

# Re-establish Parity in Taxation of Corporate Investment Income

In the early 1990's personal tax rates were rising as a result of a series of surtaxes introduced to meet government budget shortfalls. The top tax rate for individuals in B.C. rose to a high of 54.2%. For a few years the corporate tax rate on investment income was significantly lower than the top personal rate. In order to stop taxpayers from transferring investments to corporations, a new tax of 6-2/3% was levied on investment income earned by Canadian controlled private corporations (Section 123.3 was introduced in 1995).

It was never intended that this deferral of tax was to apply to investment income. Nor was it intended that by incorporating one's business one would pay more tax. Investment income earned by a corporation should be taxed at a rate no greater than the individual rates.

Successful small business owners are being penalized for having chosen to conduct their business activities within a corporation. First, the corporation is taxed at a higher rate of 47.8% versus the top personal tax rate of 43.7% in B.C. Second, when the funds are flowed to the individual they are only left with \$536 from earnings of \$1,000 whereas an individual who earned the \$1,000 directly would be left with \$563. This is an overall tax cost of \$27.

There is little incentive for corporations to retain their hard earned profits and invest them. The current tax rates force them to remove earnings annually through the payment of dividends. Otherwise they must suffer with higher tax on current earnings and a higher overall tax when the income is removed at a later date if held in the corporation.

It is not believed that this penalty was intended but it has evolved over time, as both personal and corporate tax rates have been reduced. The premise behind the taxation of small business is that a taxpayer should be indifferent (on a flow through basis) to earning business income in a corporation or as an individual.

For example, if a self employed individual earns \$1,000 and pays the top rate of personal tax on the income of 43.7% (B.C. rates are used throughout this letter - each province balances out accordingly) he will have \$563 left in his pocket. If his business was incorporated and the income taxed in the corporation at the small business rate of 17.62% followed by a dividend to the shareholder of the after tax corporate income, he would be left with \$564 in his pocket, a difference of only \$1. On a flow through basis the taxpayer is essentially in the same position. The calculations are as follows:

Income earned direct	\$1,000
Personal tax at top rate of 43.7%	(437)
After tax cash in proprietor's pocket	<u>\$563</u>
Income earned in a corporation & taxed at low rate	\$1,000
Corporate tax rate 17.62%-small business income<\$300,000	(176)
After tax corporate income available for dividends to shareholders	824
Personal tax at top rate of 31.58%	(260)
After tax cash in shareholder's pocket	<u>\$564</u>

## Re-establish Parity in Taxation of Corporate Investment Income— continued

The primary benefit of incorporating a business is to gain access to a deferral of tax payments. Corporate integration ensures there is little or no benefit or cost on the eventual flow through of the income. The advantage of the corporation is that it will have \$824 to reinvest in the business (buy new equipment, pay down debt, etc.) whereas the unincorporated business owner will only have \$563. Eventually, when the earnings are flowed through to the shareholder, the “second stage” of tax is paid and the after tax cash in the individual’s pocket is approximately the same. The tax deferral is a significant advantage where a business owner is looking to spend money to expand his business. Secondary advantages of incorporation do include possible income splitting or income smoothing, but these options are based on specific individual situations.

Because of a reduced personal top marginal tax rate, Section 123.3 is no longer necessary and should be removed to equalize the taxation of investment income.

### **Recommendations:**

That the Federal Government remove Section 123.3. Refundable Tax on Canadian Controlled Private Corporations Investment Income of the Income Tax Act.

Submitted by the Kamloops Chamber of Commerce