VIEWPOINT 2018 MAR 01

BUDGET 2018: THE GREAT RETREAT

Westward Advisors

WESTWARD'S VIEW

On July 18, 2017, the federal government announced its intent to eliminate the perceived unfair tax advantage of earning investment income in private corporations.

The announcement met with a hailstorm of opposition from the tax and business community. Major issues included the government's failure to recognize the private corporation as a retirement substitute for business owners, the cost of compliance with a complicated new tax regime, and an effective investment income tax rate as high as 73%.

On February 27, 2018, federal Finance Minister Morneau tabled his third budget **("Budget 2018")** and retreated entirely from a tax overhaul for corporate investment income. Instead, there will be two tweaks to the existing tax regime.

We celebrate the retreat with our clients, their advisors, and the tax and business community generally. We also commend the government for listening to the taxpayers' concerns and abandoning the proposal.

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Tweak #1: Small Business Deduction ("SBD")

Private corporations can claim a SBD that provides a preferential tax rate on up to $500,000 of active business income.

For tax years starting after 2018, the $500,000 of income eligible for the SBD will be gradually reduced at the rate of $5 per $1 of investment income between $50,000 and $150,000. As a result, corporate groups with over $150,000 of investment income will no longer be eligible for the SBD.

Corporate groups with over $15 million of capital are already denied access to the SBD, with a phase-out in the range of $10 - $15 million of capital. Thus, the new SBD phase-out targets smaller corporate groups.

Assuming a 5% rate of return on investment capital, the new SBD phase-out is equivalent to a phase-out in the $1 to $3 million range of investment capital.

Corporate-owned annuity contracts and dispositions of corporate-owned life insurance policies create corporate investment income that may impair access to the SBD.

Tweak #2: Refundable Dividend Tax ("RDTOH")

A portion of investment income tax paid by private corporations is refundable. The amount available for refund at any time is the RDTOH. The RDTOH can currently be refunded to the company at the rate of 38.33% of the amount of eligible or non-eligible dividends paid. Eligible dividends are taxed at a preferential tax rate versus non-eligible dividends.

Eligible dividends are paid from a corporation's general rate income pool **("GRIP")** representing business income previously taxed at the top business income tax rate. Non-eligible dividends are paid from a corporation's non-GRIP surplus, representing income previously taxed with the benefit of the SBD or RDTOH.

The intended result of all this is that the aggregate tax paid at the corporate and personal level is the same regardless of the type of income. However, a corporate group earning both business and investment income is currently allowed to pay low-taxed eligible dividends from GRIP to recover RDTOH.

For tax years starting after 2018, a corporation will generally no longer get an RDTOH refund on the payment of low-taxed eligible dividends. RDTOH will have to be recovered by paying high-taxed non-eligible dividends.

Corporate-owned annuity contracts and dispositions of corporate-owned life insurance policies create corporate investment income that increases RDTOH and the non-GRIP earnings available for non-eligible dividends.

What Is Not in the Budget

Budget 2018 does not contain any new tax measures relating to the following areas:

- Tax treatment of exempt life insurance policies;
- Rules governing the capital dividend account;
- Individual or corporate tax rates;
- Tax treatment of capital gains;
- Rules relating to intergenerational business transfers; and
- Modifications to the tax on split income (TOSI) rules.