CCPC Tax Planning for Passive Income
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2018 was a tremendous year of change for business owners in Canada, in terms of taxation. We saw two major policy changes by the government. The first was the limitations on sprinkling dividend income to family members of your corporation. And the second one were restrictions on what we call the passive income rules. I want to talk to you for a few minutes today about strategies that we can use to try to mitigate the loss of the small business deduction when it comes to passive investment income.

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Background

A corporation when it earns money pays corporate tax on that money and on the first $500,000 a year of what we call active business income it pays a low rate of tax, let's call it 12 percent. The rest of that money is then available to be paid out to the shareholder as a dividend. Contrast that with a salaried employee who receives income. That salaried employee has to pay tax on that income in the year that it's earned and we're looking at tax rates in Canada that vary by province but go all the way up to 54 percent. And in fact across Canada the range varies somewhere between 35 and 40 percent as the value of that tax deferral. The government didn't like it and they said we want to get rid of it. So to discourage Canadian companies from leaving excess retained earnings in their corporation that they're not using to reinvest directly in the business, starting in 2018 there is a new rule that comes into effect for 2019 that will reduce your access to the small business deduction based on the passive income that you have in the prior year. When we think passive income we're thinking things like interest, dividends, and capital gains. This new rule will affect any business owner who has a portfolio of securities or rental properties inside of their corporation. So basically for $50,000 of passive income and under, you get your small business rate. But anywhere between 50 and 150 you actually have a sliding scale down as you can see by this chart. So here are five strategies that you might consider to reduce passive income for this year, so as not to lose the small business deduction next year.

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Tip #1
Withdrawals to permit RRSP/TFSA contributions

The first thing that we should mention is that all business owners should consider maximizing their RRSPs. Paying enough salary or bonus each year to get the maximum amount contributed to the RRSP. Taking that money out of the corporation, making an RRSP contribution. Similarly consider paying enough money out of the company to make a TFSA contribution. After all when investment income is reinvested inside of a corporation, you're paying very high tax rates on passive income. Alternatively when it's earned inside of an RRSP or a TFSA the tax rate is zero.

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Tip #2
Tax-free withdrawals

The second idea is to look to the corporation, see if there are tax free withdrawals that can be pulled out of the corporation. So we're thinking of things like shareholder loans. If you've loaned money to your corporation why not take the money back on a tax free basis. Reducing the amount of cash sitting around inside the business that otherwise might be generating passive investment income. If there's a balance in the capital dividend account, pay it out as a tax free capital dividend to reduce again the accumulating retained earnings in the company that otherwise might be attracting this passive income.

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Tip #3
Investment strategies

Maybe you want to move to a portfolio of securities that is generating mostly capital gains. First of all capital gains are not realized every single year. And second of all capital gains are only 50 percent taxable which means it would actually take a hundred thousand dollars of realized gains to get $50,000 of passive investment income. So look at the portfolio and see if there's things that you can do in that portfolio to minimize the amount of annual passive investment income.

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Tip #4
Individual Pension Plans

Look at something called an individual pension plan which is effectively a defined benefit plan where a business owner sets it up for herself or for her spouse and it allows you to contribute tax deductible dollars from the corporation into this plan. You're effectively removing money out of the company and therefore that money is not earning income in the company that would then count towards the passive income test of the $50,000.

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Tip #5
Life insurance

Final idea is looking at the use of corporately owned permanent life insurance, universal life and whole life policies. If the corporation takes excess funds that are not needed for business and not needed for retirement it takes those monies and invests those inside of a permanent life insurance policy. All of the investment income is sheltered inside the policy. It's not included in the corporation's passive income anymore. And on death the entire death benefit can often be paid out as a tax free benefit to the shareholders through the capital dividend account. Those five strategies and more are all discussed in our latest bulletin on passive income planning for private companies.