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THE NEW PASSIVE INCOME RULES FOR PRIVATE CORPORATIONS: THE LIFE INSURANCE OPTION

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WHERE WE ARE TODAY: THE TAX DEFERRAL ADVANTAGE

Did you know that if you earn income in a Canadian controlled private corporation (CCPC), the tax rate is generally much lower than an individual income earner's top marginal tax rate? You'd have more after-tax income to invest within the corporation than you would if you earned it as an individual. This is true until you withdraw income as a dividend from the corporation.[i]

If you don't need these corporate funds for living expenses and you keep them invested long term within the corporation, you may end up with more after-tax income. This is due to the higher starting capital, and is commonly referred to as the "tax deferral advantage."

The size of the deferral advantage depends on the difference between the applicable corporate tax rate and your personal tax rate as a shareholder. The tax deferral advantage ranges from 35.3% to 41% in 2018 when income earned in the corporation is taxed at the lower small business deduction tax rate (SBD Rate). The deferral ranges from 20.4% to 27.0% where the general corporate tax rate on active business income (ABI) applies.

This benefit is changing in 2019.

WHAT'S COMING: RESTRICTING ELIGIBILITY FOR THE SBD RATE EFFECTIVE 2019

The government views the tax deferral advantage as unfair. This is because it may provide incorporated business owners additional capital for investment that isn't available to unincorporated business owners or employees who are unable to incorporate. The government proposed two measures in the 2018 federal budget to limit the tax deferral advantage. One of these would restrict eligibility for business income to be taxed at the lower SBD Rate starting in 2019.[ii]

The SBD Rate currently applies federally on the first $500,000 of qualifying active business income of a CCPC (the SBD Limit). The new rule will reduce the SBD Limit for CCPCs with over $50,000 of adjusted aggregate investment income (AAII) in the previous year. Starting in 2019, the SBD Limit will be reduced by $5 for each $1 of AAII that exceeds $50,000 in the prior year; for 2019, the 2018 AAII will be used in the calculation. The SBD Limit will be completely eliminated once $150,000 of AAII is earned in a year.[iii]

This means that where there is a certain level of AAII in a corporation, the tax deferral advantage available on ABI earned after 2018 will be limited. The limit is the difference between the personal tax rate on ordinary income and the general corporate tax rate on ABI (income that is not eligible for the SBD Rate).

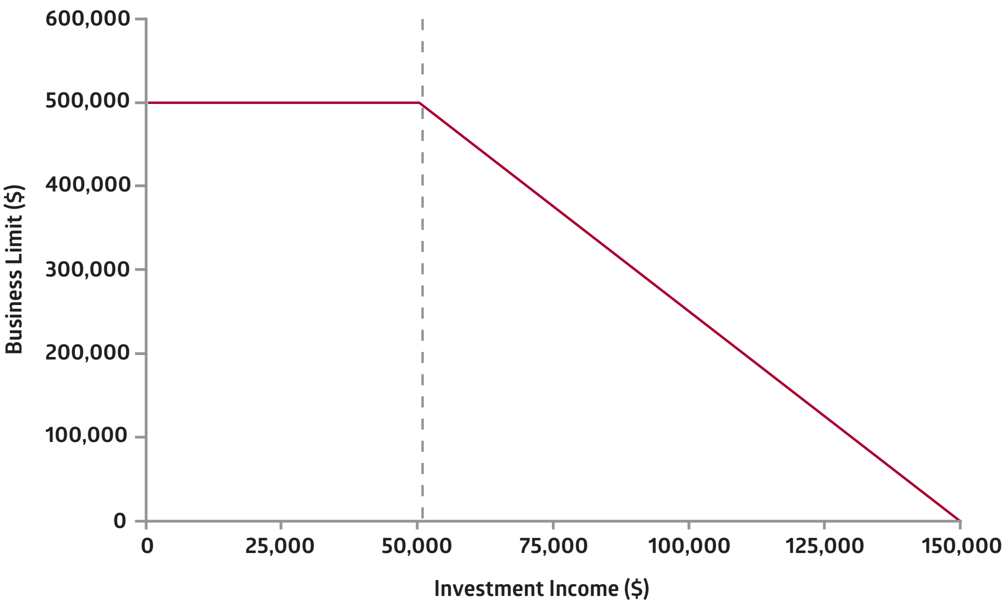
AAII is essentially passive investment income, but with some exclusions.

AN EXAMPLE TO PUT IT IN CONTEXT

Let's look at Louis who operates a successful medical practice. His business is incorporated and earns more than $500,000 of business income annually. He has accumulated a portfolio valued at $5 million in the corporation and he intends to pass this on to his children upon his death. Given this level of savings and income, beginning in 2019 the corporation will no longer receive the benefit of the small business rate. All of the business income will be taxed at the general corporate rate.

The graph below illustrates the interaction between adjusted aggregate investment income and the impact on the SBD Limit.

Reduction in the SBD Limit based on passive investment income



Source: Finance Canada, Budget Plan 2018

CORPORATE-OWNED LIFE INSURANCE: THE ROLE IT CAN PLAY

You may choose to invest the corporation's after-tax income into a life insurance policy that insures the life of the owner-manager, or some other party. So, does the savings accruing in a corporate-owned life insurance policy count towards AAII?

As long as the savings from the life insurance policy aren't included in the corporation's income on an annual basis, they shouldn't be included in AAII. This will be the case for permanent life insurance policies qualifying as "exempt policies."[iv]

That means, permanent, exempt life insurance can be a solution for business owners to consider as an alternative corporate investment where there is a life insurance need as well as a concern that the corporation's AAII could limit access to the SBD rate.[v]

NEXT STEPS

For more information about corporate-owned life insurance, as well as its inherent benefits, please contact your CIBC Wood Gundy advisor and their estate planning team.

i This assumes that the shareholder pays tax at the top marginal tax rate.
ii CCPCs that do not have any income that qualifies for the SBD Rate, such as pure investment holding corporations, will not be impacted by this measure.
iii Similar to the requirement that associated corporations share the SBD Limit, for purposes of calculating the AAII threshold, investment income of all associated corporations is combined.
iv If a life insurance policy does not qualify as an exempt policy, then the amount included in the corporation's income annually in respect of the policy will be included in AAII.
v A tax advisor should be consulted before investing in corporate owned life insurance. It should also be considered whether this fits into your overall financial plan.