Small businesses push back against Ottawa's new passive income rules

BRENDA BOUW

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John Hedden, of Bryan and Hedden Financial, says his firm has put expansion plans on hold because of new passive income rules. 'It's the biggest shock I've ever experienced' in 40 years in business, says Mr. Hedden, who estimates the new rules will cost him about $55,000 a year in additional combined federal and provincial taxes.

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John Hedden had planned to keep building his financial services business and hire more people but is rethinking that strategy in light of new passive income rules for private corporations that could cause his future tax bills to skyrocket.

“It’s a disincentive. Why would I go out and expand?” says Mr. Hedden, owner of Burlington, Ont.-based Bryan and Hedden Financial, which employs seven people.

The new passive income rules, which take effect Jan. 1, will see businesses lose access to the small-business tax deduction once they earn more than $50,000 in passive investment income in a year, and lose access entirely once they earn more than $150,000 a year.

Ottawa backed off a previous, controversial plan to heavily tax passive investment income, which is money made from investing in stocks, bonds or other sources not related to the business.

Business owners argue that passive investments allow them to set aside money for economic downturns or make future investments in their businesses, and also act as a retirement vehicle in lieu of a pension plan received by most salaried workers.

While the new passive income rules are less complicated and affect fewer companies, critics say it unfairly penalizes businesses for passive investments that were legally accumulated over several decades. The change is also considered unfair since, under its previous proposal, Ottawa assured business owners that only new passive income investments would be affected by any rule changes.

Companies, like Mr. Hedden’s, which have been around longer and have been successful, appear to be hardest hit by the new rules since they have accumulated more passive income.

“It’s the biggest shock I’ve ever experienced” in 40 years in business, says Mr. Hedden, who estimates the new rules will cost him about $55,000 a year in additional combined federal and provincial taxes, which is a good chunk of a full-time salary.

“We were going to expand, but now we probably won’t,” Mr. Hedden says. “Instead of hiring another person at that salary, the government just wants to take the money. They can have it, but they’ll lose that revenue on expansion.”

Mr. Hedden says small business owners should be rewarded for taking risks and employing people, not penalized with higher taxes. “I have taken a tremendous capital risk and business risk,” he says. “I feel like I was misled and lied to. The finance minister both in writing and verbally assured us current assets would be grandfathered. He ended up ignoring this promise.”

Companies affected by the new rules are also looking at different vehicles to help shelter earnings inside a corporation, including individual pension plans (IPPs) or corporate-owned life insurance policies.

An IPP has been described as a "supersized RRSP” and is modeled after the defined-benefit pension plan that some salaried employees receive, providing a set annual income in retirement. It's held in the name of the corporation, which is the plan sponsor. As with an RRSP, you put money into an IPP, the corporation receives a tax deduction and it grows tax-free. You don't pay tax on the funds until you take them out.

“The option likely isn’t for everyone and some care and maintenance of the pension plan is required, however, it is a valid option to create expenses within the company,” says Jon Wiens, a chartered professional accountant and partner at Calgary-based ALW Partners LLP.

He also recommends universal and whole life insurance policies for some clients “although I prefer options that have an investment component as well as the life insurance. Typically this strategy would be used by clients who want to leave a legacy at death and don’t expect to need the funds in their lifetime.”

There are some other basic tax planning measures to take as well, Mr. Wiens says, such as if one does increase their salary (and reduce retained earnings in the company), that can be offset by RRSP contributions.

In light of the pending passive income changes, Mr. Wiens is advising his clients to consider whether it makes sense to keep assets or cash or investments inside the company, or pull them out and pay the higher personal tax rate on it right away, instead of deferring it inside the corporation.

“In essence, it’s taking money out of the small business owner’s hands earlier, which is money they might utilize to invest in the business later or to create a retirement plan," Mr. Wiens says. “This is the government dictating a little bit how you should plan your finances.”

For some business owners, it still makes sense to keep the money in the business as long as possible. Others may want to use excess funds to invest in another business that would qualify as active business income, and not passive.

He uses the example of two business owners in Alberta with $100,000 in the business: One pulls out the entire sum for personal use, while the other pulls out $50,000. Assuming each taxpayer is in the highest tax bracket and their business no longer is eligible for the small business deduction rate due to passive income, the individual withdrawing the additional $50,000 pays tax at approximately 50 per cent, resulting in $25,000 of cash in hand, Mr. Wiens says. In comparison, the individual who leaves the additional $50,000 in the business will pay 27-per-cent corporate tax (an increase from 12 per cent under the old tax rules), resulting in $37,500 cash in the business.

“Another layer of tax will apply when the second individual eventually withdraws these funds from the business, but in the meantime the business can utilize the extra $12,500 of available cash,” he says, noting that other provinces have slightly different rates.

The new passive income rule changes don't affect Mr. Wiens personally, at this stage, but could down the road if his business continues to grow.

If these rules came into effect seven years ago, when Mr. Wiens started his company, he may not have made the same choice to become an entrepreneur. "The incentives for entrepreneurs [to start a company] have been minimized, while the entrepreneurial risk has not changed," he says.

For now, Mr. Wiens says he will likely take a little more income out of his corporations for personal use in the coming years, to avoid being caught in the situation of having the small business tax deduction reduced down the road.

The Coalition for Small Business Tax Fairness, a group formed to fight the federal government's tax-reform proposals for private corporations first introduced in the summer of 2017, is calling for a halt to the pending changes on passive income. Or, at the very least, it wants them grandfathered to exclude past investments.

"We're not done with this issue," says Dan Kelly, president and chief executive officer of the Canadian Federation of Independent Business.