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• YEAR END TAX PLANNING FOR BUSINESS •

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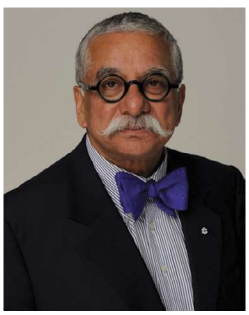

Vern Krishna CM

• In This Issue •

Canadian-controlled private corporations (CCPCs) that carry on an active business in Canada are taxable at special low rates. In 2017, the first $500,000 of income from such active business income (ABI) is taxable at a combined federal and provincial rate of about 15 per cent. Income above $500,000 is taxable at about 27.5 per cent. Hence, it is important to plan for shareholder and corporate taxation before the year end to maximize rates of return, and minimize the overall tax burden.

Taxpayers who employ their spouse or adult children in their CCPC should pay them salaries if they have a low marginal tax rate. This form of income shifting can reduce the total tax burden on the family, and put money into the hands of children to pay for their education and other expenses. Paying family members a salary also allows them to build up their retirement income through Registered Retirement Savings Plans (RRSPs).

There are, however, several traps to watch for. Any salary must be reasonable and commensurate with the nature of the work that the spouse or children perform. As a general rule, one can pay a salary that is approximately equivalent (or even *slightly* higher than market rates). Since the payment would be within the family, it is advisable to keep meticulous records as the CRA will want cogent evidence for the deductions.

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DIVIDENDS

Where the spouse and children over 18 years of age subscribed for shares in the corporation with their own funds, the corporation can pay them dividends out of its after-tax income. If the spouse and children have a lower marginal rate of tax than the principal shareholder, the dividends will be taxable at a low rate and eligible for the dividend tax credit.

The advantage of paying dividends under the current rules is that they do not need to be reasonable in amount, and the shareholder does not have to work for the income. In corporate law, dividends are a return on investment capital.

A business cannot split income with minor children under the age of 18 because of the special "kiddie tax" rules. Minor children are taxable at the top federal marginal tax rate of 33 per cent on dividends, as well as on certain types of business income.

However, under the guise of "fair taxation", the Liberals plan to upend corporate law, and convert the taxation of private corporation dividends into a form of salary income, which is taxable at a much higher rate. The Liberals also plan to extend the "kiddie tax" rules to children under the age of 25. The details of the new rules have not been released, but we can be quite certain that they will be punitive.

Hence, effective 2018, the door to income shifting through dividend sprinkling will close or, at least, become narrower. The Liberals have announced that they will curtail income shifting to family members in CCPCs. The proposals (there is no legislation to date) call for curtailing dividends to family if they are not working in the business, or have not provided capital, or assumed risk in the business.

A CCPC that pays a dividend may be able to obtain a tax refund on its corporate taxes if it previously earned investment income, and has a balance in its refundable tax on hand (RDTOH). The refund would be claimed on the corporation's tax return. However, the recipient would have to pay tax on the dividend at their personal tax rate. All in all, an individual who receives about $50,000 of dividend income will pay no tax if they have no other source of income.

This can be very helpful in splitting income with spouses, and children attending university.

The good news is that the Liberals have announced that they will lower the federal small business rate to 10 per cent in 2018, and 9 per cent in 2019 (election year). In addition, Ontario has also, coincidentally, announced a 1 per cent rate reduction for CCPCs in 2018 (election year). Hence, a certain amount of income deferral into 2018 will be advantageous.

SALARY AND DIVIDEND MIX

Business people who withdraw funds from their corporation must consider the character of their income before year-end. Each source of income has its own rules, which needs to be considered in tax planning. Generally speaking, an individual should have a mix of dividends and salary income to optimize deductions and retirement planning.

The factors to consider are the applicable corporate tax rate, and the shareholder's personal marginal rates for salary and dividend income. For example, in 2017, a salary of $145,722 will allow the maximum registered retirement savings plan contribution of $26,230 in 2018.

Income that is not characterized either as salary or dividends will be treated as a shareholder loan in many cases. A shareholder loan is taxable without the benefit of the dividend tax credit and, therefore, attracts higher tax. Additionally, the corporation cannot deduct the shareholder loan. Hence, it also pays more tax. A shareholder loan is not considered "earned income" and, as such, cannot be taken into account for the purposes of making RRSP contributions.

It is also important that the business withhold appropriate income tax, Canada Pension Plan contributions and employment insurance as well as any provincial payroll taxes. The business must report all withholdings on T-4 slips.

TAX DEFERRAL

The Liberals have also announced that they will penalize private corporations that earn and retain passive investment income above $50,000. Hence, it would be prudent to start planning for the extraction of surplus investment funds in order to avoid punitive tax rates on such income. Shareholders who have lent money to their corporations might want to start withdrawing such funds in order to control potential passive income above $50,000 in the corporation.

There are no details provided for the intended measures. Ultimately, the Liberals will reveal all, but it is reasonable to expect that what they do reveal will not be pleasant. 2018 is going to be a difficult year for tax planners and their clients. However, 2019 and beyond will be better years for tax litigators, as disputes escalate and trials become longer and more frequent.

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• CRA GETS FAILING GRADE ON ITS PUBLIC DUTIES •

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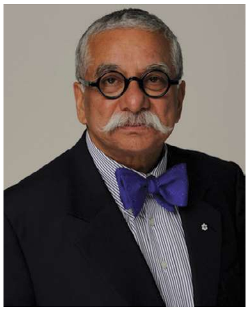

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A basic and fundamental requirement of an effective tax system is that it should demand integrity from taxpayers, and administer the system in a similar manner for the benefit of taxpayers. In the interests of promoting "fairness for the middle class", Canada should legislatively enact the Bill of Taxpayer Rights, give it some teeth and force of law and ensure fair tax administration.

The Canada Revenue Agency (CRA) requires all taxpayers to declare their income voluntarily and honestly. The sanctions for not doing so are serious for taxpayers. However, the Agency has an equal obligation to provide taxpayers with complete, accurate, clear and timely information. The evidence is overwhelming: the CRA is falling down in the performance of its public mandate. The victims of its failure, are low and middle-income taxpayers who cannot afford expensive professional advice and turn to the Agency for their information.

Canada did not legislate its Bill of Taxpayer Rights. Instead, we settled for an unlegislated declaration by the CRA of 16 so-called "rights", which have no force of law. One of these is that the CRA will provide timely and accurate information to taxpayers. The evidence in the Auditor General's Report proves otherwise. Taxpayers are not getting timely information, and in many cases, are being given erroneous information.

The CRA processes about 30 million tax returns annually, and operates nine call centres to give individuals and businesses information about their taxes, credits and benefits. The online services and telephone call centres are the primary ways for the public to obtain tax information. However, as the Auditor General's Report to Parliament reveals, the CRA blocks more than half of the calls that it receives (about 29 million out of 53.5 million) from reaching either a tax agent or the automated self-service system. Instead, callers receive either a busy signal, or a message to go to a website, or call back later.

Last year, the CRA answered only 36 per cent of the calls that it received. The remaining 64 per cent of calls were either blocked, or directed to an automated self-service system. By blocking taxpayer calls, the CRA could report that it connected with about 90 per cent of calls from the public. This is the tantamount to a misrepresentation in a tax return. Indeed, if the CRA blocked even more calls from taxpayers, it could improve its statistical performance rating to 100 per cent.

Even more alarming, when the CRA did respond to taxpayer calls, it gave taxpayers the wrong answer almost 30 per cent of the time. Taxpayers who acted on the erroneous information would file incorrect tax returns, and consequently would face tax assessments, interest charges, and possibly, penalties. Under Canadian tax law, a taxpayer is responsible for any inaccuracies in his or her tax return, even if the error is due to incorrect information provided by CRA agents. Thus, the burden of fighting the assessment is on the taxpayer, who must pay the costs of litigation, interest charges, penalties.

Canadian taxpayers face many frustrations in resolving their disputes with the CRA. As taxpayers know only too well, they must wait and then, wait some more to resolve their tax disputes. They must file a Notice of Objection to their assessment and then wait. It takes about a year to assign the Objection to a review officer in the CRA, and then more months, or a year or two to resolve the matter. Canadian taxpayers have no legal right to speedy access to justice. They must simply pay and wait. In the interim, pending resolution of the dispute, even if caused by incorrect information provided the taxpayer by the CRA, the taxpayer is charged non-deductible interest at 5 per cent, compounding daily, on any disputed taxes that are unpaid during the review.

To be sure, the Minister of National Revenue is required by law to consider the Objection “with all due dispatch”, and either vacate, confirm or vary it, and notify the taxpayer in writing. However, the CRA’s administrative review is a slow and long drawn out process, which can drag on for years. The tax courts have adopted a generous view of the meaning of “with all due dispatch”, and have said the words are not to be interpreted as meaning a fixed period of time.

Far from abiding by the law, the CRA is derelict in the performance of its public duties to taxpayers, and endangers the integrity and reputation of Canada’s tax system. Taxpayers have a duty to file their returns honestly, and with integrity. However, they have a corresponding right to timely and accurate information from the CRA in the administration of the tax system. Failure to provide such information will result in less voluntary compliance by taxpayers. Finance Minister Morneau should enact the Taxpayer Bill of Rights into law in his next budget to show his colours for a “fair” tax system for middle income taxpayers.

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