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Dentists in the crosshair of new Liberal tax announcements

The federal government has sent another warning shot to dentists and other professionals who have been using private corporations (PC) such as professional corporations/ hygiene service corporations /technical service corporations and holding corporations as a tax savings vehicle. Below are the tax planning tools that are being targeted and the proposed changes which are expected to take effect on January 1, 2018.

1. Income splitting via salary/dividends

What is it?

Paying salaries or dividends to lower income family members in order to reduce the family's overall income taxes. For example, a dentist earning $200,000 would pay a lot less tax if they were able to pay their spouse $100,000 and themselves $100,000.

What is the government proposing?

The government wants to apply a reasonableness test on all salaries and dividends paid out to family members. This reasonableness test will be stricter for those family members between 18-24 years old (i.e. adult children). The government is essentially asking "Would you pay a stranger the same amount (dividend and/or salary) you pay your family member to do the same job or who made the same contribution/investment to the business"?

What does this mean for you?

Previously the reasonableness test was applied only to salaries. The proposed legislation means it could be applied to all types of income including dividends. Failing the reasonableness test means your family member would be paying taxes on the salary/dividend at the top tax rate. The stricter test for 18-24 year olds means paying dividends to adult children attending University will be more difficult.

What can you do?

For the remainder of 2017, you will want to take advantage of income splitting tools that are not yet subject to these tests. Low income family members can still be paid dividends for the remainder of 2017. You will also want to develop a job description listing the role and responsibility of any family members involved with your dental practice. Include the number of days/hours put in by your family members. Family members should also take part of any practice management courses to demonstrate their skills and experience in running a dental practice. This will help support the compensation paid to family members when they are subject to the reasonableness test.

2. Multiplying the lifetime capital gains exemption

What is it?

Each Canadian resident has a lifetime capital gains exemption (LCGE) which shelters them from taxes on the first $835,716 of capital gains when they sell shares in a small business such as a dental practice. For example, assuming they qualified for the LCGE, a dentist selling their PC shares worth $1.6 million dollars would pay no taxes on the sale of the PC shares if the dentist and their spouse were both 50/50 equity shareholders of the PC.

What is the government proposing?

The government is looking to apply the same reasonableness test to family members who hold equity shares of a PC. Additionally, minor equity shareholders and beneficiaries of trusts are no longer eligible to claim LCGE for any accrued or realized gain.

What does this mean for you?

Failing the reasonableness test, the equity shareholder would still report the capital gain on the sale of their shares, but would not qualify for the LCGE. This could result in upwards to $220,000 in taxes per equity shareholder.

What can you do?

We have been recommending for several years now to consider locking in your LCGE through a maneuver called "Crystallization". The proposed changes has made mention of a transition period until the end of 2018 in which this can be done. Given the rule changes, we suggest you strongly consider this maneuver (i.e. crystallize you and your family members LCGE) now or face the risk of family member's not being able to claim the LCGE in the future. Each crystallized LCGE is worth up to $220,000 in tax savings. You may need to purify your corporation before crystallizing your LCGE if you have excess cash. A 24 month waiting period may be required in certain situations. However, this has been reduced to 12 months if crystallization is done in 2018 (i.e. good news for dentists).

3. Deferring taxes on investment income held by a corporation

What is it?

Many dentists use their corporations as super-sized RRSP/ savings account. Instead of paying out excess cash, many dentists accumulate cash in their corporations to invest and thereby defer any personal taxes until they withdraw the funds. For example, a dentist with $100,000 extra cash from dental profits can choose to pay that money out and incur taxes of up to 53.53% or invest that $100,000 inside the corporation in stocks, bonds, ETFs etc.

What is the government proposing?

Depending on the type of investment income, the government is looking at different approaches to increase the tax rate on investment income generated by a corporation. The government wants you to pay out excess cash/investments inside your corporations for personal use and/or personal investing, thereby triggering personal taxes or to invest the excess cash inside the corporation in order to grow the business (i.e. new equipment, additional staff etc.) The government is targeting those who invest profits within their corporation to generate "passive" income (i.e. income requiring no sweat by the dentist such as interest, dividends and capital gains).

What does it mean for you?

Corporate taxes on investment income will be much higher if these changes are implemented. It may not make sense to have a holding corporation with investments. Paying out the cash/investments and incurring the personal tax bill may result in better after-tax returns on these investments in the long run.

What can you do?

You may consider paying out some of the excess cash/investments to lower income family members who are shareholders of your PC, especially in 2017 when the reasonableness test does not apply. Alternatively, you may consider investing in active investments such as the dental building you are working in or another dental practice.

4. Transfer/sale of shares to an adult child

What is it?

Selling your PC shares to adult children who are also dentists.

What is the government proposing?

The government is looking to change rules involved in selling/transferring a dentist's PC shares to an adult child who is also a dentist, so that it is treated the same as if the sale was to a stranger.

What does it mean to you?

This is actually good news. Previously, the rules meant that either the parent won and the child lost or the child won and the parent lost. The government is looking to make changes which would allow the parent to sell their PC shares to their adult children and claim the LCGE, while the adult child can use a PC to purchase their parents PC shares which allows them to use cheap after-tax corporate dollars to pay down the loan.

What can you do?

For the time being, it’s best to wait until the changes are finalized before selling your shares to a child so that both you and your child can benefit from these tax changes.

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