Passive Investment Income in a Private Corporation

Warning: This article is toxically boring. Having it in the same room as you is likely to cause you to slip in to a coma. I'm only on the third sentence and I've already slept for three hours. But I have inserted snotty comments throughout it, out of concern for general traffic safety and the very real risk of you falling on your fork at breakfast.

On February 27, 2018, the federal government released its budget, which departed from some of their more controversial proposals originally outlined in an earlier consultation paper and instead proposed two new measures to limit the private corporation tax deferral advantages:
1. Limiting access to the small business deduction (SBD) based on the amount of passive investment income earned in a corporation and its affiliates.
2. Limiting access to a refund of high corporate taxes paid on passive investment income where dividends are paid from income taxed at lower corporate tax rates on active business income (ABI).

If you are a small business owner, (or just want another excuse to despise the Sheriff-of-Nottingham), the gripping details of the first of these two measures follow, and the second part next week:

Part 1) Limiting access to the small business deduction
Currently, there is a tax deferral advantage for business owners who retain after-tax income in their corporation. This is because corporate business income is generally taxed at lower rates than business income earned personally. (And we can't have entrepreneurs who risked everything on a dream to actually having something to look forward to, so…)

If an individual is in the highest marginal tax bracket and earns business income, this income is subject to tax at a federal tax rate of 33%. Canadian corporations, on the other hand, are subject to a general federal corporate tax rate of 15% on its ABI. In addition, if a corporation is a Canadian Controlled Private Corporation (CCPC), it may benefit from the SBD, which lowers the federal tax rate on the first $500,000 of ABI.

The small business limit must be allocated among all corporations that are associated. Also, the business limit is reduced where the affiliates have more than $10 million total taxable capital employed in Canada.

As a result of the lower corporate tax rates for ABI, incorporated business owners may have more after tax money to invest inside their corporation. Due to the larger amount of starting capital to invest, a business owner may realize after-tax returns that exceed what an individual investor saving in a personal investment account can achieve. The longer the funds are left in the corporation, the higher the value of this "tax deferral advantage". (Never mind the fact that this is their pension in every meaningful respect. And what are pensions but passive income machines?)

The government is concerned with this tax deferral advantage. (The government is led by two born-multi-millionaire frat boys with trust funds so chubby they don't see the magic in it. Money to them is like air. It just is. Did I say that out loud?) As a result, they propose to restrict access to the SBD for CCPC's that have significant income from passive investments (essentially family-owned, self-created, self-directed pension plans – and that confuses us, so… no). After 2018, the government proposes to reduce the business limit on a straight-line basis where the CCPC and its associated corporations have between $50,000 and $150,000 of investment income in a year, eliminating the benefit at the upper end. These changes will operate alongside the existing rules related to taxable capital between $10 million and $15 million, with the more painful of the two walloping sticks to be applied in a given year.

For the purposes of calculating the reduction to the business limit, investment income earned by a corporation will be measured by a new concept, known as "adjusted aggregate investment income" (Think of it as "AA" for Investment Income, or AAII – the actual official acronym). AAII will generally include net taxable capital gains, interest income, portfolio dividends, rental income and income from savings in a life insurance policy that is not an exempt policy. ZZZZZzzzzzzzzz……..

Oh hey.

The test for accessing the SBD is an annual test that is based on passive investment income earned by a CCPC and any associated corporation in the taxation year that ended in the preceding calendar year. Since this is an annual test, it is possible that a corporation could regain access to the SBD if its passive investment income was high in one tax year but lower in another tax year.

In a more complex situation… (This paragraph has been surgically removed.) You're welcome.

There was much protest over the initially proposed changes, and the decaf version is a little less punitive to small business than the original, but the message is still not well-received in the small business community.

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