Federal Budget 2018 Effects and Work Arounds for Owners of Small Business Corporations

For the clients and friends of
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Dear Friends and Clients,

The budget has come as a bit of a shock. While dialed back somewhat from the proposals of last July, the effects will be felt by many small business people including professionals (law, medicine, etc.) However, we don't need to panic as we can help manage this entrepreneurial disincentive for almost everyone now that we know the rules. In fact, most of you receiving this note will not be affected, but should consider future investments in light of changes.

Who is affected?

The big problem is for corporations that have both active income being taxed at the small business rate and passive income greater than $50,000 per year. If the company is only a holdco, with no work being done by you to generate income, then there is no change in your tax situation as all the income is passive. Passive income comes from investments held inside the company (and also in associated holding companies). The investments could include real estate, stocks, bonds, etc.

When does Passive Income Become a Problem?

When the passive income surpasses $50,000 per year the preferential tax rate on the first $500,000 of active income profit begins to erode and is gone completely when passive income reaches $150,000 per year. My current investment program has yielded 3-4% in the past, so a portfolio of about 1.5 million is getting pretty close to the line.

I don't want to change the way we invest –safety, steady returns, and tax amelioration is a prudent road to long term wealth. Our focus will remain on companies meeting human needs for such things as electricity and heat. These companies pay regular and increasing dividends based on a recurring income stream. Fortunately, there are ways to make the passive income smaller such that continue building wealth inside the corporation.

Work Arounds:

You could retire about the time when keeping the passive income below the $50,000 becomes problematic. Then the small business tax problem goes away as your company becomes a holding company only.

Lower the Dividends:

We can maintain the investment philosophy by tweaking the criteria for stock selection looking for lower, but growing dividends. For example, within the electricity sector we can sometimes choose a company with a 2.5% yield instead of a 6% yield. The expectation is that the lower yielding company will have a share price that rises faster and more rapid dividend growth. This is not certain, but has a good track record. We will need to discuss this as your portfolio income nears the critical point.

More REITS with Return of Capital:

Much of our real estate holdings are Real Estate Investment Trusts (REITS). I am fond of them from a tax perspective because a variable amount of the income comes as return of capital. Return of capital (ROC) does not count toward the passive income in the year it is received. It does lower the cost base of the investment over time and, when finally sold, it will count toward passive income via a capital gain. We could look at some options when the company has become a holdco.

Individual Pension Plan (IPP):

This may be helpful for some older people. It allows for more money to be transferred to a pension plan (similar to an RSP) from the corporation. Using an RSP may also be helpful but the amounts that can be transferred are generally much smaller. Contributions to an IPP or an RSP reduces the buildup of assets inside the corp. The rules for IPPs are complicated (in my view), but could be worthwhile considering. It may also be that we start using the TFSA more. We pay tax on the amount that comes out of the corporation by way of salary or dividend which has made the TFSA less advantageous previously.

Leverage:

We can also lever (taking out a loan against the portfolio) as is done in owning a house. The interest will reduce the passive income. We need to be careful doing this. I have some algorithmic rules that I use for myself to ensure that this is done rationally and safely.

Corporate Class Mutual Funds:

Generally these pay out little, if any income annually. The downside is the fees associated and performance.

Dividend Out assets:

Tax will need to be paid as the assets cross the line from the corp to you. This could still be beneficial if it retains the small business preferential tax rate on the active income.

I look forward to working with your accounting professionals to prevent paying extra tax. This short article is written from my perspective and from a generic viewpoint. Our accounting professionals will need to be consulted and their advice carefully considered.

Regards,

Patrick O'Brien DVM, Wealth Advisor, VP and Portfolio Manager

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