MoneySense

Morneau reveals tax treatment on small business income

$50,000 per year of passive income still qualifies for the small business tax rate

by Allan Norman
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The government wants to help small business owners invest in and grow their firms—but they don't want to give them an advantage over others when it comes to personal saving and investing.

The small business tax rate will go from 10.5% to 10% for 2018 and to 9% in 2019. This compares to the general corporate tax rate of 15%.

To curtail business owners' ability to save large sums in their corporations and take advantage of the small business tax rate the government has introduced new rules around passive income.

What do you need to know? The basic rule is that you are allowed to earn $50,000 per year of passive income and still qualify for the small business tax rate. If you earn more than this then you will gradually shift over to the general tax rate of 15%. Once you have passive income of $150,000 or more you will no longer qualify for the small business tax rate.

But what if you already have passive investments in your corporation?

There was concern that you would have to track pre-existing passive investments and future investments. That won't be the case. Going forward, income earned on past and current investments will make up the $50,000 per year of passive income, the maximum amount before higher taxes kick in. Note that the $50,000 per year is not cumulative; for example, if you earned $0 in year one and $100,000 in year two, you would not be able to average it out to reduce taxes.

The budget likes to use this example: $1 million invested at 5% generates $50,000 of passive income. We asked federal reps how they define passive income, and in simple terms if you earn income as part of your active business activities it is not considered passive income. If it is income earned from investments—stocks, ETFs, bonds, etc., as many owners use for long term savings—then it *is* passive income. Interest and dividends are fully taxed and only 50% of a capital gain is considered passive income.

If you have $1,000,000 and earn an annual return of 10%—or $100,000—as a capital gain, then only $50,000 is counted as passive income.

If you earn passive income above $50,000 then the small business deduction limit is reduced by $5 for every $1 in excess. For example, if you earn $100,000 of passive income, you are over by $50,000; $50,000 x $5 = $250,000, so $250,000 of business income qualifies for the small business tax rate and any remaining business income will be taxed at the general corporate tax rate.

In a second example, if you earn $150,000 of passive income you are over by $100,000 and you will no longer qualify for the small business tax rate. (For example: $100,000 x $5 = $500,000.)

So what's the bottom line? Saving in your business is still a good strategy but now you have to anticipate future passive income. Income sprinkling was curtailed last year but you are still able to pay dividends to a non-contributing spouse at age 65, provided they're a shareholder in your business. So if passive income is going to be an issue you may want to ask your tax expert or financial advisor about the benefits of an Individual Pension Plan (IPP) or cash value insurance.

At the same time, business owners drawing dividends rather than salary may want to review this strategy with their accountant as well. Some salary income may make sense so you can earn RRSP contribution room and make RRSP contributions. It never hurts to have more than one strategy when saving for retirement. You never know…the government may change the rules.

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