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Investment and Taxes in Your Professional Corporation

In the 2018 Federal Budget changes were made to the way income is taxed inside of a dental professional corporation (DPC). As a result, many dentists will be paying more income tax beginning in 2019. This has sparked a lot of debate about how to avoid or at least reduce the new tax. But after digging a little deeper it appears there are some very simple solutions.

What is the new income tax?

The additional tax relates to the income earned on investments inside your professional corporation (or related corporation), which is known as "passive income." These investments are not engaged in generating "active business income," such as profits from dentistry, which receives a lower tax rate, known as the small business deduction.

In Ontario, the first $500,000 of profits earned in a DPC from dentistry in 2017 were taxed at 15 per cent. If these profits had been taken out of the DPC, an additional personal income tax would be due. Therefore, it made sense, whenever possible, to retain the profits inside the DPC to defer paying the personal income taxes. Retained profits could be re-invested to earn more money, or passive income.

Starting in 2019, if your professional corporation (or related corporation) earns more than $50,000 in passive income, you will begin to lose your small business deduction. If your passive income exceeds $150,000 you lose the entire small business deduction. In this case, the first $500,000 in dentistry profits will be taxed at 26.5 per cent in 2019, instead of the 15 per cent as in 2017 — for an additional corporate tax of $57,500 per year.

Does the new income tax warrant a change in strategy?

When the news first came out about this new tax, many dentists were understandably upset, since they had planned their savings under the previously established rules, only to have the rules unilaterally changed.

One couple we met with had savings inside their corporation of more than $8,000,000. While the investments were in a holding corporation, this corporation was related to the professional corporation for tax purposes and therefore the new income tax applied. With a portfolio of $8,000,000 they were going to lose the small business deduction and pay an additional tax of $57,500 per year.

The general public may not have much sympathy for this couple, but adding $57,500 per year to their already lofty tax bill is a lot of money. So we had to look for solutions.

The client wanted to investigate the following ideas:

1. **Sell the practice.** He and his wife were financially independent, so why keep working given all of the taxes they have to pay?
2. **Remove the money from the corporation.** This idea was quickly dismissed as it would create a multi-million-dollar tax bill.
3. **Buy a universal or whole life insurance policy.** All of the evidence we have on such strategies shows us that this move would under-perform a comparable portfolio, but the income in such a policy is tax exempt.
4. **Buy a building that is principally used for the practice.** Depending on the building purchased, this can tie up corporate savings in a building that produces little to no income for the corporation.
5. **Implement an Individual Pension Plan (IPP).** This would transfer some of the passive portfolio out of the corporation and into an IPP. Future contributions would be tax deductible to the corporation.
6. **Implement a retirement compensation arrangement.** This account is an inter-vivos trust relationship. Contributions are deductible to the corporation.

Each of these strategies would be a dramatic divergence from what has helped this couple get to $8,000,000 in savings inside of their corporation. There is an old saying that "you should not let the tax tail wag the investment dog." For that reason, we ran some further analysis.

The real impact of the new tax

Eventually, the first $500,000 of profits impacted by the new rules will need to be paid out to the shareholders, to fund their personal expenses, etc. After paying a dividend to shareholders, the net effect of this new tax is a total cost to this couple of $9,056, not $57,500. A $9,056 additional income tax should not have any influence on how to invest $8,000,000.

The total cost reduces to $9,056 as a result of corporate tax rates being linked to personal tax rates. When corporate tax rates go up, typically personal tax rates to go down, and vice versa. This is what has happened with the new tax changes.

Let's compare the taxes you paid in 2017 on the first $500,000 of corporate profits with the taxes you are expected to pay in 2019 on the same profits (assuming your DPC earns more than $150,000 of passive income).

	2017	2019	Difference
Dental profits	$500,000	$500,000	$0
Corporate taxes	$75,000	$132,000	$57,500
After-tax profits	**$425,000**	**$367,500**	**-$57,500**
Taxes on profits paid out as dividends	$156,809	$108,365	-$48,444
After tax	**$286,191**	**$259,135**	**-$9,056**

Does it still make sense to save money in your corporation?

Yes. Even if you lose the entire small business deduction you are still only paying 26.5 per cent income tax inside of the corporation, which is lower than if you had earned it personally or had taken the money out of the corporation to invest.

How to minimize the new tax

Having to pay an extra $9,000 in income tax is not a reason to sell the practice, which the couple with $8,000,000 was considering. It is certainly not a reason to go through the pain and cost of moving the practice into a new building that they buy. Finally, entering into expensive and complicated strategies such as RCAs, IPPs or permanent insurance may not be warranted given the low impact this new tax can have overall.

Simple is often best and keeps you much more adaptable to future unforeseeable changes than any of the strategies mentioned above.

In the September 2016 issue of *Ontario Dentist*, I wrote an article entitled, "How to Invest Money Left Over in Your Professional Corporation." In it I referenced a young couple who had accumulated $1 million in savings in their DPC and evaluated various options for getting these savings to grow. The conclusion of the article was that investing in equity markets would be the best alternative.

If the couple had invested that $1 million in the S&P 500 (the 500 largest companies in the United States) in October 2016, it would now be worth $1,305,690, in addition to providing the client with almost $30,000 in dividends. The difference between the starting value, $1 million, and today's value, $1,305,690, represents an unrealized capital gain of $305,690. No tax is payable while a capital gain is unrealized, but once realized (i.e. when the investment is sold) a capital gain of this magnitude would create passive income of $152,845 for the DPC, as well as corporate taxes of $76,682.

If the investment were sold in 2019, the passive income generated would fully claw back the small business deduction under the new rules. Choosing to realize those gains in 2018 instead, and switching the investments into something more tax efficient, may keep the couple's passive income below the $50,000 threshold.

Consider:

1. **Reduce the passive income portfolio:** Choosing to pay the taxes on this investment in 2018 reduces the future passive income the DPC generates in two ways: first, it chooses to earn the $152,845 of passive income from the capital gain in 2018, rather than deferring the taxes to a future year where the same earnings would result in higher tax on dental profits; and second, it removes $229,527 of passive income assets from the DPC to provide room for more dental profits to be saved in the future. The $229,527 of assets are removed as a $152,845 capital dividend (discussed below), and corporate taxes payable on the gain of $76,682.
2. **Capital dividend (tax-free):** Realizing the capital gain permitted the DPC to pay a Capital Dividend to the couple, which is free of personal taxes. Fifty percent of all capital gains realized on the sale of stocks are tracked by the Capital Dividend Account. This capital gain of $305,690, allowed $152,845 to be paid as a capital dividend.
3. **Defer the new tax on split income rules another year:** For the couple mentioned in the 2016 article, the new tax on split income (TOSI) rules removes their ability to dividend to the low-income spouse in 2018. The dentist will now need to receive the dividends that were formerly paid to the spouse, to fund their family's expenses — only now those dividends will be taxed at the dentist's

higher tax rate, 46.84 per cent. Using the capital dividend (discussed in point two) the dentist has $152,845 of cash available for the family's future expenses, and avoids the $71,593 of personal taxes that would be payable on an equivalent amount of dividends for the ~~doctor~~ in 2018.

4. **Same investment, different engine:** The current investment in the S&P 500 held physical stocks in 500 U.S. companies, many of which paid dividends. Re-investing the cash in a more tax-efficient index, which replicates the performance of the same S&P 500 companies, allows the cash to grow at the same rate, but without any passive income until it is sold. The other advantage is that only 50 per cent of this income is counted toward the passive income measure, versus 100 per cent of interest, dividend and rent payments.

The net effect of implementing these minor changes to the portfolio is that the couple will maintain the small business deduction in 2019 and also will have reduced their personal tax bill by $71,593 in one year.

Complex, inflexible strategies rarely make sense. They cost real dollars to implement and are often hard to unwind if needed. What the current government has emphasized for us is that tax rules change. A federal election is approaching in 2019, and other tax changes are possible. Given the magnitude of the total increased tax cost to your DPC in 2019, I suggest you begin your planning by addressing the simple strategies mentioned above and then see how big your tax increase really is.

Mark McNulty is President of McNulty Group, a firm responsible for managing more than $350 million of Ontario dentists' retirement savings. McNulty Group helps professional families transition from a life of successful practice to a stress-free retirement. Mark is the author of The Transition Coach 2.0—A Canadian Dentist's Guide to a Perfect Retirement, and The $6 Million Dentist: Successful Succession in 7 Modules.