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FINALLY, SOME CLARITY – THE PASSIVE INCOME RULES

A sigh of relief with the long awaited passive income rules

After more than nine months of waiting, business owners have finally learned how income on corporate savings will be taxed moving forward. These have been uncertain times, as the possibility of 70%+ tax rates for corporate investments commanded headlines and media stories across Canada. Many business owners were concerned that the proposed rules would threaten their ability to save for retirement, family leave, bad economic times or future business expansions.

When the budget was tabled in the House of Commons on February 27, 2018, you could almost hear the sigh of relief around the country, or at least from business owners. Even though the "grandfathering" that was promised seems to have vanished, the changes are much less punitive than originally proposed. Very generally, the new rules do not create additional taxes, but rather limit the tax deferral opportunities of saving in a corporation, which is exactly what the government set out to do last July.

The new rules can be broken into two separate measures, a reduction to the income eligible for the small business tax rate and changes to the refundable tax regime. These rules are each discussed in detail below.

Small business deduction

For corporate taxation years that begin after the end of 2018, if a corporation and its associated corporations together earn more than $50,000 of passive investment income in the prior taxation year, the amount of the corporation's income eligible for the small business tax rate will be gradually reduced by $5 for every $1 of investment income above the $50,000 threshold. A corporation's $500,000 limit on active business income that can be taxed at the lower small business tax rate (the "small business limit") will be reduced to zero if the corporation and its associated corporations together earn $150,000 or more of passive investment income in the prior year.

As previously indicated, this change will not result in a significant overall tax rate increase, but rather a loss in tax deferral by reducing the income that can be taxed at the lower small business rate.

For the purposes of the $50,000 threshold, a corporation's passive investment income will be measured by a new concept called "adjusted aggregate investment income" (AAII), which will include:

- Taxable capital gains before any loss carry-overs are applied, except for gains on assets used in an active business
- Dividends from non-connected corporations
- Interest and foreign income that is not incidental to the business
- Rental income (unless it is reclassified as active)
- Income from non-exempt life insurance policies
- Expenses incurred to earn passive income.

Note: AAII will not include income incidental to an active business.

Before these new rules, the small business limit was only reduced on a straight-line basis where a corporation and its associated corporations had taxable capital employed in Canada between $10-$15 million. Now, the reduction in a corporation's small business limit will be the greater of the reduction under the new passive income rules and the previous reduction based on taxable capital.

Refundable taxes

The objective of the Canadian refundable tax regime is to achieve "integration" so that the total tax paid corporately and personally on income earned through a corporation is approximately equal to what would have been paid if the shareholder had earned it directly. Under these rules, a notional account called the refundable dividend tax on hand (RDTOH) account, is used to track some of the taxes paid on investment income by a corporation. The balance in a corporation's RDTOH account is refundable at a rate of $1 for every $2.61 of taxable dividends paid from the corporation to its shareholders to account for the fact that an additional layer of tax will apply in the shareholders' hands.

Under the old rules, RDTOH was refunded whether the taxable dividend paid was an eligible dividend or a non-eligible dividend. Eligible dividends are dividends that have been paid from a corporation's active business profits that were subject to the top corporate tax rate or eligible dividends received by the corporation. Non-eligible dividends are dividends that have been paid from any other corporate profits, such as active business income subject to the lower small business tax rate and passive income. To reflect the higher corporate tax rate, eligible dividends receive more favourable personal tax treatment compared to non-eligible dividends.

As a result of the lower tax rates on eligible dividends, under the old rules, the payment of eligible dividends to recover RDTOH could result in a tax deferral. The new rules will split the RDTOH account into two separate accounts in order to limit the RDTOH refund that can be claimed when an eligible dividend is paid. The chart below illustrates what will be included in each RDTOH account.

	Eligible RDTOH	Non-eligible RDTOH
Additions		
Part IV** tax on eligible portfolio dividends	✓	
Part IV tax on non-eligible dividends and eligible non-portfolio dividends		✓
Part I* refundable tax on interest, capital gains and foreign income		✓
Refunds		
Eligible dividends	✓	
Non-eligible dividends	✓	✓

* Part I tax refers to income tax assessed on business income (both active and passive). A portion of part I tax on passive income tax is refundable.

** Part IV tax refers to a refundable tax applied on dividends received by a Canadian corporation.

An ordering rule will apply with respect to these two accounts, which will require a corporation to obtain a refund from its non-eligible RDTOH account first before it can obtain a refund from its eligible RDTOH account when paying non-eligible dividends.

As with the changes to the income eligible for the small business rate, the new rules will apply for corporate taxation years starting after 2018. Where a corporation has an opening RDTOH balance, the balance will be split between the new eligible and non-eligible pools as follows:

- **Eligible RDTOH**: The lesser of the corporation's existing RDTOH balance, and an amount equal to 38 and 1/3 per cent of the balance of its general rate income pool (GRIP)*, if any
- **Non-eligible RDTOH**: Any remaining balance in the corporation's existing RDTOH account.

Both of the new measures include a provision which will deem the new rules to apply to earlier years if a corporation undertakes any transaction to delay the application of the new rules.

Planning

Now that the rules are confirmed, many taxpayers are asking what this means for them and their future planning. There are no one-size-fits-all strategies with these new rules and planning going forward will need to consider various factors including annual active business income, annual investment income, RDTOH and GRIP balances.

All business owners should contact their tax advisors to review their specific situation well before the new rules take effect to ensure any proactive planning can be completed. Planning considerations may include:

- Reviewing the amount of active business income and AAII for prior years to determine the impact, if any, on your business tax rate
- Considering strategies to reduce corporate investment income, such as reducing passive assets or choosing investments that are tax efficient for purposes of the AAII calculation, including those which generate capital gains (50% taxable), focus on capital appreciation rather than current income, or have a low dividend payout policy such as Corporate Class investments
- Reviewing passive income annually, and triggering gains in low income years or deferring gains where possible in high income years
- Reviewing the dividend payment strategy annually and considering a mix of eligible and non-eligible dividends.

*A GRIP is a balance that generally reflects cumulate corporate active business profits that were subject to the top corporate tax rate, or eligible dividends received by the corporation that have not yet been distributed to the corporate shareholders.

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