

CMA Bulletin

Breaking News Supplement to
CMA Network's *WealthHealth*

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Federal Budget 2018 – What it Means for Medical Practitioners

The recent Feb. 27, 2018 federal budget proposals, when combined with the Dec. 13, 2017 proposals designed to restrict "income sprinkling," will have a significant tax impact on many medical practitioners.

HIGHLIGHTS

- It will be more challenging for medical practitioners to tax-effectively accumulate savings after 2018.
- Taxes in many professional corporations will rise.
- Income sprinkling of dividends from professional corporations is under attack.
- Changes to dividend refund rules will make recovery of refundable taxes more costly.

Opportunities still exist – strategic financial planning is more important than ever.

Passive Income Inside a Private Corporation (Budget 2018)

Private corporate business income is taxed at lower rates than personal taxes. The federal government is introducing legislation to limit the ability for businesses to use lower tax rates to achieve a tax deferral on investments. Budget 2018 proposes two mechanisms applicable for taxation years beginning after 2018 to achieve this goal:

1. Reducing the small business limit where passive income exceeds \$50,000
2. Restricting access to a refund of refundable taxes where an "eligible" dividend is paid

Reducing the Small Business Deduction

Canadian controlled private businesses (CCPCs) have a small business deduction limit of \$500,000 on active business income earned. Income within this limit is taxed at a very favourable rate, often around 12–15% combined federal and provincial.

Budget 2018 proposes that CCPCs with passive income over \$50,000 will lose \$5 of small business deduction for every \$1 of passive income over the threshold. This will result in the entire small business deduction being eliminated for CCPCs with \$150,000 or more of passive income.

The small business deduction limit is shared among associated companies. Consistent with this concept, Budget 2018 proposes the passive income of all associated companies will apply in considering the \$50,000 threshold.

The prior year's passive income will determine the current year's small business deduction.

Passive Income

Passive income is subject to different corporate tax rates than active income. Common forms of passive income include interest, dividends from portfolio investments, taxable capital gains, rental income and royalties. The Income Tax Act (Canada) defines these passive income sources to be "aggregate investment income."

For purposes of determining the reduction in the small business limit, Budget 2018 proposes a new term – "adjusted aggregate investment income." Essentially, this is aggregate investment income adjusted for:

- Taxable capital gains and losses will be excluded where they relate to property that's used primarily in an active business, or on the sale of shares of another CCPC or an interest in a partnership (where that company or partnership meets certain active asset threshold tests).
- Net capital losses of other years will be excluded.
- Dividends from companies that aren't connected will be excluded
- Income from savings in non-exempt life insurance policies will be added.

It's important to note, income inside an exempt life insurance policy is not taxable and is not included in the passive income for purposes of the small business limit determination.

Refundable Taxes on Investment Income

Budget 2018 proposes restrictions for fiscal periods that end after 2018 on the ability to recover refundable taxes. Recovering refundable taxes under the new proposals will require the payment of non-eligible dividends. These non-eligible dividends carry a higher personal tax cost than eligible dividends. An exception will be refundable taxes arising from eligible dividends received.

PLANNING: POST-BUDGET 2018

- There are numerous tax and financial planning strategies and opportunities available to offset some of the negative impacts of Budget 2018. Some strategies to consider:
- Exempt life insurance policies – to move otherwise taxable passive income to a tax-exempt environment
- Annuities and critical illness insurance policies
- Individual pension plans and other registered investments
- Reduce the level of passive income that will be taxed inside your private corporation
- Deferral strategies on the recognition of income
- Use corporate classes of funds to defer recognition of gains
- Possible leveraging and other strategies to have allocable expenses to reduce the net taxable income
- Active management of unrealized portfolio gains and losses to get the best result given the \$50,000 passive income threshold. This could include increased buy-and-hold strategies or the crystallization of taxable capital gains in periods where the passive income would be under the threshold.

Income Sprinkling Proposals (December 13, 2017)

In December 2017, the Department of Finance released a second version of the “tax on split income” proposals, also referred to as “income sprinkling proposals.” These proposals are very complex and service businesses and specifically professional corporations are directly targeted. The impact on medical practitioners and their families is significant.

For individuals age 18 or older, a reasonableness test will be applied and the amount considered to be unreasonable would be subject to tax on split income. The reasonableness test will be most restrictive to those aged 18–24. If you currently use your professional corporation to split income with family members (either directly or through use of a family trust), you may be affected.

For income subject to these tax-on-split-income proposals, the income received will be taxed at the highest marginal tax rates and make the distributions very costly.

PLANNING: POST-INCOME SPRINKLING PROPOSALS

Some tax and financial planning strategies and opportunities to consider:

- Family members aged 18 or over, will be exempt from the provisions if they're actively engaged on a regular, continuous or substantive basis in the practice in the current or any five preceding years, either on a factual basis or by meeting a threshold of an average of 20 hours/week of employment.
- Review the reasonableness tests for 2018 (and each year after) and see if you can document how your family members may continue to have some capacity to receive dividends under the new rules.
- If you don't have a family trust, consider a share re-organization to allow each shareholder to hold a different class of shares. This enables dividends to be paid in different amounts on each class to reflect what's reasonable for each shareholder.
- Consider other income-splitting strategies such as a prescribed rate loan to your spouse or children, either directly or indirectly through a family trust.

Review, Adjust, Plan

Budget 2018 and the December 2017 income sprinkling proposals are creating new challenges for medical practitioners and their families.

Reviewing and adjusting your financial planning strategies now to work within the new proposed rules is important to ensure you stay on track and maximize your particular opportunities. The strategies mentioned here are just a starting point. Talk to your local CMA Network advisor to find out what you can do now and in the longer term to benefit. Stay in touch and meet regularly.

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DISCLAIMER

This article may contain several strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal or tax advice. To ensure your own circumstances have been properly considered and action is taken based on the latest information available, you should get professional advice from a qualified tax and/or legal advisor before acting on any of the information in this article.

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