FINANCIAL POST

A 93% tax rate? Private corporation tax could make it possible

Tax lawyer says Ottawa does not realize the extent of damage its proposed changes will cause to Canadian businesses, their employees and the economy

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Small business owners across the land are still reeling from last month's announcement by Finance Minister Bill Morneau targeting private corporations and fundamentally changing the way businesses and incorporated professionals are taxed. The tax strategies being challenged can be categorized into three main areas: income sprinkling, earning passive investment income in a corporation, and converting a corporation's ordinary income into tax-preferred capital gains.

In a previous column, I've discussed the proposed income sprinkling rules that would effectively eliminate opportunities for business owners to sprinkle dividends and capital gains among adult relatives, unless they contribute "reasonable" labour or capital to the business.

But this change, in conjunction with the other two changes, could result in a tax rate as high as 93 per cent, as pointed out by tax lawyer Michael Goldberg of Minden Gross LLP in Toronto, in a report sent out this week to clients. As Mr. Goldberg writes, "The mere proposal of these changes has already thrown the Canadian private business owner tax system into turmoil, and, unfortunately, the Government and the Department of Finance do not seem to appreciate and possibly do not understand the extent of the damage that the (plan) will cause to Canadian business owners, employees of their businesses, and the economy as a whole."

In addition to income sprinkling, what seems to be of particular concern to the government and what it calls "an unfair benefit" is the potential for a tax deferral advantage inherent in our corporate tax system. To understand what the government is targeting, we need to revisit the theory of integration. This tax principle, in a nutshell, asserts that an individual earning income personally (as opposed to inside a corporation) should be left with the same after-tax cash at the end of the day as the shareholder who earns income through a Canadian corporation (which has paid corporate tax), and receives the after-tax amount personally as a dividend.

Owner-managers who run their businesses through corporations can choose to receive compensation as either a salary (including a bonus) or dividends. If salary compensation is chosen, the corporation claims a deduction against its income for the amount of salary or bonus paid and the owner manager pays personal tax on the salary or bonus income received.

Alternatively, if dividend compensation is chosen, the company pays corporate tax on the income earned and the owner-manager pays personal tax when after-tax income is distributed as a dividend. In tax parlance, “perfect integration” is said to exist when the amount of after-tax cash in the owner-manager’s hands is the same regardless of whether the corporate earnings are paid out as a salary or taxed first in the corporation and then paid out as a dividend and taxed in the owner’s hands at dividend tax rates.

Absent perfect integration, a tax savings exists when there is a tax rate advantage from paying dividends, whereby the total corporate and personal tax paid on dividend compensation is less than the personal tax paid on salary compensation. Currently, across nearly all provinces for 2017, we have near-perfect integration on small business income, such that there is no tax rate advantage from incorporation for businesses earning under $500,000 of active business income annually and actually a tax rate disadvantage of having active business income taxed inside the corporation for income above this threshold. There is a similar tax rate disadvantage associated with earning investment income, including capital gains, in a corporation as opposed to earning that same investment income personally.

That being said, if the business owner doesn't need all of her cash in the current year, she could consider leaving excess funds in the company and defer taking dividends until a future year. This is the "tax deferral advantage" which the government is targeting. This deferral exists since corporate tax on business income is payable in the current year but personal tax on the dividend can be deferred until the money is ultimately taken out in a future year. The difference between the corporate tax and the personal tax that would be paid on business income (the deferred amount) can be reinvested within the corporation to earn additional income until the dividend is ultimately paid, possibly many years later. The current deferral advantage on small business income ranges from 35 per cent to 40 per cent, depending on the province.

To fix this problem, the government is proposing to increase the tax rate on corporately-held passive investment income where the capital invested arose from active business earnings. According to calculations performed by the report's co-authors, Mac Killoran of Fruitman Kates LLP and Jay Goodis of Tax Templates Inc., this would result in a combined corporate/personal tax burden for an Ontario business owner of 73 per cent on corporately-earned investment income and 59 per cent on corporately-realized capital gains.

Rather than issue draft legislation immediately to effect this change, however, the government has released a discussion paper on how the new rules may work. With over 20 page of analysis, nine tables, charts and graphs, and a three-page Appendix that includes algebraic formulae not seen since high school math (i.e. $[A \times (1 - t^{CIT}) \times (1 + r(1 - 0.5t^{PIT})) + RDTOH] \times (1 - G(t^{PIT} - t^{CIT})) + CDA)$, the system being proposed is not for the faint of heart. And while the government may believe the new methodology is theoretically sound, it may be virtually unworkable for small businesses with limited accounting and professional compliance resources.

Indeed, Mr. Goldberg feels the rules "are so complex and the potential harm is so great" that, rather than try to fix them through the consultation process (which continues through Oct. 2), he is calling on the government to abandon the proposals in their entirety and "restart the process of finding an effective way to meet its legitimate policy objectives."

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