2018 Federal Budget Bulletin

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Measures for Corporations

Passive Investments

There has been controversy over the taxation of passive investments in a private corporation since the release of the July 2017 consultation paper. The Federal budget released on Tuesday, February 27, added much needed simplicity and clarity on how passive investments will treated going forward. The government was concerned that Canadian-controlled private corporations (CCPCs) could access the small business rate (currently 13% in Ontario – varies by province) and the after tax monies could be invested in the business passively, allowing a tax deferral until the funds are distributed as a taxable dividend. In addition to accessing the small business rate, corporations could also access the RDTOH and Capital Dividend Account (CDA), lowering the overall corporate and personal income taxes paid.

The Federal Budget proposes two measures for passive investments held in a corporation, effective for taxation years beginning after 2018.

1. Business Limit Reduction

a) The 2018 Federal budget proposals for passive investments will not change how investment income is taxed, or eliminate the RDTOH as previously announced. Instead, it proposes to reduce the small business limit for CCPCs (and their associated corporations) on a straight-line basis when investment income ranges between $50,000 and $150,000. The small business deduction will be eliminated for use on active income when passive investment income reaches $150,000 (reduced by $5 for every $1 of investment income above the $50,000 threshold). Earning a rate of return of 5%, passive investments of $1,000,000 can be held without a reduction in the small business limit (could vary based on your rate of return). For example, a CCPC with $100,000 of investment income would have a business limit reduction to $250,000. Active income up to $250,000 will still benefit from the use of the small business limit and active income in excess of the reduced business limit will be taxed at the general corporate tax rate.

b) Adjusted Aggregate Investment Income – The budget proposes to introduce a new concept of “adjusted aggregate investment income” for determining the business limit reduction. The current concept of aggregate investment income includes interest, royalties, foreign dividends and rent as well as the taxable portion of capital gains. The new concept will have some specific exclusions.

2. Refundability of Taxes on Investment Income

Currently, investment income is taxed at the corporate passive investment rate similar to the top personal income tax rate. Some of this tax paid is refundable at a rate of $38.33 for every $100 of taxable dividends paid to shareholders. Dividends may be eligible or non-eligible.

- Non-eligible dividends (taxed at higher personal tax rates) are usually paid from income subject to the small business tax rate (including non-eligible dividends received by the corporation) or from passive investment income (except non-taxable portion of capital gains and eligible portfolio dividends).
- Eligible dividends (taxed at lower personal tax rate) generally result when active income is taxed at the general rate as well as portfolio dividends from publicly traded Canadian corporations.

The current system allowed a corporation to receive an RDTOH refund when an eligible dividend was paid. This could provide a tax deferral advantage on passive investment income by allowing private corporations paying eligible dividends sourced from active business income taxed at the general corporate income tax rate to generate a refund of taxes paid on passive income.

a) New RDTOH accounts

To better align the refund of taxes paid on investment income, the Federal budget proposes that a refund of RDTOH will be available only when a private corporation pays non-eligible dividends or when RDTOH arises from eligible portfolio dividends received.

The former RDTOH account will now be referred to as the non-eligible RDTOH account and will track refundable corporate taxes paid on investment income as well as under non-eligible portfolio dividends. In addition, different treatment proposed regarding the refund of taxes imposed on eligible portfolio dividend income will necessitate the addition of a new RDTOH account. This new account (eligible RDTOH) will track refundable taxes paid on eligible portfolio dividends. Taxable dividends paid (i.e., eligible or non-eligible) will entitle the corporation to a refund from its eligible RDTOH account but will be restricted by the new ordering rule described below.

b) RDTOH Refunds – Ordering Rule

The budget implements a new ordering rule for RDTOH refunds. Generally a non-eligible RDTOH refund must be refunded before a refund from the eligible RDTOH account.

c) RDTOH Recapture

When a dividend is received by a connected corporation, the recipient corporation will include Part IV tax to their RDTOH account. The RDTOH account of the recipient corporation must match the RDTOH account from which the payer corporation obtained its refund.

d) Treatment of existing RDTOH Balance

The transition of the existing RDTOH account will be allocated as follows. The lesser of;

- the existing RDTOH balance, and
- $38\frac{1}{3}$ per cent of the balance of its general rate income pool

will be allocated to its eligible RDTOH account.

Any remaining balance will be allocated to its non-eligible RDTOH account. For any other corporation, all of the corporation’s existing RDTOH balance will be allocated to its eligible RDTOH account.

In summary, the budget proposals continue to reinforce the importance of tax efficient investing for passive investments in a corporation. Corporate class mutual funds remain an integral component of corporate investment portfolios.