

Small Business Deduction

November 16, 2021

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What is it?

- Corporate tax reduction for Canadian business income.
- 14.3% rate advantage.
- Maximum annual corporate tax reduction \$71,500 per year.
- Used to be fairly straight forward.
- Now very complicated after the “tweaks”
- Tax benefit is deferral, not generally savings

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Before and Now – Quick Glance

What income is eligible for the SBD?

➤ Use to be:

- income from active business carried on in Canada; and
- specified partnership income (proration of \$500,000 limit)
- limit based on taxable capital (\$10 million - \$15 million phase out)

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What is Active Income

Income is active unless passive, specified investment business (SIB) income, or personal services business income.

Income incidental to active business is active (e.g. interest on short term deposits used for cash flow, liquidity or to support debt or guarantees).

Discussed in section E3

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What is a CCPC

Canadian corporation (non-foreign)

Not controlled by non-resident, public company or combination.

If non-resident or public company has option to acquire shares or cause shares to be redeemed, deemed to occur for CCPC definition (but special relieving rule for capital gains exemption)

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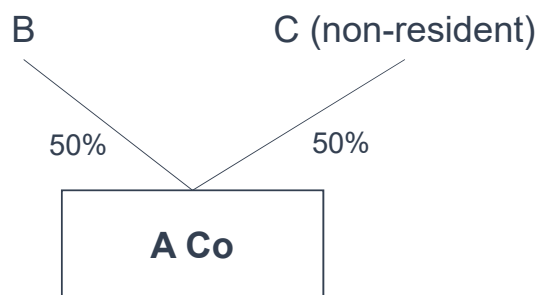


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Example



A Co is CCPC (unless C has option to buy B's shares)

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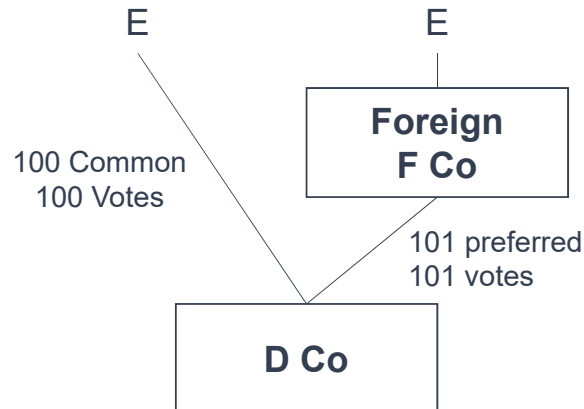


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Example



D Co is non-CCPC because direct control by F Co (foreign) even though F Co controlled by E.

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Before and Now – Quick Glance

What income is eligible for the SBD?

➤ Now is:

- income from active business carried on in Canada
EXCEPT income above pro-rated limit on
- income allocated by a partnership as a member;
- income for services/property provided to a partnership as a designated member;
- income for services/property provided to other private corporations where shareholder (or a NAL person) owns a direct or indirect interest;
- certain deemed active income in situations where a “third corporation” involved;

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Before and Now – Quick Glance

	Before	Now
Maximum	\$500,000	\$500,000
Sharing	Associated group pro-ration of partnership income	Associated group pro-ration of several income sources
Clawback	Grind for taxable capital of associated group	Grind for greater of: <ul style="list-style-type: none"> • Taxable capital of associated group; and • Passive income of associated group (or deemed associated)
Filings	T2 jacket T2SCH23 T2SCH33	T2 jacket T2SCH7 T2SCH23 T2SCH33 Assignments (both sides)

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Before and Now – Quick Glance

What does one need to do? (the good old days)

1. Compute taxable capital of associated corporations group (for taxable capital limit).
2. Compute active business income for all associated corporations for the year (for \$500,000 business limit).
3. Assign the limit amongst the companies, and limit partnership income to pro-rated \$500,000

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SBD Today

9 Steps

1. Identify associated corporations.
2. Determine taxable capital for associated corporations (prior year).
3. Determine associated corporations for passive income purposes (may include related corporations).
4. Compute passive income for associated corporations (prior year).
5. Allocate small business limit.

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SBD Today

9 Steps – cont.'d.

6. Identify “bad” income (partnership income, other income from “common” source).
7. Determine amount of bad income eligible for SBD.
8. Fill out schedules, forms.
9. Make sure all associated corporations file consistently.

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History of the “Tweaks”

- Two tweaks: 2016 and 2018 changes
- Targets multiplication of SBD claims (2016)
Professional corporations, management company.
- Reduce SBD limit based on passive income (2018)
Cash rich corporate groups.

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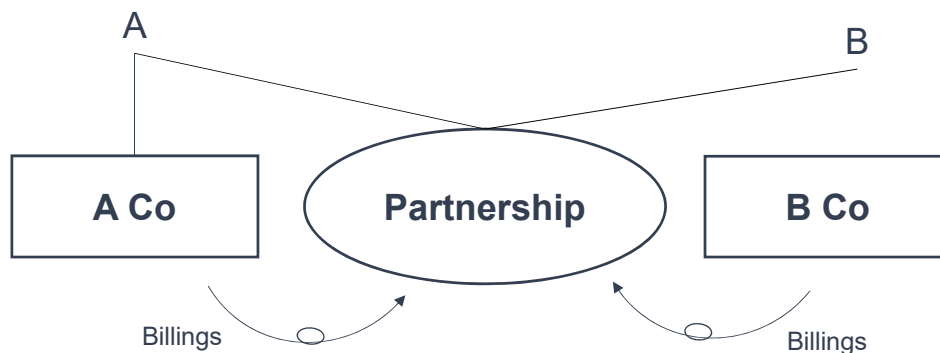


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Targeted Structures - Partnership



Old rules: A Co and B Co gets their own SBD.

New rules: SBD pro-rated based on partnership income.

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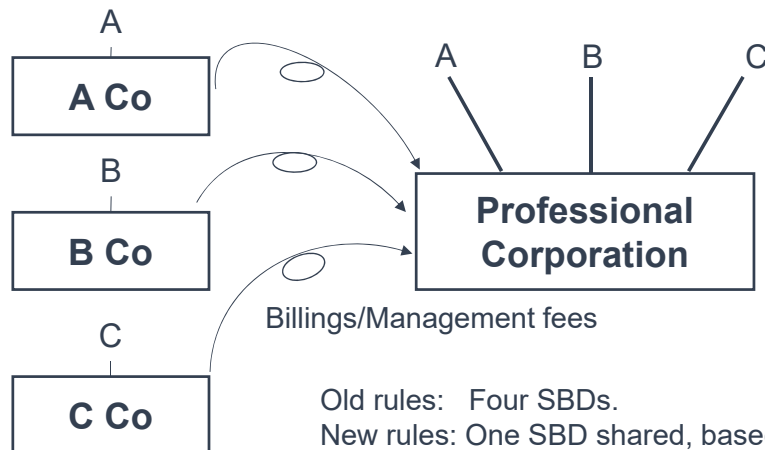


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Targeted Structures - Corporation



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How the Rules Work? - Partnership

- Actual member: SBD is limited the corporation's specified partnership business limit ("SPBL").
- Designated member: SBD is limited to extent of the SPBL assigned to this designated member.
- Definition of designated member drafted very broadly on purpose.

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Designated Member

- Does a CCPC provide services or property (directly, or indirectly, in any manner whatever) to a partnership?
 - e.g., professional corporation bills partnership
 - charging management fees
 - sells goods to partnership
- If the answer is no, not designated member.
- Language is broadly written.
- One core business, one SBD.

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Designated Member

- CCPC is providing services or property to a partnership and:
 - any shareholder of the corporation is a partner (directly or indirectly) of the partnership; or
 - the corporation does not deal at arm's length with a person that is directly or indirectly a partner, unless all or substantially all income of the corporation (90%+) is from arm's length persons and not the partnership. Not common in practice.

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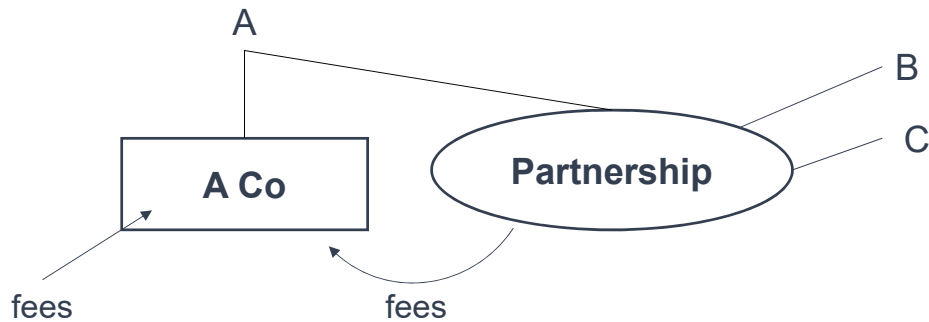


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Designated Member – Example 1



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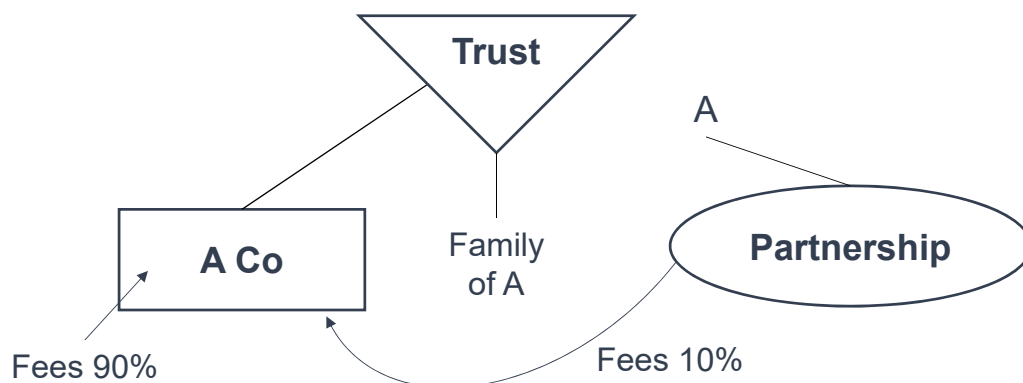


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Designated Member – Example 2



Note: 90% exception possible.

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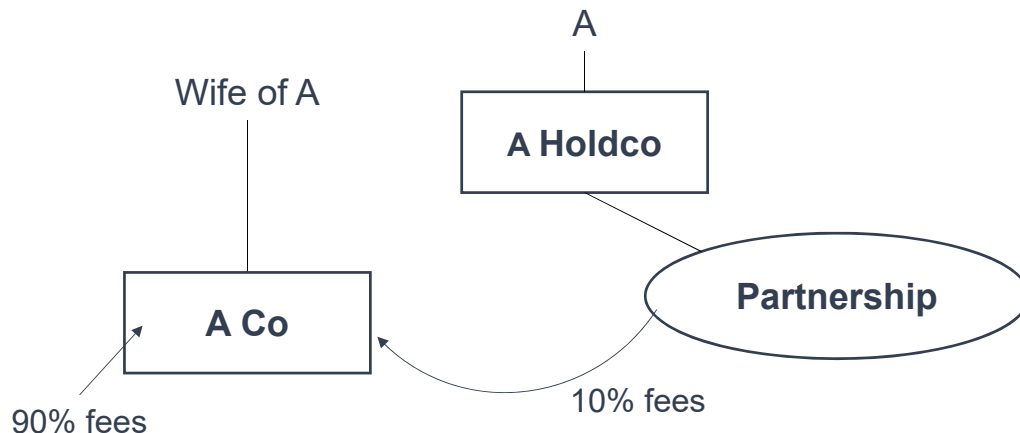


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Designated Member – Example 3



Note: Income test exception possible.

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Calculating Specified Partnership Business Limit (SPBL)

- Fees billed by corporations to partnership:
 - Partner's % share of \$500,000 or share of active business income of the partnership if less.
 - A partner may assign a value between NIL and maximum calculated to a designated member.
 - Calculation done per partnership.

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Calculating the SPBL

Example:

- Fees from partnership to Partner A's corporation (A Co) say \$200,000.
- Partner A share in residual partnership income is 30%.
- Partner A's notional limit is $\$500,000 \times 30\% = \$150,000$.
- If partner A assigns all of this limit to A Co, then \$150,000 eligible for SBD, \$50,000 of the \$200,000 fees received by A Co from partnership not eligible for SBD.

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Assigning the SPBL

- Only a partner of a partnership can make the designation (make sure the correct person makes it).
- Both partner and designated member must file designation in their respective tax returns.
- Do not forget designations (Nil amount if no designation made).
- Partnership must have some income, if nil or loss, no designation possible.
- Corporation can make designation and/or show amounts designated to them in Part 4 of Schedule 7 of the T2 return.
- The form for partners other than a corporation to assign the notional limit remains unavailable (as at November 8, 2020).

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Assigning the SPBL

Part 4 – Specified partnership income

Table 1 – Specified partnership income

Table 1: Specified partnership income			
A1 Partnership name	B1 Total income (loss) of partnership from an active business	C1 Corporation's share of amount in column B1	D1 Income of the corporation from providing (directly or indirectly) services or property to the partnership
200	300	310	311
1. ABC Partnership			200,000
2.			
3.			
4.			
5.			

E1 Adjustments (add or deduct the prorated amounts calculated under section 34.2 note 1 and deduct expenses the corporation incurred to earn partnership income)	F1 Corporation's income (loss) in respect of the partnership note 2 (add columns C1, D1 and E1)	G1 Number of days in the partnership's fiscal period	H1 Prorated business limit notes 2 and 3 (column C1 + column B1) × [\$500,000 × (column G1 + 365)] (if column C1 is negative, enter "0")
315	320	325	330
1.	200,000		
2.			
3.			
4.			
5.			
Total	350		

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Assigning the SPBL

I1 Specified partnership business limit assigned to you (from H2 in Table 2) <i>note 6</i>	J1 Specified partnership business limit assigned by you (from F3 in Table 3) <i>note 6</i>	K1 Specified partnership business limit amount (column H1 plus column I1 minus column J1)	L1 Column F1 minus column K1 (if negative, enter "0")	M1 Lesser of columns F1 and K1 (if column F1 is negative, enter "0") <i>note 4</i>
336	336			340
1. 150,000		150,000	50,000	150,000
2.				
3.				
4.				
5.				
		Total	385 50,000 360	150,000
Corporation's losses for the year from an active business carried on in Canada (other than as a member of a partnership) – enter as a positive amount				
		370		
Specified partnership loss of the corporation for the year – enter as a positive amount (total of all negative amounts in column F1)				
		380		
Subtotal (line 370 plus line 380)				N
Amount at line 385 or amount N, whichever is less				390
Specified partnership income (line 360 plus line 390) (enter at amount R in Part 5)				400 150,000

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Assigning the SPBL

Part 4 – Specified partnership income (continued)

Tables 2 and 3 are used to make an assignment of **specified partnership business limit** under subsection 125(8). A person that is a member of a partnership can make an assignment of **specified partnership business limit** under subsection 125(8) to a **designated member**.

If you are a CCPC that is a designated member and **receiving** specified partnership business limit from a person that is a member of the partnership, complete Table 2.

If you are a corporation that is a member of the partnership and **assigning** specified partnership business limit to a designated member, complete Table 3.

Table 2 – A member is assigning to you specified partnership business limit under subsection 125(8)

A2 Partnership name	B2 Name of the member	C2 Business number of the member (if applicable)	D2 Social insurance number of the member (if applicable)	E2 Trust account number of the member (if applicable)	F2 Tax year start of the member (yyyymmdd)	G2 Tax year-end of the member (yyyymmdd)	H2 Specified partnership business limit assigned to you by the member ^{note 7}
405	406	410	411	412	415	416	420
ABC Partnership	Mr. A		123456789		2019-01-01	2019-12-31	150,000

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Assigning the SPBL

Table 3 – You are assigning to a designated member (CCPC) specified partnership business limit under subsection 125(8)

A3 Partnership name	B3 Name of the designated member	C3 Business number of the designated member	D3 Tax year start of the designated member (yyyymmdd)	E3 Tax year-end of the designated member (yyyymmdd)	F3 Specified partnership business limit assigned by you to the designated member ^{note 8}
425	426	430	435	436	440

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How the Rules Work? - Corporations

- Specified corporate income (SCI) arises when a Corporation earns income from services or property provided to another corporation (Payor Co.) and:
 - A shareholder of the Corporation, or someone who does not deal at arm's length with the shareholder or the Corporation holds a direct or indirect interest in the Payor Co., unless 90%+ of Corporation's income from arm's length persons.

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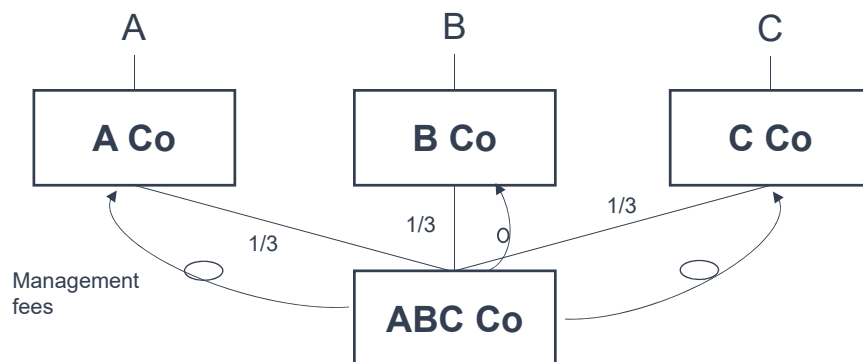


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How the Rules Work? - Corporations



4 small business deductions now limited to \$500,000 overall.

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How much SBD can you get?

- Payor corporation is allowed to assign its business limit to the other corporations, but generally is capped at the amount of fees paid to the other corporation.
- Corporate structure can freely assign to the other corporations unlike partnership situation where calculation is based on partner's income allocation.
- Prescribed form is required for both assignor and assignee, to be filed with the their tax returns for the year of the assignment.
- Lines 490, 510, 515 of the T2 return shows the limit assigned by the corporation to other corporations.
- Part 6 of Schedule 7 of T2 return shows the amounts designated to the corporation.

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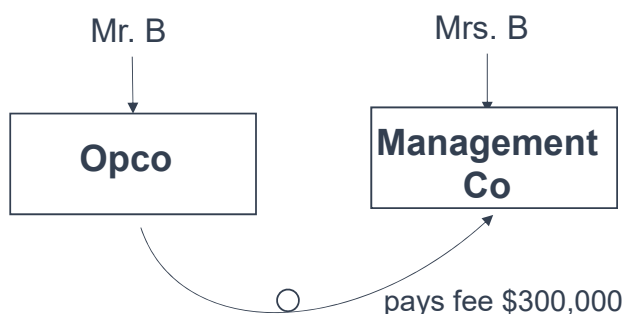
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How much SBD can you get?

Example:



Income of Management Co. subject to overall \$500,000 limit sharing Opco even though and Management Co not associated.

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How much SBD can you get?

Example:

- Opco pays Management Co a fee of \$300,000.
- Opco has the full \$500,000 SBD limit.
- Opco can assign up to \$300,000 of its SBD limit to Management Co.
- Management Co will be able to claim SBD on the amount assigned to it by Opco, subject to other SBD limitations (e.g., taxable capital, passive income).
- Opco can now only claim SBD on \$200,000 of its remaining income.

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How much SBD can you get?

Part 7 – Specified corporate income and assignment under subsection 125(3.2)

EE Business number of the corporation	FF Income described under clause 125(1)(a)(i)(B) from the corporation identified in column EE <i>note 11</i>	GG Business limit assigned from the corporation identified in column EE <i>note 12</i>
600	610	620
123456789RC0001	300,000	300,000
Total	615 300,000	625 300,000

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How much SBD can you get?

Small business deduction (continued)

Specified corporate income and assignment under subsection 125(3.2)

O Business number of the corporation receiving the assigned amount	P Income paid under clause 125(1)(a)(i)(B) to the corporation identified in column O ³	Q Business limit assigned to corporation identified in column O ⁴
490	500	505
1. 987654321RC0001	300,000	300,000
2.		
3.		
4.		
Total 510 300,000		Total 515 300,000

Notes:

3. This amount is [as defined in subsection 125(7) **specified corporate income** (a)(i)] the total of all amounts each of which is income from an active business of the corporation for the year from the provision of services or property to a private corporation (directly or indirectly, in any manner whatever) if
- (A) at any time in the year, the corporation (or one of its shareholders) or a person who does not deal at arm's length with the corporation (or one of its shareholders) holds a direct or indirect interest in the private corporation, and
- (B) it is not the case that all or substantially all of the corporation's income for the year from an active business is from the provision of services or property to
- (I) persons (other than the private corporation) with which the corporation deals at arm's length, or
- (II) partnerships with which the corporation deals at arm's length, other than a partnership in which a person that does not deal at arm's length with the corporation holds a direct or indirect interest.
4. The amount of the business limit you assign to a CCPC cannot be greater than the amount determined by the formula $A - B$, where A is the amount of income referred to in column P in respect of that CCPC and B is the portion of the amount described in A that is deductible by you in respect of the amount of income referred to in clauses 125(1)(a)(i)(A) or (B) for the year. The amount on line 515 cannot be greater than the amount on line 425 (426 for tax years starting after 2018).

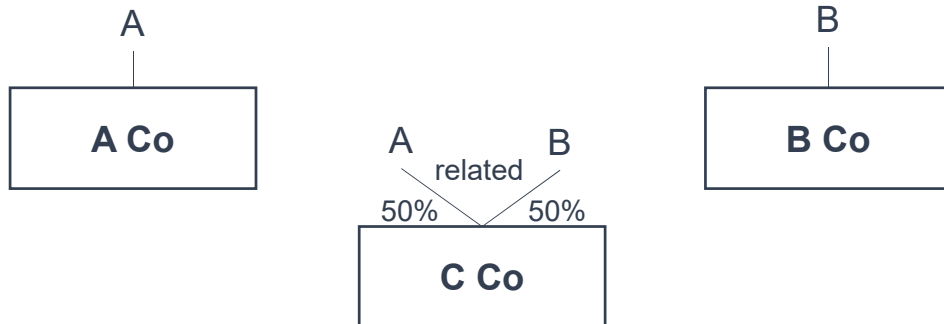
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A Co associated with C Co, A related to group that controls C Co and 25% ownership.

B Co associated with C Co, same reason.

A Co and B Co therefore associated.

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C Co has active business

A Co owns building

B Co loans money to C Co to finance C Co's business

C Co deducts rent/interest from active income

Income active to A Co (rent) and B Co (interest)

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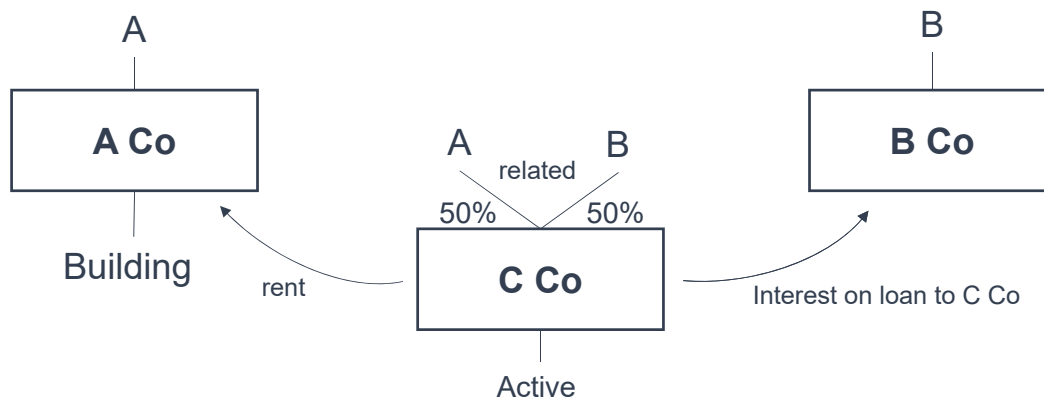


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The “Third Corporation” Problem



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The “Third Corporation” Problem

- Recharacterized passive income now not eligible for the SBD.
- There is no exception to this rule if non-association election made.
- The “third corporation” rule is also amended.

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Suggestions for Practitioners

- Review corporate structures with clients.
- Start early in terms of planning.
- Identify major revenue sources and confirm the corporation's relation with these sources.
- Maximize reasonable allocation of expenses to reduce non-eligible income.

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Suggestions for Practitioners

- For associated group, monitor taxable capital and passive income level to avoid grind.
- For associated groups with different year ends, consider aligning them to reduce filing complexity.

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Passive Income Rules

- More hurdles to claim SBD.
- Excess passive income (over \$50,000) directly reduces \$500,000 business limit.
- Applicable to taxation years beginning after 2018. Grind is based on passive income of previous tax year.

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Comparing the Grinds

	Taxable Capital	Passive Income
Measurement period	Prior year	Prior year
Who else is included	Associated corporations under normal rules	Associates corporations under normal rules, plus related corporations deemed associated
Threshold	\$10,000,000	\$50,000
Full elimination threshold	\$15,000,000	\$150,000
Reduction per dollar	\$0.10	\$5
Anti-avoidance rule	GAAR (maybe)	ss. 125(5.2) GAAR (maybe)

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Passive Income – Anti-avoidance

- Two related but unassociated corporations are deemed to be associated for purposes of the passive income calculation if:
 - one corporation lends or transfers property at any time to the other corporation; and
 - one of the reasons for the transfer/loan was to reduce the passive income of any corporation in the associated group.

Stops plan to remove funds to related but non-associated corporation.

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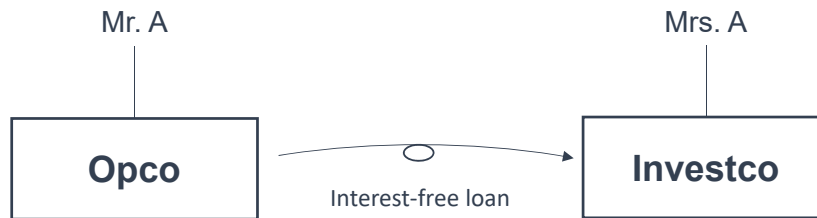


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How bad can this get?



Opco loans interest-free to Investco.

Idea is for Investco (not-associated) to earn future investments income, avoid passive income gained for Opco.

Result Opco/Investco deemed associated for passive income grind.

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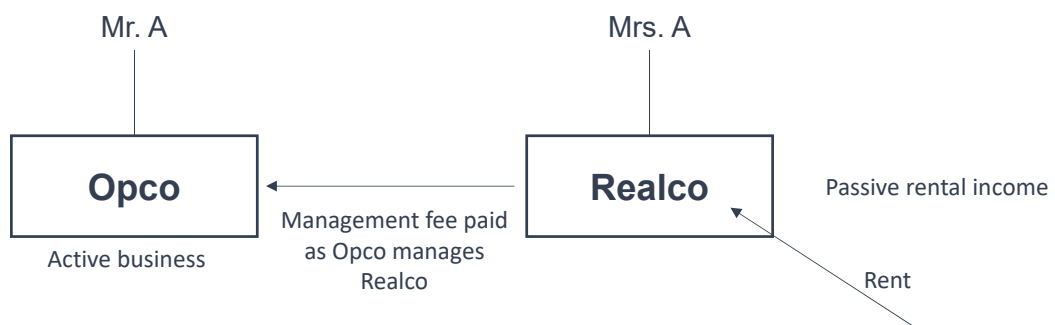


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How bad can this get?



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What is Passive Income?

- Generally investment income, but excludes:
 - taxable capital gain from sale of “active asset”; and
 - dividends from connected corporations.
- Active asset is asset:
 - used in active business primarily in Canada
 - share of connected small business corporation (“SBC”)
 - partnership interest if 10% or more (by FMV) and active asset



What is Passive Income?

All investment income less applicable expenses

All taxable capital gains (net of losses) except gains on disposal of active asset

Canadian or foreign source

Loss carryback or carryforward does not reduce passive income

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Avoid the Grind

- Reduce taxable capital of the group.
- Reduce passive income for the group.

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Avoid the Grind – Taxable Capital

Add:

- Share capital
- Retained earnings
- Loans and advances to the company

Minus:

- Deficit
- Certain investments
- Loans and advances made by the company

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Avoid the Grind - Taxable Capital

The simple ways

- Pay down loans
- Keep accounts payable current
- Reduce share capital
- Makes investments in shares and debt of other corporations (mindful of passive income rule).
- Pay out dividends
- Declare and pay bonus

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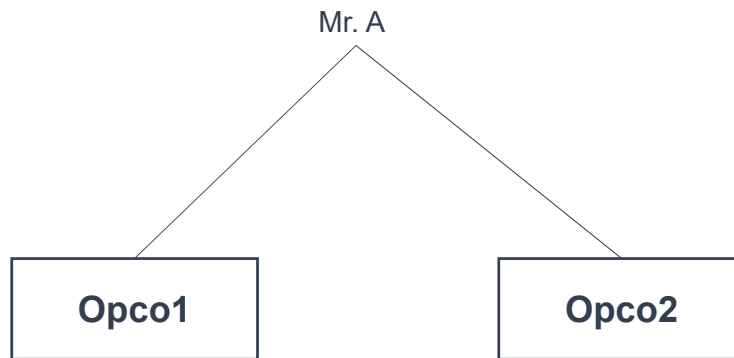


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Avoid the Grind - Taxable Capital



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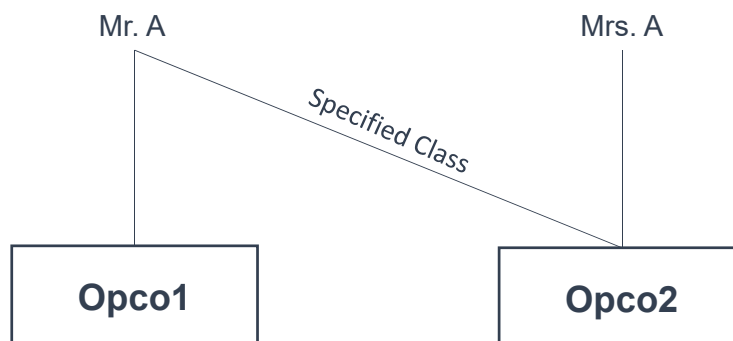


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Avoid the Grind - Taxable Capital



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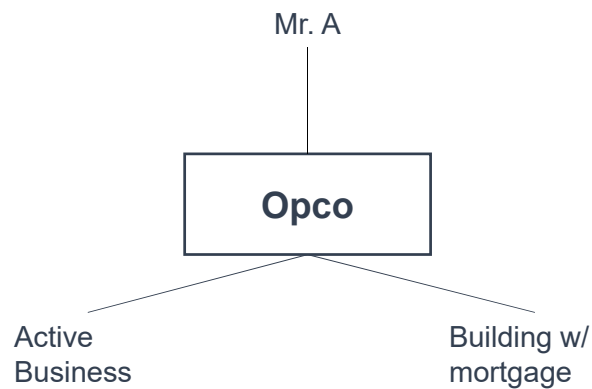
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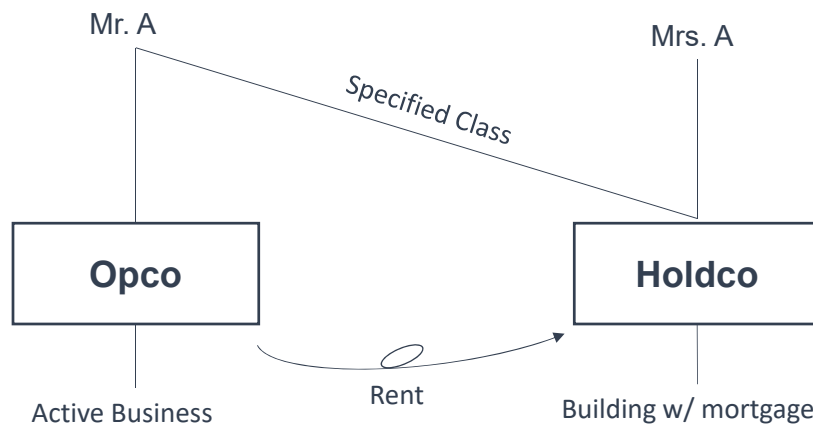
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Avoid the Grind - Taxable Capital



Avoid the Grind - Taxable Capital



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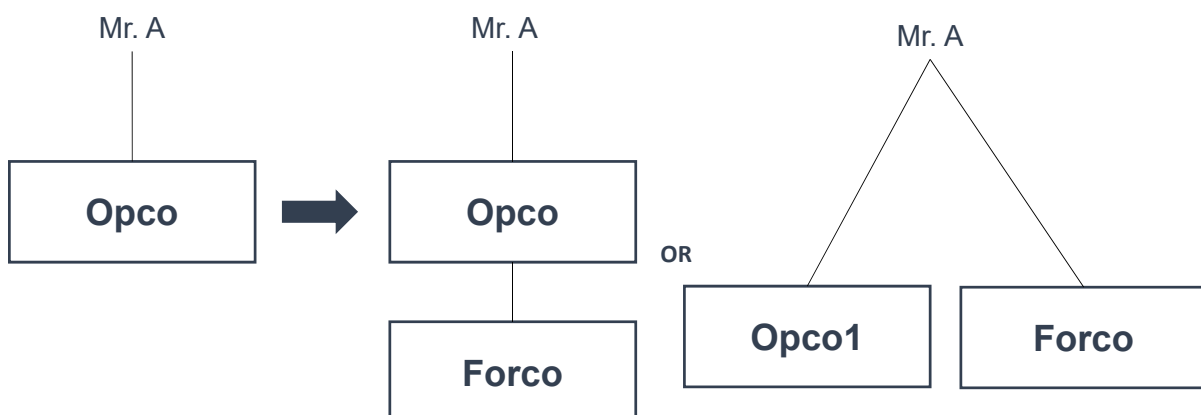


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Avoid the Grind – Taxable Capital



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Avoid the Grind – Passive Income

➤ Two possible approaches

- reduce passive income
- structure yourself out

More difficult or impossible due to anti-avoidance rule

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Avoid the Grind – Passive Income

The Easy Ways

- Move away from interest and dividends (unless the corporations are connected).
- Match timing of capital gains and losses.
- Invest in appreciating active assets (buildings, etc.).
- Borrow to invest in passive assets.
- Invest in certain mutual funds that produce capital gains.
- Individual pension plans.
- Exempt life insurance policies.
- Invest in foreign expansions.

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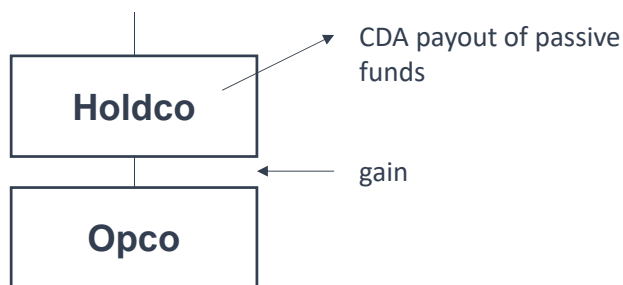
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Avoid the Grind - Passive Income

- Holdco has passive assets, earns substantial passive income
- Trigger one time large capital gain by internal sale of Opco shares
- Pay out funds by CDA and invest personally (perhaps pay out taxable dividend also)



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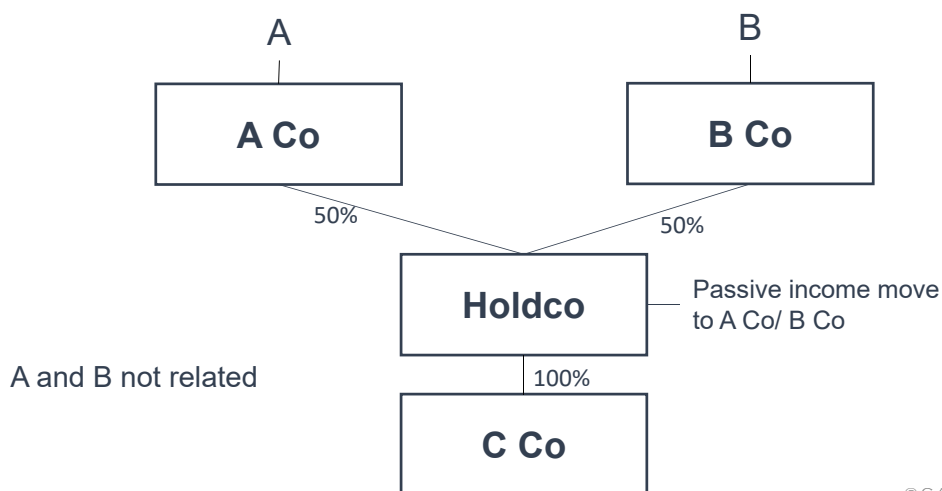
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Avoid the Grind – Passive Income



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Impact of Passive Income

Passive income grind reduces federal SBD, not Ontario.

Dividend character, eligible v ineligible based on federal definition.

Grind could be an advantage!

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	<u>ABI SBD</u>	<u>ABI SBD Gained for Passive Income</u>
Income of Corporation	100	100
Tax-Federal	9.00	15.00
Tax- Ontario	<u>3.20</u>	<u>3.20</u>
Total Corporate Tax (A)	12.20	18.20
Dividend	87.80	81.80
<u>Personal</u>		
Ineligible Dividend	87.80	
Eligible Dividend		81.80
Tax (47.74% / 39.34%)(B)	41.92	32.18
Total Tax (A)+(B)	<u>54.12</u>	<u>50.38</u>
Savings	<u>3.74%</u>	

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Savings Analysis

Tax at different rate bands	<u>\$78,784</u>	<u>\$89,483</u>	<u>\$97,070</u>	<u>\$150,001</u>
Ineligible	19.65	22.09	31.70	33.28
Eligible	7.30	10.01	20.76	22.52
Savings	12.35	12.08	10.94	10.76
Cost	<u>6.00</u>	<u>6.00</u>	<u>6.00</u>	<u>6.00</u>
Net Savings	6.35	6.08	4.94	4.76

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Savings Analysis

Savings bigger at lower brackets

But beware of gross-up pushing into higher brackets (ineligible 115%; eligible 145%)

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Savings Analysis

Note smaller dividends leads to less TOSI exposure because of reasonable amount.

Overall benefit from grind, if funds withdrawn, 3.74% - 6.35%

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