Passive income: the business owner's pet tax peeve

The tax rules for passive income that came into force two years ago can sometimes be a headache for small business owners. Here are some strategies that might help manage them better.

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Since the tax reform of 2019, Canadian owners of small and medium-sized businesses have learned to think differently about the income from their business investments. This "passive income" is now subject to rules that make such investments less attractive in a corporate context. In practice, these rules could prompt some people to take the money out of their companies and invest it personally – subject to paying an immediate and often substantial tax bite. But there could be other options.

To understand these, however, a review of the rules is in order.

Passive income and the Small Business Deduction

The tax reform established a connection between a company's passive income and the tax rate on its active income, i.e. its income from operations. In fact, companies benefit from a reduced rate, known as the small business deduction (SBD), on the portion of their income below a certain threshold, currently $500,000. While the general corporate tax rate for both levels of government ranges from 23% to 31%, depending on the province, this "small business rate," as accountants call it, may be as low as 9% to 14%.

Under the passive income rules, this threshold gradually decreases at a factor of 5 to 1 for each dollar of passive income over $50,000. For example, passive income of $60,000 would reduce the SBD by $50,000 ([60,000 – 50,000] x 5), bringing it to $450,000. The following table provides a few additional examples. As we can see, above $150,000 of passive income, the business owner simply loses all entitlement to the small business tax rate.

Everything starts at $50,000

How passive income rules affect the taxation of active income

DECREASE IN SMALL BUSINESS DEDUCTION DUE TO PASSIVE INCOME

Passive income	SBD reduction	SBD available
$0 to $50,000	$0	$500,000
$60,000	($60,000 - $50,000) x 5 = $50,000	$450,000
$70,000	($70,000 - $50,000) x 5 = $100,000	$400,000
$90,000	($90,000 - $50,000) x 5 = $200,000	$300,000
$100,000	($100,000 - $50,000) x 5 = $250,000	$250,000
$120,000	($120,000 - $50,000) x 5 = $350,000	$150,000
$150,000	($150,000 - $50,000) x 5 = $500,000	$0

Source: Desjardins / Graphics: Actualis

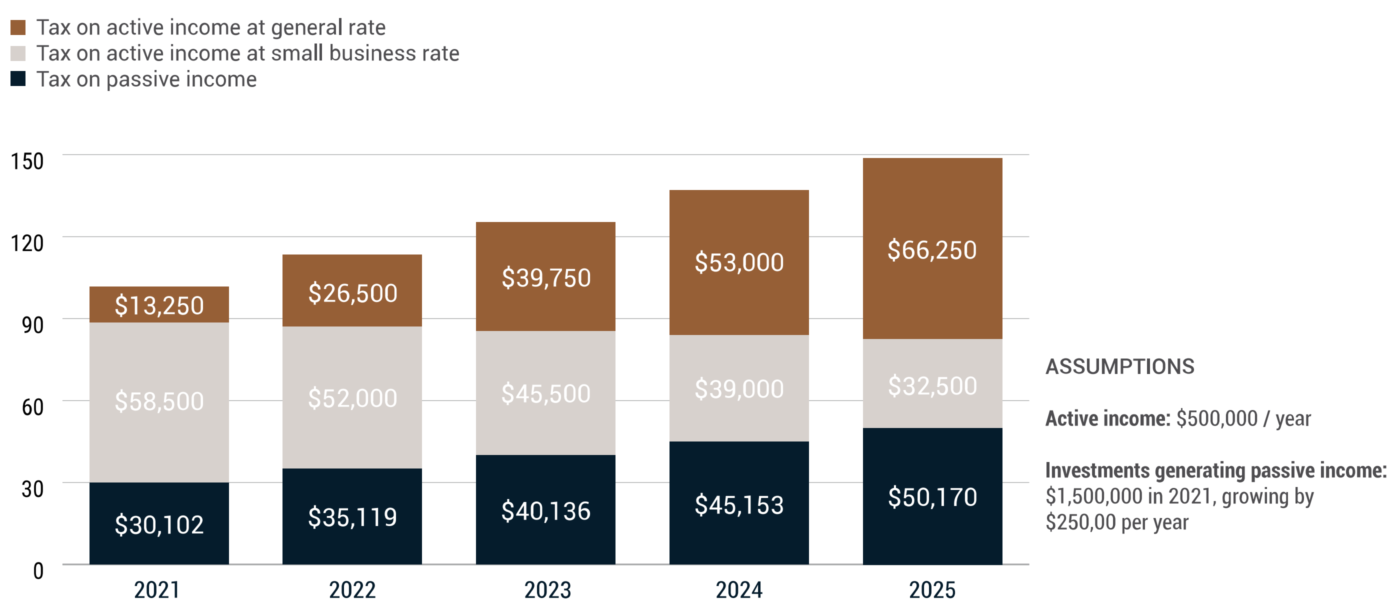
Potentially significant financial consequences

While this may seem inconsequential for a young entrepreneur with little operating profit and even less investment income in his or her company, it's a different story for those who, after years of labour, have managed to generate significant amounts of cash from their business and decided to leave it in the company (or holding company) for investment purposes.

The following graph illustrates the hypothetical situation of a prosperous entrepreneur who has $1,500,000 in business investments earning an annual return of 4%, generates operating income of $500,000 per year, and adds $250,000 to his investment portfolio every year. As we can see, the portion of his operating income benefiting from the SBD decreases each year, and the part subject to the higher tax rate increases. In the first year, he would find himself paying $6,750 more in taxes than if all of his operating income had remained eligible for the small business rate. After five years, he would have paid over $100,000 extra in taxes.

Taxes that add up fast

Fictional example for a small business based in Quebec



Source: The Link Between / Calculations and graphs: Actualis

Possible solutions

So it could be in an entrepreneur's best interests to minimize passive income as far as possible to preserve the SBD entitlement. The easiest and most obvious way to do this would be to pay some of this income to the entrepreneur him- or herself, which would result in an immediate personal tax bill, but might be a viable strategy if the objective were to max out RRSP and/or TFSA contributions – thus accumulating assets outside of the company. However, there are other approaches involving the use of asset accumulation vehicles that are not considered to generate passive income.

There are three main types.

Insurance solutions
Among other benefits, life insurance held by the company could accumulate tax-sheltered cash value within the policy in addition to providing a tax-free death benefit.

Tax-efficient investment solutions
Certain types of mutual funds, known as "corporate" funds, are designed to defer and mitigate the annual tax burden.

Individual Pension Plan (IPP)
An individual pension plan is roughly equivalent to a registered pension fund, but the business owner sets it up for him- or herself. Its many advantages include the fact that, like in an RRSP, the money invested in it is tax-sheltered as it grows and thus has no impact on passive income.

An even better option could be to combine all three strategies, in addition to making orderly withdrawals to transfer assets to the business owner, who would then invest them on a personal basis. Be aware, however, that these three options can be relatively complex and sometimes costly, especially the IPP.

The best idea might be to consult your financial security advisor, mutual fund representative and accountant to decide on the best course of action.

Sources

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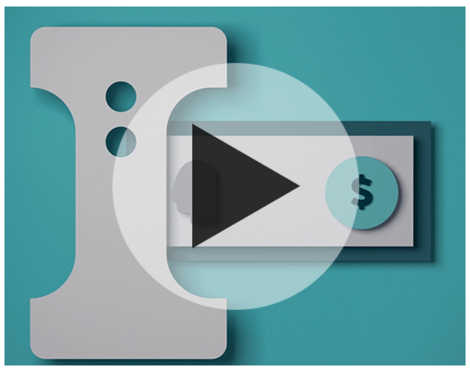

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