PLANNING FOR THE NEW PASSIVE INCOME RULES AFFECTING PRIVATE CORPORATIONS

Planning for the New Passive Income Rules Affecting Private Corporations is an article included in the Insurance Planning newsletter, published by Thomson Reuters. Re-printed with permission of Thomson Reuters

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INTRODUCTION

In July 2017, Finance Minister Bill Morneau announced potential options for changing the taxation of investment income earned by private corporations. The proposed changes were strongly opposed by many stakeholders and, in October 2017, Minister Morneau announced that changes would be made to the proposed new rules and that draft legislation would be released as part of Budget 2018. The resulting highly anticipated Budget was tabled by Minister Morneau on February 27, 2018. While Budget 2018 has scaled back many of the proposed measures from the July 2017 Consultation Paper, it has moved forward with various amendments to the *Income Tax Act*[1] that will affect small business corporations in Canada. The amendments with respect to passive income earned by a private corporation will still have an adverse effect on small business owners and may affect the way small business owners choose to invest their retained earnings. In particular, the effect of the changes on the small business deduction ("**SBD**") will likely leave small business owners seeking tax-efficient options for the investment of corporate retained earnings that will reduce the impact of these changes.

Bill C-74, which contains the legislative provisions to implement the new passive income rules, received Royal Assent on June 21, 2018.

THE NEW RULES

The new passive income rules in Budget 2018 seek to remove the deferral advantage currently obtained when a private corporation uses its retained earnings – which have been taxed only at the corporate level – to invest in passive investments within the corporation.[2] One of the proposed measures is a grind to a corporation's annual small business limit that impacts the small business deduction available to the corporation. The small business limit will be reduced by $5 for every $1 of adjusted aggregate investment income ("**AAII**") of the corporation, and of any associated corporations, in the prior taxation year. This means that once a corporation reaches $150,000 of AAII, its small business limit will be reduced to nil. The conceptual background to a $50,000 threshold is to permit business owners to accumulate investments of about $1,000,000 (assuming a 5% rate of return) that could be used for future business purposes, funding owner retirement amounts or as a "rainy day" fund.

"Adjusted aggregate investment income" is a corporation's aggregate investment income, as defined in subsection 129(4) of the Act, adjusted in accordance with a new definition found in subsection 125(7) of the Act. This new definition excludes gains and losses from the disposition of an asset that is, at the time of the disposition, an active asset of the corporation, and also excludes net-capital losses from other taxation years. This new definition expands the definition of aggregate investment income by adding to the computation dividends received from non-connected corporations and income from savings in non-exempt life insurance policies not otherwise included in the definition of aggregate investment income.

In a typical scenario, if a small business owner has retained earnings after paying expenses and after paying their own compensation, they will seek investments to allow those retained earnings to grow. For business or other reasons, the corporation may wish to retain those funds in the corporation rather than paying them out to the shareholders as dividends. Under the new AAII rules, small business owners seeking to grow the value of their retained earnings should consider approaches and investments that minimize the impact of the grind on the corporation's SBD caused by the new rules.

SALARY AND RRSP

A straightforward method of avoiding a grind to a corporation's small business limit is to pay any excess retained earnings to the business owner as salary, which will build up the individual's registered retirement savings plan ("**RRSP**") contribution room. The RRSP dollar limit for 2018 is $26,230, which means that an individual must have $145,722 of earned income in order to maximize their RRSP contribution room in 2018. A small business owner looking to avoid the passive income grind may choose to pay out salary in order to maximize his or her RRSP contribution room and to take advantage of the deduction associated with an RRSP contribution. This will allow an income deferral for the individual because the contributions will grow inside the RRSP free of tax. The utility of this strategy for a small business owner will likely depend on the individual's age; an RRSP must mature when the taxpayer attains the age of 71 years, which will make this approach less suitable for older business owners. The older a business owner, the less time available to grow the capital in the RRSP.

INDIVIDUAL PENSION PLAN

One planning option that may be considered by corporations seeking to avoid or minimize the SBD grind is an individual pension plan ("**IPP**"). Rather than using retained earnings to invest in passive assets, a corporation could choose to contribute those retained earnings to an IPP for the benefit of a corporation's shareholder.

"Individual Pension Plan" is defined in Regulation 8300 to mean a registered pension plan that contains a defined benefit provision if the plan has fewer than four members at least one of whom is related to a participating employer.[3] "Related" is defined in subsection 251(2) of the Act: a member will be related to their employer if (i) they control the corporation; (ii) if they are a member of a related group that controls the corporation; or (iii) if they are related to a person described in (i) or (ii).

The term "defined benefit provision", found in subsection 147.1(1) of the Act, requires that benefits in respect of each member are determined in any way *other than* those described in the definition of "money purchase provision". A "money purchase provision" requires a separate account for each member into which contributions are made, and the benefits to such member must be determined solely with reference to the balance of the account. A money purchase provision is commonly referred to as a "defined contribution plan", and a defined benefit provision is commonly referred to as a "defined benefit plan".

To become a registered pension plan, an application must be made to the Minister in the prescribed manner and the plan must comply with the prescribed conditions.[4] The conditions are complex and an actuarial valuation is required before a plan can be approved by the Minister.[5] The contribution limits to the plan will depend on what the actuary determines is necessary to fund the plan benefits, therefore contributions will be unique to each plan and will depend on the age of the member, benefits to be paid to the member, compensation of the member, and the time required to accumulate the required funds.

Paragraph 20(1)(q) of the Act allows the deduction of an employer's IPP eligible contributions as permitted under 147.2(1) and 147.5(10). Subsection 147.2(1) allows the employer to deduct eligible contributions made to the IPP in the taxation year. Employers are also given an additional 120 days after the end of the taxation year to make their eligible contributions for the prior year, similar to contributions to an RRSP. An eligible contribution, as per subsection 147.2(2), is a prescribed contribution or a contribution made pursuant to the recommendation of an actuary and approved by the Minister in writing. Administrative costs of the plan may also be deductible pursuant to paragraph 18(1)(a) provided they are reasonable in the circumstances.[6] Employees are not required to include the IPP contributions made by the employer in income as employment benefits pursuant to subparagraph 6(1)(a)(i).

Employers may also be permitted to make contributions in respect of an employee's past service if it is relevant to the determination of benefits, and if the Minister certifies that the prescribed conditions are met.[7] If the prescribed conditions are met, the ability to account for the past service of an employee will mean more tax-deductible contributions can be made by the employer. The increased contributions for past service may be beneficial for an employer looking for a tax-efficient investment for its retained earnings. Past service contributions will also greatly enhance the ability of the IPP to accumulate retirement savings because more funds are being contributed to the plan that can grow over time. In addition, upon the retirement of the member, the IPP may be enhanced with additional benefits which will allow for additional tax-deductible contributions to be made by the employer.

Because contributions to an IPP are determined based on what the plan requires in order to fund the benefits, the allowable annual contribution to an IPP on behalf of a member is often larger than what that person can contribute to his or her RRSP. For 2018, the RRSP contribution limit is 18% of earned income to a maximum of $26,230, regardless of the age of the taxpayer. In contrast, contributions to an IPP may be substantially higher and will continue to increase with the age of the employee. An IPP may therefore provide an opportunity to accumulate more retirement funds than would otherwise be available using only an RRSP.

For certain business owners, an IPP may provide an attractive alternative under the new passive income rules. The IPP contributions are deductible to the corporation, and the income earned by the IPP, as a registered pension plan, is exempt from Part I tax.[8] This creates the opportunity to reduce passive investment income earned by a corporation. In addition, benefits received from an IPP are eligible for income splitting with the member's spouse provided certain conditions are met.[9]

A major drawback of IPPs for most corporate taxpayers is the administrative cost. As mentioned previously, an IPP must be based on an actuarial report in order for the Minister to grant the IPP the status of a registered pension plan. In addition, a registered pension plan requires an administrator who has the ultimate responsibility for administering the plan.[10] An IPP must also meet any requirements imposed by provincial pensions legislation. Before choosing to set up an IPP, taxpayers should consider whether the administrative cost outweighs the benefits offered under the IPP, including possible avoidance of the passive investment income grind to the SBD. It should also be remembered that an IPP will reduce the member's RRSP contribution room for the year.[11]

Contributions to the IPP must be based on the member's compensation. A member with compensation of $147,222.00 or more in 2018 will maximize the contribution room available under an IPP. The term "compensation" generally includes amounts that are taxable as employment income under sections 5 and 6 of the Act. Dividends are not included in compensation and would not be considered in determining the available contributions and benefits of an IPP. As such, this model would not be appropriate for business owners who are primarily compensated through dividends. IPPs are also limited by the age of the member. Once a member reaches the age of 71, there is a minimum withdrawal required to be paid out to the member every year (similar to a registered retirement income fund).[12] As such, the appropriateness of an IPP as a planning tool must be considered in light the specific circumstances of the small business owner.

CORPORATE OWNED INSURANCE

Corporations seeking a financial product that is not captured by the definition of AAII might consider a corporate owned life insurance policy. Provided the policy is an exempt policy for the purposes of the Act, the value of the policy will not affect the corporation's SBD. An exempt policy is a life insurance policy, in respect of which certain prescribed conditions are met.[13] To be an exempt policy, the funds accumulating in the policy cannot exceed specified limits under the regulations to the Act.[14] The determination of whether a policy is an exempt policy is made each year on the anniversary of the policy.

Certain policies also allow contributions to be made to the policy in addition to the cost of insurance, which amounts will earn income and grow inside the policy on a tax-deferred basis (known as the cash surrender value ("**CSV**") of the policy). It is also possible for the CSV to be added to the face amount of the policy, allowing for greater benefits to be paid out to the corporation upon the death of the insured.

Upon the death of the insured, the corporation will receive the proceeds of the insurance policy free of tax. The proceeds of the life insurance, minus the adjusted cost basis of the policy,[15] will be added to the corporation's capital dividend account.[16] The corporation may then elect by prescribed form to pay the balance of the capital dividend account to the shareholders of the corporation tax-free.

The insured shareholder may also have the ability to access the insurance funds prior to their death by using the insurance policy as collateral for a loan. In making such arrangements the insured shareholder should be careful to ensure that the arrangement cannot be considered a shareholder benefit for the purposes of subsection 15(1) of the Act. The corporation should receive consideration from the taxpayer for the use of the policy as collateral and the arrangement should be properly documented.

The premiums paid for a life insurance policy are not deductible to the corporation unless the policy is used for collateral for the corporation's borrowing;[17] this means that amounts must be paid out of corporate after-tax dollars. The prospective life insured (typically a shareholder of the corporation) must also be insurable, which would be affected by the individuals' age and health.

In summary, a corporate owned life insurance policy not only provides needed liquidity on the death of a shareholder, but amounts contributed to the policy will also reduce a corporation's retained earnings. This will in turn reduce passive investment income that might otherwise act as a grind to the corporation's SBD. Upon the death of the insured, there will be no additional tax payable by the corporation and possibly by the estate of the deceased due to the insurance death benefit credited to the capital dividend account of the corporation.

CAPITAL GAINS

Taxpayers seeking to avoid or minimize the creation of AAII may choose to change the nature of the investments being made within the corporation. A corporation may choose to hold securities that do not pay dividends or other current income to avoid the associated grind to the small business limit. This will allow the corporation to accumulate value through accrued gains which when realized are only half-taxable, while avoiding investment income in the form of dividends. Many financial institutions offer Corporate Class Investments ("**CCI**"), for example, which are designed to minimize taxable income while still providing distributions in the form of a tax-free return of capital. CCIs are held inside a mutual fund, which is treated as a single entity for tax purposes, and therefore the gains and losses are pooled within the fund. CCI's are designed to minimize taxable distributions, which would otherwise be included in a corporation's AAII, and may therefore be attractive to corporations seeking to avoid dividend income.

As well, if a corporation chooses to avoid the creation of AAII by investing in long term assets, planning can also be undertaken in respect of the timing for the eventual disposition of such assets. The gains and losses from the sale of such investments will be AAII for the purposes of the SBD grind, so the corporation may choose to delay the disposition until such time as the active business of the corporation has ceased and the SBD is no longer available. Alternatively, the corporation may choose to time capital dispositions to all take place within the same taxation year, which would limit the impact of the SBD grind to only one taxation year. Corporations may also want to trigger capital gains in years in which the corporation has less active business income and therefore requires less of the small business limit; if the amount of SBD required by the corporation to shelter all of its active business income is less than the SBD remaining after the effects of the grind, the corporation would be indifferent to the effect of the SBD grind.

RETIREMENT COMPENSATION ARRANGEMENTS

Retirement compensation arrangement ("**RCA**") is defined in subsection 248(1) of the Act. In general terms, an RCA is a plan under which contributions are made by an employer to another person (referred to as a "custodian") in connection with benefits to be enjoyed by a person after the retirement of the taxpayer. Numerous other plans – such as RRSPs and registered pension plans – are excluded from the definition of an RCA.

Contributions made to an RCA are deductible to the corporate employer pursuant to paragraph 20(1)(r), and to the employee pursuant to paragraph 8(1)(m.2). Contributions must be reasonable in the circumstances. Employer contributions are not taxable to the employee pursuant to subparagraph 6(1)(a)(ii). As with an IPP, a contribution to an RCA will allow a corporation to reinvest its retained earnings to avoid the creation of AAII.

The custodian of the RCA must pay tax equal to the refundable tax for the year.[18] The refundable tax is equal to 50% of any contributions made during the year and 50% of the income earned by the RCA in the year.[19] When amounts are paid from the RCA to employees, such payments are included in the employees' income[20] and the RCA receives a refund of the refundable tax equal to 50% of the payment.[21]

An RCA is easier to create than an IPP and the administrative costs are typically lower. The amounts contributed to an RCA are deductible by the corporation, which would be beneficial for corporations seeking to reduce their retained earnings. However, RCAs do not offer the benefit of deferral as both contributions and income earned by the RCA are subject to a 50% tax. As such the ability to grow the capital within the RCA may be more limited than with other approaches, which reduces the attractiveness of an RCA as a method of avoiding the effects of AAII on the SBD.

DISTRIBUTION OF CORPORATE ASSETS

It may be advisable for a corporation to distribute some or all of its passive investments to its shareholders, thereby reducing or eliminating the passive income which would thereafter be earned at the corporate level and shifting this income to the shareholder level. This distribution of investments would likely result in income taxes being payable at the shareholder level and, possibly, by the corporation itself in respect of accrued capital gains. The tax consequences at the shareholder level could be reduced if the distribution is made as a shareholder loan repayment, or as a transaction that allows the shareholder to be taxed on the distributed value as a capital gain or as an eligible dividend.

INVESTING THROUGH A NON-ASSOCIATED CORPORATION

It may be possible to restructure ownership of the corporate investments so that they are owned by a non-associated corporation and the resulting income therefrom is not included in the AAII of the business corporation. Taxpayers considering this type of planning should be cautious of newly enacted subsection 125(5.2) of the Act which contains an anti-avoidance rule that applies where, generally speaking, there has been a transfer to a related corporation and one of the purposes of the transfer was to avoid the new passive investment rules.

CONCLUSION

The changes to the taxation of passive income in Canada, if enacted, may have a significant impact on the ways in which small business owners choose to accumulate and invest their retained earnings. In choosing how to best deal with the new rules and their potential grind to the SBD, small business owners and their advisors should consider various planning options, taking into account the age, needs, goals, and history of the individual business owner. While there will be no one-size fits all solution to the proposed changes, with proper planning small business owners can implement strategies that reflect the business owner's particular circumstances and reduce the impact of the new grind to the SBD that would otherwise be available to the corporation.

FOOTNOTES

[1] Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (hereinafter referred to as the "Act"). Unless otherwise stated, statutory references in this article are to the Act.

[2] Government of Canada, "Tax Measures: Supplementary Information" (2 February 2018) <https://www.budget.gc.ca/2018/docs/tm-mf/si-rs-en.html#Toc507170859>.

[3] Income Tax Regulations, CRC, c945 at Regulation 8300.

[4] Subsection 147.1(2).

[5] Subsections 147.2(2) and (3).

[6] CRA document no. 2009-0314581E5, May 13, 2009; Interpretation Bulletin [cancelled] IT-105, "Administrative Costs of Pension Plans," May 30, 1973.

[7] Subsection 147.1(10)

[8] Paragraph 149(1)(o).

[9] Section 60.03.

[10] Subsection 147.1(6).

[11] Subsection 146(1).

[12] Regulations 8500(1) and 8503(26).

[13] Regulation 306(1). See also Kevin Wark "New Policyholder Tax Rules Now Law" (2015) 21 Insurance Planning 1314.

[14] Ibid. and Regulation 307.

[15] Defined in subsection 148(9).

[16] Subsection 89(1), subparagraph (d) of the definition of "capital dividend account"

[17] Paragraph 20(1)(e.2).

[18] Subsection 207.7(1).

[19] Subsection 207.5(1).

[20] Paragraph 56(1)(x).

[21] Paragraph 207.7(2).