MARCH
2018

cardinal UPDATE

FEDERAL BUDGET 2018 – TAXING PASSIVE INCOME

The federal government released a consultation paper last summer targeting tax planning strategies using private corporations. This proposal was met with strong criticism from the business community and resulted in some awkward town hall meetings for Finance Minister Bill Morneau.

Five months after the close of the consultation period, we are being presented with a federal budget far less dramatic than originally feared. But there are still some material changes that we need to understand. One of the more impactful changes involves passive income earned within a Canadian Controlled Private Corporation (CCPC). Passive income is earned on corporate investments separate from active business operations.

WHAT IS CHANGING?

CCPCs pay a reduced rate on the first $500,000 of active business income at the federal level. For tax years beginning on or after January 1, 2019, the business income amount that qualifies for the small business tax rate would decline for passive income earned over $50,000. A CCPC will have their small business deduction ground down at a rate of 5 to 1 for every dollar of adjusted aggregate investment income (AII) in excess of $50,000. For simplicity's sake, think of AII as the usual components of passive income – dividends, interest and the taxable portion of capital gains. There are some exclusions (capital gains on active business assets or dividends paid by connected corporations for example).

Hearing references made to CCPC, active business income and the small business deduction can distort what this change is really targeting. Regardless of the mechanism used to exact the toll, this is a tax on investment income, indirect as it may be.

The calculations below illustrate the difference at the federal level. In addition, there will be a provincial impact. The true dollar impact will vary province by province.

DIVIDEND INCREASES

Bank of Nova Scotia	3.8%
CIBC	2.3%
Cisco Systems Inc.	13.8%
Gildan Activewear Inc.	19.8%
Intact Financial Corp.	9.4%
Magna International Inc.	20.0%
Royal Bank of Canada	3.3%
SAP SE	12.0%
Suncor Energy Inc.	12.5%
TransCanada Corp.	10.4%

(During the period February 1 to February 28, 2018)

cardinal UPDATE

WHAT IS THE IMPACT?

CCPC's earning $50,000 or less in passive income will not be impacted by this change. It is on the next $100,000 where you begin to see the impact. We'll refer to passive income earned between $50,000 and $150,000 as the Target Range. At a rate of 5 to 1 the small business deduction of $500,000 declines to zero on $100,000 earned in excess of the $50,000 exemption. Passive income or AII in excess of $150,000 would not qualify for the small business tax rate.

A corporation earning $150,000 in passive income and $500,000 of active business income, will see their tax bill increase by $22,500 compared to 2017 ($30,000 on the passive income offset by a $7,500 reduction on active income due to schedule rate decreases).

HOW IS IT CALCULATED?

CCPCs pay the small business tax rate on the first $500,000 of active business income at the federal level. This rate is 10% in 2018 and will be reduced to 9% in 2019. The general rate is 15%. This means by the time this change is enacted in 2019, the tax rate on AII earned in the Target Range will increase by 30% (the 6% net difference in rates at a factor of 5 to 1).

Every client's situation is different and as such will need to be assessed individually. When devising or amending a tax strategy, individuals should consult a tax accountant or other qualified professional. In consultation with your accountant, Cardinal can work through various investment options to suit your specific needs.

COMPANY FOCUS:

MAGNA

Magna has performed well since our purchase last year; up ~30% despite headline risks in NAFTA and auto cycle worries. Our research team recently attended Magna's Investor Day in New York and the Toronto Auto Show. The takeaways from these two events was largely positive, with the investor day highlighting moderating capital spending with growth ahead of the global market, focused on gains in Europe and China. A great deal of discussion was given to Magna's valuation that continues to trade at a discount to its U.S. peers, which management is now taking a more active role in trying to correct. The Toronto Auto Show emphasized that Magna is positioning their business in the right places to take advantage of the changing auto market. The displays contained an overwhelming amount of SUVs and crossovers as consumers' appetite for larger vehicles is growing. Magna's platforms are heavily weighted towards these platforms, with some divisions having close to double the exposure than the general market (Magna's seating business for example). Global diversification, overweighting towards growth categories and a discounted valuation should position Magna's stock to do well again in the coming year.

400 - 1780 Wellington Avenue
Winnipeg, Manitoba R3H 1B3

Phone: (204) 783-0716
Fax: (204) 783-0725
Toll Free: (800) 310-4664

Cardinal Capital Management, Inc.