

ONTARIO BUDGET 1998

On May 5, 1998, Finance Minister, Ernie Eaves, tabled his 3rd budget. With the provincial economy booming and unemployment down to 7.4%, the immediate future looks bright. Tax cuts and improved health care were major thrusts in the budget. The following are the budget highlights. The scheduled 1999 personal income tax cuts are being phased in on July 1, 1998. Effective July 1, 1998 the provincial income tax rate as a % of the basic federal tax rate will remain fixed at 40.5%. The rate will remain fixed at 40.5% for future years.

Top Ontario Marginal Rates		
Year	Top Bracket	Ont + Fed Tax Rate
1995	\$66,652	53.19%
1996	\$66,104	52.92%
1997	\$63,486	51.64%
1998	\$62,193	50.29%
1999	\$62,193	49.64%

The chart compares the top marginal tax rates in Ontario over the last few years. See Ontario Budget 98 on back



Recently, I attended a tax seminar put on by Jack Bernstein, a well known tax lawyer in the city. Jack shared with us some interesting ideas in pushing the income splitting envelope further than it is now, especially with the Neuman decision. I would like to share some of these ideas with our readers. The first idea involves income splitting *passive income*. In past newsletters I have discussed the concept of splitting **active business income** of a corporation with spouses and minor children. If 90% of the assets of the corporation are used in an active business, dividends of \$23,000 per annum could be paid to young children, tax free in their hands. The only tax cost is the 22.5% tax rate on the corporation's income under \$200,000. Income splitting **passive income** (interest, dividends, rents) was

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INCOME SPLITTING Alive and Well

In May 1998, the Supreme Court of Canada issued its Decision regarding the Neuman Case, discussed in our December 1996 newsletter. The decision was very good news for taxpayers and their advisors: Income splitting is alive and well. The Supreme Court ruled that arranging one's affairs to achieve the minimum amount of income tax payable is an acceptable business transaction or series of transactions. Neuman held one class of preferred shares of his management corporation while his wife held another class of preferred shares. In 1982, Neuman received \$5,000 in dividends on his shares while his wife received \$14,800 in dividends on her shares. Neuman's wife immediately loaned the funds to her husband, interest free. The

Federal Court of Appeal ruled that since Mrs. Neuman was not active in the management corporation, her dividends were out of proportion with her entitlement and that her dividends were to be taxed as her husband's income. This arrangement was common in many estate planning setups and there was great concern in the tax community that the Neuman decision could change what was previously an accepted tax planning technique. This fear is now over as the Supreme Court has overturned the Federal Court of Appeal's decision. Income splitting, when kept within the rules of the Income Tax Act, is an acceptable form of planning one's affairs. Splitting income with minors, using shares of small business corporations held by Trusts continues to be an

acceptable form of tax planning. It now remains to be seen if the Tax Department will amend portions of the Income Tax Act as a result of this decision. We will keep watch. As income tax changes tend to be prospective, not retroactive, any estate planning or income splitting transactions should be done as soon as possible. Discuss it with your lawyer or accountant.

Message From The Editor

This issue represents our 5th anniversary of publishing the **Owner Manager**. We hope you find it informative and helpful in solving tax and accounting questions. If there is a specific issue you would



like us to cover, please contact us and we will do our best. From Rich Rotstein to our clients and readers, thank you for your patronage.

Ontario Budget 1998 continued

In 1999, the top marginal tax rate in Ontario will be under 50%. In addition, the Ontario tax reduction eliminates income tax for low income Ontarians

The other big budget news for many our incorporated owner/manager clients is the reduction in the small business corporate income tax rate to be phased in over the next 8 years. Presently, the Ontario corporate income tax for private corporations carrying on an active business is 9.5% on the first \$200,000 of income. When combined with the Federal tax rate of around 13%, the combined corporate tax rate is around 22.5%. Starting May 5, 1998 the Ontario corporate tax rate on active income is reduced to 9%. From 1999 to 2005, the Ontario rate will be reduced by ½% each year until reaching 5.5%. In 2006, the rate will be reduced to 4.75%. Not only

has incorporation of a small business become more attractive, but income splitting with lower income family members has also become more beneficial.

Other measures introduced in the budget include:

- The exemption for employer health care tax (EHT) is being increased in 1998 from \$300,000 to \$350,000. For self-employed individuals, the exemption on self-employment income is increased to \$350,000 in 1998 and EHT on self-employed individuals will be completely eliminated in 1999.
- EHT can be avoided when an employee is paid directly by a third party for services provided to the 3rd party. A new measure commencing in 1999 will require employers to pay EHT on remuneration paid by a 3rd party to an employee under certain conditions. This measure will probably go after consult-

ing fees paid to holding corporations by an operating corporation where the 2 corporations are related.

- The land transfer tax refund applying to the purchase on newly built homes by first time buyers will be extended to homes purchased before March 31, 1999.
- A capital tax anti-avoidance provision is being introduced to prevent a reduction in capital tax through loans and advances to related corporations just prior to year end. This anti-avoidance rule will also extend to investments in shares and bonds. Another capital tax amendment will now include deferred revenue as part of taxable capital.
- Employers will be permitted to deduct 100% of qualifying expenditures incurred after July 1, 1998 to accommodate disabled employees, to a maximum of \$50,000 per eligible employee.

Creative Tax Planning continued

far more restrictive. Just under 10% of passive income could be income split with spouses and minors through the use of a holding corporation. It appears that by using a second holding corporation, passive income

#2 from the parent for fair consideration.

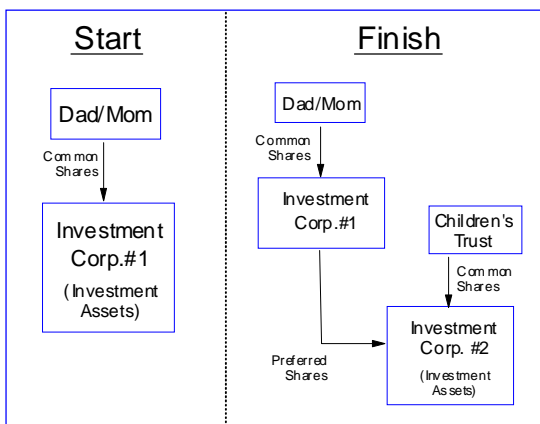
Since the common shares were purchased for fair market value consideration and no assets were transferred to investment corp. #2 while the minor children were shareholders, the investment income earnings can be

passed out as dividends to the children's trust without any restrictions. A word of caution. This method works for the initial investment of funds in the corporation. Any additional transfers of investment assets by the parent to the corporation will trigger the income attribution rules.

Management corporations have been used for a number of years to manage professional practices and earn a 15% markup on expenses. The management corporation

pays the low business tax rate on the income and pays dividends out to the children, up to \$22,000 tax free. A new twist on management corporations for income splitting purposes involves using a trust. The trust income can then be passed on to the beneficiaries (children) to be taxed in their hands. Each child can receive approximately \$6,400 of income from the trust without paying taxes on the income. If the professional parent is in a 50% marginal tax bracket, the tax savings to the family is \$3,200 per child. Testamentary trusts should be part of any estate plan where there are sizeable invest-

ment earning assets owned by the deceased. Upon death the testamentary trust created acts as another tax payer, getting the benefit of the low tax rates. Multiple testamentary trusts can be established for different beneficiaries of the estate (i.e.. spouse, children and grandchildren). Each trust gets the benefit of the low tax rates, unless the tax department can show the multiple testamentary trusts were unnecessary and only created for the purpose of tax avoidance. Testamentary trusts can also have non calender year ends, which can potentially be used to defer income. The trust is easily created by simply having the necessary clauses added to your will.



can be split up to 100% with minors and spouses. The method works as illustrated in the chart and explained below:

- 1) Dad or Mom transfers their investment income assets into investment corporation #1 in exchange for common shares.
- 2) Investment corporation #2 is created with the common shares issued to dad/mom.
- 3) Investment corp. #1 transfers its investment assets to investment corp. #2 in exchange for low paying dividend preferred shares.
- 4) A children's trust is created with the minor children as beneficiaries.
- 5) Using monies borrowed from the children, the children's trust purchases the nominal valued common shares of investment corp.

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A trust is used to manage the professional practice. Income attribution rules do not apply where trusts earn business income. The trust income can then be passed on to the beneficiaries (children) to be taxed in their hands. Each child can receive approximately \$6,400 of income from the trust without paying taxes on the income. If the professional parent is in a 50% marginal tax bracket, the tax savings to the family is \$3,200 per child.

Testamentary trusts should be part of any estate plan where there are sizeable invest-



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