The new tax rules will, therefore, limit the potential future benefits from the Tax Deferral on SBD Income by reducing the SBD Limit when a corporation has significant passive income in the previous year.

Beginning in 2019, the federal $500,000 SBD Limit will be reduced for CCPCs based on levels of "adjusted aggregate investment income" (AAII) in the previous year. The SBD Limit will be reduced by $5 for each $1 of AAII that exceeds $50,000 and will reach zero once $150,000 of AAII is earned in a year. Additional information regarding AAII and the reduction to the SBD Limit is available in our report, The updated CCPC tax proposals.[5] In practical terms, this means that if your corporation has at least $50,000 of AAII in 2018, then in 2019 some (or all) of the income that would have qualified as SBD Income will be taxed as ABI.

On November 15, 2018 the Ontario government announced that it will not follow this federal measure, so active business income up to $500,000 will continue to qualify for the Ontario small business deduction.[6] To date, Ontario is the only province that has announced that it would not follow the federal rules limiting the SBD based on passive income. In this report, it is assumed that provinces other than Ontario will follow the federal rules.

Just as associated corporations share the SBD Limit, AAII is combined for associated corporations and the $50,000 threshold is shared between them. You may be surprised to find that another corporation with only a somewhat remote connection may be associated with your corporation. For instance, for the purpose of the new rules you are deemed to personally own shares held by a trust in which you or your minor child is a beneficiary, so your corporation could be associated with another corporation where the only connection is shares held by a family trust.[7]

Impact of Losing the SBD

Is losing the SBD a big deal? The short answer is – it depends!

If you are going to take the after-tax business income out of the company in the year it's earned, then you're not enjoying any Tax Deferral and the loss of the SBD is likely immaterial. Since there's near-perfect

[5] The report *The updated CCPC tax proposals* is available online at https://www.cibc.com/content/dam/small_business/day_to_day_banking/advice_centre/pdfs/business_reports/private-corporation-tax-changes-en.pdf.

[6] Announced in the 2018 Ontario Economic Outlook and Fiscal Review, which is available online at https://www.fin.gov.on.ca/fallstatement/2018/contents.html.

[7] For further information see "The Passive Investment Rules and Their Associates", Michael Goldberg, Tax Topics (Wolters Kluwer), No. 2426, September 6, 2018, which is available online at https://www.mindengross.com/docs/default-source/publications/tax-notes-the-passive-investment-rules-and-their-associates.

integration for both SBD Income and ABI, the total corporate and personal taxes will be about the same with either dividends or salary.

Figure 3 quantifies the after-tax amount that you'll receive if $500,000 of business income is paid as salary (first column) or as dividends (columns 2 and 3), using Alberta 2019 tax rates.

Figure 3: After-tax amount to business owner when $500,000 of active business income is distributed as salary or dividends in Alberta in 2019[8]

	Salary	Dividends SBD Income	Dividends ABI	Dividends Difference
CORPORATION:				
Active business income	500,000	500,000	500,000	0
Salary expense	(500,000)	0	0	0
Taxable income	0	500,000	500,000	0
Corporate tax	0	(55,000)	(135,000)	(80,000)
Amount available for dividends / investment	0	445,000	365,000	(80,000)
BUSINESS OWNER:				
Salary / dividend	500,000	445,000	365,000	(80,000)
Personal tax	(240,000)	(189,392)	(115,742)	73,650
After-tax amount to business owner	260,000	255,608	249,258	(6,350)
Total corporate/personal tax amount	240,000	244,392	250,742	6,350
Total effective tax rate	48.00%	48.88%	50.15%	1.27%

In Figure 3, if you earned business income personally, you would pay tax of 48%. If the business income is earned in your corporation and distributed to you as a dividend, the combined corporate and personal taxes would be only slightly higher and would amount to 48.88% for SBD Income and 50.15% for ABI. As we can see from the bottom line in Figure 3, the difference in total tax between SBD Income and ABI is about 1.27%. This means that if your corporation has more than $150,000 of AAII and completely loses the SBD in 2019, it would only cost $6,350 ($500,000 x 1.27%) in taxes.

The real concern with losing the SBD, so that some (or all) of the income that would have qualified as SBD Income is taxed as ABI, is the lower Tax Deferral (as shown in Figure 2).

The line that is labelled "Amount available for investment / dividends" in Figure 3 shows the amount that can be paid as dividends. If dividends are paid in a future year, this amount can be retained in the corporation and invested for years to come, until dividends are paid. With ABI (when the SBD is not available), there is $80,000 less to invest than with SBD Income in Alberta in 2019, which can make a big difference with years of investing.

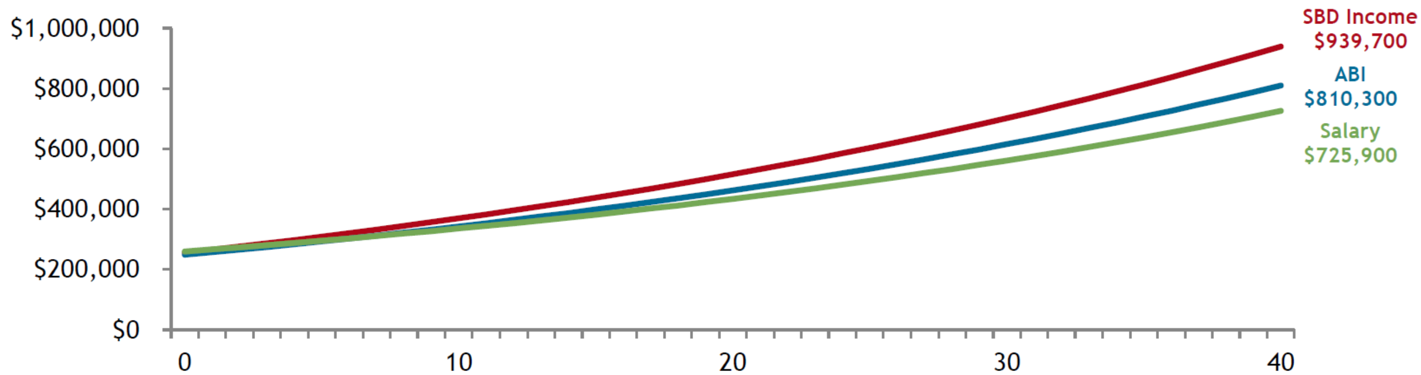
Figure 4 shows the after-tax amount that would be available to you over 40 years, assuming 2019 Alberta tax rates, if $500,000 of business income is earned and after-tax income is invested to earn 5% of ordinary investment income.

[8] Results will vary for other provinces/territories.

The “Salary” line in Figure 4 shows what would happen if your corporation distributed $500,000 of business income to you as salary/bonus in 2019 and you invested your after-tax salary in a non-registered account. In 40 years you would have $725,900 after-tax.

The two lines for SBD Income and ABI in Figure 4 show what would happen if your corporation earned $500,000 of business income in 2019 that was distributed to you as dividends.

Figure 4: After-tax amount to shareholder over 40 years with $500,000 of business income and 5% interest earned on investments, with 2019 Alberta tax rates



It is assumed that business income would be taxed in 2019 at either the SBD or ABI rate, that the after-tax business income would be invested in your corporation and, at the end of the period, all after-tax corporate income would be distributed as a dividend that was taxed in your hands at the top marginal rate. After 40 years, you would have about $939,700 if your corporation invested after-tax SBD Income or about $810,300 if your corporation invested after-tax ABI.

Comparing the ABI and SBD Income lines in Figure 4 illustrates the impact of earning at least $150,000 of AAII in 2018, so that the SBD Limit would be reduced to zero in 2019 (and all income that would have qualified as SBD Income would be taxed as ABI). With ABI, we saw in Figure 3 that the lower Tax Deferral would leave $80,000 less to invest in 2019 than with SBD Income, which would translate to $129,400 ($939,700 - $810,300) less cash to you over a 40-year period.

While this example shows ordinary investment income, taxed annually inside the corporation, the decrease in wealth from losing the SBD is even greater if other types of income such as capital gains or Canadian dividends are earned inside the corporation. And if the SBD is lost in multiple years, the loss in wealth would be multiplied for each of those years.

For Ontario taxpayers, as only the federal SBD could be lost based on AAII, the overall difference in the Tax Deferral will be lower. Hence, the potential decrease in wealth will be lower than other provinces.

Some Business Owners are *not* Affected by New Passive Income Rules

The good news is that if you have a CCPC that does not earn *any* business income that could be taxed at the SBD Rate, the new tax rules for passive income will not affect you at all. For example, if you have a holding company (or other CCPC) that earns only passive investment income, you cannot lose access to the SBD because you have no active business income. Also, incorporated professionals in large professional service firms (such as lawyers or accountants) may already have very limited (or no) access to the SBD if there is a group of associated corporations that must share the SBD.

As well, as was shown in the section titled “Impact of losing the SBD,” if you are distributing all business income as dividends in the current year, you won’t be affected as there is no Tax Deferral to lose. Similarly, if there is only a short time horizon until dividends will be paid, the impact of the new rules may be minimal.

Finally, if your corporation, along with associated corporations, does not currently earn more than $50,000 of AAII in a year, the new passive income rules do not affect you.

Planning Ideas to Preserve the SBD in 2019

Assuming that a corporation is nearing or exceeding the $50,000 threshold for AAII, here are some strategies to consider to reduce the impact to the SBD Limit.

Withdrawals to Permit RRSP / TFSA Contributions

Given current tax rates, where you are a business owner who wants to get the most from your investments over the long run and your portfolio earns a combination of interest, eligible dividends and capital gains, consider withdrawing sufficient corporate funds to maximize your RRSP and TFSA contributions, rather than leaving the funds inside the corporation for investment. Given sufficient time, RRSP and TFSA investing would outperform corporate investing when earnings come from interest, eligible dividends, annual capital gains, or a balanced portfolio. Only corporate investments exclusively earning deferred capital gains would generally outperform RRSPs and TFSAs; however, few investors would be likely to defer 100% of capital gains over a long period of time. These results are further outlined in our reports RRSPs: A Smart Choice for Business Owners[9] and TFSAs for Business Owners… A Smart Choice.[10]

Removing funds that would otherwise be invested within the corporation could reduce future AAII. This is another reason to consider withdrawing sufficient salary or dividends from a private corporation to maximize contributions to RRSPs and TFSAs. Receiving salary of at least $147,222 by December 31, 2018 will allow the maximum RRSP contribution of $26,500 in 2019. (TFSA contribution room is not dependent on income level.) Reasonable salaries may also be paid to family members who work in the business to allow them to make contributions to RRSPs and TFSAs.

It should be noted, however, that where salary is paid there may also be various associated payroll taxes, such as Canada or Quebec Pension Plan premiums, Employment Insurance premiums and provincial health taxes to consider.

Tax-free Withdrawals

Consider whether any amounts can be withdrawn from the corporation on a tax-free basis that would otherwise be invested in the corporation. For instance, if a shareholder previously made a loan to the corporation, and those funds are no longer required by the corporation, consider if the shareholder loan can be repaid.

Capital dividends can be paid without being included in the shareholder’s income. A capital dividend may be paid at any point in time when there is a positive balance in the Capital Dividend Account (CDA) of a corporation. Certain transactions, such as the realization of capital gains and the tax-free death benefit from a corporately-owned life insurance policy, result in additions to the CDA, while other transactions, such as capital losses, cause a reduction to the CDA.

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9 The report “RRSPs: A Smart Choice for Business Owners” is available online at https://www.cibc.com/content/dam/small_business/advice_centre/business-reports/RRSPs-for-business-owners-en.pdf.

10 The report “TFSAs for Business Owners… A Smart Choice” is available online at https://www.cibc.com/content/dam/small_business/day_to_day_banking/advice_centre/pdfs/personal_finances/tfsas-for-business-owners-en.pdf.

Investment Strategies

Any reduction to the SBD Limit is based on AAII in the previous year. Depending on the level of AAII otherwise earned in a particular year, you may wish to consider investments that lean towards growth rather than annual interest or dividend income, as you may better be able to time the recognition of a capital gain. In addition, since capital gains are only 50% taxable, it would take $100,000 of realized capital gains to generate $50,000 of passive income that is counted towards the AAII test.

Consider a "buy and hold" strategy to defer capital gains if a corporation is approaching the $50,000 AAII threshold in 2018. By deferring some capital gains, the SBD Limit may be maintained in 2019. It may also be possible to stagger dispositions of investments between calendar years. For example, if there will already be more than $150,000 of AAII in one year, consider triggering additional capital gains in that year, rather than the next, if that might reduce AAII below the threshold in the next year. Conversely, you may wish to trigger capital gains or losses in a specific year because capital losses cannot be carried forward to a future year for purposes of reducing AAII. As a result, you may wish to realize capital losses and gains in the same taxation year.

Some investments, such as certain notes, T-class units of mutual funds and REITs, pay a mixture of income and a return of capital. A return of capital is not included in income in the year received; rather, it reduces the adjusted cost base of the investment and increases the capital gain (or decreases the capital loss) on the future disposition of the investment.

When considering these investment strategies, you should take into account your overall investment plan, as well as AAII expectations for future years.

Individual Pension Plans

An Individual Pension Plan (IPP) is a pension plan created for one person, rather than a large group of employees. An IPP could be a strategy to consider once AAII nears or exceeds the $50,000 threshold.

An IPP is a defined benefit pension plan, meaning that the pension paid on retirement is set out by a formula so the amount of the pension benefits is predictable. Since the corporation contributes to the IPP and the income earned in the IPP does not belong to the corporation, that income is not AAII.

Another advantage of an IPP is that the corporation may be able to make higher contributions to the IPP than you could have made into an RRSP. This, in turn, may lead to higher tax-deferred accumulation inside the IPP than you could have built up inside an RRSP.

An IPP also allows you to split any pension payments with your spouse or common-law partner any time after age 55,[11] rather than having to wait until age 65 as would be the case for RRIF income.

The tax benefits of an IPP need to be offset against the administrative costs, including actuarial costs, to set up and maintain the plan.

Life Insurance

You may choose to invest after-tax income of the corporation into a corporately-owned life insurance policy that insures the life of the business owner, or some other individual. There are numerous reasons to hold life insurance in a corporation, including certain tax benefits. For instance, there is generally a lower after-tax cost of the insurance premiums, which can be paid with funds that are taxed at a lower tax rate inside the corporation than funds that are earned personally. Depending on how long the life insurance is held, the

[11] Age 65 for province of Quebec.

death benefit may flow out to the corporate shareholders on an entirely tax-free, or partially tax-free, basis via the CDA.[12]

Now that AAII could impact the SBD Limit, life insurance may offer an additional advantage. As long as the income from the investments underlying the life insurance policy is not included in the corporation's income on an annual basis, it shouldn't be included in AAII. This will be the case for permanent life insurance policies qualifying as "exempt policies."[13] That means, permanent, exempt life insurance may be an alternative investment solution for business owners to consider where there is a life insurance need as well as a concern that the corporation's AAII could limit access to the SBD.

Donations

If you are considering making a charitable donation, consider whether that donation can be made from your private corporation, rather than by you personally. Not only will your corporation receive a deduction for the amount of the donation, making a donation will reduce the funds that may be invested in your corporation to produce AAII.

There could be additional tax benefits if your corporation makes an in-kind donation of publicly-listed securities or mutual funds with unrealized capital gains. First, no tax will apply to the capital gains on the donated securities. Second, the entire capital gain is added to the CDA and capital dividends can be paid to the extent that there is a positive balance in the account, as discussed in the section called "Tax-free withdrawals." You can then receive capital dividends, which are generally tax-free, instead of taxable dividends. Third, capital gains on donated securities are excluded from AAII, so they will not impact the SBD Limit in the following year.

Conclusion

Although the new passive investment rules for private corporations do not come into effect until 2019, as an incorporated business owner it is best that you start thinking about these now. Since 2018 investment income in your private corporation may reduce the SBD Limit in 2019, you may wish to take steps in 2018 to potentially minimize the reduction of the 2019 SBD Limit. This decision should take into account whether a reduction in the SBD Limit will result in a decline in any Tax Deferral, with a resultant reduction of future after-tax funds to withdraw from your corporation.

As with all tax planning, be sure to discuss the above strategies with your tax advisor to make sure they are appropriate for you.

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[12] The amount of the death benefit, less the adjusted cost base of the insurance policy, is added to the corporation's CDA account. As discussed above, a positive balance in the CDA account may be paid out as a tax-free capital dividend. The adjusted cost base of the insurance policy will decrease over time until it eventually reaches zero.

[13] If a life insurance policy does not qualify as an exempt policy, then the amount included in the corporation's income annually in respect of the policy will be included in AAII.