Tax Alert from BDO Canada LLP

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In partnership with BDO Canada LLP, we are pleased to share highlights related to the federal government's changes from the Private Company Consultation.

Small Business Tax Rate to Be Reduced

As part of the response to the feedback on the consultation paper, the government announced that it will reduce the small business tax rate from 10.5 percent to 9 percent. This change will come with an initial reduction to 10 percent effective January 1, 2018 and a further reduction to 9 percent effective January 1, 2019. This rate applies to the first $500,000 of active business income earned by a Canadian controlled private corporation.

Income Splitting

A key component of the private company proposals are changes to the tax laws to limit opportunities for income sprinkling using private corporations. The government is of the view that only a small percentage of family businesses use income sprinkling techniques to reduce taxes and that income sprinkling is overwhelmingly used by wealthier taxpayers, rather than middle class taxpayers.

Also announced on October 16 was a promise that the proposed income sprinkling rules will not impact businesses to the extent there are clear and meaningful contributions by spouses, children and other family members.
The government announced that they will introduce reasonableness tests for adult family members aged 18-24 and for those 25 and older. These adults will be asked to demonstrate their contribution to the business based on four basic principles:

- Labour contributions;
- Capital or equity contributions to the business;
- Sharing the financial risks of the business, such as co-signing a loan or other debt; and/or
- Past contributions in respect to previous labour, capital or risks.

The original proposals announced in July also contained reasonableness tests for measuring the contributions of family members using the same basic principles as outlined above. The government has not released draft legislation to coincide with the October 16 announcement but Morneau did indicate during the press release that they "will issue simplified proposals for income splitting with those who do not work in the business". It will be particularly important to see the draft legislation in order to determine the extent of the simplification of these proposals.

It is expected that draft legislation to support these proposals will be released when the government provides their Fall Economic Statement, anticipated in November.

Lifetime Capital Gains Exemption

The government stated that it will not proceed with the proposals to address the multiplication of the Lifetime Capital Gains Exemption (LCGE) which were announced in July. Significant concerns were raised in the business community surrounding intergenerational transfers of businesses due to the proposed changes announced in July. We will need to wait until further details are released by the government to fully understand how relief from the LCGE proposals will help the transfer of family businesses to the next generation.

In response to considerable public opposition, the government revealed more changes to their controversial July 18 proposals on private company tax planning. On October 18, Finance Minister Bill Morneau issued an announcement outlining how he intends to proceed with changes to how passive income earned in private companies is taxed. This was seen by many as the most controversial feature of the original proposals and this announcement includes significant relief from these proposals that will benefit many private businesses.

October 18 Developments

The government intends to move forward with measures proposed on July 18 to limit the tax deferral benefits of passive investments in private corporations. However, the government reinforced that it intends to balance this intention with its commitment to provide flexibility for small business owners.

Most significantly, they have announced a maximum threshold of $50,000 of investment income per year that can be earned in a corporation that will not be subject to the new regime as it will continue to be subject to the current refundable tax system. The government estimates that this threshold represents approximately $1,000,000 in invested assets, using an assumed 5 percent rate of return. However, there is no indication of how the $50,000 will be determined – for example, will the full capital gain on sale of securities be included, or 50 percent of such a gain?

This threshold is meant to provide flexibility for small business owners to hold savings for multiple purposes such as sick leave, parental leave, an economic downturn or retirement.

The government gave reassurances to business owners who have significant investments in passive assets in corporations that the new rules will be prospective and will apply to new investments only. That is, income earned on existing assets will not be affected.

The government will release draft legislation as part of its 2018 federal budget. However, there is no indication of an effective date of the new proposals.

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The government also wants to ensure that incentives are maintained for Canada's venture capitalists and angel investors. The government will consult with the venture capital and angel investment sectors to identify how this might be best achieved. As well, it is also considering the appropriate scope of measures as they relate to capital gains, specifically whether capital gains realized on the sale of shares of a corporation engaged in an active business might be excluded from the new rules.

The government stated that it will ensure that the proposed changes to passive investments will not apply to income from AgriInvest.

What we know about the proposed new regime

The government's private company consultation paper, the current system allows for a tax deferral of the individual tax payable if the shareholder leaves funds in the corporation. The government believes that this tax deferral results in a significant tax advantage to owners of private corporations. For example, assuming a small business tax rate of 15 percent applies, an individual earning active business income of $100 in their private corporation would have $85 after-tax to invest passively if those funds are retained in the corporation. In contrast, if an individual earned the same $100 as salary, assuming they are subject to a high personal tax rate of 50 percent, they would have $50 after-tax to invest personally. The government believes that the additional $35 of capital available to corporate owners to invest in passive investments when using a corporation results in a significant advantage that grows over time.

Summary

Small business owners can be assured of a safe-harbour amount of investment income. Corporations with investments in passive assets that generate no more than $50,000 per year of investment income will continue to be taxed under the existing tax regime and will not be subject to the proposed new regime. We will need to wait until the 2018 federal budget for further details on how income over that threshold will be taxed.*

*This content has been fully sourced from BDO Canada LLP