CUMBERLAND
Private Wealth

# Implications of 2018 Budget on Tax for Private Corporations

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As many Canadians are aware, the Department of Finance has made major changes to the taxation of shareholders effective for 2018. What used to be known as "kiddie tax" is now referred to as "tax on split income" or "TOSI" and it can potentially apply to almost anyone with residency ties to Canada. The budget also introduced new rules for corporations earning passive income, which will become effective in 2019. As a result, incorporated professionals are more restricted in their tax planning, leading some to ask: "Is it still worth it"? The classic tax-planning answer, of course, is "it depends". This article explains some of the recent tax law changes, and considers some situations where professional corporations ("PCs") may still offer tax and financial planning benefits.

## Some Perspectives and Background

For the past decade, many professionals, most notably physicians and dentists, have used PCs for their significant financial and tax planning benefits. Unlike other professions, physicians and dentists are allowed to have family members as shareholders in their PCs, opening up the possibility for tax savings by paying dividends to lower-income shareholders ("income splitting").

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For professionals unable to benefit from income splitting, the fact that corporate tax rates are lower than most personal tax rates provides another advantage: a tax deferral. Money saved inside a corporation is subject to corporate taxes (with rates ranging from 10%-31%) instead of personal tax rates (ranging up to 54%), and therefore, a corporate investment account can accumulate assets more quickly than a personal non-registered account. If the corporate shareholder is in a lower tax bracket when the funds are withdrawn, further tax savings are possible.

## Tax benefit #1: Splitting Income

For those business owners who used income splitting in the past, the most recent TOSI rules contain some new exceptions which may allow dividends to escape TOSI, including the following:

**1)** Excluded shares – the idea here is that related persons can avoid TOSI as long as they hold the "right" type of shares (i.e. sufficient value and voting rights) in the "right" type of business (e.g., manufacturing, goods-based). Unfortunately for professionals, PCs and service-based businesses are specifically excluded.

**2)** Excluded business – The other exception from TOSI, unlike income from excluded shares, could potentially be accessed by the shareholders of professional corporations and service-based businesses. This exception allows related shareholders that are sufficiently active in the business (in that year or in any of the 5 previous years) to avoid TOSI on their dividends.

**3)** Dividends paid to spouse of a "source individual" (e.g., the professional) age 65 or older – to allow for income splitting for retirement-age couples, TOSI doesn't apply to dividends paid to a spouse once the individual who actively worked in the business reaches age 65.

With this understanding, a professional may decide to incorporate under the new rules in the following scenarios:

## The practice meets the definition of an "excluded business" for a family member shareholder.

For example, it is not uncommon for the spouse of a dentist, family physician, or other professional to have enough involvement in the practice to meet the requirements of these new rules (an average of 20 hours per week in the current year or any of the preceding 5 years). While it is true that an unincorporated professional could pay the family member a salary for their work (and salaries are not subject to TOSI), in order to be deductible to the professional it must be reasonable. Dividends would allow for better income splitting, so a PC might be a good option.

It is also not unusual for spouses to be in the same profession; in that case, combining their practices into one corporation could allow them to equalize their income regardless of their respective level of fees generated, as long as each spouse met the minimum involvement requirements mentioned above.

## The PC can be used as a source of retirement income.

Because of the exception from TOSI for professionals age 65 and above, corporate savings can still play a role in funding a tax-efficient retirement. This may be a good strategy when the corporation tax rates are lower than the personal tax rates of the active shareholder, and registered account options aren't enough to meet their retirement goals.

### Tax benefit #2: Lower corporate tax rates

There are other examples of when it might make sense to incorporate, because of the increased after-tax cash flow resulting from low corporate tax rates. Here are a few such situations:

Acquiring a practice of significant value: The ongoing decreases to corporate tax rates (and increases to top personal tax rates) make financing the purchase of a business such as a dental practice with a corporate loan much more tax-efficient than a personal loan. Because loan repayments are not deductible from income, corporations have more after-tax funds available that can be used to repay their debt (versus an unincorporated professional using his or her after-tax income). Interest payments would generally be deductible whether the loan is corporate or personal.

To illustrate with an example, consider the pre-tax income required to repay a $500,000 corporate loan (an Alberta company taxable at the small business rate of 12%) vs. a top rate Alberta taxpayer's personal loan (taxable at 48%):

**Income Required to Repay $500,000 Business Loan:**

| Income (Taxes Payable) | Corporation Loan (12%) | Personal Loan (assumed top marginal rate 48%) | Difference |
|---|---|---|---|
| Income before taxes required to repay loan: | $568,182 | $961,539 | $393,357 |
| Taxes | $68,182 | $461,539 | |
| Available to repay loan | $500,000 | $500,000 | |

In this scenario, the self-employed individual would need an additional $393,000 of pre-tax income to repay the business loan, which would clearly significantly reduce the cash flow of the business for a number of years.

## Professionals who would benefit from "income smoothing"

Depending on the nature of work and possible leaves (e.g., parental, sabbatical or unplanned), a corporation is beneficial as it is not subject to the quickly increasing marginal tax rates applicable to individuals. A professional can use a corporation to control their personal tax liabilities, keeping a steady salary (or dividend) income from year to year, to ensure that they are maximizing the benefit of lower marginal rates each year. To illustrate with an extreme example, consider a non-incorporated physician resident in Ontario who earns $440,000 in year 1, and then takes a 1-year parental leave in year 2 with no income.

| | Year 1 | Year 2 | Total |
|---|---|---|---|
| Income | $440,000 | - | $440,000 |
| Taxes payable | $199,000 | - | $199,000 |
| After-tax cash | $241,000 | - | $241,000 |
| MPC Salary to shareholder | $220,000 | $220,000 | $440,000 |
| Taxes payable | $81,000 | $81,000 | $162,000 |
| After-tax cash | $139,000 | $139,000 | $278,000 |
| Income tax savings (not including CPP) | | | $37,000 |

The non-incorporated physician would pay about 37,000 in additional income tax versus an incorporated physician able to split that income evenly between year 1 and year 2. This strategy could be thought of as "income splitting" between years instead of between individuals. An example of a non-health professional who may realize a significant benefit from this strategy is a litigator that earns contingency-based fees.

## Provide additional savings for retirement

Canada pay tax rates ranging from 10% to 31% on active income, generally lower than personal tax rates (which are as high as 54%), so professionals can accumulate business profits more quickly (and therefore produce more investment income and capital gains) inside of a corporation than in a personally-held, non-registered investment account. The exception from TOSI noted above to allow income splitting in retirement further adds to the appeal of corporate investment accounts. The impact of corporate passive income on the access to small business tax rates introduced in the 2018 budget may result in more business owners prioritizing RRSP and TFSA savings, but for savings in excess of the associated contribution limits, corporate investing is an option.

Paying non-deductible life insurance premiums: As was the case previously, for non-deductible business-related expenditures such as corporate-owned life insurance premiums, lower corporate tax rates provide greater cash flow. Therefore, using a corporation to fund a permanent life insurance policy remains an appealing option in estate planning.

### Are they worth it?

Using a corporation to operate a professional practice has always introduced additional complexity to one's tax situation. Now, perhaps more than ever, clients will require sound professional advice to navigate the complexity of today's tax laws to find the answer to this question in their particular circumstances. There is no "one size fits all", as the professional's family situation, how the practice is acquired, the anticipated income, and numerous other factors will play a role in this decision. However, even in the current tax climate there continue to be many compelling reasons to incorporate a PC.

For further insights, we encourage you to speak with your Portfolio Manager.