Impact of the Proposed Private Corporation Tax Changes

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Federal Government announces amendments to some of the proposals outlined in the July 2017 consultation paper

On July 18, 2017, the Federal Government released a consultation paper with detailed proposals that represent the most significant change to the taxation of private corporations in Canada in over 40 years (the "July Proposals"), which we previously summarized in our tax bulletin dated July 19, 2017. The July Proposals targeted four key areas the Government perceives as enabling business owners to gain unfair tax advantages: (1) income sprinkling, (2) access to the lifetime capital gains exemption, (3) surplus stripping, which involves converting corporate distributions into capital gains (instead of other forms of income such as dividends or salary, which are taxed at higher rates) and (4) investing after-tax business profits in passive investments within a corporation.

The Government faced considerable backlash from stakeholders (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 stakeholder submissions were received. In response to concerns raised by stakeholders during the consultation, the Government announced during the week of October 16, 2017 that it will make certain amendments to the July Proposals on income sprinkling and holding passive investments in a corporation, and that it intends to abandon the proposed measures on access to the lifetime capital gains exemption and surplus stripping. At the same time, the Government announced its intention, originally included in its election platform, to lower the small business tax rate to 10 per cent, effective January 1, 2018, and to 9 per cent, effective January 1, 2019.

We discuss each of the key areas targeted by the proposed tax changes below.

Impact of the Proposed Tax Changes

Income Sprinkling

The practice of splitting income within families to minimize the overall income tax payable is often referred to as "income splitting" or "income sprinkling".

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 be paid out to family members in lower tax brackets as dividends. Similar results can be achieved using trusts or partnerships. Under the current tax rules, dividends (and other distributions of business income from partnerships and trusts) received by family member shareholders who are minors are taxed at the highest marginal rate, often referred to as the "kiddie tax" or the "tax on split income" (the "TOSI"). The TOSI effectively eliminates the tax benefit of a corporation paying dividends to a minor child. The TOSI does not apply to income received as salary or wages *(i.e.*, employment income), which is received for services provided to the business.

The July Proposals will extend the TOSI to amounts received by related adult individuals (adult children, spouses, parents, aunts, uncles, nieces, nephews) commencing in 2018. These proposed rules will, however, not include amounts received by a related adult individual that are considered "reasonable" in the circumstances. The determination of whether an amount is reasonable will be based on the adult family member's contribution of labour *(i.e.*, work), assets (*i.e.*, investment of capital in the business) or assumption of risk related to the business (*i.e.*, a guarantee of the business debts). If the payment to the adult family member is considered unreasonable, the unreasonable portion (referred to as a "split portion") will be taxed at the highest marginal rate. More restrictive rules apply when assessing the reasonableness of contributions made by young adults (between the ages of 18 and 24 years old).

The following examples of the application of the reasonable test were provided in the explanatory notes to the draft legislation released by the Government with the July Proposals:

> *Example #1*
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> Pat works in the mailroom of a business owned by other members of Pat's immediate family. Pat contributes no capital and assumes no risk in respect of the business. Pat is paid a salary of $40,000, but a salary of up to $50,000 would be reasonable given what comparable mailroom workers earn in the same industry. Pat receives a dividend of $10,000 at the end of the year from the business. Taking into account Pat's labour contributions and the amounts previously received, the dividend of $10,000 would be considered reasonable.
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> *Example #2*
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> Rasmin is not actively involved in the business carried on by Rasmin's sibling, but has invested $100,000 to be used in the business and has taken back preferred shares that pay 5 per cent annual dividends. Given the assets of the business, its liabilities and the terms of the preferred shares, an arm's length investor acquiring the preferred shares would be expected to require a return in the range of 4-6 per cent. The annual dividends would therefore be considered reasonable.

These rules will eliminate the benefits of income splitting with related family members who do not work in, or have not contributed to, the business, and will make it difficult to determine the reasonable amount of income that can be paid to the related family member without triggering the TOSI in situations where some contribution of services or capital has been made.

The TOSI rules as proposed were very technical and may have resulted in double taxation in certain circumstances, in particular, on the death of a non-contributing shareholder.

On October 16, 2017, the Government announced that it will make some changes to "simplify" the proposed income sprinkling measures, better target the rules, address double taxation, and reduce the burden associated with establishing contributions of spouses and other family members. The Government announced it will introduce revised draft legislation later this fall and it is intended the revised rules will still come into effect on January 1, 2018.

Lifetime Capital Gains Exemption ("LCGE")

The LCGE currently exempts from taxable income capital gains realized by individuals (up to a lifetime limit of $835,716 in 2017) on the disposition of qualified small business corporation shares and qualified farm or fishing property. A business corporation can meet the requirements of a qualified small business corporation, entitling its shareholders to claim the LCGE on an eventual sale of the business.

The July Proposals would have limited the multiplication of the LCGE among family members who are not actively engaged in the business (again, measured based upon a reasonableness test), and prevented gains accruing during periods while shares are held by minors, or in a family trust, from qualifying for the exemption. On October 16, 2017, the Government announced that it is not moving forward with these measures, in large part because of the potential adverse impact on intergenerational transfers of family businesses. However, as these rules were aligned with the TOSI proposals, which will be re-introduced, it is unclear how the TOSI will be expanded without adversely impacting access to the LCGE.

Surplus Stripping and Other Anti-Avoidance Measures

The July Proposals would have significantly restricted the ability of shareholders to extract corporate surplus from corporations as capital gains effective for distributions after July 17, 2017. Under prior rules, a taxpayer was able to extract corporate surplus as capital gains up to the amount of the taxpayer's adjusted cost base, subject to an exclusion for cost base arising from a tax-exempt transaction such as the use of the LCGE by the taxpayer or a non-arm's length person. The July Proposals extended the exclusion to all cost base arising after 1984 attributable to a non-arm's length person (even if that non-arm's length person had paid tax attributable to his or her capital gain).

These rules would have made it even more difficult to pass down a private corporation business from one generation to another in a tax efficient manner, as tax at dividend tax rates (significantly higher than the effective capital gains rates) would generally be triggered. Further, certain planning undertaken after death to avoid double taxation where the deceased owned shares in a corporation, was adversely impacted.

A second component of the July Proposals restricted the amounts that could be added to a corporation's capital dividend account, which is an account where amounts received by a corporation which are exempt from tax (such as insurance proceeds and the non-taxable portion of capital gains) are tracked, that can be paid out to shareholders on a tax-free basis. A number of stakeholders raised concerns about the uncertainty of the scope of this provision to every-day situations. Fortunately, the Government announced on October 19, 2017 that it will not move forward with these proposed measures.

The Government announced further that in the coming year, it will continue its outreach to farmers, fishers and other business owners to develop proposals to better accommodate intergenerational transfers of businesses while protecting the fairness of the tax system.

Passive Investment

Business income earned in a corporation is taxed at lower rates than business income earned directly by an individual. When the after-tax business income is paid out to a shareholder as a dividend, a second level of tax is triggered, and the resulting combined corporate and individual tax burden is generally the same as if the income had been earned directly by the individual at the outset. However, until the corporation distributes an amount to the shareholder, only the corporate level tax has been paid, which leaves the corporation with more money to reinvest in the business or in passive investments (such as real estate, marketable securities, etc.). The Government is of the view that this deferral gives rise to an unfair tax benefit.

The July Proposals identified several options to eliminate the incentive to retain after-tax business income and invest it passively within a corporation. First, the Government indicated it had considered introducing a corporate refundable tax on business income that is invested passively (and not used in the business), but was not pursuing this alternative. A refundable tax system is already in place for investment income earned within a corporation.

Second, the Government suggested a deferred taxation approach whereby the payment to the shareholder would be subject to a much higher effective rate of taxation at that time. This would be accomplished by (i) eliminating any refundable tax associated with the investment income, and (ii) preventing the addition to the capital dividend account of the non-taxable portion of capital gains earned from the investment of after-tax business profits. Several alternatives were suggested, each of which is complex and would increase the compliance and reporting obligations on private corporations. For example, one such alternative (the "apportionment method") would require the tracking of all after tax investment income into three "pools", each of which would give rise to different tax treatment when distributions were made to the shareholder.

Concerns were raised as to the impact of these rules on the ability of small businesses to save for contingencies such as an economic downturn or a parental leave, or for business owners to save for retirement in a flexible manner.

On October 18, 2017, the Government announced its intention to move forward with passive investment measures, which would be introduced in the 2018 Federal Budget. In further developing these measures, the Government announced that it will ensure that:

- All past investments and the income earned from those investments will be protected, although no details are provided as to how this will be accomplished;
- Businesses can continue to save for contingencies or future investments in growth;
- A $50,000 threshold on passive income in a year (equivalent to $1 million in savings, based on a nominal 5 per cent rate of return) will be available to provide more flexibility for business owners to hold savings for multiple purposes, including savings that can later be used for personal benefits such as sick-leave, maternity or parental leave, or retirement; and

- Incentives are in place so that Canada's venture capital and angel investors can continue to invest in the next generation of Canadian innovation.

Although some of the July Proposals will still be moving forward and will adversely impact small business owners and their families, the Government has retrenched on some of the most problematic proposals. This is a rapidly evolving area which our Tax Group is following closely. If you wish to discuss how these developments may impact you and your business, please contact Pamela Cross, Natasha Miklaucic, Lindsay Holmes, Peter Wong or Joseph Takhmizdjian.

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