ESTATE PLANNING COUNCIL OF WINNIPEG
THE NEW TAX RULES FOR PASSIVE INVESTMENTS

MONDAY, OCTOBER 1, 2018

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THE NEW TAX RULES – PASSIVE INVESTMENTS

<u>AGENDA</u>

- Overview
- How will the new tax rules apply?
- Tax Integration
- Accumulate Personally vs. Corporately
- RRSP vs. Corporate Accumulation
- What this means for your clients

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THE NEW TAX RULES – PASSIVE INVESTMENTS

<u>OVERVIEW</u>

- Effective January 1, 2019 (Taxation years beginning after 2018)
- New Definition: Adjusted Aggregate Investment Income (AAII)
- AAII includes AAII of a CCPC or any associated corporation for each taxation year that ended in the preceding calendar year

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THE NEW TAX RULES – PASSIVE INVESTMENTS

OVERVIEW

- Adjusted Aggregate Investment Income (AAII) includes:
  - Income from property (interest, rents…)
  - Portfolio dividends
  - Dividends from non-connected private corps
  - Taxable capital gains
  - Income from a life insurance policy
- Dividends from a connected CCPC will NOT be AAII

THE NEW TAX RULES – PASSIVE INVESTMENTS

HOW WILL THE NEW TAX RULES APPLY?

The Good News

- No actual change to how passive income will be taxed within corporation

The Bad News

- Tax rate on Active Business Income will increase if AAII exceeds $50K
- Reduction or grind of annual $500K SBD
- Reduced on straight-line basis $5.00 of SBD for every $1.00 of AAII greater than $50K
- At $150K – No SBD whatsover

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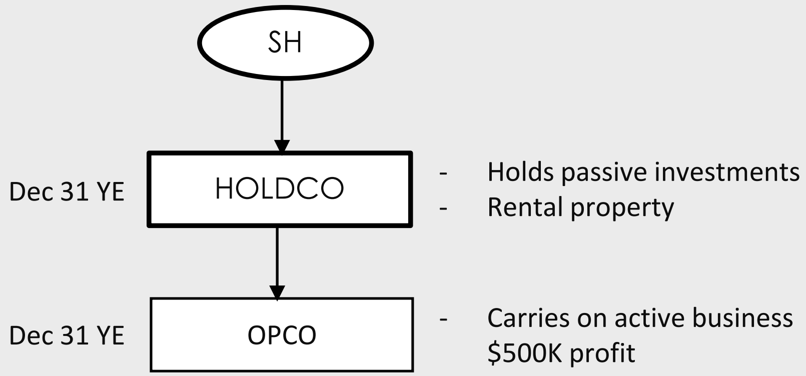
HOW WILL THE NEW TAX RULES APPLY?

Example



Assumptions:

1. OPCO earns $500,000 of ABI subject to corporate tax
2. HOLDCO owns all the shares of OPCO and HOLDCO earns $150K of net property income
3. HOLDCO and OPCO are associated, because HOLDCO controls OPCO

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HOW WILL THE NEW TAX RULES APPLY?

Example – continued

	Assumes Manitoba Tax Rates			
		OLD RULES		NEW RULES
CORPORATE TAX				
HOLDCO	$		$	
SIBI		150,000		150,000
CORP TAX @ 50.67%		(76,000)		(76,000)
		74,000		74,000
RDTOH		46,000		46,000
		120,000		120,000
OPCO				
ABI		500,000		500,000
CORP TAX @ 10%/27%		(50,000)		(135,000)
		450,000		365,000
TOTAL DISTRIBUTABLE		570,000		485,000

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HOW WILL THE NEW TAX RULES APPLY?

Example – continued

SHAREHOLDER TAX				
NON-ELIG DIV		570,000		125,000
ELIGIBLE DIV		-		360,000
		570,000		485,000
TAX THEREON (TOP TAX RATE)				
ON NON-ELIG DIV 45.92%		(261,744)		(57,400)
ON ELIGIBLE DIV 37.78%		-		(136,008)
AFTER TAX CASH		308,256		291,592
IF ALL EARNED PERSONALLY				
BUSINESS INCOME		500,000		500,000
PASSIVE INCOME		150,000		150,000
		650,000		650,000
TAX THEREON @ 50.4%		(327,600)		(327,600)
		322,400		322,400
(DISADVANTAGE) THRU CORP		(14,144)		(30,808)
ADDITIONAL TAX PAID	$	16,664		

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TAX INTEGRATION

Passive Income, eligible for RDTOH

		B.C.		Alberta		Sask		Man		Ont
Corporation	$		$		$		$		$	
Income		100.00		100.00		100.00		100.00		100.00
Tax		(50.67)		(50.67)		(50.67)		(50.67)		(50.17)
		49.33		49.33		49.33		49.33		49.83
RDTOH		30.67		30.67		30.67		30.67		30.67
		80.00		80.00		80.00		80.00		80.50
Dividend		(80.00)		(80.00)		(80.00)		(80.00)		(80.50)
		0		0		0		0		0
Personal										
Dividend		80.00		80.00		80.00		80.00		80.50
Tax		(34.98)		(33.31)		(31.68)		(36.74)		(37.71)
After-tax		45.02		46.69		48.32		43.26		42.79
If earned personally										
Income		100.00		100.00		100.00		100.00		100.00
Tax-top rate		(49.80)		(48.00)		(47.50)		(50.40)		(53.53)
		50.20		52.00		52.50		49.60		46.47
Advantage		(5.18)		(5.31)		(4.18)		(6.34)		(3.68)

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TAX INTEGRATION

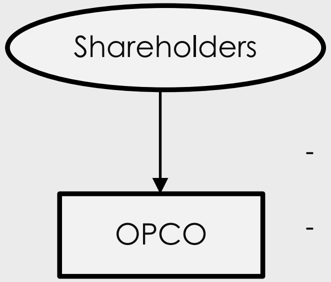
What does this mean

- Never use a company to accumulate passive wealth?
- Is there a break-even point?
- Would different types of passive income matter?

THE NEW TAX RULES – PASSIVE INVESTMENTS

ACCUMULATE PERSONALLY VS. CORPORATELY

Example 1 – Earning Interest/**SBD**



- Earns ABI-taxed at low corporate rate, eligible for SBD
- Generates $50K/yr of pre-tax re-investable cash flow
- 20-year time horizon to invest

- **Assume that:**
  - The $50K is invested in a very safe fixed portfolio yielding 3% pre-tax per annum
  - Corporate tax rate is 10% ($45K available to invest)
  - Top personal tax rate is 50.4%

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THE NEW TAX RULES – PASSIVE INVESTMENTS

ACCUMULATE PERSONALLY VS. CORPORATELY

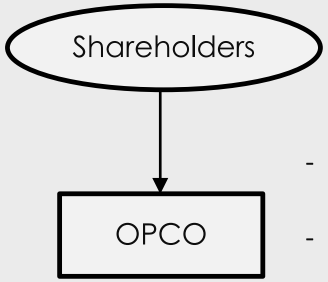
Example 1 – Earning Interest/**SBD**

SUMMARY COMPARISON				
Personally accumulated funds		**Corporately accumulated funds**		
20 years of gross bonuses at $50K per annum	1,000,000	20 years of gross savings (pre-tax)		1,000,000
Personal income taxes on the bonus	(504,000)	Corporate taxes on ABI (assume taxed at low rate)		(100,000)
	496,000			900,000
20 years of accum int at 3% per annum	172,002	20 years of accum int at 3% per annum		311,977
Personal income taxes thereon	(86,689)	Corporate income taxes thereon		(157,860)
	581,313	RDTOH		95,683
		Distributable surplus available		1,149,800
		Personal income taxes thereon (assumes top div tax rate of 45.92%)		(527,988)
				621,812
Conclusion:				
Corp better off by			$	**40,449**

THE NEW TAX RULES – PASSIVE INVESTMENTS

ACCUMULATE PERSONALLY VS. CORPORATELY

Example 1 – Earning Interest/**No SBD**



- Earns ABI/GRIP rate applies (not eligible for SBD
- Generates $50K/yr of pre-tax re-investable cash flow
- 20-year time horizon to invest

- **Assume that:**
  - The $50K is invested in a very safe fixed portfolio, yielding 3% pre-tax per annum
  - Corporate tax rate is 27% ($36.5K available to invest)
  - Top personal tax rate is 50.4%

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THE NEW TAX RULES – PASSIVE INVESTMENTS

ACCUMULATE PERSONALLY VS. CORPORATELY

Example 1 – Earning Interest/**No SBD**

SUMMARY COMPARISON			
Personally accumulated funds		**Corporately accumulated funds**	
20 years of gross bonuses at $50K per annum	1,000,000	20 years of gross savings (pre-tax)	1,000,000
Personal income taxes on the bonus	(504,000)	Corporate taxes at GRIP rates (27%)	(270,000)
	496,000		730,000
20 years of accum int at 3% per annum	172,002	20 years of accum int at 3% per annum	253,048
Personal income taxes thereon	(86,689)	Corporate income taxes thereon	(128,042)
	581,313	RDTOH	77,610
		Distributable surplus available	932,616
		Distributed as:	
		Taxable eligible dividend ($1.0M @ 72% GRIP)	720,000
		Taxable Non-eligible dividend	212,616
			932,616
		Pers income taxes on Elig div of $720,000 at 37.78%	(272,016)
		Pers income taxes on Non-elig div of $212,616 at 45.92%	(97,633)
			562,966
Conclusion:			
Better off personally by		$	**18,347**

THE NEW TAX RULES – PASSIVE INVESTMENTS

Example 2

Comparison

- Why did this happen?
- Less cash to re-invest in corp. 73¢ on dollar versus 90¢ on dollar in Example 1
- But…possible to "Dividend-Split" at Age 65 maybe a game leveler!
- Can structure when distributions are made

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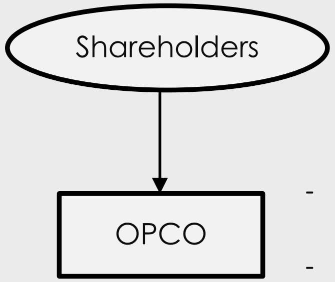
ACCUMULATE PERSONALLY VS. CORPORATELY

Example 3 – Earning Capital Gains/**SBD Available**



- Earns ABI-taxed at low corporate rate, eligible for SBD
- Generates $50K/yr of pre-tax re-investable cash flow
- 20-year time horizon to invest

- **Assume that:**
  - The $50K is invested annually in an equity portfolio (mutual fund or ETF) which yields little or no annual income and is geared for growth over the 20 years.
  - After 20 years, the portfolio has increased in value by $800,000 on the $900,000 invested over 20 years

THE NEW TAX RULES – PASSIVE INVESTMENTS

ACCUMULATE PERSONALLY VS. CORPORATELY

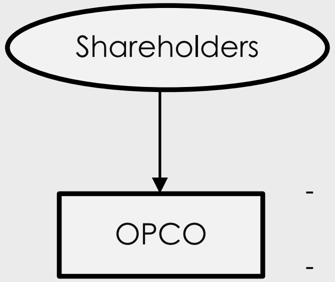
Example 3 – Earning Capital Gains/**SBD Available**

SUMMARY COMPARISON			
Personally accumulated funds		**Corporately accumulated funds**	
20 years of gross bonuses at $50K per annum	1,000,000	20 years of gross savings (pre-tax)	1,000,000
Personal income taxes on the bonus	(504,000)	Corporate taxes on ABI (assume taxed at low rate)	(100,000)
	496,000		900,000
Capital gain realized in year 20	440,889	Capital gain realized in year 20	800,000
Personal income taxes thereon	(111,104)	Corporate income taxes thereon	(404,800)
	825,785	RDTOH	122,680
		Distributable surplus available	1,417,880
		Distributed as:	
		Tax-free capital dividend	400,000
		Taxable Non-eligible dividend	1,017,880
			1,417,880
		Pers income taxes (assumes top div tax rate of 45.92%)	(467,410)
			950,470
Conclusion:			
Corporation better off			$ **124,685**

THE NEW TAX RULES – PASSIVE INVESTMENTS

ACCUMULATE PERSONALLY VS. CORPORATELY

Example 4 – Earning Capital Gains/**No SBD**



- Earns ABI/GRIP rate applies (not eligible for SBD
- Generates $50K/yr of pre-tax re-investable cash flow
- 20-year time horizon to invest

- **Assume that:**
  - The $50K is invested annually in an equity portfolio (mutual fund or ETF) which yields little or no annual income, and is geared for growth over the 20 years.
  - Afters 20 years, the portfolio has increased in value by $648,889 on the $730,000 invested over 20 years.
  - The portfolio is liquidated at the end of year 20 to provide a sustained retirement income to the shareholder(s).
  - Corporate tax rate is 27% (36.5K available to invest)
  - Top personal tax rate is 50.4%

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THE NEW TAX RULES – PASSIVE INVESTMENTS

ACCUMULATE PERSONALLY VS. CORPORATELY

Example 4 – Earning Capital Gains/**No SBD**

SUMMARY COMPARISON			
Personally accumulated funds		**Corporately accumulated funds**	
20 years of gross bonuses at $50K per annum	1,000,000	20 years of gross savings (pre-tax)	1,000,000
Personal income taxes on the bonus	(504,000)	Corporate taxes on ABI (assume taxed at low rate)	(270,000)
	496,000		730,000
Capital gain realized in year 20	440,889	Capital gain realized in year 20	648,889
Personal income taxes thereon	(111,104)	Corporate income taxes thereon	(328,338)
	825,785	RDTOH	99,507
		Distributable surplus available	1,150,058
		Distributed as:	
		Tax-free capital dividend	324,445
		Taxable eligible dividend ($1.0M @ 72%)	720,000
		Taxable Non-eligible dividend	105,614
			1,150,058
		Pers income taxes on Elig div of $720,000 at 37.78%	(272,016)
		Pers income taxes on Non-elig div of $105,614 at 45.92%	(48,498)
			829,544
Conclusion:			
Virtually the same? Diff =			$ **3,759**

THE NEW TAX RULES – PASSIVE INVESTMENTS

RULES OF THUMB

1. Higher after-tax returns if the company is re-investing profits taxed at the low rate, eligible for the SBD
2. Long-term appreciation and accumulation is much better through a corporation, when there are low tax rate dollars to re-invest (see example 3)
3. The ability to income-split at age 65 could have a dramatic (and favourable) impact on the after-tax returns.
4. Paying corporate tax at GRIP rates, more or less "evens the playing field", with no real advantage to corporate accumulation. If future income-splitting is not feasible, it might be better and easier to bonus out re-investable profits along the way.

THE NEW TAX RULES – PASSIVE INVESTMENTS

RRSP VS. CORPORATE ACCUMULATION

FIXED INCOME

		RRSP	CORP SBD	CORP NO SBD
SAVINGS	$			
20 YRS @ $10K/YR		200,000	200,000	200,000
CORP TAX		-	(20,000)	(54,000)
ACCUM INCOME		76,765	62,395	50,610
		276,765	242,395	196,610
TAX ON INT		-	(31,572)	(25,608)
		276,765	210,823	171,002
RDTOH		-	19,137	15,522
		276,765	229,960	186,524
		(139,489)	(105,598)	(73,930)
PERS TAXES		137,275	124,362	112,594

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THE NEW TAX RULES – PASSIVE INVESTMENTS

RRSP VS. CORPORATE ACCUMULATION

CAPITAL GAINS

		RRSP	CORP SBD	CORP NO SBD
SAVINGS	$			
20 YRS @ 10K/YR		200,000	200,000	200,000
CORP TAX		-	(20,000)	(54,000)
ACCUM INCOME		200,000	180,000	146,000
		400,000	360,000	292,000
TAX ON CAP GAIN		-	(45,540)	(36,938)
RDTOH		-	27,603	22,389
		400,000	342,063	277,451
		(201,600)	(115,747)	(82,162)
PERS TAXES		198,400	226,316	195,289

Assume that annual $10K contribution, with growth that "doubles" after-tax capital, after 20 years.

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THE NEW TAX RULES – PASSIVE INVESTMENTS

RRSP VS. CORPORATE ACCUMULATION

TAKE-AWAYS

- RRSP is better for Fixed Income
- Corp is better to accumulate Cap Gains
- More flexibility with Corp
- Potential to income-split at age 65 with corp

THE NEW TAX RULES – PASSIVE INVESTMENTS

WHAT THIS MEANS FOR YOUR CLIENTS

- Manage passive income to less than $50K per annum if possible
- Design HOLDCO portfolio for L-T capital appreciation – not income generation
- Use RRSP for Fixed Income
- Leverage/use debt to reduce passive income/build capital appreciation

QUESTIONS?

Thank you!

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Frostiak & Leslie

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