CANADIAN PRIVATE CORPORATION TAX CHANGES: A FEINTED RETREAT?

Understanding Updates to the Changes to the Taxation of Private Corporations in Canada

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In a series of press releases (and accompanying background materials) during the week of October 16, 2017, the Government of Canada has seemingly walked back several of the proposals previously put forward on the taxation of private corporations in Canada. For a backgrounder on the originally-proposed changes, please see my earlier resource material. The changes are welcome but much uncertainty still remains as to how these fundamental changes to private corporation taxation in Canada will manifest themselves. The purpose of this blog is to provide a high level summary of this supposed "retreat" on several previous measures proposed.

<u>What You Need to Know</u>

1. **Small Business Tax Rate = Reduced** - The federal small business tax rate will be reduced from its current 10.5% to 9% (10% effective January 1, 2018, and 9% effective January 1, 2019). This rate of tax applies on the first $500,000 of active business income earned by a Canadian-controlled private corporation (a CCPC). A CCPC, broadly speaking, is any corporation (i) that was incorporated pursuant to a federal or provincial business corporation statute, and (ii) that is not controlled (i.e. more than 50% of the voting rights of that company are held) by non-residents of Canada. Additionally, note that the term "active business income" becomes trickier to satisfy where the CCPC is deriving its income from passive sources (e.g. rents, royalties, etc.).

2. **Lifetime Capital Gains Changes = Gone -** The proposals to change access to the lifetime capital gains exemption (LCGE) have been withdrawn. The LCGE provides an exemption on (i) approximately $835,716 (2017 amount, indexed to inflation in future years) of capital gains on the disposition of shares of a qualified small business corporation in Canada, and (ii) $1,000,000 of capital gains on the disposition of qualified farm or fishing property.

3. **Income Sprinkling Proposals = Modified? -** While the Government stated that it is working to "simplify" the quagmire they created with the original income sprinkling proposals, the press releases (and backgrounders) suggest that the original proposals are very much intact. The term "contribute to a business" is littered throughout the press releases and so the main focus point seems to be on whether a particular person has "contributed" to a business; if they have, they will be entitled to the "old world" treatment of dividends and other distributions – if they have not, they will get hit with the "new world" increased tax treatment on dividends and other distributions. The Government reiterated its plan to introduce reasonableness tests for adult family members

aged 18-24, and those 25 and older, stating that these adults will be asked to demonstrate their contribution to the business based on four basic principles: (i) labour contributions; (ii) capital or equity contributions; (iii) financial risks, such as co-signing a loan or other debt; and/or (iv) past contributions in respect of previous labour, capital or risks.

Ultimately, the comments leave us asking "where's the beef?" since nothing concrete has been announced here. The best we have is an example of a "good" corporate scenario where the proposals would not affect the family members:

Example Scenario

Jacob owns a family farm in southwestern Ontario which he works with his wife Frieda and their adult son Herman. The farm is incorporated and earns $120,000 in net income before salary.

- The farm pays Jacob $65,000 in salary and dividends.
- The farm pays Frieda, who does the farm's accounting and helps out on the farm, $30,000 in salary and dividends.
- Herman, who is 25 years old and works on the farm during the summer, on weekends and during breaks from university, receives $17,500 in salary and dividends.

This family will not be affected by the proposed rules on divident income sprinkling because dividend allocations to Frieda and Herman are reasonable compensation for their contributions to the farm.

- Once the small business tax reductions are fully implemented, the business will save an additional $750 which could be used to help pay for new farm equipment.

4. **Capital Gains Proposals = Gone -** The prior proposals relating to the conversion of income into capital gains have been abandoned. Previously, these were the proposals causing great concern around (i) tax planning after the death of an individual (so-called "pipeline planning"), (ii) inter-generational transfers of businesses (including farms), (iii) estate freeze planning, (iv) recognition of capital gains previously incurred by family members, (v) impairment of a corporation's capital dividend account, and (vi) standard asset or share sales of a business. This is a welcome development given the high degree of uncertainty which these proposals would have created around very typical tax planning. Additionally, there is positive commentary from the Government here about reviewing the ways in which businesses are transferred from generation to generation. This generally indicates some consideration around making this process easier (particularly for farming businesses).

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5. **Passive Investment Proposals = Modified -** These prior proposals caused great consternation in the media (with headlines focusing on the possible 73% tax rate and the complete destruction of business owners' retirement or rainy day funds). In an effort to "quell the masses", the Government has somewhat softened its prior proposal by now indicating that:

    - All past investments in a corporation (and income earned on those investments) will be "safe" (presumably, the Government will provide a certain date when this will take effect)
    - Businesses will continue to be able to save for contingencies or future investments in growth (albeit the Government has not provided any concrete proposals on what "contingencies" or "investments" are and how much one can save for these items)
    - The first $50,000 of investment (i.e. passive) income per year enjoys "old world" tax treatment (this is based on a 5% rate of return on $1,000,000 of savings) – this is, ostensibly, to cover a business owner for "savings that can later be used for personal benefits such as sick-leave, maternity, or parental leave, or retirement"

    While the changes here are positive, there is still uncertainty around how this will work. The proposals seemingly invite a separation between "good investments" (i.e. those acquired prior to some particular date) and "bad investments" (i.e. those acquired after that particular date). The "good investments" (and income generated from them) will enjoy "old world" tax treatment. Conversely, the "bad investments" will enjoy (i) on the first $50,000 of income generated on them, "old world" tax treatment, and (ii) on the remaining income, "new world" tax treatment. Ultimately, we will have to wait for the draft legislation to truly understand the mechanics of these proposals; it is expected this will come out as part of the Government's 2018 federal budget.

It is expected that revised draft legislation on measures other than the taxation of passive investments, along with measures related to private corporation taxation, will be released later this fall. We will continue to monitor these revisions and will report on them at the appropriate time. In the interim, please contact **Joseph A. Gill** or **Michael T. Petrescue** if you have any questions.

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