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Update on the proposed changes to taxation of private corporations

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As many of you have heard in the news, on July 18, 2017, the Government of Canada released a consultation paper with proposed changes to the taxation of private corporations.

The proposed changes, if implemented, would have limited or eliminated some of the common tax planning strategies used by owners of private corporations such as small-business owners and professionals. The Government faced considerable backlash from the public (including tax professionals, business organizations and small business owners) due to the complex and far-reaching nature of the July proposals. The consultation period formally ended on October 2, 2017, and over 21,000 submissions were received by the Department of Finance. In response to concerns raised by the public during the consultation, the Government announced during the week of October 16, 2017 many amendments to the July proposals and the abandonment of certain proposed measures. Below is a summary of these revised proposals.

THE PROPOSED CHANGES, AS ORIGINALLY PROPOSED, CONCERN THESE FOUR MAIN ISSUES:

1. Income Sprinkling

Income Sprinkling refers to the method often used by owners of private corporations to split the income from the corporation amongst the family members. One way of achieving income sprinkling is for the business owner's family members to own shares of the operating business corporation so that dividends can be declared and be paid out to family members in lower tax brackets. Similar results can be achieved using trusts or partnerships. The current tax rules impose what is known as a "kiddie tax" on income split with children under the age of 18 at the highest marginal tax rate. The proposed changes would bring about the extension of kiddie tax to family members who are 18 years old or older. However, an exception would be provided to 18 years old or older upon meeting a reasonableness standard which is quite arbitrary.

2. Passive Investment Income

When it comes to active business income, corporations are taxed at a much lower rate than individuals. Hence, if the business income is earned through a corporation and retained, there is more after-tax income available for investment. However, the proposal conveys the government's concern that businesses are using the after-tax profits to make passive investments when they should be reinvesting the profits in active business. At this time, the government has not introduced the measures they will implement to address their concern.

3. Multiplication of the Capital Gains Exemption

Canadians have been "exempted" from paying tax on capital gains from the disposition of "Qualified small business corporations" shares up to a lifetime limit (currently $835,716 in 2017). However, the government had initially proposed that this exemption no longer be available to: those under the age of 18; those who are subject to the kiddie tax with respect to the shares; and the beneficiaries of a trust who earn capital gains on the value of shares that accrued during the period in which the trust hold the shares.

4. Conversion of Income into Capital Gains

Capital gains are taxed at a lower rate than dividends. As a tax planning strategy, a shareholder can take out retrained earnings of a private corporation as capital gains instead of through dividends. Given the possible tax savings from using this strategy, the Government had initially proposed to restrict this type of tax planning by amending current section 84.1 of the Income Tax Act and by adding a new anti-surplus stripping rule. The proposed rules would have affected most intergenerational transfers and post-mortem tax planning, such as the so-called "pipeline planning", yielding substantial increase in overall tax liability in these situations.

SUMMARY OF RECENT ANNOUNCEMENTS

Monday, Oct 16, 2017

The Government of Canada announced its intention to reduce the current small business tax rate of 10.5% to 10% effective January 1, 2018 and then to 9% effective January 1, 2019. In addition, they announced that they will not be going ahead with the changes to the Multiplication of the Capital Gains Exemption.

Wednesday, Oct 18, 2017

The Government made an announcement about changes respecting passive investment income. They stated that investments that have already been made and the income earned from them are protected and that there will be a passive income threshold of $50,000 per year (equivalent to $1 million in savings, based on a nominal 5% rate of return), that can be earned in a corporation and that will not be subject to the new higher tax regime. Thus, we understand that the first $50,000 per year of passive income will continue to be subject to the current refundable tax system. They have failed to explain the logistics behind these changes and have instead announced that draft legislation will be released as part of Budget 2018. For instance, they have not indicated how the $50,000 threshold will be determined with respect to capital gains. In this respect, it is unclear whether the full capital gain on sale of securities will be included, or 50% of such a gain. Finally, the Government also announced that its passive investment tax changes will maintain incentives that encourage venture capital and angel investors to invest in innovative companies.

Thursday, Oct 19, 2017

The Government announced that they will not move ahead with proposed changes that would restrict the conversion of income into capital gains and adverse tax consequences on intergenerational transfers and post-mortem planning.

Tuesday, Oct 24, 2017

The Government released the Fall Economic Statement. The Government stated it will move forward with changes to income sprinkling but that they would “simplify” the planned changes. The reasonableness test will be introduced and adult family members aged 18-24 and those 25 and older will need to show their contribution to the business based on four basic principles: labour contributions; capital or equity contributions to the business; financial risks of the business taken on, such as co-signing a loan or other debt; and/or past contributions in respect of previous labour, capital or risks. It is expected that the revised draft legislative proposals on income sprinkling will be released later this fall. Furthermore, the Government stated that there will be no tax increase on passive income below the $50,000 threshold.

SUMMARY OF REVISED PROPOSALS ON THE TAXATION OF PRIVATE CORPORATIONS

	Initial Proposals (July 18, 2017)	**Revised Proposals (up to October 24, 2017)**
Income sprinkling	Introduce a "reasonableness test" that could restrict income sprinkling to adult family members 18-24 as well as those 25 and older.	Revised draft legislative proposals to be released later this fall that will simplify the proposed changes.
Passive investment income	No draft legislation released, but various proposals were put forward in the Department of Finance's consultation paper.	All past investments and income earned from them will be protected. There will be an annual passive income threshold of $50,000. No tax increase on passive income below the $50,000 threshold.
Multiplication of the capital gains exemption	Restrictions on the access to the capital gains exemption were proposed, including when shares are held by a trust or during the time the shareholder is a minor.	Proposed changes abandoned.
Conversion of income into capital gains	Restrict conversion of income into capital gains (amendments to section 84.1 and new section 246.1 affecting intergenerational transfers and post-mortem planning).	Proposed changes abandoned.
Small business tax rate	No changes originally proposed.	Rate reduction from 10.5% to 10% for the 2018 year and to 9% for the 2019 year.

This article is for informational purposes only and does not constitute legal advice.

ABOUT THE AUTHOR

Jonathan M. Charron is a tax lawyer who focuses his practice on tax administration, cross-border transactions, corporate reorganization, and tax and estate planning for individuals, including the establishment of family trusts dealing inter alia with inter-jurisdictional matters, estate freezes, life insurance planning, philanthropic tax planning, shareholders agreement and the general administration of trusts and estates in the provinces of Québec and Ontario. Jonathan also structures professional corporations and provides tax planning for professionals and their families. Prior to joining our Firm, Jonathan was a tax lawyer at premier international law firms, Norton Rose Fulbright LLP and Stikeman Elliot LLP. Jonathan is fully bilingual and he is also a member of the Quebec (c.l.a.) and Ontario Bars.

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