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Tax

Budget tries to keep it simple with two proposed tax changes

By **David Rotfleisch**

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(March 15, 2018, 9:01 AM EDT) -- The Trudeau government brought down its third budget earlier this month. The most significant changes related to private corporations — the backbone of Canada's economy and the well known engine of job creation. The sugar that helped the medicine go down was a reduction in corporate tax rates.

Those reductions, promised in the 2015 election campaign and subsequently abandoned, then revived last fall as part of the fallout from the proposed changes to the small business tax regimen, lower the tax rate from the current 10.5 per cent to 10 per cent for 2018 and to nine per cent for 2019 and beyond.

The saga of the new passive investment in private corporation changes began in July 2017 when the Finance Department released draft legislation as well as a consultation paper setting out changes that proposed to limit income sprinkling, restrict certain capital gains provisions and introduce a new tax on passive income earned in Canadian Controlled Private Corporations (CCPCs).

The proposals, which gathered little notice when first released in the dog days of summer, garnered significant backlash by business and members of the Liberal caucus after Labour Day, resulting in a massive retreat by the government.

The revised proposals would still have entailed a likely unworkable accounting nightmare.

The justification for changing the taxation of passive income in private corporations is a deferral advantage that corporations enjoy when earning active business income and investing their profits in the corporation rather than the business owners extracting profits and investing personally. Most of this advantage does not exist due to a refundable tax on aggregate investment income earned by private corporations, which has the effect of increasing the tax rate on passive income to approximately the top personal tax rate. However, a deferral advantage remains since a business entitled to the small business deduction pays a lower rate of tax, about 15 per cent, on its active business income, which it can then invest. That means that the starting investment capital of the CCPC would be higher than a comparable individual.

The system is complex. To account for the fact that investment income earned in a private corporation will eventually be paid out to shareholders, a percentage of the tax paid by the corporation is a refundable tax (paid in advance and then refunded) and is tracked in the refundable dividend tax on hand account (RDTOH). This refundable tax is basically a prepayment of the tax that the individual shareholder will eventually pay. Once a dividend is paid by the corporation it can claim a refund to the extent of the amount in its RDTOH account.

To eliminate the deferral advantage of investing through a private corporation rather than personally, the July 2017 proposals contemplated several potential approaches. The current budget has taken a less onerous path and has introduced two proposed changes.

The first change reduces the amount that can be claimed for the small business deduction for CCPCs based on the amount of adjusted aggregate investment income that it earns.

Right now, the first $500,000 of active business income that a CCPC earns is subject to a lower tax rate through the small business deduction. The budget will reduce that $500,000 limit by $5 for every $1 of investment income that the CCPC earns in excess of a $50,000 threshold.

So, a CCPC with $50,000 or less of investment income per year will still be entitled to the full small business deduction. The small business deduction will be phased out starting with investment income greater than $50,000 and will be reduced to zero at $150,000 of passive income. Capital gains from the sale of active business assets, sale of shares of connected small business corporations and investment income that was earned incidentally to the business (interest earned on short-term deposits or investments held to fund business operations) are not counted towards this calculation.

Further complicating the tax system, the second change introduces a second RDTOH account in order to limit the use of RDTOH to non-eligible dividends for private corporations.

The old rules, with a single RDTOH account, allow for a certain degree of tax planning for a CCPC that earns both aggregate investment income and active business income over $500,000. Aggregate investment income is normally paid out as a non-eligible dividend which provides only an ordinary dividend tax credit compared to the greater dividend tax credit available for eligible dividends.

The dividend tax credit is a flat reduction in tax for the individual who receives a dividend in order to take into account the corporate tax that the corporation already paid on that dividend when it was earned. The enhanced dividend tax credit for eligible dividends is greater than the regular dividend tax credit to account for the higher corporate taxes paid.

So, for all active business income in excess of $500,000, the CCPC would have paid the general corporate tax rate on that income and thus have a balance in its general rate income pool (GRIP) which tracks the amount of income subject to the higher general income tax rate. A CCPC can issue eligible dividends for the amount of GRIP it has. Previously, the CCPC would have paid eligible dividends and claimed the RDTOH on that dividend, gaining an extra tax advantage through the refund plus enhanced dividend tax credit.

Corporations will now track two RDTOH accounts, an eligible RDTOH account and a non-eligible RDTOH account.

The new rules will come into effect for taxation years beginning after 2018. So, the current rules are still in effect, and depending on the date of the corporation’s fiscal year end, the current rules will apply on Jan. 1, 2019, at earliest and on Dec. 31, 2019, at latest.

CCPCs that currently have both GRIP and RDTOH can still issue eligible dividends and use their RDTOH balance under the current rules but have to act fast before the new rules come into effect.

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