BY JAMIE GOLOMBEK

CCPC Planning

An update on how the CCPC rules will work

If you have clients who are either business owners or incorporated professionals, no doubt they are well aware of the significant changes to the tax rules that came into force earlier this year surrounding the taxation of Canadian controlled private corporations (CCPCs).

Effective for 2018, new rules were put in place to block most attempts at sprinkling income among family members as shareholders of a CCPC. Rules were also put in place that may limit the ability for some CCPCs to claim the small business deduction (SBD) in 2019, based on their corporate passive investment income in 2018.

It's the passive income problem that provides an opportunity for advisors to add considerable value by suggesting a variety of investment and life insurance solutions to reduce the adjusted aggregate investment income (AAII), and help business owner and incorporated professional clients preserve as much as the SBD as possible in 2019, and future years.

BACKGROUND

The tax rate on business income earned in a corporation is generally much lower than the top personal marginal tax rate for an individual who earns business income; consequently, until income is withdrawn from a corporation as a dividend, there is a "tax deferral" in the form of personal taxes that are deferred until a dividend is paid. Where active business income earned in the corporation is eligible for the SBD, a lower corporate tax rate (the SBD rate) applies. For this "SBD income" the tax deferral ranges from 35.5 per cent to 41 per cent in 2018, depending on the province.

The amount of tax deferred in the corporation results in higher starting capital for investment, compared to an individual investor. So if the higher amount of after-tax business income is invested inside the corporation, a shareholder may end up with more after-tax income from the corporation (compared to investing personally) at the end of the investment period. The government considered this unfair and took steps to minimize the tax deferral.

THE NEW RULE (2019)

The SBD rate currently applies federally up to the SBD limit, which is the first $500,000 of qualifying active business income of a CCPC. Starting next year, in 2019, the SBD limit will be reduced for CCPCs with more than $50,000 of certain investment income, or AAII, in the previous year. The SBD limit will be reduced by $5 for each $1 of AAII that exceeds $50,000 and will reach zero once $150,000 of AAII is earned in the previous year. This will decrease the tax deferral available on SBD income earned after 2018. Note that private corporations (including pure investment holding corporations with no active income) that do not have any income that qualifies for the SBD rate will not be impacted by this measure. The Ontario government has announced that it will not be following this federal tax change.

STRATEGIES TO REDUCE AAII

First, business owners or incorporated professionals may wish to consider withdrawing sufficient salary from their CCPC by December 31, 2018 to maximize contributions to RRSPs and TFSAs. Previous studies have shown that RRSPs and TFSAs may provide a higher level of after-tax retirement income than leaving funds in the CCPC to be withdrawn as dividends in retirement. Receiving salary of at least $147,222 by December 31, 2018 will allow the maximum RRSP contribution of $26,500 in 2019. Reasonable salaries may also be paid to family members who work in the business to allow them to make contributions to their own RRSPs and TFSAs.

When it comes to investments, business owners may wish to consider investments that lean toward growth rather than annual interest or dividend income, as this way they can better time the recognition of a capital gain. In addition, since capital gains are only 50 per cent taxable, it would take $100,000 of realized capital gains to generate $50,000 of passive income that is counted toward the AAII test.

It may also be possible to stagger dispositions of investments between calendar years. For example, if there will already be more than $150,000 of AAII in one year, consider triggering additional capital gains in that year, rather than the next, if that might reduce AAII below the threshold in the next year. Conversely, it may be worth triggering capital gains or losses in a specific year because capital losses cannot be carried forward to a future year for purposes of reducing AAII. As a result, capital losses and gains should generally be realized in the same taxation year.

Finally, choosing to invest the after-tax income of the corporation into a corporately owned life insurance policy that insures the life of the business owner, or some other individual, may be an ideal solution. The death benefit may flow out partially, or perhaps even entirely, as a capital dividend that is generally tax-free to the shareholder. Income and growth on the underlying investments are tax-sheltered within the life insurance policy and are not included in the corporation's income on an annual basis, so they don't form part of AAII.

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