

BREAKING NEWS: "Hurricane Bill" Inflicts Major Damage

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Over the past week, most people were undoubtedly following the gripping news coming out of Florida and the Caribbean with respect to Hurricane Irma and the hurricanes that followed. But the small business working class is facing their own crisis as a result of the July 18 proposals from Finance Minister "Hurricane Bill". As most people are increasingly becoming aware, these proposals represent a Category 5 assault on the small business tax landscape. For some reason, public company owners were left completely unscathed by this recent assault. For public company owners, the forecast is, at least at this point, forever perpetually clear and sunny. Interestingly, we understand the Finance Minister's family business is a public company.

Many people are still under the assumption that the "tax hurricane" has yet to make landfall. This assumption is incorrect. Part of the July 18 tax proposals, dealing with capital gains versus dividends, are **effective as of July 18, 2017**. The damage caused to date has yet to be calculated. Taxpayers and their advisers have been struggling with these vague rules and, in most cases, those that have been forced to deal with these rules are perplexed by the wording of this unclear legislation. To be clear, these rules are already considered effective and taxpayers caught in these situations had absolutely no warning of these Category 5 tax changes.

So what changes are we talking about? In an effort to deny capital gains treatment to small business owners, the feds have introduced amendments to section 84.1 of the *Income Tax Act* and have also introduced a new section 246.1 so that taxpayers will now be saddled with higher dividend rates rather than capital gains rates. In their common pattern of speaking in half-truths, the federal government has announced that these changes are necessary to prevent small business owners from converting dividend income into capital gains. This, however, is not the whole story. While there may be some specific situations where such rules may be justified, the proposed rules – which, remember, are already effective – hit small business owners in a way that you won't believe unless you work through the numbers in a real-life situation. The federal government speaks of introducing "fairness" to the system but is it fair that a small business owner pays much higher taxes than other investors, including wealthy public company owners and high paid executives, with public company options?¹

Set out below is an example of a situation that is very similar to real life situations that families of private company owners and their advisors are currently facing:

Mr. and Mrs. S were the owners of Should've Gone Public Inc. ("SGPI"). SGPI ceased carrying on an active business in 2007 when it became a passive investment company

¹ I have nothing against public company owners or successful executives. In fact, I believe our tax system should have remained as it was. But if this current government is intent on taxing the wealthy, why have they only targeted small businesses, the vast majority of which are made up of working class individuals?

which was going to be used to fund Mr. and Mrs. S's retirement². Unfortunately, Mr. S died prematurely in 2008 at the age of 64. Mrs. S became the sole shareholder of SGPI but she died in June, 2016 at the age of 69. She was survived by her three adult children.

At the time of her death, Mrs. S's shares of SGPI had a fair market value of \$1 million dollars and an adjusted cost base and paid up of \$1.00. As a result of the deemed disposition on death, Mrs. S was forced to realize a capital gain of \$1 million dollars on her shares of SGPI. As a result of this capital gain, Mrs. S's estate was liable for tax on the capital gain in the amount of approximately \$270,000³. Since the shares of SGPI are illiquid and the estate could not get access to the value in SGPI in the short-term, the estate had to fund this tax liability through other means. Luckily, there were enough proceeds from the sale of her condominium/principal residence to fund this tax liability.

So where does that leave the estate? At this point, the estate still owns shares of SGPI with a value of approximately \$1 million dollars but it already had to pay \$270,000 on the value of these shares. The beneficiaries of Mrs. S's estate (her three children) would like to get their distributions as soon as possible as they each want to use the funds to pay down their mortgages on their principal residences so that their families can reduce their debt burden.

Regarding the children's expectation of what they expect to receive from the inheritance of SGPI shares, they understand that \$270,000 had to be paid on account of capital gains tax. They also appreciate that an additional amount of up to \$100,000 needs to be paid for various items such as estate administration costs, legal costs for the estate solicitor, accounting costs and costs to deal with the corporate reorganization and dissolution process. Accordingly, they each expect to receive \$210,000 of these remaining funds.

Now, from a starting point of \$1 million dollars, the expectation of splitting approximately \$630,000 in three equal shares does not sound unreasonable nor does it sound excessive or abusive in any way⁴. You can imagine the reaction of all three children when their tax

² Mr. and Mrs. S did not have available resources to contribute to RRSPs or set up a pension plan as cash flow was tight for many years after establishing their business. Once they started realizing excess cash flow in their business, they were advised that they were likely too old to effectively contribute to RRSPs or set up pension plans so they realized they would need to rely on their corporate retained earnings for their retirement. For anyone who is not aware or may be confused by statements from our government, SGPI has been paying full tax rates on all of its investment income since 2007 at a tax rate generally equal to the highest marginal tax rate paid by high income individuals resident in Canada and a rate that is also much higher than the tax rate paid by public companies or non-resident controlled companies on investment income.

³ The capital gain realized on her death was in addition to her CPP and OAS income for 2016 as well as approximately \$150,000 in dividends she received from SGPI for the year.

⁴ Does the Government consider losing approximately 30% or more on death as some sort of loophole? Remember that the \$1 million dollars sitting in SGPI is not funds that have enjoyed some tax holiday. These funds represent retained earnings of the company that have already borne corporate tax whether as an active business at preferential rates or as investment income at ordinary rates. Remember, a public company owner would only have to pay a

accountant must tell them that there is an additional tax of approximately 45% (i.e. \$450,000) that needs to be paid if they want to enjoy these funds personally. Leaving out the expletives, they respond "but I thought the Liberal Government came in with a promise to go after the wealthiest families in Canada? Certainly, our family and our parents are not in this category. When you take into account pensions and RRSPs that others have been able to accumulate without any risk whatsoever, our parents earned and accumulated much less than what they could have accumulated as employees, particularly as government employees".

Then they ask another very important question: "Are wealthy individuals with a controlling interest in a public company and other public company shareholders also subject to the same punishing tax of approximately 72%"? Nervously, the accountant responds: "No, if a wealthy owner of a public company has a capital gain of \$1 million dollars due to the deemed disposition of their shares on death, the only tax to be paid would be the capital gain tax of approximately \$270,000. In order to take that money out of the estate and into personal hands for the beneficiaries personal use, there would actually be no further tax to be paid". "Surely, this can't be right?", the children angrily respond. "There is no way Canada would tax the small business working class at a tax rate of approximately 72% on death while a truly wealthy public company owner pays a tax rate of only 27%! We are going to call our MP as this was surely an oversight which will be fixed."

So what do you think? Was this an intentional attack on the small business working class which the government felt was an easier tax grab then going after all business owners including more powerful and politically connected elites? Even if this was not intended and the true intention is to tax private company owners at dividend rates of approximately 45%, we still have at least two big problems with all of this. First, this would be an example of sloppiness for the government to introduce legislation with unintended results that cause such confusion amongst taxpayers and their advisors. This puts honest hard-working taxpayers in a position where they don't know how to comply with the tax legislation and don't know what steps they should take to handle their affairs. Certainly this can't be good for anyone. Second, if the government truly intends to tax the small business working class at a tax rate of approximately 45% on value, what is the rationale of taxing public company owners and other investors at a top rate of approximately 27%? Are public company owners not, on average, as wealthy or even wealthier than small business owners? If anything, you would expect small business owners to be taxed at lower rates to give them an incentive for the greater risks they take but – in the worst case scenario – you would at least expect that they would be taxed at rates no higher than the wealthiest in Canada. If we can't count on this government or their advisors with this legislation (that is already considered effective), how can we count on them with any tax policy initiatives? Are they in way over their heads? Should they just leave this stuff to their successors?

maximum of 27% in taxes and can get access to funds by simply selling shares and not having to incur legal restructuring costs.