Tax Proposals Affecting Private Corporations – Initial Government Response Following Consultation Period

As noted in our recent publication **Tax Planning Using Private Companies – Draft Proposals Released for Consultation**, the federal government released an important tax consultation paper on July 18, 2017. The consultation paper outlined proposed policy responses for certain tax planning strategies involving private corporations that it perceives unfairly reduce personal taxes of high-income earners through a variety of tax reduction strategies unavailable to other Canadians.

The three strategies involving private corporations targeted by these draft tax proposals introduced by the government are as follows:

- **Income Splitting**, which can reduce income taxes by causing income (such as dividends and capital gains) that would otherwise be realized by an individual facing a high personal income tax rate to instead be realized by family members who are subject to lower personal tax rates.
- **Holding passive investment portfolios**, which may be financially advantageous for owners of private corporations since lower corporate income tax rates facilitate accumulation of earnings that can be invested in a passive portfolio.
- **Converting regular income into capital gains**, which can reduce income taxes by taking advantage of the lower tax rates on capital gains relative to regular income.

The consultation period was open until October 2, 2017. In the course of the consultations, over 21,000 written submissions were received by the Department of Finance. Based on these submissions, the federal government released a series of announcements this week affecting the taxation of Canadian-controlled private corporations (CCPCs).

Reduction in the Small Business Tax Rate

The government announced that it intends to lower the federal small business tax rate (which applies to the first $500,000 of active business income) from 10.5% to 10%, effective January 1, 2018, and to 9%, effective January 1, 2019. The taxation of non-eligible dividends will be adjusted to reflect the lower small business tax rate in order to maintain integration of corporate and personal taxes.

Amendments to Proposed CCPC Tax Changes

The feedback received by the government during the consultation period raised significant concerns and identified areas where improvements are required to the draft CCPC tax proposals. With the goal of better targeting these proposals originally introduced on July 18, the government provided some direction on its revised approaches in the series of announcements this week.

Although specific amendments to the remaining proposals are still forthcoming, the government provided some initial guidance on impacts to the above proposed measures, as follows:

- **Income Splitting**

  Sprinkling income

  The government indicated that it has recognized the complexity and the potential impact of the draft legislative proposals on small family businesses, noting that the measures could create uncertainty as to how amounts received from a family business would be taxed. As a result, it intends to simplify the proposals to limit the ability of owners of private corporations to lower their personal income taxes by sprinkling their income to family members who do not contribute to the business, but reiterated that the vast majority of private corporations should not be impacted by these measures.

  To that end, the government intends to move forward with these measures to limit income sprinkling using private corporations, while ensuring that the rules will not impact businesses to the extent there are clear and meaningful contributions by spouses, children and other family members. Specifically, the government indicated that it will release revised draft legislative proposals later this fall outlining the proposed changes, which will be effective for the 2018 and subsequent taxation years.

  Lifetime Capital Gains Exemption (LCGE)

  The government noted that a number of submissions identified potential unintended consequences associated with the proposed measures to address the multiplication of the LCGE, including concerns raised about the potential impact on intergenerational transfers of family businesses. Based on this feedback, the government announced it will **not be moving forward with the proposed measures to limit access to the Lifetime Capital Gains Exemption.**

- **Holding passive investment portfolios**

  The proposed measures involving passive investment income, considered the most controversial but also those least defined, seek to limit the tax deferral advantage that can be achieved if after-tax profits of an active business are retained within a private corporation. Due to the lower corporate income tax rates a higher initial amount of after-tax capital can be invested within the corporation thereby resulting in a larger amount of net after-tax funds accumulated, in comparison to an individual earning the same business income personally and investing the after-tax funds personally.

  Although short on detail, the government announced this week that it intends to move forward with these measures to:

  - limit the tax deferral opportunities related to passive investments, while providing business owners with more flexibility to build a cushion of savings for business purposes – such as a possible downturn or finance a future expansion.
  - deal with personal circumstances, such as for parental leave, sick days or retirement.

The government's stated intent of the new rules will be to target high-income individuals who can benefit under current rules from an unlimited, "tax-preferred" savings account via their corporation, beyond the pension, RRSP and TFSA limits available to other Canadians.

In further developing these measures, the government seeks to ensure that:

- All past investments and the income earned from those investments will be protected;
- 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) – is 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.

The government indicated that it will release draft legislation for these measures limiting the tax deferral related to passive investments in a private corporation as part of Budget 2018, including a technical description of how the passive investment income threshold will be applied. The government also reiterated that these proposals will only apply on a go-forward basis.

Continued

- **Converting regular income into capital gains**

  During the consultation period, the government heard from many business owners that these proposed measures could result in several unintended consequences, particularly to the taxation upon death and with intergenerational transfers of businesses. As a result of these possible unintended consequences, which could impair estate planning and the transfer of farms and small businesses to the next generation, the government also announced this week that it will **not be moving forward with the proposed measures relating to the conversion of income into capital gains.**

  In addition, the government announced that it will continue to reach out to business owners to develop proposals to better accommodate intergenerational transfers of businesses while protecting the fairness of the tax system.

Summary

The remaining income tax measures outlined herein are still only proposals at this stage, and may not ultimately be enacted into law. As these proposals are very complex and wide-ranging, and may have significant implications to your particular tax situation, you should consult with your tax advisors for specific advice and direction on how your particular situation may be affected by these potential changes in the tax law.

Please stay tuned for future developments regarding these income tax proposals.

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