The CCPC tax rules

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The federal government first announced proposed changes to the taxation of Canadian-controlled private corporations (CCPCs) in July 2017. The rules that were ultimately enacted substantially modified the original proposals, and some measures were withdrawn completely.

This report will generally review these CCPC tax rules as ultimately enacted, and set out steps that you may wish to consider. If you have a private corporation structure (including a professional corporation), or are thinking of setting up a private corporation, you should contact a tax advisor to discuss how these steps may apply in your particular circumstances.

Income sprinkling

Income splitting

By sprinkling income from a corporation among family members, rather than having one individual receive all of the income, the overall tax paid by the family may be reduced if some of the family members pay no tax or are taxed at a lower tax rate than the individual.

Anti-avoidance measures were put in place to limit this, such as the original "kiddie tax" that resulted in certain dividends paid to children under age 18 being taxed at the highest rate in the child's hands. Effective for 2018, the new CCPC tax rules expanded the kiddie tax rules so that they apply to more types of income and also cover certain adults (the "split income" rules).

The revised rules for split income generally apply where an adult receives dividend or interest income from a corporation, or realizes a capital gain, and a related individual is either actively engaged in the business of the corporation or holds a significant amount of equity (with at least 10% of the value) in the corporation.

The exceptions

The rules include various exceptions, so that the split income rules do not apply in certain circumstances. The availability of these exceptions depends on one's age.

Excluded business

There is a broad exception that is available to anyone over age 17. The split income rules do not apply when the adult is "actively engaged on a regular, continuous and substantial basis in the business" in the year, or in any five previous years (which need not be consecutive). Adults are treated as satisfying this condition if they worked in the business for an average of 20 hours per week during the year, or the part of the year during which the business operates if it is a seasonable business. For adults who work less than this amount, it is a question of fact to determine if the exception is available.

The Canada Revenue Agency (CRA) issued guidance on how it would be applying the split income rules for adults. The CRA stated that "records such as timesheets, schedules or logbooks" and payroll records could be used to demonstrate the number of hours an individual has worked.

Excluded shares

For those over the age of 24, another wide-ranging exception is available where the individual holds a significant interest in the corporation. If an individual is at least 25 years old and owns shares with at least 10% of both votes and value of the corporation, then the split income rules do not apply.

Under the CRA's guidance, if shares are owned by a family trust, they are not considered to be owned by beneficiaries for purposes of the 10% test.

This exception is not available for professional corporations (such as those for physicians, dentists, lawyers and others), or for corporations where at least 90% of the business income is from the provision of services. Corporations with business income flowing from both services and non-services, such as sales, will need to track each type of income separately. CRA has taken the position that where non-services income is incidental to the provision of a service, then it will be considered to be part of the services income.

Reasonable rate of return

The split income rules do not apply if the income received is considered a "reasonable return" as compared to contributions made by certain other people to the business. For those over the age of 24, among the criteria considered are: the work performed, the property contributed and risks assumed.

The CRA stated that it "does not intend to generally substitute its judgment of what would be considered a reasonable amount unless there has not been a good faith attempt to determine a reasonable amount based on" the criteria to determine a reasonable return.

This exception, however, is not as generous for those in the 18-24 year-old age range. The only factor that is considered for these young adults is the "arm's length capital" that they have contributed. The value of work performed for a corporation is ignored for this age group. To qualify as "arm's length capital," the funds cannot have been acquired from related parties. Salary received from a corporation that is reinvested in that or another corporation is acceptable, but not dividends or interest received from a private corporation.

Where capital invested does not satisfy the definition of "arm's length capital," the permitted rate of return before the split income rules come into play for this age group is calculated based on the CRA prescribed interest rate, which is 1% for the third quarter of 2020.

Retirement

A further exception is available to accommodate certain retirees. If a shareholder who is involved in the business is at least 65 years of age, and if income received directly by that person would not be subject to the split income rules, income received by the shareholder's spouse or common-law partner is not subject to the split income rules. This is consistent with the rules for pension income splitting. Note that this exception is available with respect to all corporations, including professional corporations.

Capital gains

Exemptions to the application of the proposed split income rules apply to certain capital gains realized on the disposition of private company shares.

When an individual dies, he or she is deemed to have disposed of all of their capital property, including private company shares, at their fair market value. If such a capital gain arises on a person's death as a result of this deemed disposition, then the split income rules do not apply.

Also, if the capital gain is derived from the disposition of either qualified farm or fishing property, or qualified small business corporation shares, on which the lifetime capital gains exemption[1] ("LCGE") could be claimed, then the split income rules do not apply. If, however, the individual is under the age of 18, and the shares are transferred to a related party, then this exception does not apply and the capital gain is subject to the split income rules.

Action items:

- Where dividend payments would be split income if paid to a shareholder under age 25, but would not be split income if they were at least 25 years of age, consider delaying the payments until the shareholder reaches 25 years of age.
- Where a shareholder under age 25 works in a business, but does not satisfy the average of 20 hours per week test, make sure the shareholder is paid a reasonable salary, and is not compensated for work performed through dividend payments.
- Consider the full effect of these proposed rules before finalizing any contemplated estate freeze transactions. Dividends and gains on shares purchased for a nominal amount may be subject to tax at the highest rate.
- Review the share structure of any private corporations to determine if a reorganization should be considered.
  - You might consider changing the share structure to allow shareholders to qualify for the excluded share exception.
  - If more than one shareholder owns shares of the same class, corporate law might require you pay the same rate of dividends to all shareholders of the same class of shares. If you cannot pay dividends to one shareholder without causing another shareholder to receive dividends that would be taxed at the highest tax rate, you might consider a corporate reorganization so that the shareholders own different classes of shares.

Passive investment income

The Tax Deferral Advantage

One of the goals of the system for taxing private corporations is that after-tax active business income earned through a corporation is approximately equal to after-tax active business income earned by an individual directly, after taking into account the personal tax liability on the dividend paid to move funds out of the corporation.

That is,

Corporate taxes on earnings plus Personal taxes on dividends = Personal taxes on income otherwise earned directly

The tax rate on income earned in a corporation is generally much lower than the top personal marginal tax rate for an individual income earner; consequently, until income is withdrawn from a corporation as a dividend, there is more after-tax income to invest within the corporation than there would be if the income was earned by the individual.[2]

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1 The LCGE exempts the first $883,384 (2020 amount) of lifetime capital gains on the sale of qualifying small business corporation shares from tax. For qualified farm or fishing property, the exemption is $1 million.

2 This assumes that the shareholder pays tax at the top marginal tax rate.

If these corporate funds are not needed for a shareholder's living expenses and these funds are invested inside the corporation over long periods of time, a shareholder may end up with more after-tax income within the corporation at the end of the investment period because of the higher starting capital. This is commonly referred to as the "tax deferral."

Figure 1: 2020 Tax Deferral by province for SBD Income and General Income

Province or territory	SBD Income (eligible for small business deduction)	General Income (not eligible for small business deduction)
AB	37.00%	23.00%
BC	42.50%	26.50%
MB	41.40%	23.40%
NB	41.80%	24.30%
NL	39.30%	21.30%
NS	42.38%	24.50%
NT	34.05%	20.55%
NU	32.50%	17.50%
ON	41.33%	27.03%
PE	39.37%	20.37%
QC	39.30%	26.80%
SK	36.50%	20.50%
YT	37.00%	21.00%

Source: Tax Templates Inc., as at June 30, 2020

The size of the Tax Deferral depends on the difference between the applicable corporate tax rate and the shareholder's personal tax rate. Where income earned in the corporation is taxed at the lower small business deduction tax rate (SBD Rate), the Tax Deferral, which ranges from 32.5% to 42.5% among the provinces and territories in 2020, is magnified as shown in Figure 1. For General Income, the Tax Deferral ranges from 20.37% to 27.03% in 2020.

Example

Amira is an Ontario resident and pays tax at the top marginal tax rate. If she, as a "sole proprietor," earns $10,000 of business income personally from an unincorporated manufacturing business, after paying taxes she would have approximately $4,650 left for investment purposes. If, however, Amira earned that $10,000 through a private corporation paying tax at the SBD Rate, the private corporation would be left with $8,780 after-tax to invest. Even though the after-tax business income and the investment income would be taxable in Amira's hands once paid out as a dividend, she is likely to end up with more after-tax income from the private corporation at the end of the investment period because of the higher starting capital of $8,780 rather than $4,650.

The government considered this unfair and wanted to neutralize the benefit of this Tax Deferral.

The "new" tax rules for passive income

Two measures were proposed to address the Tax Deferral. The first impacts eligibility for business income to be taxed at the lower SBD Rate. The second measure restricts payouts from the refundable dividend tax on hand account (RDTOH). Both of these measures became effective on January 1, 2019.

Restricting the SBD Rate

The SBD Rate applies federally on the first $500,000 of qualifying active business income of a CCPC (the SBD Limit.) The first new measure reduces the SBD Limit for CCPCs with over $50,000 of "adjusted aggregate investment income" (AAII) in a year.

AAII excludes capital gains / losses from the disposition of both property used principally in a Canadian active business, and shares of a connected CCPC where certain conditions are met. It also excludes dividends that are received from connected corporations, and investment income that is incidental to an active business (such as interest from short-term deposits held for operational purposes.) It does include, however, dividends received from non-connected corporations, commonly referred to as portfolio dividends. In addition, net capital losses carried over from previous years are not included in the calculation. Note that this measure does not exclude investment income earned on capital generated before the effective date, nor does it exclude investment income arising from capital invested by a shareholder.

As of January 1, 2019, the SBD Limit is reduced by $5 for each $1 of AAII that exceeds $50,000. It reaches zero once $150,000 of AAII is earned in a year. Put another way, the SBD Limit of $500,000 is reduced on a straight line basis once AAII is $50,000 or more and is completely eliminated once AAII is $150,000. Similar to the requirement that associated corporations share the SBD Limit, for purposes of calculating the AAII threshold, investment income of all associated corporations is combined.

Starting in 2019, ABI that exceeds the SBD Limit (and is not eligible for the SBD Rate of 9% federally) is taxed at the general rate of 15%.

Where there is a certain level of AAII in a corporation, this rule limits the Tax Deferral available on ABI earned starting in 2019 to the difference between the personal tax rate on ordinary income and the general corporate tax rate (which applies to active business income that is not eligible for the SBD Rate.) CCPCs that do not have any income that qualifies for the SBD Rate, such as pure investment holding corporations, are not impacted by this measure.

Figure 2 illustrates the interaction between AAII and the impact on the SBD Limit.

Figure 2: Examples of reduction in the federal small business deduction limit based on passive investment income

If AAII is…	the SBD Limit will be…
$50,000	$500,000 minus ($50,000 minus $50,000) times 5 = $500,000
$75,000	$500,000 minus ($75,000 minus $50,000) times 5 = $375,000
$100,000	$500,000 minus ($100,000 minus $50,000) times 5 = $250,000
$125,000	$500,000 minus ($125,000 minus $50,000) times 5 = $125,000
$150,000	$500,000 minus ($150,000 minus $50,000) times 5 = $0

The provinces have their own SBD Limits and SBD Rates. Two provinces (Ontario and New Brunswick) have announced that they are not following this federal measure, but all other provinces follow the federal rule.

Examples of new passive investment income / SBD limitation rules

The following examples are adapted from the 2018 Budget Plan and demonstrate how the new rules may affect a small business owner in 2020.

Example 1:

Elise owns an incorporated catering business which earns $100,000 (after tax) annually and pays out $75,000 as non-eligible dividends each year. She retains the extra $25,000 annually to build up a fund for a planned parental leave. Elise is not affected by the new rules since the investment income on her savings is well below the $50,000 annual threshold. Thus, she does not have any income taxed at the general corporate rate.

Example 2:

Simon is an incorporated farmer who puts aside excess funds annually to manage weather and other risks affecting his livelihood. His goal is to save $500,000. He chooses to save through his corporation in the AgriInvest program to take advantage of matching government contributions. Investment income from AgriInvest is not considered AAII. As such, Simon is not affected by the new rules.

Example 3:

Claire owns a retail business and uses the retained earnings in her corporation to invest in promising start-ups. She recently sold a 20-per-cent stake in a growing clean-tech firm, and realized a $1 million capital gain, which she reinvested into two new start-ups. Claire is not affected by the new rules because her ownership stake in the active business she just sold is such that her capital gain does not count towards the $50,000 threshold, and she is actively reinvesting.

Example 4:

Amrita owns a hotel whose income depends on a number of factors outside her control, so she sets aside funds each year to ensure she can continue to pay salaries and expenses in case of a downturn. She has $400,000 in savings in her corporation that she invests in low-risk bonds. Amrita is not affected by the new rules because the investment income on her savings is well below the $50,000 threshold, and therefore she does not have any business income taxed at the general corporate rate.

Example 5:

Saanvi owns a retail store and keeps cash deposits to pay her suppliers and the salary of her employee. She earns interest income on these deposits, which in her circumstances is considered incidental to her business. As a result, Saanvi is not affected by the new rules.

Example 6:

Louis operates a successful medical practice, which is incorporated and earns more than $500,000 annually. He has accumulated a portfolio with a value of $5 million, which he intends to pass on to his children. Given his level of savings and level of income, beginning in 2019, Louis no longer receives the benefit of the small business rate to fund further passive investments. All of his business' income is taxed at the general corporate rate.

Example 7:

Jeff is an incorporated Ontario physician who earns $500,000 of net income annually in his professional corporation. He has accumulated $2,000,000 of retained earnings, which will be used to fund his retirement. Assume he earns a 5% annual rate of return which produces $100,000 of annual investment income. For simplicity's sake, we'll also assume that this is ordinary investment income, although in reality it would likely be a mix of dividends and current and deferred capital gains, which would further complicate our math.

The new rule means that, starting in 2019, Jeff's corporation was only entitled to the SBD Rate on $250,000 of his professional income ($500,000 minus ($100,000 minus $50,000) times 5).

Limiting access to refundable taxes

The second proposed measure limits the tax advantages that CCPCs can obtain through the RDTOH system.

The tax system is designed to tax investment income earned by CCPCs at a higher rate, which is approximately equal to the top personal income tax rate. A portion of this high rate tax is then refunded when that investment income is paid out to shareholders as a dividend (and the shareholder is subject to tax.) This refund is made through the RDTOH account system.

Prior to the new tax rules, any taxable dividends paid by a private corporation could trigger this refund, regardless of the source of that dividend. In other words, a dividend refund could be obtained irrespective of whether the dividend came from higher taxed investment income or lower-taxed general income. This meant that some CCPCs could pay out dividends from their pool of ABI taxed at the general corporate rate, even though the dividend was taxed in the shareholder’s hands at a preferential tax rate, and could still claim a refund of taxes paid on their investment income, which is intended to be taxed at higher tax rates when paid to a shareholder.

The government noted that this could provide a significant tax advantage; therefore, under the new rules, CCPCs can generally no longer obtain refunds of taxes paid on investment income while distributing dividends from income taxed at the general corporate rate.[3] Refunds will continue to be available when “non-eligible dividends” are paid out. Shareholders pay a higher rate of tax on non-eligible dividends. RDTOH is now tracked using two separate accounts.

Alternative corporate investment strategies: corporate owned life insurance & Individual Pension Plans

A corporation may choose to invest its after-tax income into a life insurance policy that insures the life of the owner-manager, or some other party. While income from savings in a life insurance policy that is not an exempt policy is specifically captured in the annual passive income test, an “exempt policy,” where no income is required to be included in the holder’s income over the life of the policy, does not come under the ambit of these new rules. This could be a strategy for business owners to consider in consultation with their advisors.[4]

An Individual Pension Plan (IPP) is a pension plan created for one person, rather than a large group of employees.[5] Since the corporation contributes to the IPP and the income earned in the IPP does not belong to the corporation, it too should not be subject to the new rules. An IPP could be a strategy to consider once adjusted aggregate investment income exceeds the $50,000 threshold.[6]

Action items:

Where parties are resident in a province or territory where the restriction of the SBD could be of issue, there are some strategies to consider.

- Consider a buy and hold strategy to defer capital gains if a corporation is approaching the $50,000 threshold.
- Consider withdrawing sufficient salary from a private corporation to maximize contributions to RRSPs and TFSAs. For additional information, see our reports, RRSPs: A Smart Choice for Business Owners and TFSAs for Business Owners… A Smart Choice.[7]
- Consider whether an Individual Pension Plan or corporately-owned life insurance may be appropriate.

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3 A limited exception will apply to portfolio dividends.

4 A tax advisor should be consulted before investing in corporate owned life insurance. It should also be considered whether this fits into your overall financial plan.

5 The main advantages of an IPP are that you can potentially contribute more money than you could with an RRSP and the plan is creditor-protected to the extent provided under the governing pension benefits legislation. There are setup and ongoing administrative costs associated with an IPP.

6 A tax advisor should be consulted before setting up an IPP.

7 The reports RRSPs: A Smart Choice for Business Owners and TFSAs for Business Owners… A Smart Choice are available online in the “Business owners” section at cibc.com/en/personalbanking/advice-centre/tax-savings-tips.html.

Converting income into capital gains (WITHDRAWN)

There are anti-avoidance rules in place to prevent converting dividend income from private corporations to capital gains, which are taxed at a lower tax rate. The government was concerned that the anti-avoidance rules do not specifically address certain transactions that they consider to be abusive.

The original draft legislation released in 2017 contained a proposed expansion of the anti-avoidance rules that would have impacted certain post-mortem tax planning that provides relief from double taxation where private corporation shares are held at death. This is commonly referred to as a “pipeline transaction.” The rules could also have treated capital gains realized on the disposition of private corporation shares to a family member as dividends. This was in addition to the gain being subject to the highest tax rate if it is considered split income.

In response to concerns expressed during the consultation period, the government withdrew these proposals. It is possible, however, that revised measures could be introduced at a later time.

Conclusion

The new rules affecting the taxation of CCPCs are extremely complex. Those who may be impacted should consult tax and legal advisors to determine any actions that they may wish to take.

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