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Cidel's Perspective: Budget 2018

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On February 27, 2018, the Department of Finance (Canada) released the 2018 Federal Budget (the "Budget"). The Budget was eagerly anticipated by the tax community because of the promise of settling the controversial new rules regarding the taxation of passive investments in Canadian-controlled private corporations ("CCPC"). As a reminder, in July of 2017, Finance released complicated proposals that would apply an effective tax rate of over 70% to investment income earned in a CCPC, thereby eliminating any advantages to investing corporate profits.

The Budget should be a welcome relief for those who were concerned with the July 17th announcement; Finance has abandoned the majority of their previous proposals. As an alternative, the Budget intends to deal with the taxation of passive investments in CCPCs in two ways.

First, the Budget will limit a CCPC's access to the small business deduction. This will reduce, but not eliminate, the deferral advantage that is realized when investing after-tax corporate dollars into passive investments (i.e. portfolio investments)[1]. Currently, CCPCs that carry on an active business are subject to a 13.5% tax rate (combined federal and Ontario provincial rate) on the first $500,000 of net active business income (the "Business Limit"). Any active income earned above $500,000 is taxed at the general corporate rate of 26.5% (combined federal and Ontario provincial rate). Under the Budget, CCPCs with passive income between $50,000-$150,000 will have their Business Limit reduced on a straight line basis, at a rate of $5:$1. For example, if a CCPC has $100,000 of passive income (i.e. $50,000 above the floor of $50,000), its Business Limit will be reduced to $250,000. Any active income earned above the $250,000 will be taxed at the general corporate rate of 26.5%. This change will reduce the deferral advantages of investing after-tax corporate profits by certain CCPCs.

[1]Corporate tax rates are well below the top marginal tax rate for individuals in Ontario. As a result, using after-tax corporate funds to finance portfolio investments results in a significant deferral opportunity when compared to distributing corporate funds to a shareholder to finance portfolio investments.

Second, the Budget will modify the way a CCPC can receive a refund of certain corporate taxes. Currently, CCPCs are subject to an additional refundable tax on income earned on passive investments. This tax is refunded to the CCPC when the CCPC pays a dividend to its shareholders. Under the Budget, the refund will generally only be available where the CCPC pays an "ineligible" dividend to its shareholders. In Ontario, individual shareholders that are taxed at the highest marginal rate pay a 46.84% tax on "ineligible" dividends, compared to a 39.54% tax on "eligible" dividends. The effect of the new Budget rule will be to increase the overall tax burden on investment income earned in a CCPC by forcing the CCPC to pay an "ineligible" dividend in order to receive a refund of taxes, where, today, the CCPC could otherwise pay an "eligible" dividend to obtain the refund.

By limiting the availability of the small business tax rate, combined with the higher shareholder tax to be paid on dividends, the Budget has made investing corporate profits less beneficial than under current rules. However, corporate investors should be very pleased with the Budget rules when compared to the severity of the proposed framework announced in July of 2017. As stated above, the Budget will reduce the advantages of investing through certain corporate entities, but will not eliminate the advantages as previously feared. In fact, there still remains a significant advantage for certain CCPCs to invest after-tax corporate profits.

Lastly, Finance announced that it will be proceeding with the proposed rules on "income sprinkling" released on December 13, 2017.

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