FINANCIAL POST

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Federal budget only tweaks tax rules, but hints at more changes coming down the road

By Jamie Golombek

The federal budget didn't contain much in terms of meaningful tax policy announcements, but let's take a look at changes that may be of interest...

While this week's federal budget didn't contain much in terms of meaningful tax policy announcements, let's take a closer look at a couple of changes that may be of interest to investors or small business owners.

Investors

Investors are no-doubt pleased that Mr. Morneau didn't increase taxes on capital gains in this week's federal budget, although in a post-budget interview, he said he isn't completely ruling out changes in the future. The budget did, however, attack a more sophisticated type of financial transaction called a "straddle."

In a nutshell, a straddle is a transaction in which a taxpayer concurrently enters into two or more financial derivative positions, such as forward contracts, that are expected to generate equal and offsetting gains and losses. Shortly before the end of the year, the taxpayer disposes of the position with the accrued loss (the "losing leg") and realizes the loss. Then, shortly after the beginning of the following tax year, the taxpayer disposes of the offsetting position with the accrued gain (the "winning leg") and realizes the gain.

The net result is that the taxpayer claims a deduction for the realized loss against other sources of income in the first tax year but defers recognizing the offsetting gain until the subsequent tax year. By doing so, the taxpayer is able to benefit from the tax deferral despite the fact that, economically, the two positions perfectly offset each other. In some cases, taxpayers are able to indefinitely defer the recognition of the gain on the winning leg by continually entering into successive straddle transactions. More advanced versions of a straddle include an exit strategy that shifts the offsetting gain to a non-taxable investor.

In its budget, the government said that "straddle transactions raise significant tax base and fairness concerns … (and while) ... these transactions are being challenged using certain judicial principles and existing provisions of the Income Tax Act, including the general anti-avoidance rule, these challenges can be time-consuming and costly."

As a result, the budget introduced a specific anti-avoidance rule that targets straddle transactions that will have the effect of deferring the ability to realize the loss while the taxpayer is still sitting on any unrealized gain on an offsetting position.

Small business owners

Small business owners, including incorporated professionals, who feared that the budget would come down hard on their ability to enjoy a low tax rate on the first $500,000 of active business income (via the "small business deduction" or "SBD") and put a stop to income splitting were granted at least a temporary reprieve.

In the budget, the government signaled that it was reviewing "a number of issues regarding tax planning strategies using private corporations, which can result in high-income individuals gaining unfair tax advantages." It singled out three strategies which are "available to these individuals that are not available to other Canadians."

The first is "income sprinkling" using private corporations whereby a business owner or incorporated professional can reduce her tax bill by causing income that would otherwise be taxed in her hands at a high rate (over 50 per cent in seven provinces) to instead be realized, via the payment of dividends or through a sale via capital gains, by other family members. These individuals, such as a spouse, partner or kids, are subject to either lower personal tax rates or, in some cases, may not be taxable at all, due to the use of various credits, such as the basic personal amount or the tuition credit for children enrolled in post-secondary education.

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Next, the government is concerned about holding a passive investment portfolio inside a private corporation "which may be financially advantageous for owners of private corporations compared to otherwise similar investors." What the government is likely getting at is the tax deferral advantage that stems from the fact that corporate income tax rates on active business income eligible for the

SBD are significantly lower than personal income tax rates. This allows incorporated business owners and professionals to enjoy up to a 40 per cent tax deferral advantage, depending on the province, by leaving funds in the corporation, to be invested in a passive securities portfolio.

Finally, the government was troubled by a business owner's ability to convert a private corporation's retained earnings into half-taxable capital gains upon exiting the business. Income is normally paid out of a private corporation in the form of salary or dividends to its owners who pay tax at their personal income tax rates (allowing for the dividend tax credit to avoid double-taxing corporate income). But, if the shares are sold, only 50 per cent of the capital gains are included in income which, given the current tax rates, can result "in a significantly lower tax rate on income that is converted from dividends to capital gains."

While the government acknowledges that a number of measures have been put in place over the years to limit the scope of some of these planning arrangements, it feels that "such measures have not always been fully effective." As a result, the government is "further reviewing the use of tax planning strategies involving private corporations that inappropriately reduce personal taxes of high-income earners … (and) will also consider whether there are features of the current income tax system that have an inappropriate, adverse impact on genuine business transactions involving family members." It intends to release a paper in the months ahead that will set out the issues in more detail along with proposed policy measures.

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References

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