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Making sense of the new passive income rules

Budget 2018 revealed the government's new approach to passive income in a CCPC; let's crunch some numbers

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The federal budget delivered last month was a welcome surprise to small business owners as well as incorporated doctors, lawyers and other professionals who were waiting anxiously to see how Ottawa would deal with passive investment assets held by Canadian controlled private corporations (CCPCs).

The government's concern is that under the current rules, a "tax deferral advantage" exists because the tax rate on active business income earned in a corporation is generally much lower than the top marginal tax rate for individuals earning business income or employment income directly. If this after-tax corporate business income is not needed for a shareholder's living expenses and is retained in the corporation, there's more after-tax income to be used as capital for investment than there would be if an individual earned the business income.

If these corporate funds are invested for a sufficiently long period of time, shareholders may end up with a higher after-tax amount than if income was earned directly by the individual shareholder and invested in his or her hands because of the larger amount of starting capital to invest. The purpose of the new passive investment income proposals is to remove some of this tax deferral advantage, the size of which depends on the difference between the applicable corporate tax rate and the shareholder's personal tax rate.

Federally, the first $500,000 of active business income is taxed at the small business deduction (SBD) tax rate. This $500,000 is referred to as the "business limit." The SBD tax rate is a lower tax rate than the general corporate tax rate on active business income (ABI). Thus, the tax deferral advantage is magnified for small business income and the deferral ranges from 35.3% to 41% in 2018, depending on the province. For ABI, the tax deferral advantage ranges from 20.4% to 27%.

The primary measure that the government introduced in the budget was to restrict access to the SBD tax rate starting in 2019. This new measure proposes to reduce the business limit for CCPCs that have more than $50,000 of "adjusted aggregate investment income" (AAII) in a year. Each dollar of AAII above $50,000 annually reduces the CCPC's business limit by $5, so the business limit will be reduced to zero once $150,000 of AAII is earned in a year.

Essentially, in certain circumstances, this proposed measure will limit the tax deferral advantage available on “new” (i.e. post 2018) ABI by the difference between the personal tax rate on ordinary income and the tax rate on ABI that’s earned in a corporation and is not eligible for the SBD tax rate.

For example, let’s take Marni, an incorporated physician in Ontario, who earns $500,000 of net income annually in her professional corporation. She has accumulated $2 million of retained earnings that will be used to fund her retirement. Let’s assume she earns a 5% annual rate of return, which produces $100,000 of annual investment income. The new rule means that, starting in 2019, Marni’s corporation would be entitled to the SBD tax rate only on her professional income of $250,000 (calculated as $500,000 – [($100,000 – $50,000) X $5]).

Does this mean Marni actually pays more taxes, overall, on the business income that will not be eligible for the small business deduction under the new rules? Yes, but only slightly more (1.51% in Ontario) on a fully integrated basis (i.e. once the funds are distributed from the corporation as a dividend and taxed in Marni’s hands). Rather, the main purpose of this new rule is to reduce Marni’s future corporate tax deferral to 27% from 41% on the $250,000 of 2019 income no longer subject to the SBD rate.