

## Adjusted Aggregate Investment Income – A Closer Look

In 2018, the federal government approved legislation that has changed the way private companies are taxed. After hearing feedback from numerous tax professionals, changes were implemented that restrict the small business deduction (“SBD”) available for Canadian-Controlled Private Corporations (“CCPC’s”). The motivating policy behind this was a perceived unfairness in the Canadian tax system. The belief is that allowing a private company to use after-tax dollars, earned at the low small business rate, to invest in passive income-earning investments, is unfair. Rather than taxing investment income at a higher rate and disturbing the integrated tax rates that Canada’s tax system is based on, the government chose to “clawback” the SBD for certain associated groups of companies.

The idea of a clawback is not new. Companies with “taxable capital” above \$15 million do not benefit from the preferential low tax rate on active business income. In general terms, taxable capital is comprised of retained earnings plus non-trade liabilities less loans with and investments in Canadian companies. It appears the policy behind this is that companies with substantial retained earnings and/or certain liabilities are not viewed as “small” and therefore should not benefit from the SBD. The additional clawback rules introduce a new term, Adjusted Aggregate Investment Income (“AAIL”). This second clawback rule would begin to restrict access to the SBD where AAIL from the previous fiscal year was \$50,000. Access would be completely eliminated where AAIL reaches \$150,000. The original clawback rule targeted at “large” companies, restricts the SBD where taxable capital was above \$10 million and completely eliminates it at \$15 million. As the SBD will be reduced where assets invested are as little as \$1,000,000, assuming a modest 5% return, the policy behind the new rule does not necessarily target only large companies. With these new rules, an understanding of AAIL will be important for small business owners to ensure they continue to benefit from the low tax rate afforded by the SBD.

So how exactly is AAIL calculated and how can a small business owner attempt to manage it so the company can still benefit from the SBD? The starting point for calculating AAIL is aggregate investment income (“All”) as defined in the Income Tax Act (“the Act”). Generally, a company’s All is made up of:

- Interest
- Taxable capital gains, net of allowable capital losses from current or previous years
- Passive rental income
- Passive foreign income, including foreign accrual property income (“FAPI”)
- Losses from property

**When calculating AAIL, the following income sources are not included:**

- Dividends from connected corporations (note, however, that dividends from non-connected corporations are included in AAIL)
- Taxable capital gains from business assets, including gains on shares that are Qualified Small Business Corporation shares

**Also, the following deductions cannot be used to reduce AAIL:**

- Net capital losses from previous or subsequent years
- Deductions for charitable donations
- Deductions for foreign accrual taxes

### Dividends from Connected Corporations

Where a corporate shareholder owns more than 10% of the votes and value of any class of shares of a corporation, that corporation is connected. Dividends from connected corporations are not included in the calculation of AAIL and therefore do not impact the availability of the SBD for the associated group of companies. This seems consistent from a policy perspective as it is common for an operating company to pay a dividend to its holding company for creditor protection and other reasons. Since AAIL is measured as an aggregate of all associated companies it would be unfair to include these dividends in that calculation as the dividends represent income from an investment in an “active” asset (i.e. the operating company) as opposed to a “passive asset”, such as publicly-traded shares.

### Gain on Sale of Active Business Assets

Taxable capital gains from the sale of assets that were used in an active business are also excluded from AAIL. Like the policy of excluding connected corporation dividends, excluding gains from business assets shows the government still wants to encourage investment in small businesses. A significant aspect of operating a

small business may include replacing assets and selling off old assets. Also, several business owners may sell their business assets as part of the business exit strategy. The government does not want to penalize private companies when they sell these assets and have therefore allowed for this exclusion.

### Net Capital Losses from Other Years

On an annual basis, taxpayers, including corporations, must calculate their net income for tax purposes ("net income"). Certain inclusions and deductions are defined in the Act to determine how to calculate net income. However, a taxpayer's tax liability is not calculated on net income but rather on taxable income. In calculating taxable income certain deductions are allowed pursuant to division C of the Act. However, in calculating AAIL certain of these deductions are not allowed, one of which is net capital losses of other years. Net capital losses can be carried back three years or carried forward indefinitely to reduce net capital gains of the year to which they are applied. Although this option is still available to reduce a private company's current year taxable capital gains, only current year net capital losses can be used to reduce AAIL. Therefore, small business owners wishing to continue to benefit from the SBD will need to manage capital gains and losses to ensure they occur during the same fiscal year.

### Donations

As noted earlier, All (i.e. the starting point for AAIL) includes several components; however, deductions for donations is not one of these. In calculating All a deduction for losses from property is allowed. A loss from property occurs where expenses incurred to earn income from that property exceed the income earned. A charitable donation is not

considered an expense incurred for the purpose of earning income, but rather an act of charity for which corporations are allowed a separate deduction in calculating taxable income.

### Foreign Accrual Tax ("FAT")

There is also an exclusion in the definition of AAIL relating to FAT paid on foreign accrual property income ("FAPI"). Although FAPI is a complex topic and not something typically seen by the average small business, with the globalization of markets and Canada's closeness to the United States, it is not that uncommon to see this in a private company context. Generally, where a Canadian taxpayer (including a Canadian private company) owns a foreign company, which is a controlled foreign affiliate ("CFA"), and the CFA earns passive income, the Canadian shareholder may have to include income (i.e. FAPI) from that CFA even if it does not receive dividends from it during the year. In addition, the Canadian shareholder is also entitled to a deduction based on the amount of FAT paid by the CFA. Often, due to how the FAT deduction is calculated, the FAPI inclusion is less than the FAT deduction such that the Canadian shareholder has little, or no taxable income related to their investment in the CFA. However, in calculating AAIL, the new rules do not allow for a FAT deduction such that the full amount of FAPI is included in AAIL.

While the concept of income or loss may seem simple from a business or accounting perspective the definition of AAIL is much more complex. A full and careful analysis of that definition is a starting point to protecting a corporation's access to the SBD on an annual basis. It is always prudent to consult a professional tax specialist, particularly where uncertainties exist.

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