FACT SHEET – PASSIVE INCOME

Budget 2018 announced important changes to our government's previous tax reform proposal on passive income. This document will provide you with a quick overview of the changes.

WHAT IS PASSIVE INCOME?

Passive income is characterized as investment income (interest and dividend) earned by a corporation on after-tax profits.

For example, if a corporation has a profit of $100,000 in 2019 and pays the small business tax of 12.5%, it retains $87,500 ($100,000 x 12.5%) in after tax profits. If it invests the after-tax profit of $87,500 and earns interest of 10 per cent, the passive income earned is $8,750.

EXISTING BASIC RULES

In Canada, the general federal corporate tax rate is 15 per cent. This rate is increased by the provincial general corporate tax rate of 11.5 per cent. In Ontario, the combined federal/provincial general corporate tax rate is 26.5 per cent.

General corporate tax rate	Provincial corporate tax rate	Total rate
15%	11.5%	26.5%

In order to encourage small businesses, the federal government set a low federal tax rate of 10 per cent in 2018 and nine per cent in 2019. This is the small business tax rate. The combined small business deduction in Ontario for 2019 is 12.5 per cent.

Year	Federal small business tax rate	Provincial small business tax rate	Total rate
2018	10%	3.5%	13.5%
2019	9%	3.5%	12.5%

To qualify for the small business deduction, the corporation must meet the following criteria:

- Earn less than $500,000 in profit; and
- Have less than $15 million in capital assets.

NEW POLICY

The new budget measures will add another criterion to qualify for the small business rate. This new criterion applies where the corporation or associated corporations earn more than $50,000 of passive income.

Once annual passive income increases beyond $50,000 ($1 million after-tax profits earning a five-per-cent return) the new rules will apply. After the $50,000 threshold is surpassed, the small business tax deduction limit of $500,000, which qualifies for the lower 12.5-per-cent rate, will start to be reduced.

For every $1 of investment income above the $50,000 threshold, the small business deduction limit will be decreased by $5, such that, once a corporation's annual passive income reaches $150,000, it no longer has access to the small business limit. Companies whose passive income exceeds $150,000 are therefore subject to the general 26.5-per-cent corporate tax rate.

EXAMPLES: Application of proposed new rules
A) If a corporation's annual passive income were $75,000 ($1.5 million in after-tax profits earning five-per-cent interest) the small business deduction limit would be reduced by $125,000. The tax rate on the remaining small business limit of $375,000 would result in tax payable of $46,875 (12.5 per cent of $375,000) while the balance over $375,000 would be taxed at 26.5 per cent. **B)** If a corporation's annual passive income were $130,000, the small business limit would be $100,000. All profit in that year below $100,000 would be taxed at the small business tax rate of 12.5% and the profit above $100,000 would be taxed at 26.5 per cent. However, if the business uses those passive funds to reinvest in the business, the small business limit will be adjusted accordingly. **C)** If the corporation were to pay a dividend to its shareholders, where it would have already paid 12.5 per cent tax on the profits, the tax rate on the dividend at the personal level will be (through the dividend tax credit system) 37.5 per cent for a total tax of 50 per cent, and where the corporation has paid 26.5 per cent tax on the profits, the dividend tax rate at the individual level will be 23.5 per cent for a total tax of 50 per cent. (This is a simplification of the dividend tax system but illustrates the principle of integration. It does not matter how the income is earned and taxed, at the end of the day it should be taxed at around 50%, depending on the province.)

This policy protects the system of integration on which the Canadian tax system is built. The system of integration of the corporate and personal tax regimes equalize the taxes paid on income earned directly by an individual, to the combined corporate and personal taxes paid on income earned and taxed in a corporation and distributed to individual shareholders as a dividend.