Government Responds to Consultation Process

How the Proposed Legislation Impacts You and Your Business

Government of Canada Proposed Tax Changes for Private Corporations | 2017

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On July 18, 2017, the Minister of Finance released proposals for “Improving Fairness in the Tax System.” The changes announced were intended to target the wealthiest of Canadians by addressing three areas of tax planning in private corporations:

- Income sprinkling with family members who receive allocations perceived to be in excess of their contributions to the growth of the business; (click for details)
- Using lower corporate tax rates to accelerate investment growth by shareholders of private corporations (click for details); and
- Conversion of dividend income into lower rate capital gains (click for details).

The proposals were accompanied by a 75-day consultation period in which over 21,000 papers were submitted to the Department of Finance expressing the concerns and broader impact that these changes will have on small businesses. MNP represented its 165,000 clients across Canada with our own technical submission, many discussions with MPs and Finance officials, and a presentation to the House of Commons Standing Committee on Finance in late September.

We would like to congratulate the many individuals and organizations who found the time and the resources to investigate and voice the impact of these proposals and to advocate on behalf of Canadian small business owners. Such efforts demonstrated strength and solidarity and we are pleased that the government has listened to some of these concerns and made some changes to their proposals.

Last week, we and many other advisors and stakeholders across Canada breathed a small sigh of relief when the finance minister released a series of announcements to amend the proposals and withdraw certain new measures. This was generally accepted as good news, though there are still areas of uncertainty and the updated legislation will need to be reviewed to ensure there are no additional ambiguities or unintended consequences.

Small Business Rate:

The first release last week announced the small business corporation tax rate would be reduced from our current rate of 10.5 percent, to 10 percent as of January 1, 2018, and then to 9 percent as of January 1, 2019. This reduced rate applies to income qualifying for the small business deduction.

A note to watch for: the integration theory that has been at the center of concern with the proposed changes, would suggest an increase in the tax rates for dividends received from companies taking advantage of this low rate is likely. Under integration, a shareholder of a corporation should be indifferent to receiving earnings personally, at their personal tax rates, and receiving the earnings within the corporation, paying corporate taxes and distributing the balance as dividends to be taxed personally. This theory would suggest a reduction in the small business rate of 1.5 percent would be accompanied by an increase in dividend rates of approximately 1 percent. However, the proposals on the passive income may indicate that such integration is less of a focus for the current regime.

Tax on Split Income (TOSI):

Under the proposed legislation, there was much ambiguity as to how family members would be taxed when compensated for their contributions to a business. Formerly benign income would become TOSI for many adult family members, including spouses and children. Historically, TOSI only applied to dividends, capital gains on a disposition to a related person and business income when earned by a minor; such income would be subject to the highest tax rate.

The Minister has announced that they will continue to pursue these changes, though with more guidance as to the reasonability tests applied, and specifically, with a clear framework for auditors to follow. These announcements would seem to suggest that the "arm's length" application of the reasonability test may no longer apply.

The TOSI proposals also aimed to reduce the use of the lifetime capital gains exemption (LCGE) by minors and by shareholders who utilized a higher proportion of the gain than they could reasonably be considered to have contributed. In each scenario, the LCGE would be denied and the proceeds would be treated as a dividend at the highest marginal rate. As an olive branch, a special election was created to allow some shareholders to qualify and elect to "crystalize" their exemption in 2018. In many cases, qualifying would require an expensive restructuring and valuation of the business. In last week's release, the Minister stated that to address the impact on intergenerational transfers, they will not be moving forward with the measure to limit access to the LCGE. This is welcome news for many individuals with family trust structures.

Passive Investment Income

In the July 18 proposals, this section was introduced without draft legislation; however, methodologies were presented that would frame an exorbitant level of tax on those who were taking advantage of lower corporate tax rates to invest their earnings. The methodologies proposed also have an extremely onerous record keeping requirement that will likely be costly to maintain. Through the consultation process this was identified as having a distinct gender bias, as many entrepreneurial females must accumulate funds to accommodate maternity leave when they have children; a problem not typical for male entrepreneurs, or EI-funded employees. Concerns were also raised by retirees whose funds came from the sale of their business and their retirement was tied to those passive earnings. In addition, this seemed to overlook the need of many businesses to maintain liquid assets, such as cash or securities, to support recession, bank covenants, or partly or wholly fund expansions. In all of this, though the government expressed the intent of "grandfathering" existing investments and income, the "how" was left unclear, and with potential for an additional record keeping burden.

Last week's release reiterated the government's intent to target passive investment inside Canadian-controlled private corporations (CCPC). The Minister has reiterated the plan to leave existing assets and past earnings alone; however, no guidance was provided as to the implementation of the grandfathering provision and how it will work in application. Newly announced was an acknowledgement of the need for passive returns within a corporation and a $50,000 threshold of annual passive earnings was established (based on the government's expressed analysis of a 5 percent return on $1,000,000 of investments). Income under this threshold will be taxed as in the current system; income in excess of this threshold will be subject to a non-refundable corporate rate, resulting in a level of double taxation.

The introduction of a threshold does not eliminate all concerns with respect to the passive income proposals. For example, where real property exists within a corporation, such as with profitable rentals, income could easily exceed the maximum threshold in a year. In this scenario, it may be difficult to structure only "part" of a property into a corporation. Further gains on dispositions of property, potentially passive as above, but also potentially actively used in a business, could easily exceed this threshold and be subject to a much harsher tax rate. One can still question how much of the income is "passive" when the cash is required for operations or debt financing.

Much of the noise surrounding the proposals involved putting small business owners on an equal footing with employees. Therefore, the question remains as to whether the $50,000 threshold of passive income will be treated in the same manner as pension income. It stands to reason that "fair" treatment would also allow splitting of the investment income with spouses, in the same manner as is allowed for pension income.

It appears we must wait for the actual draft legislation to be released before we can reasonably advise as to the final impact of the changes.

Conversion of Dividend Income to Capital Gains

Under the current tax regime, tax planners and corporate business owners can engage in strategies that convert dividend income to capital gains. This planning is considered desirable because of the tax rates on capital gains are considerably lower than the dividend rates and a personal tax savings can be achieved. The Minister proposed to end this type of planning with the introduction of two significant changes to the Income Tax Act. Firstly, the introduction of Section 246.1, a broad and vaguely worded “anti-surplus stripping” legislation intended to prevent internally generated gains. Public concern was raised because the wording was sufficiently broad and vague to include many basic transactions where no surplus stripping intention existed. The changes further inhibited the ability to apply the tax code with certainty and in many situations potentially egregious tax adjustments would result.

Secondly, to account for “related cost base,” an expansion was proposed to Section 84.1, an anti-avoidance rule that prevents individuals from stripping surplus funds from their corporation. When shares are sold to a corporation without “hard” cost base, the proceeds are treated as dividends as opposed to a capital gain. Hard cost base is created by paying tax on the disposition prior to the sale to the company; for example, if Mom and Dad sold shares to their child but did not claim their LCGE on the transaction. By paying the necessary taxes, the child could then dispose of these shares to their own corporation and receive the funds on a tax paid basis to repay Mom and Dad. The July proposals expanded this section to include where the hard cost base was not created at arm’s length (as in the example with Mom and Dad). This could result in significant costs when someone has been deemed to dispose of their shares on death, or in the transition of businesses between related parties, often parent to child, where there is a real intent to monetize a portion or all of the value, as often the retirement funding is tied directly into the value of the business.

Many practitioners thought certain policy changes could be implemented to enhance “fairness” in this area. However, the proposals introduced were perceived as overly harsh; it does not seem fair to risk double tax to an estate, or for an arm’s length sale to receive significantly preferential tax treatment over a related party transaction. In the context of generational transfers of the family farm or fishing business this provision has always been problematic as it prevented individuals from selling shares to family members. The expanded legislation would have made it even more preferential for people to transition their business to arm’s length purchasers rather than family members who have grown up in the business and contributed to its growth and success.

On October 19, the government announced they were not going ahead with the tax measures relating to the LCGE and conversion of income into capital gains. They recognized the unintended consequences of the draft legislation and promised to work to develop better proposals to accommodate the intergenerational transfers, while still protecting fairness.

Questions Remain

Although in the most recent announcements, the government addressed certain unintended consequences of the proposals, there remain situations that appear to be adversely and unfairly impacted by the changes.

Consider the example of a retired husband and wife who effected an estate freeze of their small business corporation several years ago and have been redeeming the resulting preferred shares at an amount of $40,000 each annually. Their son is now the principal of the corporation and is responsible for the day-to-day operations of the business. The combined tax liability of the couple each year under current legislation is approximately $5,000. Under the draft proposals, as they are no longer active in the operations of the business, no longer have capital invested in the company and no longer have any risk assumed in relation to the business, it appears the deemed dividends on the redemption of their preferred shares will be subject to TOSI. Their combined annual tax liability can increase to over $36,000, even if both spouses were active in the business before retirement.

We are hopeful this type of situation will be addressed and corrected in the re-draft of the legislation, as the retroactive effect of the proposed rules appears highly punitive.

Economic Update

The federal Fall Economic Update, on October 24 could see additional information announced around changes to the proposals, although it may be a number of months before we see new draft legislation. MNP will continue to monitor the updates, provide feedback to the government and work to protect our clients’ best interests in light of the coming changes.

Everything Counts

When it comes to tax, it’s all about the details. Knowing the rules and regulations, what qualifies, what doesn’t and how to structure your business and claims most effectively. Our specialized teams are focussed on every facet of tax. We have the in-depth knowledge and experience that will allow you to capitalize on all the opportunities available. We know what to look for, right down to the smallest details. And it’s the small details that can add up to make a big difference.