Update on Private Corporation Taxation Proposals

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"In the *Fall Economic Statement*, the Government is confirming that it is moving forward on proposals to fix a tax system that encourages the wealthy to incorporate, so they can get a better tax rate."

- ***Fall Economic Statement 2017***, Government of Canada, October 24, 2017

Background

On July 18, 2017, the federal government proposed a number of tax measures to address the following tax-planning strategies the government believes are unfair:

- ***Income sprinkling:*** Reducing taxes by moving income that would otherwise be received by an individual facing a high personal income tax rate to a family member who has a lower personal tax rate (or who may not be taxable at all).
- ***Holding a passive investment portfolio:*** Deferring and potentially reducing taxes by investing using private corporations. This may result in the use of the private corporation as an unlimited, personal, tax-preferred savings account.
- ***Converting a private corporation's regular income into capital gains*****:** Reducing taxes by taking advantage of lower-taxed capital gains.

The proposed measures triggered a backlash from entrepreneurs, businesses and associations, generating over 21,000 submissions that raised significant concerns about the complexity of the proposed measures, potential unintended consequences and the uncertainty being created.

In response, the government recently made a series of announcements, including reductions in the small business tax rate. The government also unveiled some adjustments to the proposals, with an emphasis on targeting "unfair tax advantages" used by the wealthiest Canadians, which the government suggests should have no impact on the vast majority of private corporations. Although the government has backed down on some of the most controversial proposals, many issues and questions remain, and details are still pending.

Where do things stand now?

Reduction of the small business tax rate (NEW)

- The government announced that it intends to lower the small business tax rate from 10.5% to 10%, effective January 1, 2018, and to 9%, effective January 1, 2019. Providing a small business with up to $7,500 in federal tax savings per year, the government contends, will enable small businesses to retain more of their earnings for reinvestment and job creation.

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- However, the taxation of non-eligible dividends will be increased to reflect the lower small business tax rate, in order to maintain integration of corporate and personal taxes. To the extent that this affects the payout of existing retained earnings, it can be regarded as a tax increase. Further, it exacerbates the existing over-taxation of investment income earned in private corporations.

Income sprinkling

- The government also announced its intention to move forward with the income sprinkling proposals. As part of this, it intends to simplify the proposals in order to reduce the compliance burden with respect to establishing contributions of spouses and family members, including labour, capital, risk and past contributions.
- The intention is to ensure that simplified proposals do not affect businesses to the extent that there are clear and meaningful contributions by spouses, children and other family members.
- These provisions will in some cases result in a significant tax increase for small businesses that have been shifting income to non-participating family members.
- The government also announced that it will not be moving forward with measures that limit access to the lifetime capital gains exemption. Further details are required to clarify some uncertainty with respect to whether all aspects of the proposed draft legislation will be abandoned or whether certain aspects will be retained.
- Revised draft legislation has been promised for later this fall.

Holding a passive investment portfolio

- The government introduced a new $50,000 threshold on passive income in a year (equivalent to $1 million in savings, based on a nominal 5% rate of return) and committed to releasing draft legislation as part of Budget 2018. This threshold is meant to allow a certain amount of savings within private corporations to use for downturns, sick leave, maternity leave or retirement.
- The government will also examine all deferral benefits from passive investments and will continue to assess key design aspects. For example, consideration will be given to the appropriate scope of the new tax regime with respect to capital gains, including whether in certain circumstances the new rules should exclude capital gains realized on the sale of shares of a corporation engaged in an active business.
- Any proposals will apply on a go-forward basis – that is, existing investments should not be affected by the changes. However, further details are required to clarify what exactly will be grandfathered, and as of what date.
- These provisions will result in significant increases to tax on certain investment income earned in private corporations, but the new $50,000 threshold mitigates the impact and pushes the impact into the future, because in most cases it will take a number of years to build up sufficient assets to earn income above the threshold.

Converting a private corporation's income into capital gains

- The government announced it will no longer be moving forward with measures relating to the conversion of income into capital gains. However, there were also indications that we may not have seen the last of this issue.

Next steps

As noted above, there continues to be significant uncertainty in several areas; we await additional details and draft legislation from the government. We recommend that small business owners talk to their tax advisors to consider whether any steps should be taken in contemplation of the proposed changes coming into force.