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UPDATE ON PROPOSED TAX CHANGES AFFECTING PRIVATE CORPORATIONS

Background

A recent Robins Appleby LLP newsletter discussed a series of proposed legislative amendments that were announced by Minister of Finance Bill Morneau on July 18, 2017. These proposals were aimed at addressing planning opportunities that the government labeled as "unfair tax advantages" afforded to private corporations and their shareholders, and contained measures that were intended to:

- Broaden the rules aimed at curtailing income splitting;
- Restrict access to the lifetime capital gains exemption;
- Limit tax benefits associated with earning passive income through a corporation; and
- Prevent the extraction of corporate surplus at low capital gains tax rates.

Finance's announcement of the proposed changes was followed by a 75-day period for public comment and consultation. During this consultation period, Finance received over 21,000 submissions, no shortage of mainstream media coverage, and widespread criticism from business owners and members of Canada's tax planning community.

Throughout the week of October 16, 2017, the federal government announced several updates to these proposed changes, which are summarized here.

Income Splitting

Currently, the concept of "split income" in the *Income Tax Act* applies only to minors; however, under Finance's proposed amendments, many payments made by private corporations to adult shareholders and debtholders would also constitute "split income" that would be subject to the highest marginal rate of income tax.

It was proposed that payments would not be characterized as "split income" to the extent that they were "reasonable" in the circumstances; much of the criticism of this proposal related to the ambiguous nature of this "reasonableness" test. The federal government has since announced its intention to simplify this proposal, noting that family members who "meaningfully contribute" to the business will not be impacted by the proposed measures.

Lifetime Capital Gains Exemption

The amendments announced on July 18, 2017 proposed to restrict access to the lifetime capital gains exemption (the "LCGE") in a number of ways, including: (i) not allowing minors to claim the LCGE; (ii) eliminating the LCGE in respect of gains accrued while eligible shares were held in a trust or by a minor; and (iii) restricting the LCGE in cases where the income associated with the gain is "split income" under the proposal discussed above.

On October 16, 2017 Finance announced that it would not be moving forward with its proposals to amend the LCGE.

Earning Passive Income Through a Corporation

In its July 18, 2017 announcement, the Department of Finance noted that, as a result of Canada's low corporate tax rates on active business income, a corporation that earns the same amount of income as an individual will have more after-tax dollars to invest. According to the government, this would result in a substantial and "unfair" tax advantage to owners of private corporations over the long-term. Without releasing any detailed legislative amendments, Finance's consultation paper proposed several alternatives to remedy this perceived problem.

This aspect of the proposed changes drew the ire of many business owners and professionals. Members of these groups asserted that the accumulation of passive investments within a corporation is necessary in order to, amongst other things: (i) finance business growth; (ii) ensure that the business can continue to meet its financial obligations in the event of an economic downturn; and (iii) provide the owners of the business with a means of savings for sick leave, parental leave, or retirement.

On October 18, 2017, the Department of Finance announced that it will continue to develop these measures, but that in doing so it would:

- Protect past investments and the income earned from these investments; and
- Allow $50,000 of passive income to be earned within a corporation each year (presumably to be taxed under existing rules) in order to provide business owners with flexibility to hold savings for various purposes.

Converting Income to Capital Gains

As part of its initial set of proposals, Finance introduced measures that would prevent taxpayers from extracting corporate surplus as a capital gain (as opposed to income, which is taxed at a higher rate). The feedback that Finance received during the public consultation process was that the enactment of the draft provisions would have a significant adverse impact on post-mortem planning as well as the ability to transfer a business to family members.

Accordingly, the federal government has since announced that it would not be moving forward with the proposed amendments at this time. Instead, the government expressed its intention to work with stakeholders over the coming year in order to develop a revised set of amendments that would not hinder the intergenerational transfer of a business.

Corporate Tax Rate

In an unexpected development, the Department of Finance also announced last week that the small business tax rate payable by Canadian-controlled private corporations ("CCPCs") on their first $500,000 of active business income will be lowered from 10.5% to 10% effective January 1, 2018, and then to 9% effective January 1, 2019. Based on this announcement, the combined federal and provincial corporate tax rates on small business income earned by Ontario CCPCs are expected to be 14.5% in 2018 and 13.5% in 2019.

To ensure the continued integration of corporate and personal taxes, the tax rate and credits applicable to non-eligible dividends will be adjusted accordingly, however the details of these adjustments have not yet been publicized.

Conclusion

With its announcements over the past week, Finance appears to be taking a step back in what is hopefully an effort to engage all stakeholders in a meaningful discussion regarding the government's objectives and how they might be implemented in a way that is practical and does not give rise to unintended consequences.

Robins Appleby's Tax and Estates Group will continue to monitor the status of the federal government's proposals to change the taxation of private corporations and will keep you informed as further updates are announced.

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