How to plan around the small business tax changes

Strategies to address the new rules in 2019

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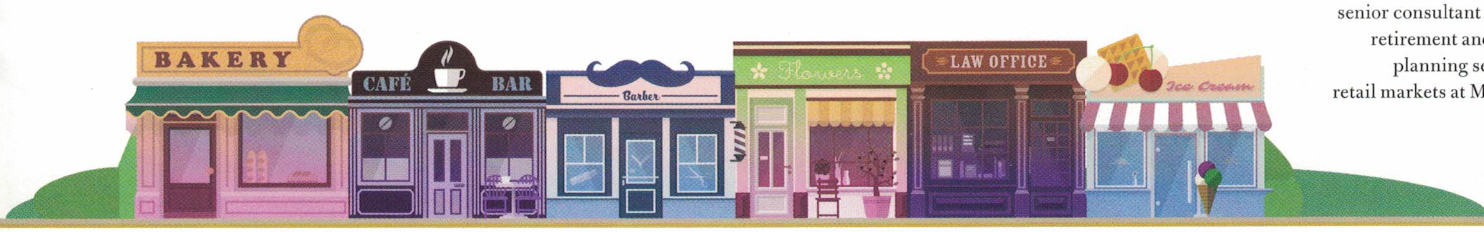

As we enter the final stretch before changes to small business taxation take effect in 2019, it's time to look at how corporations can reduce the impact of those changes on their bottom lines.

Strategies could fall into one of the three following buckets. Here are tips for clients.

1 Reduce active business income (ABI)

If your current year's passive income can be reasonably forecast, then so can your small business deduction (SBD). As a result, if your ABI can be reduced to be at or below your anticipated SBD, then you can avoid the higher general corporate tax rate. Here are some ideas for doing so.

a **Revisit compensation mix:** Salaries and bonuses are employment income, reported on a T4. They are also deducted from ABI.

b **Pay salaries to spouse and children:** If the salary is reasonable for the job, this income splitting strategy is still viable.

2 Reduce passive income

Directly reducing passive income or passive investment assets within a corporation can also reduce the impact of the upcoming changes. There are several ways to do this.

a **Realize capital losses in the current year:** Capital loss carryforward amounts will not help, as any used are added back as part of the adjusted aggregate investment income (AAII) calculation for determining passive income levels. That said, capital losses realized in the current year can offset capital gains also realized in the current year. This can be beneficial if you are rebalancing current passive assets to reduce passive income in future years.

b **Invest in low-taxable income and low-distribution assets:** Investments that generate little or no taxable income, such as corporate class mutual funds, will result in less passive income now and possibly in future years. Some mutual funds trusts also follow investment strategies that minimize taxable distributions.

c **Consider T-series mutual funds:** T-series provide an income stream consisting primarily of return of capital (ROC), which is not taxable. Using passive assets within the corporation in conjunction with T-series to provide liquidity can be tax efficient and won't impact passive income for AAII purposes.

d **Don't forget expenses:** Expenses incurred to generate passive income, such as interest expenses or investment counsel fees, can be used to reduce passive income.

e **Repay shareholder loans:** Using passive assets to repay outstanding shareholder loans can reduce passive investment income.

f **Pay dividends from the Capital Dividend Account (CDA):** Funding capital dividends with funds from passive assets can reduce such balances, which in turn can reduce passive income. Capital dividends are also received tax-free by the shareholder, not impacting their personal tax position.

g **Combine multiple years' transactions:** When considering rebalancing passive assets, funding dividends to corporate shareholders with passive assets or expanding operations, you can combine multiple years' transactions into one. This may allow the negative impact of realized capital gains on the SBD to occur only once.

h **Purchase corporate-owned life insurance:** Investments in a life insurance policy are generally tax sheltered. This can reduce passive investment asset balances while addressing a planning need for you and your corporation.

3 A combination of both

There may be opportunities to combine items from the lists above to lower ABI and passive income. There are also these options.

a **Review investment options outside your corporation:** Investment plans such as RRSPs, individual pension plans or retirement compensation arrangements can create a deduction against ABI for employer contributions. If such contributions come from passive assets, they'll be reduced. If they're earmarked for future personal use, it may be beneficial to hold them outside your corporation, especially when your personal marginal tax rate is lower than your corporate tax rate on investments.

b **Make a corporate donation:** A corporate donation creates a deduction against income and may reduce passive investments as it is funded with corporate money. Further, in-kind donations attract a 0% capital gains inclusion rate and therefore do not increase the current year's passive income. Finally, since 100% of the capital gain is tax-free, the entire gain is added to the CDA, which could be paid to the shareholder tax-free.

Conclusion

The small business tax changes are another round in the game of tax change and adaptation: rules change, new strategies emerge and the process repeats. **AE**

Starting in 2019, passive income earned inside a corporation can lower a corporation's small business deduction (SBD). This reduction begins when a corporation (or a group of associated corporations) earns $50,000 of passive income in a year. The SBD will be fully eliminated when passive income reaches $150,000. For each dollar of passive income over $50,000, the SBD will be reduced by $5.