



February 27, 2018

ADVISOR'S PAGE – PASSIVE INCOME CHANGES (BUDGET 2018)

Passive Investment Proposals – Who, What, When, Where, Why and How?

It has been over seven months since the July 18, 2017 Consultation Paper's comments on passive income sent a wave of panic through the business and tax communities. The February 27, 2018 Federal Budget has now provided detailed proposals and draft legislation very different from the initial alternatives raised by the Federal Government over seven months ago.

This overview is intended to provide the basics of these proposals for tax advisors. The proposals take a two-pronged approach. The first is a restriction to the small business deduction (SBD) where significant passive income is earned. The second is a restriction on the ability to recover refundable dividend tax on hand (RDTOH) by paying out eligible dividends.

Who will be affected?

The SBD changes will only apply to all corporations eligible for dividend refunds which, alone or as an associated group, earn passive income in excess of \$50,000 per year. Changes to the requirements for the recovery of RDTOH will apply to all corporations eligible for dividend refunds.

What is passive income?

Passive income for these purposes will be called "adjusted aggregate investment income" (AAll), a new defined term. The starting point for AAll, the income which attracts the 10 2/3% surtax on investment income, and is eligible for refundable dividend tax on hand.

In addition to aggregate investment income, AAll will include dividends from non-connected corporations and income from the investment component of a life insurance policy to the extent it is not already included. AAll will not be reduced by capital losses carried forward or back.

Some capital gains will be excluded from AAll, being those realized on "active assets", a new definition. Active assets will include:

- assets used principally in an active business carried on in Canada;
- shares of a connected corporation which would meet the definition of "qualified small business corporation (QSBC) shares" if held by an individual; and
- an interest in a partnership where the corporation's interest exceeds 10% of the total value of the partnership and, basically, the partnership meets the same asset tests which apply to determine whether shares of a corporation are QSBC shares.

This information is for educational purposes only. As it is impossible to include all situations, circumstances and exceptions in a newsletter such as this, a further review should be done by a qualified professional. No individual or organization involved in either the preparation or distribution of this letter accepts any contractual, tortious, or any other form of liability for its contents or for any consequences arising from its use. © Video Tax News Inc, February 2018. All Rights Reserved. Published on February 27, 2018. www.videtax.com



A new anti-avoidance rule will require inclusion of passive income earned by a related, but not associated, corporation where assets have been transferred to that related corporation and it is reasonable to consider that one of the reasons for the transfer was to reduce the grind to the business limit.

Why does passive income matter?

Every \$1 of passive income in excess of the \$50,000 de minimis amount will reduce the business limit of the CCPC or associated group by \$5. No SBD will be available if passive income exceeds \$150,000. Passive income for the latest fiscal year ending in the previous calendar year will determine access to the SBD for all taxation years ending in the subsequent calendar year.

For example, assume that ACo (year-end April 30), BCo (year-end September 30) and CCo (year end-December 31) are associated. ACo and BCo will not be affected by these new rules for their April 30, 2019 and September 30, 2019 year-ends. CCo's access to the SBD in its December 31, 2019 year-end will depend on the passive income of ACo for its year ended April 30, 2018, BCo for its year ended September 30, 2018 and CCo for its year ended December 31, 2018.

Passive income for ACo's year ended April 30, 2019, BCo's year ended September 30, 2019 and CCo's year ended December 31, 2019 will impact the associated group's business limit for their 2020 year-ends.

Where an associated group is also subject to a reduction in business limit due to having taxable capital in excess of \$10 million, the higher of the "taxable capital" reduction and the "passive income" reduction will apply.

How does the promised grandfathering work?

Previous announcements indicated that any existing investment assets would be exempt from changes to the taxation of passive income. As these proposals do not change the taxation of passive income, the Government considers its commitment to have been met.

Some taxpayers whose access to the SBD will be reduced or eliminated due to their investment capital accumulated prior to these changes may not agree with that conclusion. However, the proposals do not differentiate between income on existing passive investments and income on passive investments which will be accumulated in the future.

Where does the RDTOH go?

Although RDTOH will continue, there will be restrictions on the ability to recover RDTOH by the payment of eligible dividends. RDTOH will be divided into two pools, as follows:

- "eligible RDTOH" will start with a balance equal to the lesser of RDTOH at the end of the last taxation year before the new rules apply (so the last tax year commencing before 2019) and 38 1/3% of the GRIP balance at the end of that taxation year, reduced for any eligible dividends paid in that year, and will be increased by eligible dividends received on which Part IV tax is payable; and
- "non-eligible RDTOH" will be all RDTOH other than eligible RDTOH.

Payment of an eligible dividend will generate a dividend refund of up to 38 1/3% of eligible RDTOH. Payment of a non-eligible dividend will generate a dividend refund of up to 38 1/3% of all RDTOH (both eligible and non-eligible), first coming from non-eligible RDTOH.

When will these new rules apply?

Generally, these new rules will apply to corporate tax years commencing after 2018. The first full 12-month year-end to which the rules will apply would be December 31, 2019.

However, an anti-avoidance provision can accelerate the application of these new rules where a CCPC undertakes transactions intended to delay the application of these new rules.

This information is for educational purposes only. As it is impossible to include all situations, circumstances and exceptions in a newsletter such as this, a further review should be done by a qualified professional. No individual or organization involved in either the preparation or distribution of this letter accepts any contractual, tortious, or any other form of liability for its contents or for any consequences arising from its use. © Video Tax News Inc, February 2018. All Rights Reserved. Published on February 27, 2018. www.videtax.com

