July 18, 2017 Department of Finance Draft Legislation on
Investment Income

Written By: *Paul Morton, CPA, CA, CFP, TEP*
Partner, Ginsberg Gluzman Fage & Levitz, LLP

Overview of Proposed Changes

Many small businesses hold and invest their retained earnings within the corporation. This income is subject to a special set of taxation rules. Currently a temporary tax is levied on this investment income, or “passive income”. When investment income is paid out to shareholders, they are able to claim a refund on the temporary tax.

The Department of Finance’s proposals aim for an individual to pay the same amount of tax on investment income, regardless of whether the income was earned personally or through a corporation. The proposals eliminate the perceived advantages of investing the after-tax income in a corporation.

The proposals outlined by Department are designed to achieve the following outcome:

- Investment income would be taxed at a rate approximately equal to the top personal tax rates, similar to how they are taxed today.
- Under the current rules, some taxes on investment income are refundable when dividends are paid to shareholders. The new proposed methods eliminate refundable taxes where the original income was taxed at the lower small business corporate tax rates.
- For investment income earned on retained active business income that was originally taxed at the small business tax rates, the non-taxable portion of capital gains can no longer be added to the Capital Dividend Account (CDA). The CDA are funds that can be paid tax free to shareholders.

The two methods proposed are as follows:

a) Apportionment Method
   - Track the source of income into three pools:
     - Corporate earnings taxed at the small business rate
     - Corporate earnings taxed at the general rate
     - Shareholder loans and other contributions to the company
   - Each year, investment earnings would be apportioned to the three pools above, all of which have different tax treatments
   - If a dividend is paid in a particular year, the business owner would designate from which pool a dividend was paid

   This method is cumbersome, and requires business owners to track how their investment income is earned. This can be onerous.

b) Elective Method
   - Assumes that all investment income is funded by income that was earned at the small business rate
   - investment income earned by a company is subject to non-refundable tax of about 50%
   - When investment income is distributed, the dividend would be a non-eligible dividend
   - Companies could elect for dividends from investment income to be eligible dividends, but the company would then not get the lower small business tax rate on active income

   This method is less cumbersome for business owners than the apportionment method, but would force business owners to decide if they want to access the small business deduction on active income, or pay higher taxes on their investment income.

   Finance has also invited submissions that would include alternate methods to the above.

Companies Focused on Portfolio Investments (Holding Companies)

For holding companies that are not taxed at the low corporate tax rates, the system will remain mostly unchanged. The main change for holding companies is that under the old rules, dividends received from a related company were generally exempt from tax. Going forward, the dividends from related companies will be subject to refundable tax rules, similar to dividends from portfolio investments. As a result, holding companies will have less capital to invest.

There will still be advantages of using holding companies:

- The “estate freeze” will still be available, where the taxes on the death of a parent can potentially be reduced, and the benefit from the growth in value of a portfolio is passed to the next generation.
- By paying dividends from an operating company to a holding company, the capital has more creditor protection.

What Are We Doing?

As part of DFK Canada, we are pro-actively seeking changes to these proposals by discussing their impact with our clients and contacting local MP’s to advise them of the far-reaching impact these rule changes will have on all clients. Those most impacted by the proposals are being portrayed as the wealthiest of Canadians. We know otherwise. We will continue to keep our clients up to date as we learn more about the proposed changes.