



New Pitfalls in Investing through Private Corporations

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Overview

- Low small business corporate tax rates permitted investing greater after-tax business income in passive investments (e.g. GICs, stocks, real estate) compared to unincorporated comparatives.
- Owners of private corporations benefit from a tax deferral relative to a situation where the corporation distributes the earnings to the owners who then invest the funds personally in passive investments

Pre-2018 CCPC Tax Advantage

- Simple illustration:
 - CCPC in BC earns \$500k active business income
 - Small Business Deduction available on full \$500k
 - 2017 corp taxes @ 13% = \$65,000
 - CCPC left with \$435,000 to invest in portfolio
 - If \$500k earned by unincorporated person in BC directly, tax would total approx. \$215k, left with \$285k to invest
- Although CCPC investment income taxed at high rate (~50%), portfolio able to grow bigger/quicker with initial corp tax deferral compared to individual earning directly

New Passive Investment Rules

- The 2018 Federal Budget introduced new rules pertaining to the taxation of passive investment income earned by private corporations
- Effective for taxation years beginning after 2018
- Tax deferral advantages on private corp small business income re-invested through corp to generate passive investment income (rents, interest, property gains, etc) will become limited

New Passive Investment Rules

- New phase-out rules on small business income eligible for low corp tax rate based on the amount of passive income earned by a CCPC (Cdn Controlled Private Corp), applying on an associated group basis
- Adding restrictions to the RDTOH refund rules where the dividend paid to obtain a refund the refundable corp tax was subject to the small business rate



Business Limit Phase-out Rules

Previous Legislation

- The rules provided that the small business deduction (“SBD”) was available on active business income up to \$500,000 (shared among associated corporations) per annum
- The income available for the SBD is reduced to the extent that an associated group of companies has taxable capital in excess of \$10 million

Business Limit Phase-out Rules

- The new rules will affect private business corporations that earn passive investment income in excess of \$50,000
- The objective is to limit private corporations to re-invest business earnings that were taxed at a lower rate into passive investments

Business Limit Phase-out Rules

- Business limit (“BL”) is maximum amount of taxable income eligible for small business deduction (“SBD”) resulting in low rate corp tax
- New rules grind down BL on straight-line basis based on the *adjusted aggregate investment income* (“AAII”) of the CCPC

Calculation of the BL reduction

$$\text{BL}/\$500,000 \times 5 (\text{AAIL} - \$50,000)$$

where

- **BL** is the CCPC's business limit otherwise determined for the particular year
- **AAIL** is the total of all amounts each of which is the AAIL of the CCPC, or of any corporations with which it is associated at any time in the particular year, for each of their taxation years that ended in the preceding calendar year.

What is AAI?

Excludes:

- Gain/Loss realized on sale of property used in active business in Canada
- Gain/Loss realized on sale of shares of another connected CCPC in which the assets were primarily used in an active business
- Net capital losses from prior years

Includes:

- Rental income
- Interest
- Gains on property/securities
- Dividends from non-connected corporations
- Income from savings in a life insurance policy that is not an exempt policy

Application of the new rules

- The BL will be eliminated when the AAI (and that of all associated corporations) exceeds \$150,000
- This reduction operates alongside with the existing reduction imposed when taxable capital exceeds \$10m. The amount by which the business limit is reduced will be the greater of the two reductions.

Application of the new rules

- An annual test based on the income for the year that ended in the preceding calendar year
- A corporation may regain access to the SBD if the investment income was high in one year and lower in next year

Example 1 – ABI exceeds AAll

- ABC Company is a CCPC with a December 31, 2020 taxation year end
- ABC Company's AAll for its December 31, 2019 taxation year was \$75,000
- Active business income ("ABI") = \$100,000
- It is not associated with any other corporations in the year

Example 1 – ABI exceeds AAI

- ABC Company's passive income BL reduction for its 2020 taxation year is determined as follows:

$$\begin{aligned} & \$500,000/\$500,000 \times 5(\$75,000 - \$50,000) \\ & = 1 \times 5(\$25,000) \\ & = \$125,000 \end{aligned}$$

Example 1 – ABI exceeds AAll

- Consequently, ABC Company's BL for its December 31, 2020, taxation year will be reduced from \$500,000 to **\$375,000** (i.e., \$500,000 - \$125,000)
- However, \$100,000 of ABI would still be taxed at the SB Fed tax rate of 9% for 2019 (11% incl BC tax) because it is within the reduced BL of \$375,000

Example 2 – AAll exceeds ABI

- Same as Example 1 above, but assume ABC Company's AAll for its December 31, 2019 taxation year was \$200,000

Example 2 – AAI exceeds ABI


- ABC Company's passive income BL reduction for its 2020 taxation year is determined as follows:

$$\$500,000 / \$500,000 \times 5(\$200,000 - \$50,000)$$

$$= 1 \times 5(\$150,000)$$

$$= \$750,000$$

- Consequently, ABC Company's business limit for its December 31, 2020, taxation year will be completely eliminated, and the entire ABI of \$100,000 will be taxed at the general tax rate of 15% (27% incl BC tax).



Changes to Refundable Dividend Tax on Hand (“RDTOH”)

The RDTOH System

- The RDTOH system provides integration – corporate investment income taxed at approximately the same rate that would apply if that income was earned by an individual at the top marginal tax rate
- Portion of corp tax is refunded on the payment of dividends by the corporation to individual shareholders that are taxed personally – the refundable portion is known as the “RDTOH”

Previous RDTOH System

- Previously, a corporation with a General Rate Income Pool (“GRIP”) balance could pay eligible dividends out of its GRIP pool and recover RDTOH unrestricted
- The individual shareholder would be subject to personal taxes at a lower tax rate than it had not been designated as an eligible dividend
- As a result, the total taxes paid by the corporation and the individual shareholders may be much lower than if the same income was earned by the individual directly

Changes to RDTOH

- Introducing two new RDTOH accounts – **eligible RDTOH account** and **non-eligible RDTOH account**
- A payment of eligible dividends will recover eligible RDTOH refund
- A payment of non-eligible dividends will recover non-eligible RDTOH refund *first*

Changes to RDTOH

- **Eligible RDTOH** includes:
 - Part IV refundable tax paid on eligible dividends received from Canadian portfolio investment income or intercorporate dividends
- **Non-eligible RDTOH** includes:
 - The refundable portion of Part I tax
 - Part IV tax refundable on non-eligible dividends from non-connected Canadian corporations

Changes to RDTOH

- Eligible RDTOH account can still be refunded on the payment of a non-eligible dividend if the non-eligible RDTOH pool is fully exhausted
- Eligible dividends can be paid while the CCPC has a non-eligible RDTOH pool, but will effectively only track the ABI earned and not the investment income that actually generated the RDTOH balance, and would not provide a RDTOH refund

Transitional rules to RDTOH

- Transitional rules will apply to permit the RDTOH refunds on eligible dividends to the extent of GRIP balances arising from taxation years before 2019
- For CCPCs – the lesser of its existing RDTOH balance and 38.33% of its GRIP will be allocated to its eligible RDTOH account
- For non-CCPCs – all existing RDTOH balance will carryforward as the eligible RDTOH account

Other considerations

- Anti-avoidance – new rules would apply should a corporation have a short year-end in an attempt to defer the application of the new rules
- Deeming rule applies when two related companies to be associated for the purpose of the SBD if one company lends or transfer property to the other corporation with a view to reduce the grind of BL