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Department of Finance Announces Measures to Stop Tax Planning Strategies Involving Private Corporations

On July 18, 2017, Federal Finance Minister Bill Morneau announced next steps in improving fairness in the tax system. The Department of Finance release was anticipated to some degree – the March 2017 Federal Budget noted that the Government would be taking steps towards eliminating tax measures that disproportionately benefit the wealthy. However, the July 18th announcement proposed tax changes well beyond what most tax practitioners expected.

Finance's consultation paper attacks strategies that have been in place for decades - the most dramatic proposals seek to equate the tax treatment of an incorporated business owner with that of individual salaried employee. By doing so, the Minister is ignoring the most fundamental non-tax difference - the inherent risk in starting and operating a small business. The scope of the proposals merits scrutiny as to their application to existing corporate structures. We are currently reviewing the proposals and ensuring that we plan accordingly to minimize their impact on structures involving private corporations.

The proposed tax changes are at this point just that - proposals. Finance has called for input regarding the proposed amendments is accepting submissions until October 2, 2017.

Our office continues to review the potential impact of these anticipated measures. Over the coming weeks we will be circulating a series of newsletters to explore key areas in greater detail and provide further clarity on what these proposals mean if enacted.

The following is an initial summary of what we think will most affect our clients.

I - INCOME SPLITTING WITH FAMILY MEMBERS

Dividends (and Other Income Distributions)

Existing tax legislation includes rules – tax on split income ("**TOSI**")[1] rules or "kiddie tax" - which effectively prevent income splitting with minors. The Department of Finance is proposing to significantly expand the TOSI regime to apply to ***spouses, minor and adult children, parents, siblings, aunts, uncles, nieces and nephews***. The new rules plan to apply a "reasonableness test" assessing an individual's contribution to the business. Amounts individuals receive which are deemed ***unreasonable*** would be subject to tax at the top marginal rate.

Finance has suggested that they will consider the following elements in assessing reasonableness:

1. labour contributions;
2. capital contributions;
3. risks assumed;
4. functions performed; and,
5. amounts received.

Two sets of rules are proposed – the 1st set will apply for individuals aged 18-24 and the 2nd set for those 25 and up.

[1] TOSI is a tax levied at the highest marginal rate of personal tax.

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The reasonableness test related to salary and wages is not new - taxpayers who were ***not*** owner manager shareholders were always required to satisfy a reasonableness test for amounts paid - however historically no reasonableness test has applied to dividend distributions.

Lifetime Capital Gains Exemption

The new rules also propose to limit the lifetime capital gains exemption ("**LCGE**") that currently shelters $835,716[2] of capital gains on the disposition of qualified small business corporation shares. Under existing legislation business owners can utilize the LCGE afforded to their family members by using family trusts in their overall structures. A family trust owns the common shares of the private corporation - on the sale of these shares the trust then allocates the capital gains to its beneficiaries who in turn claim their LCGE against the capital gains allocated (thus multiplying the use of the LCGE and sheltering more tax). Finance proposes to eliminate this strategy by removing the ability to claim the LCGE on capital gains accrued in a family trust. Furthermore, Finance proposes to eliminate the availability of the LCGE exemption to minors.

II - UTILIZING SURPLUS CORPORATE FUNDS TO ACQUIRE PASSIVE INVESTMENTS

When a corporation generates active business income it generally pays tax at a rate of 15% (in Ontario) on the first $500,000 of net income earned. This provides the opportunity for accelerated wealth accumulation if the business owner maintains the surplus cash and reinvests the after-tax earnings inside the corporation. For example, earnings of $1,000 of active business income attract $150 of corporate tax leaving the owner with $850 to invest inside the corporation. Contrast this with an individual earning $1,000 of income personally (i.e. as a T4'd employee or self-employed proprietor) where you are left with only $466 to invest (assuming top Ontario marginal tax of about 53.4%). There is an immediate advantage of $384 ($850 – 466) of additional funds to invest where you have a surplus and the corporate structure is used.

It is important to note that the business owner who retains the surplus inside their corporation will generally pay more tax overall if he invests at the corporate level and eventually repatriates that income out to himself as dividends. As such the only meaningful benefit is the larger base amount retained and initially available to invest as described above.

The Department of Finance is currently exploring how to limit the perceived benefit of leaving excess earnings inside a corporation to grow in a passive portfolio. To this end they have proposed two options aimed at evening out the basis on which a corporate entity can earn passive investment income:

1. Implementing a refundable tax regime that would apply to ineligible investments (the tax would be refunded once the capital is either paid out as taxable dividends personally, or is used in the active business operations); or
2. Changing the current refundable tax system on annual passive income so that the tax is no longer refundable if the investments were made with excess business income taxed at low rates.

[2] The lifetime capital gains exemption is indexed to the rate of inflation and is expected to increase year over year.

GOING FORWARD

Until the proposals are passed, there does not appear to be any disadvantage to maintaining existing structures and tax plans that have been implemented.

It is anticipated that changes would apply as follows if the proposals are implemented:

- Income Splitting (Dividend) – applicable for the 2018 and later taxation years;
- Income Splitting (Lifetime Capital Gains Exemption Restrictions) – applicable to dispositions occurring after 2017; transitional rules are proposed and would require affected businesses to review current structures in place as action may be required before end of 2017;
- Changes to the Taxation of Passive Income – applicable for periods after the release of draft legislation and prospectively thereafter;
    - NOTE: the release on July 18th did not include any draft legislation on this proposal – Finance does not yet seem to have a clear vision as to how it will achieve their objective for passive investments inside a corporation.

INVITATION FOR COMMENT

We encourage you to contact your Member of Parliament to voice your concerns with respect to the proposals.

You can also share your views directly with the Department of Finance - **Have your say! Get your submissions in by October 2, 2017 http://www.fin.gc.ca/activty/consult/tppc-pfsp-eng.asp**

SPEAK WITH YOUR ADVISOR AT INNOVO LLP

Please contact us if you have any questions regarding the proposals and how they may impact you or your business/corporation/trust.

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