Tax Hikes for Professionals

rlb Chartered Professional Accountants

AGENDA

- Introduction
- Proposed Changes and Related Issues/Analysis
    - Income Splitting
    - Converting Income to Capital Gains
    - Taxation of Passive Income
    - Other Considerations
- General Comments and Other Considerations
- Myth Busters – The Math Behind the Madness
- Call to Action
- Questions

INTRODUCTION

- Most significant tax changes in 40 years
- “Tax loopholes” vs. current legislation
- Targeting wealthiest Canadians, having an unintended affect on middle class
- Physicians permitted to incorporate 15 years ago to compensate for not increasing billing limit
- Impact of conversion of GST to HST and clawback of MD billings
- Government is receiving commentary until October 2, 2017
- OMA is actively involved in campaign to shut down changes

INCOME SPLITTING – THE CHANGES

- Dividends and salaries subject to reasonableness provisions
- Anything in excess taxed at highest marginal tax rate
- Reasonableness still needs to be clearly defined – will be a function of labour and capital contributions
- Additional restrictions for shareholders between the ages of 18 and 24

INCOME SPLITTING – AGE ANALYSIS

	18 - 24	25 or older
Labour Contributions	Actively engaged on a regular, continuous and substantial basis	Involved in activities
Capital Contributions	Legislatively-prescribed maximum distributions in relation to the assets contributed by the individual	Contributed assets or assumed risk in support of the business

INCOME SPLITTING – ANALYSIS

- Entire family unit vs. individuals within the family
- Value of spouse and children contributions to practice
- Stay-at-home spouse vs. traditional child care for physicians
- Raises question of age discrimination
- RESP grants and capital accumulation lost for people who have planned to fund post-secondary education via dividends
- Defining and implementing rules around reasonableness will be difficult
- Expect more audit enquiry and CRA conflict
- Planning will need to be implemented before the end of the year

INCOME SPLITTING – PLANNING

- RRSP contributions (may be an issue with no contribution room if salaries haven’t been paid)
- Individual pensions plans (IPP’s)
- Front load income in 2017 (may be corporate law limitations)
- Moving forward work done for the company by spouses and children will need to be documented (i.e. salary paid should be a function of hours worked)
- Prescribed rate loans for capital contributions will not be allowed

INCOME SPLITTING – RLB RECOMMENDATIONS

- Extend implementation period
- Effectively govern the payment of dividends to adult children versus elimination
- Restrict the purpose of dividends / apply de minis test
- Restrict issuance of income splitting shares
- Dividends to spouses for RRSP contribution should avoid the reasonableness test
- Income splitting exists for pension income – consider something similar for working individuals

CONVERTING INCOME TO CAPITAL GAINS - DETAILS

- Post-mortem planning - potential for double taxation at death
  - First shareholder is deemed to dispose of shares at death – reports a capital gain
  - Beneficiaries pay second level of tax on the same income when estate assets are distributed – reports a dividend
- To avoid double taxation, wind up and loss carryback or pipeline strategy can be implemented
- Under proposed rules, the pipeline strategy will be eliminated making estate tax increasingly complex and more costly

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CONVERTING INCOME TO CAPITAL GAINS - PLANNING

- Wills to be updated
- Revise estate planning calculations – these changes coupled with increasing marginal tax rates will have detrimental effects on current estate plans

PASSIVE INCOME – CURRENT RULES

Tax Treatment of Different Types of Passive Investment Income (Dollars)

			Types of Passive Investment Income		
		Formula	Interest Income/ Rental Income	Portfolio Dividends	Capital Gains
A	Passive investment income		100	100	100
B	Taxable passive investment income	A, or 50% of A for capital gains	100	100	50
C	Provincial corporate tax	B * 11.5% or 0 for dividends	11.50	0	5.75
D	Federal tax on interest, rental income and capital gains	B * 38⅔%	38.67	n/a	19.34
E	Federal tax on dividends	B * 38⅓%	n/a	38.33	n/a
	Refundable taxes and exempt amounts[1]				
F	Refundable portion of taxes on interest, rental income and capital gains	B * 30⅔%	30.67	n/a	15.34
G	Refundable portion of taxes paid on dividends	B * 38⅓%	n/a	38.33	n/a
H	Capital dividend account	A - B	n/a	n/a	50
	Distribution of income to individuals				
I	Taxable Dividends[2]	B – C – D + F or B – C – E + G	80.50	100	40.25
J	Capital dividends	H	0	0	50
K	Personal income tax[3]	I * 45.30% or 39.34%	36.47	39.34	18.23
L	After-tax income (Corporate owner)	(I + J – K)	44.03	60.66	72.02

PASSIVE INCOME - THE CHANGES

- Proposal to eliminate corporate tax deferral on invested assets
- Highest personal rate vs. 15% corporate rate
- A couple of different approaches are proposed:
    - The 1972 approach
    - Deferred taxation approach
- Two methods for determining dividend categorization
    - Apportionment method
    - Elective method
- The changes are only proposed – not in draft legislation format yet

PASSIVE INCOME – DEFERRED TAXATION APPROACH

Illustration of Proposed System Mechanics (Dollars)

	Individual	Corporation	
		Current System	Proposed System
Source capital			
Income	100,000	100,000	100,000
Federal personal or corporate tax	33,000	10,500	10,500
Provincial personal or corporate tax	17,367	3,900	3,900
Starting portfolio	**49,633**	**85,600**	**85,600**
Return on investment in year 1*			
Interest (3 per cent)	1,489	2,568	2,568
Non-refundable personal or corporate tax	750	506	
Federal	*491*	*205*	
Provincial	*259*	*300*	
Non-refundable taxes (new system)			1,293
Refundable taxes (RDTOH)		788	
After-tax investment income (re-invested passively)	739	1,275	1,275
Portfolio value after 10 years	**57,539**	**99,235**	**99,235**
Refund of pre-paid tax (RDTOH)		8,424	
Distribution of taxable dividends		107,659	99,235
Personal income tax on dividends		45,235	41,696
Net worth	**57,539**	**62,424**	**57,539**

PASSIVE INCOME – POSSIBLE EFFECTIVE TAX RATES

	Individual	Corporation Existing Rules	Corporation Proposed Rules
Interest Income	50%	53%	71%
Capital Gains	25%	27%	57%
Public Company Dividends	32%	32%	64%

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PASSIVE INCOME - ANALYSIS

- Integration and how it works
    - Capital dividend account
    - Refundable tax
- Proposed rules are very complex – difficult to administer
- Grandfathering assets will be difficult to manage
- Businesses saving for corporate reinvestment penalized as it can't be differentiated
- Replacement property rules

PASSIVE INCOME - PLANNING

- We generally pay dividends for RRSP contributions and recover refundable tax – change to bonus moving forward
- RRSP contributions vs. investing within the corporation
- Rental property accumulation within the corporation
- These changes have only been proposed and are not in draft legislation format yet – don't change what you're doing until we have confirmation of what will actually change

PASSIVE INCOME – RLB RECOMENDATIONS

- Threshold for application of new rules
- Reduce or eliminate capital cost allowance rates for passive rental properties
- Intercompany loans treated like shareholder loans as main purpose is generally creditor proofing

OTHER CONSIDERATIONS

- Risk versus reward – what will be the incentive for small business owners?
- Retirement planning – baby boomer generation will have issues with their previous planning
- Business owners do not get access to EI benefits
- No RRSP contribution room if a taxpayer has been taking dividends vs. salary
- No changes to insurance policies yet
- Incentive to stay in Canada?
- Added complexity

MYTH BUSTERS - THE MATH BEHIND THE MADNESS

	Self-Employed (Current Rules)	Self-Employed (Proposed Rules)	Salaried Employee
Lifestyle as a Percentage of Pretax Income (Average)	47%	47%	47%
Average Savings Rate as a Percentage of Pretax Income (CPP Included)	31%	17%	17%
Starting Retirement Income Exposed to Investment Risk	82%	82%	20%
Average Tax Rate while Working	24%	35%	36%
Average Tax Rate while Retired	25%	21%	24%
Retirement Income as Percentage of Pre-tax Income	47%	47%	47%

MYTH BUSTERS - THE MATH BEHIND THE MADNESS

	Self-Employed (Current Rules)	Self-Employed (Proposed Rules)	Salaried Employee
Age When Capital Is Exhausted	NA	Age 80	NA
Capital at Age 65 *	$ 3,510,000	$ 2,030,000	$ 700,000
Income and Return of Capital in Retirement	$ 6,764,000	$ 3,728,000	$ 6,835,000
Taxes in Retirement	$ 1,364,000	$ 662,000	$ 1,440,000
Spending in Retirement	$ 5,400,000	$ 3,066,000	$ 5,395,000

CALL TO ACTION

- Provide commentary
- Educate other taxpayers
- Stay informed
- Be prepared for last minute tax planning

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