TAXES

Proposed tax changes would shake the small-business world

TIM CESTNICK
Special to The Globe and Mail

Last updated Friday, Jul. 21, 2017 8:09AM EDT

While the proposed tax changes are meant to affect the wealthy, there will be no shortage of small-business owners, the backbone of the Canadian economy, who will be significantly worse off as a result. (NicoElNino/Getty Images/iStockphoto)

Ever since the 2017 federal budget in March, when the government announced that tax changes affecting private corporations would be coming, I've been feeling queasy. Well, the proposed tax changes were announced by Bill Morneau, the Finance Minister, on Tuesday. And ugly they are. Here's a primer on the potential changes.

The overview

Mr. Morneau announced in the budget back in March that the Liberals have not been pleased with some Canadians who are using corporations in their tax planning, and that changes would be made. The claim is that certain folks are using corporations to pay less than their fair share of taxes. While the proposed changes are meant to affect the wealthy, there will be no shortage of small-business owners, the backbone of the Canadian economy, who will be significantly worse off as a result.

The proposals

There are three tax-planning tactics the government is looking to shut down:

Income sprinkling

Some business owners sprinkle income to family members by way of salary or wages, or dividends, to reduce the family's overall tax burden. There are already rules in place to prevent unreasonable salary or wages from being paid to family members who are not truly earning the compensation they receive. There are even "kiddie tax" rules to prevent dividends paid to minor children from being taxed at their lower rates.

So, what's changing? The government wants to now restrict the ability to pay salary or wages, or dividends, to adult children between the ages of 18 and 24, by extending the "kiddie tax" rules – formally called the "tax on split income" (TOSI) – to them. The proposals will apply a "reasonableness test" that will assess the adult child's contributions to the business (both labour and capital) in determining whether amounts paid to that child should be taxed at his or her normal tax rates, or at the highest tax rate possible.

In the past, families have also taken advantage of the lifetime capital gains exemption (LCGE), which shelters from tax up to $835,716, in 2017, of capital gains on qualifying small-business corporation shares). Good tax planning has seen the LCGE of each family member used to shelter gains on the family business. The government has proposed to restrict this. Starting after 2017, capital gains realized by a family member can no longer be sheltered with the

LCGE to the extent those gains accrued while the individual was a minor. Further, any capital gains accrued while the shares are held in a family trust, or gains subject to the TOSI would not be eligible for shelter using the LCGE.

Finally, in the past, the TOSI (which you'll recall is a special tax, at the highest rate going, that applies to certain income reported in the hands of children) has not applied to second generation income – that is, income on income. So, if a corporation paid, say $100 in dividends to a child, and the child paid the highest rate of tax (the TOSI) of, say, $40, there would be $60 left after taxes. That $60 could be invested and any income in the future on that $60 (income on the income) would not be subject to the high rate of tax (the TOSI). This will change if the new proposals are enacted. All future income (income on any income) will be subject to the same high rate tax (the TOSI). Confused yet?

Passive income

When a corporation generates income, it's eligible for a pretty attractive rate of tax (about 15 per cent, but it varies by province) on the first $500,000 (federally) of active business income. If a business owner doesn't need all of his earnings to support his lifestyle, it's common to leave the rest in the corporation to invest – perhaps in a portfolio earning passive income. For example, if you earn $100 in active business income and pay $15 of that to the taxman, you'd have $85 left to invest in the corporation. If you had earned that business income personally, and you're in the highest tax bracket (a marginal tax rate of about 50 per cent), you'd be left with just $50 to invest. So, there's an advantage to earning business income in a corporation if you earn enough that you won't spend it all.

The government thinks this is unfair, notwithstanding that you'll actually pay more tax over all if you invest inside the corporation and then eventually pay that income out to yourself as dividends later. That's right, corporate tax rates on passive income are high even under today's rules – don't let the government tell you otherwise. So, the only meaningful benefit is the larger amount to invest up front as noted in my example above. It appears that the government believes that having more money working for you today, if you have a corporation, is offensive (so much for helping Canadians save for the future).

The government is exploring how to limit the perceived benefit of leaving excess earnings inside a corporation to grow in a passive portfolio. Mr. Morneau is looking for comments from Canadians on a couple of primary options: (1) implementing a refundable tax that would apply to ineligible investments (the tax would be refunded once the capital is either paid out to you as taxable dividends personally, or is used in the active business), or (2) change the current refundable tax system on annual passive income so that the tax is no longer refundable if the

investments were made with excess business income taxed at low rates. How does all of this simplify our tax system?

Converting income to capital gains

Some corporate owners have taken steps to convert what would otherwise be taxed as salary or dividends into capital gains. This has been done using a complex set of steps involving selling of some shares to another company related to the shareholder. The government proposes to close these opportunities by tweaking section 84.1 of our tax law, which was intended to prevent this type of planning but doesn't quite do the trick. On this one, I think the changes make sense.

If you're so inclined, read over the 63-page consultation paper that outlines these proposed changes (available on the Department of Finance website). In my view, what you'll find are a lot of changes that will do nothing but make our convoluted tax law even more complex.

Tim Cestnick, FCPA, FCA, CPA(IL), CFP, TEP, is an author and founder of WaterStreet Family Offices.

Related

The benefits of a strategic investment approach to charitable giving

The four most common reasons the wealthy invest in life insurance

How to get money from your corporation in a tax-friendly way

© Copyright 2017 The Globe and Mail Inc. All Rights Reserved.