HENDRY WARREN LLP
MONTHLY NEWSLETTER

2016 Federal Budget Predictions and Planning

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Our goal is to provide updates on topical tax issues. Information contained in the newsletters is not meant to be a comprehensive summary of the issues raised. Rather, we wish to bring what we believe to be important issues to the attention of our valued clients. We would be pleased to discuss any questions that you, the reader, might have in greater detail.

During the heat of the 2015 election, Liberal leader Justin Trudeau was quoted as saying in an interview that "more than half of small business owners are high net worth individuals who incorporate to avoid paying as high taxes as they otherwise would." With the election of a Liberal majority, many small business owners are uncertain as to how the next Federal Budget will affect them. The Federal Budget is set to be released on March 22, 2016.

There have been some suggestions that access to the small business deduction may be curtailed in the upcoming budget. While this is all speculative at this point, this article focuses on what may be the subject of change and what you can do about it beforehand.

At the time of writing, Professional Corporations (PCs) and other Canadian Controlled Private Corporations (CCPCs) pay Federal and Ontario tax at a combined rate of 15.5% on the first $500,000 of active business income and 26.5 % above that income level. These rates are quite favourable when compared with personal tax rates, which will exceed 53% in Ontario this year.

The lower corporate tax of 15.5% is available to PCs and CCPCs who are engaged in active business and hence qualify for the Small Business Deduction (SBD). Certain activities do not qualify for the SBD such as those which generate investment or rental income. PCs are a distinct type of CCPC where the principal shareholder is a member of a profession such as Medicine, Law, Dentistry or Accounting. Medical and Dental PCs may have other family members (spouses, children, parents) as shareholders. Other PCs may not as only members of the profession may be shareholders.

There are three areas of speculated changes to the taxation of PC's and CCPC's. Each area is described below:

<u>Implementation of a Minimum Employment Test</u>

The March 2015 Quebec Provincial Budget introduced a new requirement for businesses in that province to access the SBD. For fiscal years ending after December 31, 2016, businesses will have to employ more than 3 full-time employees (except those in manufacturing or primary industries) to qualify for the SBD provincially.

There has been speculation that as Quebec has opened this door, that the Federal government may adopt similar legislation. Should there be such a change, PC's and CCPC's with 3 or fewer full time employees would pay tax at a rate of 26.5 % on every dollar of profit.

The negative aspect if such a change were to occur could be mitigated by the distribution of a salary or dividends. However to the extent that corporate profits were retained by a PC or CCPC, they would experience an additional tax burden of 11%. This increase in tax would be a timing issue and not a permanent cost however.

Restriction on Dividend Distributions to Other Family Members

Many Medical and Dental PCs, along with other CCPCs that earn active business income, distribute dividend income to the business principal, their spouse and age of majority children. This can be done directly or through a discretionary family trust. The ability to allocate income to multiple family members smooths out income and reduces the average tax rate.

Prior to the implementation of the "Kiddie Tax" in 1999, dividends could be paid to children of any age. After its implementation, the “Kiddie Tax” effectively attributes dividend income paid to a minor to have been earned by the parent. Consequently, the lower tax rate of the minor child is unavailable.

An expansion of this type of provision to spouses or age of majority children would have a substantial adverse income tax impact on these current arrangements.

Typically substantive tax changes are effective on the day prior to the announcement of the Budget provisions. Should a widening of the “Kiddie Tax” be introduced later this year, we would recommend that the 2016 dividend distributions to a spouse or age of majority child be made before the next Federal Budget. In essence, dividends that would otherwise be payable on a monthly basis should be accelerated and paid before the Budget.

We are currently considering other planning techniques to counteract the effects of an expanded “Kiddie Tax” rule should this occur. We will have to wait and see if this becomes necessary.

Reduction in Access to the SBD for certain PCs

At present, many Medical PCs operate under a structure whereby the physician is a member of a medical partnership and his/her PC bills the partnership for services rendered.

This structure is attractive as it greatly enhances the availability of the SBD to the participants. Where for example 10 physicians practice in this manner, and each of their PC's earn $500,000 of business income per year, $5,000,000 of earnings would be eligible for the 15.5% corporate tax rate. Alternatively, had the 10 PCs been partners in the medical partnership the aggregate small business deduction would only be $500,000 for all.

Should the new government implement rules to prohibit wider access to the small business limit virtually all of the income of the PC could be subject to a tax rate of 26.5 %. The effect of this would be similar to the effect of the > 3 full-time employee provision discussed earlier.

Summary

It is impossible to accurately predict what the Department of Finance will do in matters of tax policy. However, as noted earlier, it would be wise for those who were planning to distribute dividends to adult children or a spouse in 2016 to do so before the next budget, to be presented on March 22, 2016.