PASSIVE INCOME

iA Financial Group

WHAT IS PASSIVE INCOME?

Generally speaking, the term passive income describes income generated from passive sources, as opposed to active income which is generated from active business activities. Examples of passive income include rental income, interest income, royalties, dividends, and capital gains. Depending on the type of income, the tax treatment may differ. This article will focus on the Canadian tax treatment of passive income in corporations, the potential downside of earning passive income within a corporation, and some alternatives that may provide certain tax advantages to a corporation.

RENTAL INCOME
INTEREST INCOME
ROYALTIES
DIVIDENDS
CAPITAL GAINS

TAXATION OF PASSIVE INCOME

For individuals, income from all sources is generally taxed in accordance with the individual's tax bracket. However, passive income is taxed differently compared to active business income when it comes to corporations. For Canadian-controlled private corporations (CCPCs), passive income may be subject to additional tax when compared to active income. One example is when a private corporation receives dividends from a corporation which it is not connected with (broadly speaking, corporations are connected when one controls the other, or when one holds more than 10% of the total equity in the other corporation). In this case, the dividend would be subject to an additional refundable tax at 38.33%, which may become refundable when the recipient corporation pays dividends to its shareholders.

Additional tax may also apply when a CCPC earns other types of passive income within the corporation. For example, when a CCPC earns interest or rental income from properties, an additional refundable tax of 10.67% would apply to such income. Similar to the refundable tax on dividends discussed above, this 10.67% tax may also become refundable when the corporation pays out taxable dividends.

Another point to consider when it comes to passive income within a corporation is that unlike active business income, passive incomes are not eligible for the general rate tax reduction, which is currently at 13%.

The following table summarizes the effective tax rate of different types of income for CCPCs:

Source of Income	Tax Rate[1]
Active Business Income eligible for the small business deduction[2]	**12.20%**
Active Business Income not eligible for the small business deduction[3]	**26.50%**
Investment Income, excluding dividends (e.g., taxable portion of capital gains, interest, and rental income)	**50.17%**[4]
Taxable dividends received from non-connected corporations	**38.33%**[5]

[1] As of 2024. In this example, the CCPC would be situated in Ontario and is not subject to provincial tax from any other provinces.

[2] Assuming the income is not qualifying zero-emission technology manufacturing profits or manufacturing and processing income.

[3] See footnote 2.

[4] May be partially refundable, see discussion above.

[5] See footnote 4.

SMALL BUSINESS DEDUCTION

Earning passive income within a corporation may also have other disadvantages. For CCPCs that are eligible for the small business deduction, their first $500,000 in active business income is taxed at 12.20%[6] instead of the general rate of 26.50%[7] (the $500,000 threshold is shared with all associated corporations – which in general, means all other corporations that are controlled by the same groups of shareholders)[8].

Their first $500,000 in active business income is taxed at **12.20%[6]**

However, the small business deduction amount a CCPC can claim may be reduced under two circumstances.

1

If a CCPC along with its associated corporations have over $10,000,000 of taxable capital employed in Canada, the small business deduction it may claim would be reduced on a linear basis, where its small business deduction would reach nil once the total taxable capital employed in Canada reaches $15,000,000.

2

Beginning 2019, if a corporation earns over $50,000 of passive income in a given taxation year, its small business deduction limit would be reduced on a linear basis, which reaches nil when the corporation earns over $150,000 in passive income. In other words, each dollar of passive income in excess of $50,000 may lower the amount of active income eligible for the small business deduction by $5, and when passive income reaches $150,000 per year, all associated corporations would be ineligible for the small business deduction.

[6] Combined Federal and Provincial (Ontario) tax rate.

[7] Combined Federal and Provincial (Ontario) tax rate.

[8] The small business deduction also starts to phase out if the corporation and all its associated corporations have over $10M in "taxable capital employed in Canada", which reduces to nil once it reaches $15M.

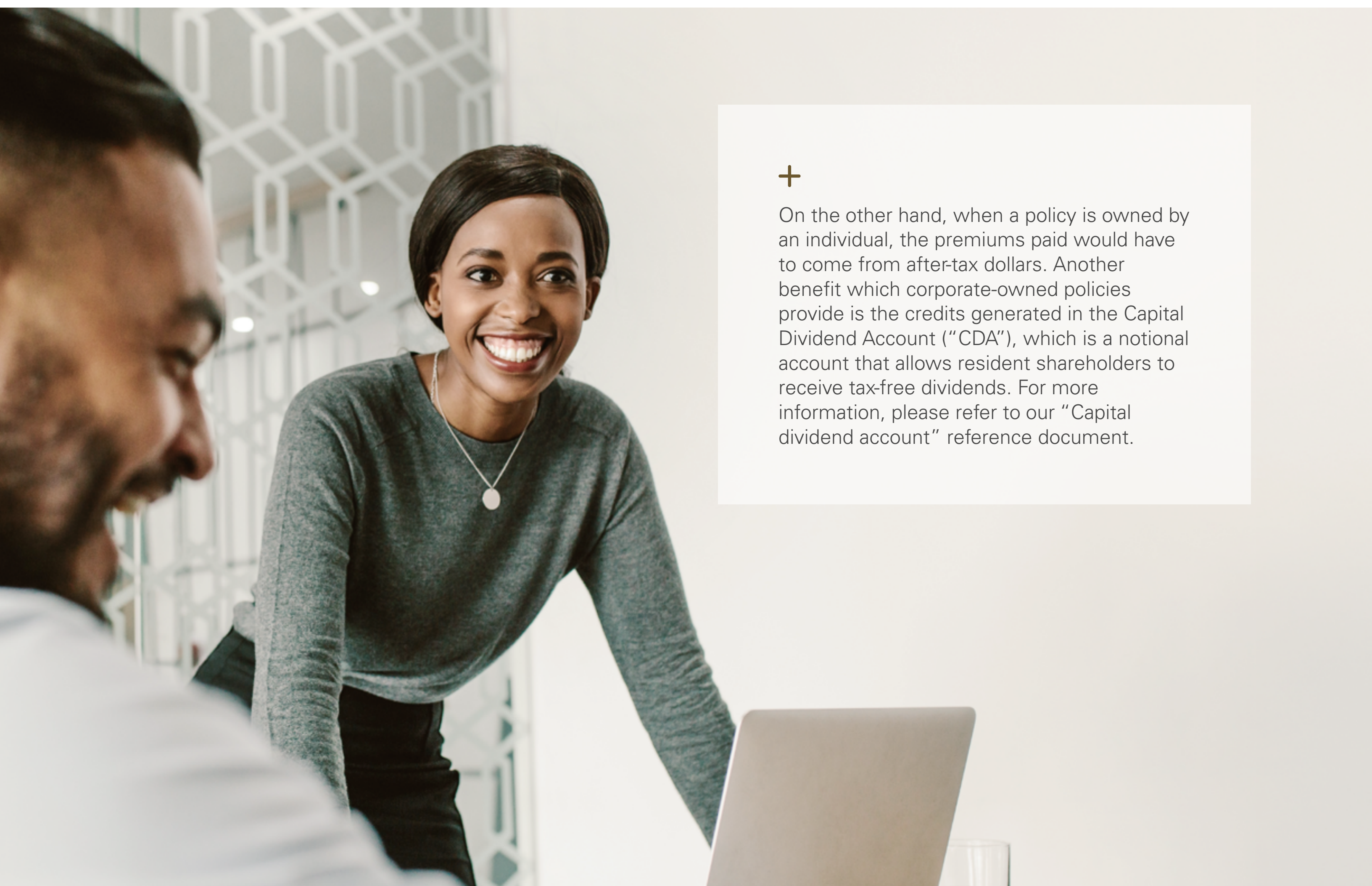
WAYS TO REDUCE PASSIVE INCOME WITHIN CORPORATIONS

Given the disadvantages caused by passive income within corporations, most business owners of small businesses or owner-manager type corporations could benefit from different ways to utilize retained earnings within their corporations. Ideally, business owners may wish to utilize the excess cash by expanding their active business operations; however, that is not always a viable option.

Business owners have several alternatives to reduce the amount of taxable passive income. Here are some examples of measures that can be implemented.

One alternative to keeping typical investment products (e.g., GIC, fixed income, or stocks) within a corporation is to have a corporate-owned permanent life insurance policy as an asset class. It is important to assess the need for life insurance before considering this option. Compared to a traditional corporate-owned investment portfolio, life insurance as an asset class has several tax advantages. First of all, unlike traditional investment products (e.g., dividends from stocks, or interest from savings accounts), which would be taxed significantly within a corporation (see discussion above), the cash value of a life insurance policy generally grows tax-free. Furthermore, as mentioned previously, corporate-owned life insurance policies are not subject to the passive income rules in terms of small business deduction eligibility .

Owning a life insurance policy via a corporation versus personally may also provide other benefits. When a corporation is the owner of the policy, it can pay the premiums using funds that have not been subject to personal tax.



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On the other hand, when a policy is owned by an individual, the premiums paid would have to come from after-tax dollars. Another benefit which corporate-owned policies provide is the credits generated in the Capital Dividend Account ("CDA"), which is a notional account that allows resident shareholders to receive tax-free dividends. For more information, please refer to our "Capital dividend account" reference document.

CASE STUDY

Alex is a pharmacist who owns his own practice (corporation). Alex wishes to invest his corporate surplus in a tax-efficient manner.

Non-smoker, age 50

iA PAR 20-year payment

Initial face amount: $1,000,000

Insurance annual premium: $36,940 for 20 years

Additional Deposit Option (ADO) contribution: $34,720 for 20 years

Total premium: **$71,660** for 20 years

Assumptions

Corporate tax on investment income	**50%**
Rate of return on non-registered investments	**4.64%**

By using corporate surplus that has not been subject to any personal tax, the before-tax amount required to fund the policy's premium is significantly lower in a corporate-owned policy versus an individually owned policy, as shown below.

To pay a premium of $71,660/year	
If individually owned	**If owned by Alex's corporation**
Would require a salary of $154,207/year	Would require revenue of $97,496 without the small business deduction or $81,617 with the small business deduction

Furthermore, unlike traditional investment vehicles which could compromise the small business deduction of Alex's corporation (see discussion above from ''Small Business Deduction''), the policy would not have this effect on the corporation.

Also, by utilizing the tax-free growth within the policy, Alex's corporation can earn a higher after-tax return when compared to non-registered investments. The following table illustrates the gross return that non-registered investments should generate in order to achieve the same net value as the death benefit paid out by insurance through a corporation.

Age	iA PAR Net Estate Value	iA PAR Net Return to the Estate	Investment Net Estate Value	Equivalent Gross Return on Investment
70	$2,877,825	6.25%	$1,036,118	13.57%
75	$3,645,308	5.84%	$1,200,318	11.43%
85	$6,065,336	5.51%	$1,581,205	9.63%
90	$7,328,214	5.34%	$1,801,243	9.05%
95	$8,734,631	5.10%	$2,043,708	8.47%

Another alternative is to purchase a critical illness insurance policy within the corporation. A corporately owned critical illness policy could protect the corporation against the owner's or a key person's critical illness by making sure that the corporation has sufficient cash flow to maintain its operations and meet its obligations in the event of critical illness. The corporation's cash flow is therefore reduced by the premium amount. If a claim is made, the benefit paid will generally exceed the total premiums paid and will be non-taxable for the corporation. Furthermore, the refund of premium rider could ensure that the corporation and/or shareholder could get back the premium paid in the event of death, or the insured meeting a certain age, if no claim has been made. While this approach may be more tax-efficient compared to the taxation of passive income, advisors and tax professionals should ensure that the set-up of the critical illness insurance policy would not lead to an unexpected taxable benefit to the shareholder.

Another option for the corporation to utilize its excess cash is to set up an Individual Pension Plan (IPP) for the business owner/key person. Compared to typical RRSP contributions, IPPs have several distinctive advantages, such as greater contribution room and reduction of the overall tax burden, as the contributions are made directly from the corporation's funds.

Lastly, reviewing an investment portfolio to prioritize assets that generate dividend income from Canadian sources and promote long-term growth can help mitigate tax implications. Of course, the client's investor profile must be considered. Also, business owners might consider taking out any excess cash within a corporation in the form of salary or dividends, which would generally be taxable in the recipient's hands. Furthermore, there may be cases where the corporation wishes to keep its assets for various reasons, in particular, for investment purposes.

IN CONCLUSION

Passive income can cause significant tax and financial consequences for private corporations. Not only are the tax rates on passive income high, but passive income can also affect the corporation's eligibility for the small business deduction, thereby increasing the tax burden on active business income.

As a result, business owners should consider deploying excess cash in more tax-advantaged options, such as purchasing life or critical illness insurance or making contributions to an IPP.

Finally, clients should consult an independent and qualified professional to establish appropriate financial and tax planning strategies.

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