There are perks to being a small-business owner, including a tax rate of just under 15%, the ability to accumulate retained earnings in a Canadian Controlled Private Corporation (CCPC) and income split with family members who are also shareholders. There are challenges too, not the least of which is navigating our tax system which became significantly more complicated in 2017 with the introduction of new rules that, among other things, penalizes businesses owners for using their corporations to accumulate savings for retirement.

The small business deduction (SBD) is a special deduction available to CCPCs that can reduce the overall tax rate paid by smaller companies on the first $500k of active net business income. This lower tax rate is considered an important incentive to help business owners in their efforts to start and sustain a business in a highly competitive 21st century economy (more than half of all businesses fail in the first five years). But new rules were introduced in 2017 -called the passive investment income rules- which limit access for tax rules going forward. Any CCPC that earned more than $50k of investment income in the previous year will generally face a reduction in the amount of income eligible for the reduced small business rate. Specifically, the $500k small-business limit is reduced by $5 for every $1 of investment income above the $50k threshold. This means that the $500k limit is eliminated when investment income reaches $150k in the previous tax year. And by the way, the investment income is aggregated for all associated corporations when figuring out whether a business owner has reached the $50k limits

There are a few ideas that can help business owners keep access to the full SBD and make saving for the future earlier. The key is to reduce the amount of passive income earned annually in the company. Two key strategies for doing so include:

***Tax efficient asset allocation**. By adjusting your asset allocation inside your corporation that holds passive investments, you can potentially reduce the amount of passive income reported in a given year. It could make sense, for example, to structure your portfolio to emphasize equites, where only half of all capital gains realized are taxable (the other half can be flowed out to the shareholders *tax free* as a capital dividend). Further, you can defer the tax and avoid reporting taxable income on unrealized capital gains by continuing to hold those investments for the long term.

***Invest in life insurance**. Permanent life insurance allows business owners to accumulate cash value through investments in the policy on a fully non-reportable tax deferred basis. This means that the income earned avoids annual income tax and is not included in the calculation of passive income, which as explained, claws back the SBD at $50k threshold. Further, the proceeds of the policy will pay out tax-free upon death of the insured (the shareholders) and will increase the capital dividend account of the corporation. This means that beneficiaries of the small-business owner will be able to withdraw funds from the corporation on a tax-free basis in later years, by paying tax-free capital dividends out of the company.

We are of the view that the new rules on passive income unfairly penalize small business owners for using their corporations as retirement vehicles. Absent of a pension plan, accumulating savings inside a CCPC makes sense and allows entrepreneurs to plan for financial security at retirement. Passive investment rules unnecessarily complicates this and represent an additional hardship for small-business owners. CCPCs are the backbone of the Canadian economy and employ two-thirds of all private sector jobs. Future governments may well change direction on this, but until then, the strategies outlined will help small-business owners and we're here to help.

Be safe, be well!

Martin
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