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Proposed Tax Changes for Private Corporations

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Proposed Tax Changes for Private Corporations

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Agenda

1. Background
2. Key Features of the Income Tax System
3. Tax Planning Strategies
    a) Income Sprinkling
    b) Passive Investment Income
    c) Converting Income into Capital Gains
4. What Actions Can We Take?
5. Questions/Comments/Discussion

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Background

- Recent Taxation Changes That Negatively Affect Entrepreneurs
  - Federal Liberals increased tax rates for “high income” individuals by 4% (2016)
  - AB’s government increased personal tax rates by 5% for “high income” earners, leaving an increase of 9% for those affected in Alberta.
  - 55(2) – Inter-Corporate cash movements
  - Multiplication of Small Business Deduction (S. 125)

- Overall increase in tax for small business owners
- Increased complexity for regular compliance (increased costs)

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Background

- July 18, 2017 Minister of Finance (Bill Morneau) released proposed changes to Canadian tax legislation regarding income sprinkling, passive income and capital gains

- Some important quotes from that release:
  - "Asking Canadians for **input** into how to close loopholes and address tax planning strategies that give unfair tax advantages"
  - "Ensure that the **richest Canadians** pay their fair share of taxes"
  - "People in **similar circumstances** pay similar amounts of tax"
  - "Many of the richest Canadians are **unfairly exploiting** the tax rules"
  - "Tax advantages are in place to help these businesses **reinvest and grow**"

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Background

- Input
  - Still in the consultation stage but there are 60 pages of draft legislation
- Unfairly Exploiting
  - Tone that accuses small business owners of cheating
- Reinvest and Grow
  - Almost all small businesses will be paying more tax
  - Added complexities & compliance costs
  - Double or triple taxation

Key Features of the Income Tax System

- Salary vs. Dividend
  - Salary
    - Payment for services provided
    - Deduction from income (expense to the company)
    - Reduces corporate taxes payable

  - Dividend
    - “Related to a shareholders’ capital or share interest in a corporation not to contributions provided by that shareholder to the corporation”
    - Distribution of after tax profits

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Key Features of the Income Tax System

- Theory of Integration

Corporate tax on earnings
+ Personal tax on dividends
Personal tax on salaries

Note: This ignores the benefits of a tax deferral and uses the highest marginal tax rates.

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Key Features of the Income Tax System

- Theory of Integration Example

Individual		Corporate Owner	
Salary	$1,000	Business Income	$1,000
Personal Income Tax	($500)	Corporate Income Tax	($150)
After-Tax Income	**$500**	Income After Corporate Tax	$850
		On Distribution as Dividend: • Dividend income grossed up • Personal income tax rates apply • Claim dividend tax credit	($350)
		Total Tax Paid	$500
		After-Tax Income	**$500**

Key Features of the Income Tax System

- Personal Income Tax – Progressive Tax Rates
  - "Canada's personal income tax system is based on the individual's ability to pay"
  - "Those with higher ability to pay tax should bear a proportionally higher amount of tax"

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Key Features of the Income Tax System

- Personal Income Tax – Progressive Tax Rates

Taxable Income	Federal Tax Rate
Up to $45,916	15%
$45,916 to $91,831	20.5%
$91,831 to $142,353	26%
$142,353 to $202,800	29%
Over $202,800	33%

Taxable Income	Alberta Tax Rate
Up to $126,625	10%
$126,625 to $151,950	12%
$151,950 to $202,600	13%
$202,600 to $303,900	14%
Over $303,900	15%

- Ignoring personal tax credits in this example
- Tax on $45,916 = $11,479 (25%)
- Tax on $45,917 = $11,479.31 ($1 @ 30.5%)
- Highest marginal tax rate in AB is 48%

Income Sprinkling

- What is the right tax unit?
  - Individual
  - Family
- Carter Commission Report (1966)
- Shifts income to an individual in a lower personal tax bracket

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Tax Planning Strategies

- Income Sprinkling
  - Current legislation
    - Reasonability test applies only to salaries
  - Dividend sprinkling example (extract Department of Finance - July 18, 2017 release)

	Jonah	Susan
Total Earnings	$220,000	$220,000
Salary paid	$100,000	$220,000
Dividends paid to family members (after corporate tax)	$102,000	-
Total tax paid (personal and corporate)	**$44,000**	**$79,000**
After-Tax Income	$176,000	$141,000

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Tax Planning Strategies

- Income Sprinkling
  - Proposed Legislation
    - Proposed application date of January 1, 2018
    - Split income allocations will be subject to a **reasonability test** based on:
      - Labour contributed
      - Assets contributed
      - Risk assumed
    - CRA can assess what is reasonable, the taxpayer must disprove the assessment
    - Tax on split income will be paid at the top marginal tax rate and is not subject to personal tax credits
    - This may require a reorganization of shares in a corporation

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Quotes Revisited

- Unfair Advantage
  - Are there any remaining incentives to encourage entrepreneurs to take the risk of being self-employed?

- People in Similar Circumstances
  - Employees vs. Entrepreneurs have significantly different circumstances
  - Example – Two families with a household income of $100,000

- Richest Canadians are exploiting tax rules
  - "66% of small businesses earn less than $73,000 a year"
  - "Most middle-class Canadians and small businesses will be unaffected"

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Tax Planning Strategies

- Income Sprinkling
  - Lifetime capital gains exemption and Qualified small business corporation explained
  - Current legislation
    - Direct ownership or family trust
  - Proposed legislation
    - Similar limitations to dividend sprinkling where there would be a reasonability test
    - No capital gains exemption or accrual of a gain would be available to minors
    - No capital gains exemption can be claimed on shares subject to tax on split income
    - Transitional provisions
      - Issues: Purification, availability for minors, retroactive valuation, elections to be filed & late filing penalties

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Tax Planning Strategies

- Passive Investment Income
  - Active vs. Passive Income explained
  - Tax Deferral
    - Lower corporate tax rates to assist with growth and increases cash-flows
    - Example

	Employee	Corporate Owner
Taxable Income	$100,000	$100,000
Corporate Income Tax	-	$12,500
Personal Income Tax	$48,000	-
Net Income Available to Invest	**$52,000**	**$87,500**

***Potential issues with the ability to claimed the lifetime capital gains exemption

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Tax Planning Strategies

- Passive Investment Income
  - Current legislation
    - Retain excess active income in a corporation and invest
    - Pay tax at 50.67% on the passive investment earnings, including a refundable component of 30.67%
    - Pay dividends to recover refundable tax as the shareholder likely required personal income
    - Result is a 20% corporate tax rate and same/similar personal taxes
    - Current rules allow for income smoothing regardless of the business' fluctuating income
    - Combination of smoothing/sprinkling results in less overall tax payable

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Tax Planning Strategies

- Passive Investment Income
  - White Paper Suggestions
    - Proposed options include the following methods:
      1. 50.67% tax paid with no refundable component and removal of the CDA
      2. Track 3 types of funds and allocate dividends accordingly from:
         - Income taxed at the SBD rate
         - Income taxed at the General rate
         - Shareholder contributions
      3. Elective Method
         - Default – all dividends are paid from income at the SBD rate
         - Election – lose access to the SBD
  - All methods result in additional tax payable for corporations, potentially in excess of 70% once paid to the shareholder (currently at 53%)

Tax Planning Strategies

- Passive Investment Income
  - White Paper Suggestions
    - Income smoothing is no longer available

Note: This item did not have draft legislation but it is anticipated to be applied prospectively with transitional rules.

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Tax Planning Strategies

- Converting Income Into Capital Gains
  - History
  - 50% inclusion rate (currently)
  - Current legislation
    - Series of transactions, none of which contravene the Income Tax Act to convert what would otherwise be taxed as a dividend (100% inclusion) into a capital gain (50% inclusion)
    - CRA has tried to apply the General Anti-Avoidance Rule unsuccessfully
    - Pipeline strategy for estate purposes

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Tax Planning Strategies

- Converting Income Into Capital Gains
  - Proposed Legislation
    - Application date of July 18, 2017
    - Negative consequences for genuine estate planning matters which can result in double taxation
    - Proposal to treat transactions as arm’s length has other unintended results for CRA
    - “Amendments will be made to the income tax rules to address such tax planning”

What Actions Can We Take?

- The proposed legislation will have significant effects on almost all business owners
- Deadline for comments is October 2, 2017
- Options
  1. Medicine Hat & District Chamber of Commerce
  2. Local MP – Glen Motz
  3. Minister of Finance - Bill Morneau
  4. Petitions
- Stay informed

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Questions?

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