Federal Liberal Government Proposes Drastic Income Tax Rule Changes for the Self Employed in Canada

By Kurt Rosentreter, CPA, CA, CFP, CLU, TEP, FMA, CIMA, FCSI, CIM

What Just Happened

In mid-July, Bill Morneau, the Finance Minister and the Liberal government launched some of the largest proposed income tax rule changes that Canada has ever seen – all targeted at one group: the self-employed.

The key changes proposed can be summarized in three main proposals:

- *One change seeks to eliminate an incentive that enables small-business owners to use their corporations as a way to shift some of their income to family members who face lower personal tax rates, even if those relatives are not active in the business. For example, it is common for doctors to earn revenue in a corporation and pay dividends to a spouse and/or adult children that may be in a lower tax bracket.*
- *Another change would limit the use of private corporations to make passive investments in stocks or real estate. The proposed change is designed to ensure that taxes on passive investments inside a corporation are treated the same way as those outside the company.*
- *The third reform would limit the ability to convert a corporation's regular income into capital gains, which are typically taxed at a lower rate.*

The mid-July announcement launched a 75-day consultation period, ending October 2, 2017 to allow people to digest the complex proposals and provide feedback that could lead to adjustments.

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These proposed changes along with the increased contributions to CPP starting in 2018 for businesses, the increase of the income tax rates last year for the wealthiest Canadians and Ontario's increase in minimum hourly rate, all comprise significant new cash grabs from small business with little warning.

Nationally the business community, accountants, lawyers, doctors and most professionals are outraged. No government of any party in 80 years has sought to strip away tax planning opportunities for risk taking entrepreneurs who employ millions of fellow Canadians.

Finance Minister Bill Morneau has said to date he has not heard any convincing arguments to warrant a change to his proposed rules. It appears we will hear finalized plans around October 2017.

The unknown future impact of these changes will include loss of small business jobs for Canadians, reduced business and personal investment and less international investment as Canada may be viewed as unfriendly to entrepreneurs seeking to avoid high taxation.

What to Do Now

Literally everyone with a corporation has an accountant that is doing the books and provides tax advice annually. Start by talking to your accountant about positioning for all possible outcomes. I would hope they would be reaching out to you by now.

Let's assume that any income tax rule changes are passed as of a set date – let's say October 31st and apply in the future only (not retroactively). And let's say that the worst-case scenario is applied – all the rules as originally set out. This means you have six weeks to explore how to benefit from the current rules.

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Some accountants and tax lawyers are advising to "stay put" until we have clarity around the new rules. The problem is that it could be too late to act depending on how the rules come out. It could make sense for example, to pay a dividend to a low-income spouse now and hopefully have it count under the existing beneficial rules – the reality is that we just don't know. But talk to your accountant and at least get perspective.

The Future Impact

Self-employed Canadians (business owners, doctors, dentists, veterinarians, accountants, lawyers and more) will need to re-think their entire approach to their finances and cash flows if these rule changes take effect.

The dollar impact to each family could be huge. One high income doctor, currently income splitting through a corporation with a low-income spouse and three adult children could find themselves paying more than $100,000/year more in income tax as a result of these rule changes. Not only will this have an impact on month by month cash flow, but it will impact planning for income tax installments personally and corporately each year. Worse, professionals have bought homes, put kids in schools, bought cars and generally taken on lifestyles assuming they would have a certain amount of cash flow to pay for it all. Now all of this could change to the point that entire lifestyles will need to be re-thought.

Worse, professionals do not have guaranteed pension plans the way a fireman or a nurse does. And professionals need to save proportionately more because there is no employer putting money away for them. With a significant reduction in cash flow in the future perhaps hitting a 55-year-old when there is little time left to save, means the professional will either have to work a lot longer or significantly cut back in spending to allow for more saving – saving they may not even be doing today in their current cash flow before these rule changes.

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How We Can Help

As a Chartered Accountant and tax trained, Kurt and team has long offered tax planning advice to clients on a variety of topics. We work with you and your accountant to ensure your annual tax filings are accurate and we can work with your accountants on advanced tax planning strategies. We are watching these rule changes closely and commented back in August to the Minister of Finance with our thoughts on these rule changes.

Specifically, how we can help:

- *We can talk to your accountant about the best route through the tax change for you.*
- *We can help you to understand what your accountant is saying – cutting through the lingo to make the tax talk easy to understand.*
- *We can help you to plan for your personal and corporate income tax installments under any new tax rules.*
- *We can help you to assess if keeping corporations make sense.*
- *We can modify any personal investment strategies to accommodate the rule changes and look for new beneficial approaches.*
- *We can examine new compensation options for family income splitting once the new rules are clarified.*
- *We can update our retirement forecasts to age 100 prepared for clients to show the integrated saving and spending strategy that considers careers, real estate plans, support for children, elderly parent costs, investing, saving, spending and income taxes. This tool, called our retirement cash flow forecast, is the best way to create a dashboard of facts and assumptions to help your family, guided by our expertise, to make the best financial decisions for your short term and long-term goals.*

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There is no other way to say it: these rule changes are draconian and may have significant impact on the ability of professionals to continue their current lifestyle. Furthermore, long term goals such as retirement and helping children may become more distant as the professional's ability to save will be hindered.

One final thought: only 2.5 years until the next Federal Election. Canada does have a history of new governments changing the tax rules of previous governments. Perhaps another change is on the horizon.

Warm regards,

- *Kurt*

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