Ontario passes on passive investment income rules impacting the small business limit

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On November 15, 2018, the Ontario Government announced that it would not parallel recently enacted federal legislation that reduces a Canadian-controlled private corporation's (CCPC's) access to the small business deduction where passive investment income earned by a CCPC exceeds a specific threshold. This may lead to anomalous results, with a CCPC having different small business limits in a year, one for federal purposes and another for Ontario purposes.

In June 2018, amendments to the *Income Tax Act* (Canada) were enacted that include new rules that reduce the federal $500,000 small business limit for CCPCs (and associated corporations) earning passive investment income in excess of $50,000, effective for taxation years beginning after 2018 (subject to transitional rules). This reduction results in reduced access by a CCPC to the federal small business corporate income tax rate (9% in 2019, compared with the 15% general corporate tax rate). These amendments were announced in the 2018 federal budget with the objective of limiting the deferral advantage of private companies earning passive investment income.

Under the new federal rules, a CCPC's small business limit for a taxation year will be reduced by $5 for every $1 by which the CCPC's passive investment income and that of its associated companies in total exceeds $50,000 in the preceding year. A CCPC's small business limit will be reduced by the greater of the reduction determined by the taxable capital grind and the reduction determined by the passive investment income grind. The entire small business deduction will not be available to a CCPC in a taxation year if income from passive investments of the associated group exceeded $150,000 in the preceding year, or if the total taxable capital of the associated group exceeded $15 million in the preceding year.

Each of the provinces and territories has its own small business limit and small business income tax rate. The provinces and territories have legislation that generally parallels the federal legislation for the determination of income that is eligible for their small business deduction.

Ontario and Quebec have their own formulas for calculating the taxable capital grind, with each producing the same result as the federal formula. Since the announcement of the new federal passive investment income rules, only Quebec and Ontario have commented on whether they intend to parallel the federal legislation.

In its fall economic update released on November 15, 2018, Ontario announced that it would not parallel the federal rules. For now, the other provinces and territories are expected, at least in the short term, to follow the new rules, as their respective legislation already parallels the federal small business deduction rules. However, the story does not end there. One or more of these provinces or territories could potentially still announce, perhaps in their next budget, their intention not to adopt the federal rules.

Ontario small business limit

Ontario recently enacted legislation that includes an amendment to ensure that it will not parallel the new federal rules noted above. Section 31 of the *Ontario Taxation Act, 2007*, contains provisions that outline the calculation of a CCPC's small business limit and deduction for Ontario purposes.

Generally speaking, if a CCPC meets the criteria to claim the federal small business deduction, then it is eligible to claim the Ontario small business deduction. For 2019, the Ontario small business limit is also $500,000 and the Ontario small business tax rate is 3.5%. The Ontario general corporate income tax rate is 11.5%.

The Ontario legislation also includes a provision for a taxable capital grind, calculated in the same manner as the federal taxable capital grind. As the new Ontario rules remove the impact of the federal passive income grind, there will continue to be only one grind for Ontario purposes for taxation years beginning after 2018. Since the federal legislation stipulates that a CCPC's small business limit is reduced by the greater of the two grinds noted above, it will be possible for a CCPC's Ontario small business limit to be different from its federal small business limit in certain situations for taxation years beginning after 2018, as shown in the example below.

In some cases, the resulting difference in a CCPC's income tax liability could be significant where the small business limit is different for federal and Ontario purposes. For example, if a CCPC is eligible for the full $500,000 small business deduction for Ontario purposes in 2019, but is not eligible at all for the federal small business deduction because it (and/or any associated corporations) had passive investment income exceeding $150,000 in the preceding year, the combined federal and Ontario tax rate on the first $500,000 of active business income for tax purposes would be 18.5% (15% federal general tax rate plus 3.5% Ontario small business rate). Had Ontario paralleled the new federal rules, the tax rate would have been 26.5% (15% federal plus 11.5% Ontario general tax rate), resulting in an increased income tax liability of $40,000 ($500,000 x (11.5% - 3.5%)).

Example - Small business limit, Federal vs. Ontario purposes

Joseph is a Canadian resident and is the CEO and sole shareholder of Profitable Limited, a wholesale distributor of auto parts located near Windsor, Ontario. Profitable Limited has a 31 December year end and is not associated with any other corporations for taxation purposes in either 2018 or 2019. Ontario is the only province in which the company has a permanent establishment for taxation purposes and, therefore, Profitable Limited is only subject to income tax federally and in the province of Ontario.

Since Profitable Limited is a CCPC earning active business income, it could potentially qualify for the small business deduction. Not all of Profitable Limited's after-tax income is required by the company or by Joseph each year and, therefore, a portion of the company's retained earnings is invested each year in a portfolio of blue chip stocks.

Upon retirement, Joseph intends to sell the portfolio, withdraw the proceeds from the company and purchase a home in Arizona. For the 2018 taxation year, Profitable Limited's taxable capital employed in Canada was $13 million and the stock portfolio earned $125,000 in dividend income.

Federal small business limit calculation

As Profitable Limited's 2018 taxable capital employed in Canada was between $10 million and $15 million, and because its passive investment income was between $50,000 and $150,000 that year, the company's federal $500,000 small business limit for 2019 will be reduced by the greater of the taxable capital grind and the grind applicable to the passive investment income earned in the company in 2018.

The federal reduction attributable to taxable capital in this case will be $300,000, calculated in the same manner as has been in place for many years.

The new passive income grind is calculated as $500,000 x 5 x (125,000-50,000) / 500,000 = $375,000.

In this case the greater of the two grind amounts is the passive income grind of $375,000, leaving $125,000 as Profitable Limited's federal small business limit for 2019.

Ontario small business limit calculation

As Profitable Limited's 2018 taxable capital employed in Canada was between $10 million and $15 million, the company's Ontario $500,000 small business limit for 2019 will be reduced by the Ontario taxable capital grind. There is no passive investment income grind for Ontario purposes.

The reduction to the 2019 Ontario small business limit attributable to the company's taxable capital is calculated in the same manner under the applicable Ontario legislation as the federal taxable capital grind and is, therefore, $300,000 in this example. Since there is no other small business limit grind for Ontario purposes, Profitable Limited's Ontario small business limit in 2019 will be $200,000 ($500,000 - $300,000). This leaves a difference of $75,000 that could potentially be taxed at small business rates in Ontario and at the general rate federally.

Conclusion

If your corporation or associated corporate group has a passive investment income portfolio that may be affected by the new federal rules, your corporation's small business limit for federal purposes calculated under these rules may potentially be different from its small business limit for Ontario purposes. The impact on your corporation's income tax liability may be significant, depending on the extent of that difference.

Accordingly, you may wish to re-evaluate your overall remuneration and investment strategy. As the full tax cost of earning passive investment income through your corporation may now be greater than holding it personally, take a step back and consider implementing a full integration analysis to determine an appropriate strategy in your particular circumstances.

If you have any questions, please feel free to contact us at (905) 549-8463.