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Passive Income Changes for Corporations

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The 2018 federal Budget introduced substantial revisions to the rules applicable to corporations that earn passive investment income. The government initially expressed its intention to amend the tax rules because it observed taxpayers reducing their tax bills by investing in their private corporation rather than holding the investments personally. Rules that disincentivize or outright eliminate the tax benefits from the accumulation of passive assets in a private corporation already existed, so these recent changes are merely tightening the existing rules.

The Small Business Deduction

The federal tax rate on a Canadian-controlled private corporation's income from an active business is 9%, on up to the first $500,000 of income for the year. This $500,000 limit must be shared between corporations that are associated with each other. However, where a corporation and any associated corporations have total capital in excess of $10 million, the $500,000 limit is reduced, such that the small business limit is completely eliminated once the corporation's capital is $15 million or greater. For taxation years that begin after 2018, the reduction to the small business limit is the greater of either the reduction for taxable capital discussed above, or the new reduction for investment income.

For every $1 of "adjusted aggregate investment income" that a corporation earns over $50,000 in a year, its small business limit is reduced by $5 in the following year. As a result, once the investment income reaches $150,000, the corporation's small business limit in the following year (assuming the $500,000 is not shared with any associated corporations) is completely eliminated. The introduction of this rule was intended to disincentivize taxpayers from using their private corporations as investment holding companies—earn more than $50,000 per year, and lose your lower small business tax rate. This being said, it is important to understand what adjusted aggregate investment income is since it will determine the reduction.

At a glance, adjusted aggregate investment income is equal to the sum of:

(a) the amount by which the corporation's taxable capital gains exceed its allowable capital losses, other than gains and losses from "active assets" (see below) and loss carryforwards;

(b) the corporation's income from property, other than exempt income and dividend from connected corporations;

(c) the corporation's income from a specified investment business; and

(d) income from a non-exempt insurance policy;

minus

(e) the corporation's total property losses for the year.

An active asset is property used principally (more than 50%) in an active business carried on primarily in Canada by the corporation or a corporation related to it. Active assets also include shares of a connected corporation that would be qualified small business corporation shares if the shareholder were an individual. Moreover, active assets include an interest in a partnership if conditions similar to those above are met by the property held by the partnership.

In conclusion, the greater of the taxable capital reduction and the investment income reduction is subtracted from the small business limit, and therefore reduces or eliminates the amount that the corporation can claim as its small business deduction for the year.

Refundable Taxes on Investment Income

Assuming that an owner-manager shareholder is in the highest tax bracket, absent certain refundable taxes that a private corporation must pay on its investment income, its tax rate on that income would be much lower than that of the shareholder. Therefore, a high-bracket shareholder would otherwise prefer to earn investment income through a corporation since a lower tax rate at the corporate level would result in a significant deferral of personal income tax on that investment income. There are two types of refundable taxes that a private corporation pays on investment income, which effectively eliminate any opportunity to defer taxes. First, there is a refundable 38 ⅓% tax on dividends from non-connected corporations and dividends from connected corporations that generate a refund of tax to that corporation (more on refunds below). Second, on most other types of passive investment income, a private corporation pays an additional refundable tax of 10 ⅔%.

Refundable Tax Accounts

Prior to the changes that came into effect for tax years beginning after 2018, these refundable taxes, plus a portion of the regular corporate tax paid on other investment income, were added to a single account which tracked all of the refundable tax paid by the corporation. This account was formerly called refundable dividend tax on hand, or RDTOH. When the corporate paid a taxable dividend, the tax was refunded back to the corporation at a rate of 38 ⅓% of the amount of the dividend paid.

For taxation years that begin after 2018, the RDTOH account was split into two accounts: eligible RDTOH and non-eligible RDTOH. Their names refer to types of dividends that a corporation can pay: eligible dividends and non-eligible dividends. Eligible dividends represent income that was subject to the general corporate tax rate. Non-eligible dividends represent income that was subject to the small business tax rate and passive investment income. Basically, eligible dividends result in a lower tax burden to the shareholder thanks to a more generous dividend tax credit which exists to compensate shareholders for the higher rate of tax that was initially paid on that amount on the corporate level.

However, prior to these changes, corporate taxpayers were engaging in some creative tax planning where their corporation earned both general rate income and investment income. Basically, the corporation could pay a dividend, which would trigger a refund of taxes that were paid with respect to investment income, but the dividend would be an eligible dividend with respect to taxes on active business income. By refunding the tax on investment income by paying out lower-tax eligible dividends from general tax rate income, a corporation was perceived to be deferring tax on the investment income since the tax is refunded. Enter eligible RDTOH and non-eligible RDTOH.

New Dividend Refund Rules

When a corporation pays a taxable dividend in a year and files a tax return for that year, the CRA will pay a tax refund ("dividend refund"), the amount of which depends on the value of the eligible RDTOH and non-eligible RDTOH accounts and the size and type of the dividend. Also, there are certain limitations and ordering applicable to obtaining a dividend refund.

With respect to eligible dividends paid, the dividend refund is the lesser of 38 1/3% of the amount paid and the eligible RDTOH balance. Basically, eligible dividends paid can only attract a dividend refund where there is a balance in eligible RDTOH. In contrast, for tax years beginning before 2019, a corporation could trigger a refund of taxes paid with respect to investment income by paying a dividend with respect to general rate income (eligible). Since the refundable tax on investment income is added to a different account, as discussed above, eligible dividends no longer refund tax paid in respect of investment income.

A dividend refund of up to 38 1/3% of the amount of any non-eligible dividends paid is available to the extent of the balances of both the non-eligible RDTOH and eligible RDTOH. However, a non-eligible dividend cannot generate a refund from eligible RDTOH unless the non-eligible RDTOH balance is reduced to zero. That is, when a corporation is paying non-eligible dividends, it must deplete its non-eligible RDTOH before receiving a refund from its eligible RDTOH.

Eligible Refundable Dividend Tax on Hand

For tax years beginning after 2018, a private corporation has a separate refundable tax account known as the eligible RDTOH, which tracks refundable tax paid in respect of eligible dividends. The tax is 38 1/3% of eligible dividends and taxable dividends from a connected corporation (to the extent that the dividends triggered a refund from eligible RDTOH for the payor corporation). The value of the eligible RDTOH of a corporation at the end of the tax year is the amount, if any, by which the total of:

(a) total refundable taxes paid in respect of

(i) eligible dividends received in the year from corporations other than connected corpora tions; and

(ii) taxable dividends received in the year from a connected corporation to the extent that the dividends triggered a refund from the payor corporation's eligible RDTOH; and

(b) the corporation's eligible RDTOH at the end of the preceding tax year;

exceeds

(c) the corporation's dividend refund from eligible RDTOH for the preceding tax year.

Simply put, the eligible RDTOH at the end of each tax year is equal to last year's eligible RDTOH, plus refundable tax paid in respect of eligible dividends in the year, minus last year's refund from eligible RDTOH.

Non-Eligible Refundable Dividend Tax on Hand

Effective for tax years beginning after 2018, the non-eligible RDTOH is computed at the end of each tax year. The formula is complex and not unlike its predecessor account, the RDTOH, which applied for tax years beginning before 2019. Non-eligible RDTOH is essentially a continuation of the old RDTOH account, but refundable tax in respect of eligible dividends has been carved out and added to eligible RDTOH instead. At a high level, the non-eligible RDTOH is the sum of:

(a) where the corporation is a Canadian-con trolled private corporation, 30 2/3% of aggre gate investment income for the year, adjusted for foreign tax credit deductions;

(b) the corporation's total refundable tax on dividends paid for the year; and

(c) the corporation's non-eligible RDTOH at the end of the previous year;

minus

(d) the corporation's dividend refund from non-eligible RDTOH for the preceding year.

Aggregate investment income includes taxable capital gains (net of capital losses and loss carryforwards), and income from property other than exempt income and dividends that are deductible. Therefore, aggregate investment income generally includes interest income, rental income, foreign dividends, and other foreign income, to name a few.

Conclusion

In some circumstances, there may have been a tax deferral opportunity where passive investments were acquired using after-tax income that was subject to the low-tax small business rate. These changes were implemented to prevent this type of tax planning, and the reduction to the small business limit will likely disincentivize small businesses from earning investment income over $50,000 per year by restricting their access to lower tax rates. That said, these tax rules are complex, and will affect every businesses differently depending on the circumstances.