BUDGET 2018: TEMPERED PRIVATE COMPANY PASSIVE INVESTMENT INCOME CHANGES UNVEILED

Posted on March 9, 2018

Categories: Insights, Publications

In July 2017, the Department of Finance tabled proposals to significantly amend the rules respecting the taxation of passive income earned by private corporations to address what it perceived to be an inappropriate deferral advantage enjoyed by the shareholders of such corporations. During the public consultation period that followed the release of the proposals, the Government received stakeholder feedback that was almost universally negative, with criticisms that highlighted the far-reaching impact of the proposed measures, their damaging effect on Canada's global tax competitiveness, and their administrative complexity.

While Budget 2018 introduced measures to limit the tax deferral advantages perceived to be afforded to private company investment income, they are simpler and narrower in scope than those originally envisioned and, thus, are (at least to some extent) responsive to the extensive public feedback provided over the course of last summer.

If enacted, the new measures will impose (i) an additional limit on the favourable small business tax rate enjoyed by a Canadian-controlled private corporation (a "CCPC")[1] to the extent the passive investment income of the CCPC (or what the new rules refer to as the "adjusted aggregate investment income" of the CCPC) exceeds $50,000, and (ii) more stringent requirements on the types of dividends that must be paid by a private corporation to trigger a refund of refundable dividend tax on hand.

Reduced "Business Limit" Where Passive Income Threshold Exceeded

At present, the preferential small business tax rate (currently 10.5%) applies in respect of up to $500,000 of "qualifying active business income" of a CCPC (the "business limit")[2]. Active business income of a CCPC exceeding the business limit is taxed at the higher, general corporate tax rate.

The business limit is reduced on a straight-line basis for CCPCs having between $10 million and $15 million of "total taxable capital employed in Canada" (and is completely eliminated when such capital exceeds $15 million).

As part of its stated objective of encouraging CCPCs benefiting from the favourable small business tax rate to

reinvest a greater portion of their after-tax profits in active business assets and operations, Budget 2018 introduces a second business limit reduction test, which will be based on a CCPC's passive investment income. Specifically, where a CCPC (and corporations with which it is associated) earns more than $50,000 of passive investment income in a particular taxation year, the amount of income eligible for the favourable small business rate will be reduced on a straight-line basis on passive income earnings up to $150,000, at which point the business limit will be completely eliminated.

For purposes of the new business limit reduction measures, passive income will be determined with reference to the CCPC's "adjusted aggregate investment income" ("AAII"), which will be based on the CCPC's existing "aggregate investment income" (i.e., income otherwise subject to refundable tax under section 129 of the *Income Tax Act* (Canada) (the "Tax Act")) with the following notable adjustments:

Exclusions

- Capital gains and losses realized from the disposition of (i) property used principally in an active business carried on primarily in Canada by the CCPC or a related CCPC, (ii) a share of another CCPC that is connected[3] with the CCPC, where all or substantially all of the fair market value of its assets are attributable (directly or indirectly) to assets used principally in an active business carried on primarily in Canada, and (iii) certain partnership assets;
- Net capital losses carried over from other taxation years; and
- Investment income that may be considered incidental to the CCPC's active business.

Inclusions

- Dividends from non-connected corporations; and
- Income from savings in a life insurance policy that is not an exempt policy.

The new business limit reduction measures with respect to passive investment income are set to apply to taxation years beginning after 2018 and will, as indicated, operate alongside the existing taxable capital-related reduction rule discussed above (thus, a particular CCPC's business limit will be determined by applying the greater of the two reductions). It should also be noted that the new business limit proposals contain certain anti-avoidance measures designed to prevent taxpayers from inappropriately delaying or circumventing the application of the new rules through, for example, the use of short taxation years or transfers of assets to a related, but unassociated, corporation.

Limiting Access to Refundable Taxes

The Tax Act contains a series of rules concerning the computation and taxation of income earned by private

corporations. A cornerstone of the rules is the principle of "integration", which essentially strives to equate the overall tax burden associated with income earned by a corporation and distributed to its shareholders with the tax that would have been paid by the shareholders had they earned the income directly.

In furtherance of this objective, investment income earned by a private corporation is taxed at rates that are substantially similar to the highest personal income tax rates, with a portion of such tax being refundable upon the payment of dividends to shareholders (known as "refundable dividend tax on hand" or "RDTOH"), in recognition of the shareholder tax liability in respect of such dividends.

Under current rules, business income of a private corporation not benefitting from the favourable small business rate is generally added to a notional tax account known as the "general rate income pool" or "GRIP", and is available for distribution out of such account (with full RDTOH recovery to the corporation upon the payment of sufficient dividends) as an "eligible dividend" (dividends designated as "eligible dividends" are taxed in the hands of shareholders at a lower net rate than those that are not so designated[4]).

To address concerns associated with allowing business income taxed at the comparatively low general corporate tax rate to trigger RDTOH recovery on distributions to shareholders, and yet benefit from "eligible dividend" treatment, Budget 2018 proposes to divide a private corporation's RDTOH account into two accounts – an "eligible RDTOH account", that will be accessible upon the payment of eligible dividends and in certain instances, non-eligible dividends, and an "non-eligible RDTOH account" that will only be accessible on the payment of non-eligible dividends.

For the purposes of the new rules, the "eligible RDTOH account" of a private corporation will include refundable taxes paid by the corporation under Part IV of the Tax Act in respect of eligible dividends received from non-connected Canadian corporations (i.e., portfolio dividends), whereas the "non-eligible RDTOH account" will generally include investment income-related taxes paid by the corporation under Part I and under Part IV (in relation to non-eligible portfolio dividends or dividends from a "connected" corporation[5]) of the Tax Act.

The rules provide that the payment of an eligible dividend will give rise to a refund only to the extent that there is a positive balance in the corporation's eligible RDTOH account. Payments of non-eligible dividends will trigger refunds from the corporation's non-eligible RDTOH account until exhausted (at which point non-eligible dividends will trigger refunds from the corporation's eligible RDTOH account (to the extent of the balance thereof)).

The proposed rules contain transitional provisions with respect to the allocation of current RDTOH balances between the two new accounts.[6]

The new measures concerning RDTOH access are applicable to taxation years beginning after 2018, with the

same anti-avoidance rules noted above potentially applying in respect of taxpayer attempts to defer the effective time of the measures through the use of short taxation years.

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[1] The favourable small business rate available to CCPCs must be shared amongst any group of CCPCs that are "associated" for the purposes of the *Income Tax Act* (Canada).
[2] Budget 2018 confirmed that the Government is moving ahead with its previously announced proposal to reduce the small business tax rate for qualifying active business income of CCPCs from 10.5% to 10% in 2018, and to 9% in 2019.
[3] Within the meaning contained in subsection 186(4) of the Tax Act.
[4] The difference in the net tax burden imposed on eligible and non-eligible dividends varies fairly significantly between provinces. Generally, a non-eligible dividend is one paid from a private corporation's active business income that is subject to the small business tax rate, or its investment income earnings.
[5] Excluding certain eligible dividends from a connected corporation in circumstances where the dividend triggers a refund out of the paying corporation's eligible RDTOH account.
[6] For CCPCs, the eligible RDTOH account will be set at the lesser of (i) the CCPC's existing RDTOH balance, and (ii) 38 1/3% of its GRIP balance, with the remaining balance being allocated to the non-eligible RDTOH account (in the case of any other corporation, the existing RDTOH balance will be allocated to the eligible RDTOH account).

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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