Business Owners, Investors, and Seniors Dodge Bullet in Recent Budget

Description

The recent federal budget was noteworthy mostly for feared measures that did not come to pass: principally, there was no change to the current 50% capital gains tax inclusion rate or even a rumoured elimination of the tax-free capital gains on principal residences.

Still, as Canadians turn their attention to the looming May 1st tax-filing deadline, financial advisors and tax professionals aren't convinced their clients can breathe easily just yet, particularly if they are business owners.

While it was expected some boutique tax credits would be targeted, the main casualty was the loss of the tax credit on public transit passes. But that may be a straw in the wind. "I feel they are going for a more general credit and deduction strategy and in effect unwinding the credits put in place by the Conservatives," says Tridelta Financial vice president, wealth advisor Matthew Ardrey. He says we may be in "for some interesting changes in the tax landscape in the coming years."

As T.E. Wealth's senior vice president Warren Baldwin points out, tax planning is akin to the proverbial dog chasing its tail, because "the government has all the cards and can alter the rules of the process quite easily."

Some seniors fretted about a pre-budget rumour that the Age Credit — an extra $7,125 tax-free zone once you reach age 65 — might be phased out. This did not occur, but because the Age Credit is means-tested, this was hardly a major win for affluent seniors. As Baldwin notes, the Age Credit is 15% clawed back after $35,927 of net income and completely eliminated when net income reaches $83,427.

While the budget for 2017 stood pat on capital gains, inclusion rate increases could still come later in the Liberal's mandate. Investors can do several things to prepare, such as triggering gains in 2017 or early 2018 (paying the tax now instead of later) or just planning to hold long-term. After all, even if today's government raised the inclusion rate, a future one could reduce it again.

Fortunately, pension income splitting remained intact. Pension splitting "is a sleeper," Baldwin says, since some believe spousal RRSP contributions no longer matter because pension income can be split. But he says it would be hard for Ottawa to unwind spousal RRSP structures. "Shun spousal RRSPs if you wish but I still think they are a strong strategy."

Small-business owners have reason for concern. As Tridelta's Ardrey notes, three budget measures that could affect business owners include income sprinkling by family members in corporations, tax deferral on passive income, and converting dividend income to capital gains on sale.

Income sprinkling is where a business owner has adult children or a spouse in a lower tax bracket as shareholders; dividends sprinkled to them reduce the overall family tax bill. (Corporate tax rates are usually lower than personal rates). Therefore, investments that generate passive income have more tax deferral on growth until withdrawn into personal income. And if a Canadian-controlled private corporation is sold, it will convert how the income is paid from its assets from dividends to capital gains, Ardrey explains. This capital gain can qualify for the lifetime capital gains exemption, which can be magnified if shares were held in a trust with multiple beneficiaries, each with their own exemption amount.

Ardrey raised a question I tackled in my pre-budget speculation here at the Fool: at what point does Old Age Security (OAS) no longer become affordable? OAS benefits are paid out of general government revenues, and Ardrey wouldn't be surprised if, at some point, Ottawa implements a more aggressive clawback of OAS benefits or sets the clawback threshold lower.

As noted earlier here, back in 1995, a different Liberal government tried to merge the OAS and Guaranteed Income Supplement (GIS) system into a single integrated system called the Seniors Benefit. Had it not been overturned because of a huge outcry by the media and public, the effect would have been to deny many middle-income seniors OAS benefits at much lower thresholds. We dodged this bullet in March, but who knows what can happen in the second half of the Liberal's term?

"I think there is more to come," Ardrey warns. "It may be next year's budget or the one after, but I felt the Liberals took a warning shot at those with private corporations. There is a real chance that in the near future we may be looking at some real changes in corporate tax planning. The government stated that they will be issuing a paper with strategies that they feel give unfair tax advantages. So stay tuned."

Tim Paziuk, president of Victoria-based TPC Financial Group Ltd., is concerned about that looming Liberal paper on the middle class and tax fairness. In a blog that ran this weekend, Paziuk points out the finance minister stated, "All Canadians must pay their fair share of taxes," but what does that really mean? "Does fair share mean the total amount of taxes one pays as a percentage of their gross income? Is it based on an annual consideration or a lifetime consideration? Or does fair share mean positively contributing to the general revenue?"

Citing former finance minister Joe Oliver, Paziuk says the middle class could include households earning as much as $120,000. According to *MoneySense Magazine*, the middle class could include households earning incomes ranging from $38,800 to $125,000. "But does owning a private corporation automatically exclude you from the middle class? The continued witch hunt on private corporations by the Liberal Government would indicate this is the case since it directly contradicts their mandate to build a strong middle class."

Personally, I would have thought anyone who valued the Tax-free Savings Account (TFSA) is in the sweet spot of the middle class, yet one of the first things the Liberals did when they won power was to whack the $10,000 annual TFSA contribution limit the Tories had introduced back almost in half to $5,500.

The budget made no changes to TFSA, RRSP, or pension limits in general. But I'd argue that even if Ottawa had raised those tax-assisted savings levels, it would merely introduce only a modicum of parity with the fortunate few who enjoy employer-sponsored defined-benefit pensions, including most of the civil servants and politicians in Ottawa who make or enforce the rules. About the only way business owners can mimic such pensions is to use vehicles like the Individual Pension Plan (IPP) or a hybrid variant known as the Personal Pension Plan (PPP).

If we’re talking fairness, let’s compare the tax burden of business owners to employees of the public sector and large corporations. They enjoy benefits and retirement plans that are unavailable to private business owners, Paziuk says (apart from PPPs mentioned above). “The only means the private business owner has to narrow the gap is the few tax breaks currently available, tax breaks that help save for retirement but don’t ultimately negatively impact the general revenue.”

The real middle class are arguably employees of private businesses who, due to high business costs, often suffer inferior benefits and lack of group retirement plans. The expanded Canada Pension Plan (see the Motley Fool’s 2016 report on CPP expansion) will help these employees to some degree, but Paziuk says the added expense on private business may ultimately neutralize the benefit by compromising the ability to provide competitive compensation packages.

If the tax burden on private business and their owners increases further, “it will be both to the detriment of the private business employees and the private businesses themselves,” Paziuk warns. “Rather than destroy the employment sector that helps the economy grow, help them to compete with large corporate and public sector employers to provide competitive employment.”

Investors, seniors, and business owners should remember Baldwin’s conclusion: when Ottawa is concerned, it’s best not to let the proverbial tax tail wag the dog: “Don’t take extreme or risky measures to avoid an anticipated tax; you could be wrong and take a lot of trouble later to resurrect the original position.”

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Date
2025/07/21
Date Created
2017/04/10
Author
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