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The consequences of federal tax reform in Quebec. A portion of income is subject to a higher tax rate.

We have already written extensively about the federal government's tax reform, especially about the changes to the tax regulations governing passive income in a private corporation. However, the effects of these new measures are yet to be felt by our clients and their accountants.

In contrast, we have not sufficiently discussed the consequences of the provincial budget tabled on March 27, 2018, which included a significant increase in the tax rate applied to passive investment income in a corporation.

Investment income and the small business deduction (SBD)

The SBD allows an active business carried on in Canada to benefit from a lower tax rate on its first $500,000 of income. This $500,000 limit is called the "business limit". The federal government has tightened the SBD eligibility rules when a Canadian-controlled private corporation has passive income that exceeds $50,000. For every dollar of passive income earned above $50,000, the business limit will be reduced by $5, up to $150,000 in passive income, at which point the business limit will be reduced to zero.

Once a corporation's business limit reaches zero, its active business income will not be taxed at lower tax rate (14% for 2020) but at the general tax rate (26.50% for 2020).

The new rules governing the SBD and dividend refunds are applicable to taxation years starting after 2018.

Refundable Dividend Tax On Hand (RDTOH)

Before the tax reform, there was one single RDTOH account that comprised the refundable portion of Part I tax paid on investment income (30.66% of aggregate investment income) and the total Part IV tax (that the company pays on dividends received from private corporations). When a corporation pays out a taxable dividend, it may receive an RDTOH refund. Starting in 2019, there are now two RDTOH accounts.

In general terms, under federal rules a private corporation would only receive a dividend refund on the payment of any non-eligible dividends. An exception is provided where the RDTOH arises from eligible portfolio dividends received by the corporation. In this case, the corporation may obtain a dividend refund upon the payment of eligible dividends. To implement this, the private corporation's dividend refunds now have to be calculated using two new amounts – the eligible refundable dividend tax on hand (eligible RDTOH) and the non-eligible refundable dividend tax on hand (non-eligible RDTOH) – which will replace the previously used RDTOH balance.

The eligible RDTOH includes the Part IV tax and the non-eligible RDTOH includes the refundable portion of Part I tax.

Transitional rules exist, whereby any remaining general rate income pool balance in an existing RDTOH account at the beginning of the 2019 tax year is allocated to the CCPC's eligible RDTOH account.

Impacts of the reduced small business tax rate in Quebec

In Quebec, corporations where employees work less than a combined 5,500 hours annually became ineligible for the small business tax rate in 2017. However, the new federal regime also applies to private corporations in Quebec.

Here is an overview of the rates applicable in Quebec since the March 2018 provincial budget was adopted. We can see that the small business rate has been reduced, the tax rate on dividends is higher and the dividend tax credit is lower.

Rate/Year	Before 2018 Budget	After March 2018	2019	2020	2021
Business tax rates					
Small business rate	18.00%	17.00%	15.00%	14.00%	13.00%
Not eligible for the 5,500-hour rule	21.70%	21.70%	20.60%	20.50%	20.50%
General tax rate	26.70%	26.70%	26.60%	26.50%	26.50%
Investment income rate (after RDTOH)	19.70%	19.70%	19.60%	19.50%	19.50%
Dividend rates					
Eligible (maximum rate)	39.83%	39.89%	40.00%	40.11%	40.11%
Non-eligible (maximum rate)	43.94%	44.83%	46.25%	47.14%	48.02%
Non-eligible dividend tax credit	17.08%	16.31%	14.58%	13.8%	13.04%
Eligible dividend tax credit	26.92%	26.88%	26.80%	26.72%	26.72%

Let's analyze how rates are changing in Quebec. The tax rate on the first $500,000 of active business income will drop and the increase in the dividend tax rate and the decrease in the dividend tax credit will be adjusted as a result. However, the tax rates on the other types of business income remain stable. So, starting in 2019, shareholders will pay more tax on income that is not eligible for the small business tax rate.

Let's look at the same scenario for two different years. Suppose that in 2018, before the March 2018 budget, a corporation has income of $300,000, on which it pays a tax rate of 21.70% because it is not eligible for the small business tax rate in Quebec and it pays a non-eligible dividend to its shareholder. In 2019, the company's income is stable but the business tax rate is reduced to 20.60% and the individual tax rate on the non-eligible dividend is 46.25% (we are assuming that the shareholder pays the maximum rate).

2018 before the provincial budget

Business income tax: $300,000 x 21.70% = $65,100
Dividend paid: $234,900
Personal income tax (43.94%): $103,215
Total tax (business and personal): $168,315

2019

Business income tax: $300,000 x 20.60% = $61,800
Dividend paid: $238,200
Personal income tax (46.25%): $110,168
Total tax (business and personal): $171,968

If we compare the two scenarios, it is clear that the total tax payable increases in 2019, while the tax increase in 2021 will be even greater. In 2021, company shareholders will pay an additional 4.85% in tax (at the maximum rate) on a non-eligible dividend paid out of passive investment income, and an additional 5.37% in tax on a non-eligible dividend paid out of active business income, which is taxed at the federal small business tax rate, but at the regular rate in Quebec, which is a significant increase.

Strategies

Each case is unique and should be analyzed as such. However, in light of the increased tax rate on investment income, it is more advantageous for owners of private corporations to pay a salary rather than dividends.

Here are some potential strategies to avoid being overtaxed and losing the SBD:

- Take out life insurance
- Contribute to an individual retirement plan
- Acquire flow-through shares
- Optimize investment management
- Optimize tax treatments
- Take advantage of the RDTOH transitional rules

It is very important for each strategy to be tailored to the client's circumstances and reviewed annually.

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