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KEY TAX CHANGES FOR 2019
SMALL BUSINESS / CANADIAN CONTROLLED PRIVATE CORPORATIONS ("CCPC'S")

Small Business Deduction

- Federal tax rate on active business income – 9% (10% - 2018). This causes the SBD combined federal and Ontario tax rate to fall to 12.5% (13.5% - 2018).

Work In Progress for Professionals

While not new for 2019, the changes with respect to WIP reporting for professionals is now just beginning to cause an impact. The 2017 federal budget set out new rules that cause professionals, as defined as accountants, lawyers, dentists, doctors, veterinarians and chiropractors for this purpose (note that other professionals such as architects, engineers, etc. are not affected by this change, likely because the government assumes they tend to progress bill while the affected professionals may not bill until the job is fully complete) to have to recognize the value of their WIP.

WIP is essentially work that has been performed but has not yet been billed. Previously, professionals could ignore the value of WIP and report income based upon when it was billed. These new rules cause the value of WIP to be subject to income tax in the year the WIP arose. The new rules affect year-ends beginning after March 21, 2017, which for many professionals and firms would be the calendar year of 2018.

WIP is recognized as an asset on the balance sheet, with the corresponding credit falling as revenue on the income statement, thus increasing the taxable income of the professional or firm accordingly. There is a five-year phase-in period for these rules, meaning that in the first year beginning after March 21, 2017, WIP needs to be calculated and 20% of that value has to be included in income for the year. After the second year, WIP is recalculated and 40% of that new value has to be included in income. This pattern continues so that by the end of the fifth year, 100% of the WIP value will have to be included.

The transitional rules have been written in a way that the portion of WIP included in income each year over the five years is fixed. There is no option to report a greater portion of WIP earlier, although it's hard to imagine that CRA would take issue with additional income being reported. However, where some firms might wish to report more income in early years where their profits might be lower than expected in the future to take advantage of the lower Small Business Deduction tax rate on active business income (12.5% for 2019 vs.26.5% on ABI above the SBD), it appears as though it's not an option to do so unless they cancel the S.34 election entirely. This would cause 100% of WIP to be included in income in the year that the election is cancelled.

Because many professionals and firms were able to simply ignore WIP for tax purposes, it will take some work to establish the WIP value and tracking mechanisms. WIP includes certain costs associated with preforming the professional services that will later be billed to clients.

In CRA's letter to CPA Canada, which was also published as an income tax ruling, CRA has made the following comments regarding the calculation and valuation of WIP as per CPA Canada's website:

- CRA reiterated that the basic principles of Canderel v. the Queen ([1998] 1 SCR 147) would apply in computing WIP, and that whatever method is chosen, it should result in an accurate picture of profit for the given year. Thus, taxpayers have some flexibility in choosing how they cost WIP as long as they can show that the method they chose accurately depicts their income for the year.

- Designated professionals should use the guidance on inventory valuation in archived CRA Interpretation Bulletin IT-473R, "Inventory Valuation." The CRA's position in paragraph 12 has not changed, so taxpayers may use either direct (*allocating variable overheads to inventory*) or absorption (*allocating both variable and fixed overheads to* inventory) costing. However, prime costing, a method where no overhead is allocated to inventory, remains unacceptable for income tax purposes. This will likely cause professionals/P.C.'s to go through the management accounting exercise of determining variable overhead costs exclusive of fixed overhead costs as it will result in a lower value of WIP and in turn, a lower amount of taxable income.

- No matter what costing method is chosen, variable costs must be included in WIP (more on this later).

- WIP includes the cost of labour of designated professionals, including employee benefits, but does not include the time contributed to the WIP by partners or sole proprietors (as no costs are typically associated with this work). However, for P.C.'s that pay owners a salary, it appears likely that the portion of salary relating to the provision of billable professional services should be included.

- For contingency fee arrangements, when determining the FMV of WIP, the CRA says that designated professionals should use the amount of the fee that is reasonably expected to become receivable. In some cases, the CRA has recognized that it will not be possible to determine the expected fee and in these cases, the WIP would have a nil value (see the CRA letter for their specific comments in this regard).

Once WIP has been calculated and reported on the balance sheet and the corresponding revenue on the income statement, a deduction for this accounting amount can then be claimed on the professional's or professional corporation's income tax return. For tax purposes, the professional/P.C. can then decide to report the lesser of fair market value and cost for tax purposes, following the 20% in year one, 40% in year two, etc. schedule. The FMV of WIP is equal to what the professional/P.C. expects to recover once clients have been billed. If that is less than the cost of WIP (i.e. the practice is providing services at a loss), it is an option to use FMV rather than cost.

Tax On Split Income ("TOSI")

2018 saw the introduction of the new dreaded Tax On Split Income, or TOSI rules. These rules cause income earned and capital gains triggered from many private companies, partnerships that derive income from a business, and trusts that earn income from either of these sources to be taxed at the highest marginal rate in effect unless there is an exception to the TOSI rules. The following is a high-level summary of how the TOSI rules flow:

1. **Specified Individuals** are subject to TOSI.
    a. Adult resident in Canada
    b. Individual under 18 with a parent resident in Canada
2. **Split Income** is subject to TOSI.
    a. Private company taxable dividends, shareholder benefits
    b. Partnership income from a **related business**, or rental business where a **related person** is involved.
    i. **Related business: related person** is involved directly or indirectly, or owns 10% or more
    ii. **Related person:** spouse, common-law partner, lineal relatives including in-laws, siblings, siblings-in-law
    c. Trust income from a. or b.
    d. Interest income from a private corporation, partnership or trust.
    e. Income or capital gains from dispositions of private company shares or other capital property with historical TOSI.
3. If any of the following exclusions apply, TOSI doesn't apply:
    a. Under 25: received the property from death of parent
    b. Under 25: received the property from death of anyone AND enrolled as a full-time student or entitled to disability tax credit
    c. Anybody: Property received in respect of a separation agreement or judgement resulting from a marriage or CLP breakdown
    d. Anybody: Taxable capital gain on deemed disposition on death
    e. Over 17: Taxable capital gain on QFP, QFP or QSBC shares
    f. If spouse is 65+ or deceased: if no TOSI for spouse

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4. For those 18+, if income or gain is not derived from a **Related Business**, it is not subject to TOSI.
5. For those under 18 who sell shares:
   a. Sale to a non-arm's length party causes capital gain to be deemed a non-eligible dividend subject to the top marginal tax rate in effect.
   b. Sale to an arm's length party subject to TOSI, meaning capital gain is taxed at the top marginal rate.
6. If **split income** is from an **Excluded Business**, TOSI does not apply.
   a. **Excluded Business** is one where you are actively engaged on a regular, continuous and substantial basis in the business in the current or any five preceding years, either on a factual basis or by meeting a threshold of an average of 20 hours per week.
7. If **split income** is earned or gains relate to **Excluded Shares**, TOSI does not apply. **Excluded Shares**:
   a. Less than 90% of the corporation's business income for the last year was from providing services
   b. The corporation is not a Professional Corporation
   c. You own shares in aggregate that give you at least 10% of votes and value AND less than 10% of the income of the corporation in the prior year was derived from a **related business**
8. Those 18-24 may earn a **Safe Harbour Capital Return**, which is equal to the prescribed rate multiplied by the fair market value of the property contributed.
9. Those 25+ may earn a **Reasonable Return**, which is based on the relative contributions from you and each **related person** considering:
   a. The work performed
   b. The property contributed directly or indirectly
   c. The risks assumed
   d. The total amounts already paid to or for the benefit of the individual
   e. Any other factors that may be relevant
10. Those 18-24 may earn a **Reasonable Return in Respect of Arm's Length Capital**, which is based on the relative contributions from you and each **related person**, but considering only your contribution of arm's length capital.

As you will see by reading through these rules, TOSI is very complicated, not clear, and there is much that remains to be determined. Taxpayers will be required to report income and capital gains while considering these new rules and if CRA disagrees with a filing position and the taxpayer decides to fight, we will see TOSI cases going through the tax court process. Ultimately courts will rule on how these rules should be interpreted, but until that time, much remains uncertain about exactly how and when TOSI may apply in many circumstances.

KEY TAX CHANGES FOR 2019
SMALL BUSINESS / CANADIAN CONTROLLED PRIVATE CORPORATIONS ("CCPC'S") – (CONTINUED)

Passive Investment Income

Beginning in 2019, there are new rules in place that cause the $500,000 Small Business Deduction ("SBD") to shrink or disappear if a group of associated corporations has excessive passive investment income in the previous year. These new rules introduce the concept of **Adjusted Aggregate Investment Income** or **AAII**. AAII is comprised of:

- Portfolio income from passive investment assets (capital gains, interest, foreign income, eligible and non-eligible dividends)
- Taxable capital gains unless the gain arises from the disposition of:
  - *A property that is used principally in an active business carried on primarily in Canada by the CCPC or by a related CCPC; or*
  - *A share of another CCPC that is connected with the CCPC, where, in general terms, all or substantially all of the fair market value of the assets of the other CCPC is attributable directly or indirectly to assets that are used principally in an active business carried on primarily in Canada*
- Dividends from non-connected corporations
- Rental income (*in most circumstances*)
- Income from non-exempt life insurance policies
- Expenses that directly relate to investments are subtracted

When AAII in the previous year exceeds $50,000, the SBD is ground down by $5 for every $1 of AAII over $50K. Therefore, if AAII hits $150,000, the full $500K SBD would disappear. If AAII was $100,000, the SBD would be ground down by $100,000 AAII - $50,000 cushion = $50,000 x $5 grind = $250,000.

The effect of losing the SBD is that active business income would be taxed at higher corporate rates. Despite this being a function of investment income, it is the tax rate on active business income that is affected. In Ontario in 2019, the normal corporate tax rate on active business income is 26.5%. The SBD rate is 12.5%. Therefore, the loss of the SBD would cause active business income to have an additional 14% tax apply on up to $500K of income.

One slightly offsetting benefit is that active business income that is taxed at the ordinary rate creates the ability to pay out eligible dividends, which are taxed at lower rates than non-eligible dividends. 72% of any active business income in excess of the SBD gets added to a notional tax account called General Rate Income Pool ("GRIP"), which is then used to track the magnitude of eligible dividends a corporation can pay out.

KEY TAX CHANGES FOR 2019
SMALL BUSINESS / CANADIAN CONTROLLED PRIVATE CORPORATIONS ("CCPC'S") – (CONTINUED)

Refundability of Taxes on Investment Income

When Canadian Controlled Private Corporations ("CCPC's") earn passive investment income, a portion of the tax initially paid by the corporation is refundable. The government set up these refundable tax rules to cause corporations to initially pay tax on investment income at similar rates to individuals who are in a high tax bracket to avoid people using corporations to shelter investment income from tax. However, because distributions of after-tax corporate income (i.e. dividends) are taxable to the recipients once paid out by a corporation, to keep the overall or "integrated" tax rate fair, a portion of the corporate tax paid is refunded, meaning that the total tax paid by the corporation and the individual together equates to a rate similar to what an individual would pay directly.

When a corporation pays refundable tax to CRA, it is tracked in a notional tax account called Refundable Dividend Tax On Hand ("RDTOH"), even though it's not only dividend income that causes refundable tax to be paid. Currently in Ontario, investment income is taxed inside CCPC's as follows:

- Interest/other/foreign income – 19.5% non-refundable, 30.67% refundable, 50.17% total
- Capital gains – subject to a 50% inclusion rate, so 50% of the capital gain is subject to the same rates as above. This means on the full capital gain, there is 9.75% non-refundable, 15.33% refundable, 25.08% total
- Eligible & non-eligible dividends – 38.33% refundable (no non-refundable portion)

To recover the refundable tax paid, the corporation needs to pay out taxable dividends to the shareholder(s). For every $1 of taxable dividends paid out, the corporation recovers 38.33 cents of RDTOH.

The 2018 budget has introduced a new component to this system. Previously all refundable tax was tracked in one notional account (i.e. RDTOH). Beginning in 2019 we now have two RDTOH accounts, with the new one being called "eligible RDTOH".

Eligible RDTOH will arise when a corporation earns eligible dividends from another corporation. Typically, with passive investment income, we expect this to come from Canadian public companies or funds that hold Canadian public company shares that pay dividends. When non-eligible dividends are paid out, the corporation will first recover refundable tax from the normal RDTOH account. Only when the normal RDTOH account is $nil will the payment of non-eligible dividends result in the recover of eligible RDTOH. When eligible dividends are paid out, only eligible RDTOH can be recovered.

The result of this new system is that paying out eligible dividends will not recover refundable tax paid on interest, capital gains, foreign income, rent, etc. Previously shareholders could receive lower-taxed eligible dividends while still allowing the corporation to recover RDTOH on passive investment income other than eligible dividends, which created a tax deferral opportunity, which the government has now shut down.