TAXATION OF PRIVATE CORPORATIONS: AN UPDATE

Hendry Warren Chronicle - Tax and Accounting Simplified November 2017

By now, most are aware of the widespread changes to the taxation of private corporations that were proposed by Finance Minister Bill Morneau on July 18, 2017. During the 75 day consultation period that ended on October 2, 2017, the government received over 20,000 submissions from taxpayers, advisors and organizations. In mid-October, in a series of separate announcements, Minister Morneau announced modifications to the initial proposals. However, with the exception of updates related to the income sprinkling rules, no updated draft legislation is expected until the New Year as finance needs time to make the necessary revisions. This newsletter will review where the proposals currently stand.

Income Sprinkling

Under the current rules, owners of private corporations are able to pay dividends to family members that are disproportionate to that family member's contribution to the business. As individual taxpayers in Canada are subject to graduated tax rates, current dividend sprinkling can provide for an absolute tax saving for families. The July 18, 2017 proposals sought to eliminate this benefit by taxing dividends paid to family members in excess of a "reasonable" amount at the top marginal rate of tax. Draft legislation was released as part of the proposals. The rules were highly technical and left many tax professionals unclear as to what "reasonable" meant in different circumstances.

Our goal is to provide updates on topical accounting and tax issues. Information contained in this newsletter is not meant to be a comprehensive summary of the issues raised. Rather, we wish to bring what we believe to be important issues to the attention of our valued clients and readers. We would be pleased to discuss any questions that you, the reader, might have in greater detail.

The government recently reiterated that it is moving forward with a more simplified plan to limit income splitting for family members not active in a business. The specifics of these simplified rules have not yet been made available. The government stated that revised legislation would be made available in "late fall", so we expect more information in the coming weeks. The rules are proposed to be effective January 1, 2018. It would appear prudent for private corporations to pay dividends to its shareholders, active or not, in 2017 as the new income sprinkling rules will not apply until 2018. Remuneration plans for 2018 and future years will need to be revisited once the new simplified legislation is released.

Lifetime Capital Gains Exemption

The lifetime capital gains exemption ("LCGE") allows each individual taxpayer to shelter up to $835,714 of capital gains on the disposition of qualifying private corporation shares. The LCGE is currently worth up to approximately $223,000 of income tax savings per taxpayer. It has, therefore, been common practice for the shares of private corporations to be owned directly or indirectly through a family trust by family members who may not active in the business. In its July 18, 2017 proposals, the government attacked this type of planning by proposing to extend the reasonableness test for dividends described above to capital gains. A number of other rules were also proposed which would have precluded claiming the LCGE with respect to capital gains that accrued while a taxpayer was a minor or while the shares were held by non-qualifying trusts.

Surprisingly, Minister Morneau recently recanted on his initial proposals in this regard, stating that the government will not move forward with the proposed measures to limit access to the LCGE. As a result, it may still be beneficial to include non-active family members as shareholders of private corporations (either directly or through a family trust) where it is likely that shares of the corporation will be sold in the future.

Taxation of Passive Investments

Many private corporations in Canada have accumulated passive investments from the retention of business profits. The benefit of investing in a private corporation is the ability to pay lower corporate tax rates on business income and invest the after tax funds corporately to accumulate savings for the shareholders. The July 18, 2017 proposals suggested a new methodology of taxing passive income earned by a private corporation which would eliminate this deferral benefit. The mechanics of the proposal were complex and the government was not definitive on what exactly the new system look like. There was no draft legislation released. However, it is clear that the proposed system would have increased the combined corporate and personal income tax rate applicable to investment

income. The government also promised at that time that existing wealth will be grandfathered such that initial capital will not be subject to the new proposals.

These proposals received harsh criticism from entrepreneurs who stressed that there are valid reasons for retaining cash and investments within a corporation, namely saving for economic downturns or business expansion and for retirement. In mid-October, the government stated that the first $50,000 of annual investment income, equivalent to a 5% return on $1,000,000 in savings, would be taxed under the existing rules. Only investment income of a corporation in excess of $50,000 per year will be subject to the more punitive rules. The grandfathering of existing wealth remains part of the proposal, so only new wealth will be impacted. The tracking and administration of the taxation of two streams of passive income could prove onerous for private corporations with large investment portfolios.

The draft legislation related to the taxation of passive investments is expected to be released as part of the 2018 federal budget. The federal budget is typically released in March of each year. We do not recommend any changes to existing corporate structures or in the nature of investments until more definitive rules are announced. It may be advisable to incorporate a new company and transfer the investments thereto prior to the release of the new legislation where a significant level of investments are held by an individual or trust. This would allow the taxpayer to benefit from the grandfathering of existing wealth. However, the merits of such planning must be reviewed on a case by case basis.

Conversion of Income to Capital Gains

As capital gains provide a lower rate of taxation than dividends (as much as 18.5% less), the government has expressed concerns about tax planning strategies that seek to convert dividend income to capital gains. The July 18, 2017 proposals contained a number provisions which if enacted would prevent such planning. However, the proposals were extremely broad and would make legitimate intergenerational business transfers between family members more difficult from an income tax perspective.

The Government recently announced that it will not be moving forward on any measures that could affect the transfer of a family business to the next generation. Specifically, Minister Morneau recanted on the proposed rules meant to curtail the conversion of income to capital gains. The government also committed to reviewing existing legislation which restricts the tax efficient transfer of businesses from one generation to another.

Reduction of the Small Business Rate

The Liberal government promised to lower the federal small business rate to 9% in its 2015 election campaign. In their first budget, they announced they would not be proceeding with such a reduction. Perhaps in light of recent political difficulties, the Department of Finance recently approved a reduction in the federal small business rate from 10.5% to 10% on January 1, 2018 and to 9% on January 1, 2019.

It is important to note that this announcement is not all good news for taxpayers. A Notice of Ways and Means Motion released by the Department of Finance on October 24, 2017 implemented the change to the small business rate but also increased the effective rate that will apply on non-eligible dividends. In Ontario, the highest marginal tax rate applicable to non-eligible dividends will increase from 45.30% in 2017 to 45.74% in 2018 and 46.75% for 2019 and future years. In other words, once income flows through the corporation to the individual taxpayer, they will be no better off. Taxpayers with existing wealth within their corporations will be worse off as a result of these changes as they would not have benefited from reduced corporate tax rates but of course will be subject to the same higher personal tax rates.

Conclusion

The July 18, 2017 proposals suggested significant changes to the taxation of private corporations. The recent modifications made by the government as a result of the feedback they received during the consultation period have also been significant. Unfortunately, these changes have created a great deal of uncertainty with respect to tax planning as no revised legislation has been provided. We expect such updates related to the income sprinkling rules to be announced in the next few weeks and the remaining legislation to be released in the New Year, perhaps as part of the 2018 federal budget.

Hendry Warren LLP can assist you in understanding these rules and navigating a path for the future. At this time our recommendation is to wait until final legislation is provided before making any significant changes to existing corporate structures. We will continue to monitor these issues for any changes and will provide updates to affected corporate clients as appropriate.

HENDRY WARREN LLP
CHARTERED PROFESSIONAL ACCOUNTANTS

Jacob Milosek
CPA, CA Partner

Contact Us

Give us a call for more information about this article.

Hendry Warren LLP
881 Lady Ellen Place, Suite 200
Ottawa, ON K1Z 5L3

(613) 235-2000

Visit us on the web at
www.hwllp.ca