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GOLOMBEK'S THOUGHTS ON NEW PASSIVE INCOME RULES

Katie Keir / February 27, 2018

The Liberal government's third federal budget promises more help for the middle class, workplace equality, a boost for tomorrow's economy and a fair tax system.

But, for all those promises, "there's not a lot there for the average individual, and not a lot of changes from a personal tax perspective," says Jamie Golombek, managing director for tax and estate planning at CIBC Financial Planning and Advice. He notes there are also "very few changes in credits." (There's the Canada Workers Benefit for low-income workers, previously the Working Income Tax Benefit, and the expansion of the tax credit for those who rely on psychiatric service dogs.)

As a result, the big ticket item of Budget 2018 is "how the government will deal with passive investment income inside a private corporation," says Golombek. The news on this front "will be welcomed by private business owners in terms of the proposed change."

In short, "the government has decided to approach the entire issue of private corporation taxation of investment income in a new light," he explains. "Instead of taxing the investment income above the $50,000 threshold at a highly punitive effective rate of as high as 73%—as previously announced back in October 2017—the government has taken a different approach."

Instead, "once you have passive income [of more than] $50,000 annually in your corporation, then [the government is] going to restrict access to the small business deduction in the current year. This starts in 2019."

Under current rules, says Golombek, "we have a small business rate on the first $500,000 of active business income; that's a very low tax rate. So, what the government is saying is once you've accumulated [more than] $50,000 of passive income, [they're] going to reduce the small business deduction by 5% for every dollar over that threshold, until you get to $150,000 of passive income."

The new math is very simple: "you take that $150,000, less the $50,000 of passive income. You then get $100,000 of extra passive at 5%; there's your full $500,000 of small business deduction eliminated," he adds.

WHAT THAT MEANS FOR CLIENTS

The effect of this change is "business owners will no longer be able to retain income inside the corporation taxed at low rates, once they've got a certain amount of retained earnings that [are] earning an annual passive investment income," says Golombek.

On the upside, "you do have full grandfathering of all retained earnings that are already in there; you could [have been] saving that for investing, retirement or other purposes," he adds.

Business owners won't love this development, says Golombek, but it will be welcomed nonetheless, given it's "much simpler" than what was previously proposed.

Going forward, as of 2019, Golombek predicts the number of businesses that claim the small business deduction will drop—but not significantly. "The government estimates that less than 3% of business owners would have [the] type of retained earnings that are subject to potential clawback," he says.

TAX STRATEGIES TO EXPLORE

There may be viable strategies that you can use to get around the $50,000 annual limit, suggests Golombek.

This could include "investing in buy-and-hold strategies that report no income. [In that scenario], you'd only face a clawback in the year that you sold a particular investment and realized a capital gain; of course, capital gains are only 50% taxable, and that's also beneficial toward the $50,000 limit," he notes.

Also, business owners of private corporations could consider the use of permanent corporate-owned life insurance. "For example, exempt policies that effectively accumulate inside the policy and [do not] generate any annual investment income."

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