Planning Matters

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Navigating the New Tax Rules for Your Small Business

The 2018 budget marked the culmination of a tumultuous year in which we saw the proposal of the most significant tax changes in the last 45 years, many specifically targeted at professionals including dentists, lawyers, and doctors. Through the budget, the federal government confirmed it would be moving forward with changes regarding income sprinkling that were pre-released in December 2017, and included draft legislation regarding the taxation of passive income earned by private corporations.

Tax on Split Income (a.k.a. "Income Sprinkling")

The December 2017 proposals introduced several "bright-line" exclusions from the application of Tax on Split Income ("TOSI"). If a taxpayer can meet the conditions for one of the exclusions, the new TOSI rules would not apply, and he or she would be able to continue paying income to family members at the graduated rates, and not the highest marginal rates.

Some of the notable exclusions to the new legislation:

- Excluded Business:

Family members who have made a substantial labour contribution (generally an average of at least 20 hours per week) to the business during the year, or any five previous taxation years;

- Excluded Shares:

Adults aged 25 or older who own 10% or more of a corporation, provided that the corporation earns less than 90% of its income from the provision of services, and is not a professional corporation;

- Qualifying Capital Gains:

Individuals who receive capital gains on the disposition of qualified small business corporation shares will not be subject to TOSI;

- Age Test:

If the business owner is age 65 or older, their spouse will generally be able to continue receiving income.

If none of the exclusions apply, then individuals who reach the age of 25 during or before the current year will be subject to TOSI on amounts if they exceed what CRA deems a "reasonable return."

In light of these new rules, we recommend meeting with your tax advisor to determine if any exclusions might be available for your business.

Holding Passive Investments Inside a Private Corporation

Active business income earned by Canadian Controlled Private Corporations ("CCPCs") is taxed at corporate rates that are generally significantly lower than personal tax rates. As a result, CCPCs have more after-tax income to invest than individuals earning the same income. Where this after-tax income is invested passively, the government is of the view that CCPCs have an unfair advantage compared to unincorporated individuals. Budget 2018 introduced two measures to limit the value of this perceived advantage:

Business Limit Reduction

Where a CCPC and its associated corporations earn annual investment income in excess of $50,000, Budget 2018 proposes to limit the corporation's access to the small business deduction ("SBD"). For every $1 of investment income earned in excess of $50,000, the SBD will be reduced by $5. This means that when a CCPC and its associated corporations earn $150,000 of investment income, access to the $500,000 SBD will be eliminated, and income earned by the CCPC will be subject to the higher general corporate tax rate.

Refundability of Taxes on Investment Income

When a CCPC earns passive investment income, a portion of the tax it pays is refundable when the corporation eventually pays dividends to its shareholders. This refundable dividend tax on hand (RDTOH) is refunded at a rate of $38.33 for every $100 of dividends paid. CCPCs can typically pay two types of taxable dividends – eligible or ineligible. When a CCPC is taxed at the general corporate tax rate, it can generally distribute its retained earnings as eligible dividends, which are subject to preferential personal tax rates. Where a CCPC is taxed at the small business tax rate, or earns passive investment income, its retained earnings are distributed as ineligible dividends, which are subject to higher personal tax rates. Under the current system, both eligible and ineligible dividends can generate a refund of the RDTOH.

Budget 2018 proposes there be two pools of RDTOH, eligible and non-eligible. A refund of RDTOH will be available only in cases where a private corporation pays non-eligible dividends. An exception will be provided in respect of RDTOH that arises from eligible portfolio dividends received by a corporation. This will continue to be refunded if the CCPC pays eligible dividends. There will be transitional rules that will convert the existing RDTOH pool balances into eligible and non-eligible RDTOH balances. Due to the high level of complexity in these changes, it is strongly advised that you speak with a tax professional. These measures will apply to taxation years that begin after 2018.

As a result of these changes to holding passive investments inside a private corporation, it will be essential to work closely with your financial advisor and tax advisor to minimize and manage the possible impact on your business. By modifying your investment strategy, you may be able to manage the amount of investment income realized in a given year. Additionally, it is advisable to revisit your remuneration strategy with your tax advisor.

About the Authors:

Mark Waslen, CPA, CA, CFA, is a Partner and a member of MNP's Professional Services team in Vancouver. A trusted advisor, Mark delivers strong business solutions to professionals, including doctors, lawyers, dentists and small businesses to help them maximize profit and achieve their personal and professional goals. In service of community, he also volunteers with the Vancouver Cherry Blossom Festival, People's Law School, and minor sports.

Kerry Smith, CPA, CA is a Senior Manager and a member of MNP's Professional Services team in Vancouver. With a strong focus on incorporated professionals, Kerry provides efficient and effective accounting, taxation and business consulting services. He takes pride in working with clients to help them achieve their personal and business goals by looking beyond tax returns and financial statements.

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