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A STORY ABOUT THE BIRDS AND THE BEEBES

Sally Bird and her neighbour, Roberta Beebe, were recently discussing that they were pleased to hear that the government will be closing tax loopholes which it says are used by the rich 1% to pay less than their fair share of tax.

Sally and her husband own and operate a fast food franchise through a private company. They have one son, Michael, who is just completing his first year of university, in a sports management program. Roberta and her husband, also have one child, Richard, who is also completing his first year of university. Roberta and her husband both work for large companies. Both families would be considered to be "middle class".

Sally owns her private company through a family trust. Last year, the company paid a $15,000 dividend to the trust, which the trust distributed to Michael to pay for his university tuition, books and supplies.

Last year, Richard got a scholarship from Roberta's employer and last summer, Roberta was able to get Richard a summer job with her employer. Only children of employees can qualify for the scholarship or be hired for summer jobs with her employer. Richard received $15,000 from a combination of the scholarship and his summer job.

Because of personal deductions and credits, including the tuition credit, neither Michael nor Richard paid any tax on the money that they received.

Michael has been able to obtain an unpaid internship, at a sport management firm for next summer. Michael and his parents all agree that the internship will give Michael valuable experience and hopefully, will lead to a well paying job after he graduates from university. Richard has been unable to find a summer job. Roberta's employer has recently laid off a number of full time employees and will not be hiring any summer students next year. As Sally usually hires a summer student for the restaurant, she wants to offer Richard a summer job for next summer.

I suspect that under the existing tax rules, everyone is happy:

Richard will have a summer job next summer, so he can pay for his university education. He will pay little or no tax on his summer earnings.

Michael will not be earning any income, but will gain valuable experience at his unpaid internship. Sally will arrange for Michael to get a dividend from the trust, so that he can pay for university.

Sally needs a worker for the summer and is happy to give her friend's son a job, so that he can pay for his schooling.

While Sally and Roberta are quite happy that the "rich" will pay more tax, they are in for quite a surprise. Both of their middle class families will be directly and adversely affected by the July 18, 2017 finance tax proposals. As Michael is under age 25, the dividend that he receives from the company, through the family trust, will now be taxed at the rate of approximately 45%, even though he has the same personal deduction and tax credits available to him. If Michael is considered to have "actively engaged on a regular, continuous and substantial basis in the activities of the [company]", which is the phrase used in the tax proposals, Michael may be able to avoid these new tax rules, and be subject to tax under the existing rules.

As a result, Sally and Michael may have to rethink their summer plans. If he is taxed at 45% on his dividend, he will be short of funds for university or will need roughly double the amount from the business, which Sally did not budget for. To avoid this 45% tax on the dividend, Michael would have to spend the summer working for Sally's company and forego his unpaid internship and the valuable experience and future job opportunities that go with it. The other option would be for Sally to receive a dividend, which would increase her income and would be subject to tax of about 33%. Sally would need a dividend of approximately $22,000, to net out the $15,000 needed by Michael.

If Michael chooses to work for Sally's company, instead of doing the internship, there is still no certainty. How will the Canada Revenue Agency interpret the phrase "actively engaged on a regular, continuous and substantial basis"? Will a summer job qualify, or does it refer only to full time employment? Even if summer employment satisfies the test, it is still up to the Canada Revenue Agency to determine what is a reasonable amount of a dividend for the work that is done. Is $15,000 reasonable? If not, the amount that the Canada Revenue Agency deems to be reasonable will be considered to be a regular dividend, and the excess will still be taxed at the 45% tax rate.

If Michael works for Sally's company, she will not hire Richard. Richard will have to find another summer job to pay for his university education. Even if Michael takes the unpaid internship, as the Bird family will have to pay more tax than in the past, there is less money available to hire a summer student.

So, what is the net result for these two middle class families? Michael may be forced to work in the family business, rather than taking the first step in his career. Richard will have lost out on a job and will have to look for a summer job so that he can pay for his schooling. Is either family better off? Seems like the only one who is better off in this example is the tax man.

Not surprisingly, Sally and Roberta and their families wonder why any of the new rules apply to them, as they are middle class and not part of the 1%. They thought that the proposed rules only apply to those who the government considers rich, which is clearly not the case. The rules can apply to any private corporation, will increase the tax burden to even middle class families and can negatively affect even people who do not own a private company. And this will become a fact of life!