Tax spotlight: The impact of 2018 Federal Budget on business owners

The incentives business owners have for saving earnings inside their corporations are targeted by a new tax measure.

The budget measure affects a corporation's access to the small business tax rate where its passive income exceeds $50,000. The small business tax rate is generally the low rate of tax on a corporation's first $500,000 of active business income. This $500,000 threshold is called the small business limit. **The budget tax measure reduces the small business limit by $5 for every $1 of corporate passive income earned above $50,000** in the preceding taxation year. Therefore, the business limit would be reduced to zero at $150,000 of passive income. Passive income includes interest, rent, portfolio dividends and taxable capital gains from marketable securities.

The small business tax rate can be as low as 12 per cent in some provinces. Active business income that isn't taxed at the small business rate is taxed at the higher general business rate, which is generally around 27 per cent depending on your province.

Key details about this budget measure include:

- Passive income earned by an "associated" corporation (like a holding company) will impact a corporation's small business limit.
- This measure is effective for a corporation's taxation years ending after 2018.
- There's no grandfathering for passive income from existing investment assets.
- Growth inside a tax-exempt life insurance policy doesn't produce passive income.

This measure will affect business owners who:

1. Plan to keep their corporation's excess business earnings inside their corporation(s) for business or investment purposes; and
2. Whose corporation(s) earns a level of active business income such that earning passive income corporate would limit their access to the small business tax rate.

This measure won't impact corporations that are large enough so their small business limit is nil because they have more than $15,000,000 of taxable capital employed in Canada.

What's the cost of this measure?

The cost of this measure is the lost tax-deferral opportunity where corporate business income that would have been taxed at the small business rate is otherwise taxed at the higher general rate.

For example, let's say your company's small business rate is 14 per cent and the general business rate is 27 per cent. It has earned over $150,000 of passive income in the prior year so that its small business limit is reduced to nil in the current year. However, it has also earned $500,000 of active business income which will, as a result, now be subject to tax at 27 per cent instead of 14 per cent. Based on these assumptions, your company will now have $65,000 less after-tax earnings that it can invest back into the business or use to purchase marketable securities and insurance.

The following table illustrates how this lost tax-deferral is calculated:

	Small business rate	General rate
Business income	$500,000	$500,000
Corporate tax rate	14%	27%
After-tax	$430,000	$365,000
Difference (lost tax-deferral)	**$65,000**	**n/a**

Where insurance can help

Referring to the example above, a $65,000 tax deferral opportunity is significant. What could your company do with another $65,000 each year? It can reinvest it back into business operations or purchase investments that could produce passive income, which adds to the problem. A potential solution may be to have your company reposition existing investment assets or divert new cash flow into either a permanent life insurance policy or a critical illness policy with a return of premium option, or both.

Life insurance

A corporate-owned permanent life insurance policy could be an excellent solution to provide insurance protection in the event of your death while limiting the amount of passive income earned in your company. The growth in policy values (i.e., cash value and death benefit) are tax-advantaged, meaning they don't produce taxable income, unless in certain circumstances where cash is withdrawn from the policy. The policy's cash value may be accessed without creating any passive income by assigning it to a bank as security for a loan. On death, the corporation receives the insurance payout tax-free. Generally, the insurance payout, less the policy's adjusted cost basis, credits the corporation's capital dividend account (CDA). A corporation can pay tax-free capital dividends to its Canadian resident shareholder(s) to the extent that it has a CDA balance. This combination of tax-advantage policy growth and the CDA credit results in life insurance being a tax-efficient way of both growing corporate wealth and transferring it to your heirs. Policy premiums are generally not tax-deductible.

Critical illness insurance with return of premium

A corporate-owned critical illness policy is another strategy that may provide financial protection in the event you succumb to a critical illness. These policies also help limit the amount of passive income earned in your company. Critical illness policies have an optional return of premium (ROP) rider that enables the policyowner to receive 100% of the total premiums paid into the policy after 15 years. In a sense, this strategy is a forced savings plan with critical illness protection – and the cost of this protection is the opportunity cost of the premiums. The premiums are not tax-deductible. The ROP benefit is received tax-free and, if the full amount is claimed, the policy terminates. The critical illness benefit is also received tax-free. Once any critical illness benefit is claimed, the ROP option is no longer available. For both the ROP benefit and the critical illness benefit, the proceeds may be used by the company or paid to the shareholder as a taxable distribution.

Conclusion

The 2018 Federal Budget contains a tax measure that could be costly to business owners by limiting the amount of after-tax corporate earnings available for either investing into the business or for savings. This measure is triggered by the amount of passive income earned in your company (or companies). Permanent life insurance and critical illness insurance may be a way to obtain insurance protection while limiting the amount of passive income earned in a corporation.