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Tax Alert — Canada

Private company tax reform: where are we now?

EY Tax Alerts cover significant tax news, developments and changes in legislation that affect Canadian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor or EY Law advisor.

On 2 October 2017, the consultation period ended for the 18 July 2017 draft legislation and consultation paper, both of which proposed to fundamentally overhaul the system of taxation for private companies, as well as for their shareholders and family members.

Over 21,000 individual submissions were made to the proposals, including some that were several hundred pages long.

During the week of 16 October 2017, only two weeks after receiving the submissions, federal Finance Minister Bill Morneau outlined the government's response to the submissions in five individual press conferences, news releases and backgrounder documents. A culminating and reiterative message on private company tax reform was provided in the 24 October 2017 fall economic statement.

While much attention was given in the media to certain economic groups and sectors that were impacted by the proposals (farmers and doctors), the government's proposals and their October 2017 responses apply to any economic sector, and generally to all Canadian private companies and their shareholders.

The following is an executive summary of the updated proposals, EY's insights into the potential implication of the rules and an outline of what currently remains uncertain for Canadian businesses.

EY

Building a better working world

Corporate reinvestment: proceeding with proposal to increase taxes

Original proposal to increase tax

The 18 July 2017 proposals outlined the government's view that the deferral of tax associated with corporate reinvestment, namely that a corporation has (on a temporary basis) additional funds to reinvest, is a perceived and unfair tax advantage not available to unincorporated individuals.

The government proposed to increase tax on corporate "passive investments" funded from after-tax active business earnings. The proposal would intentionally double-tax the eventual distribution of passive investment earnings (on investments funded from business-taxed earnings). The examples provided suggested eliminating the dividend refund on high-rate corporate investment tax and potentially eliminating the tax-free capital dividend account addition for corporate capital gains on assets funded from business-taxed corporate reinvestment. The stated intent of the double-tax is to eliminate the financial advantage associated with corporate reinvestment of business-taxed earnings in passive assets. Reinvestment in active business assets that do not produce capital gains (for example, machinery or inventory) would not be affected by the proposed measures; it is unclear how the proposals may apply to the eventual taxation of business assets that produce capital gains.

Updated proposals to increase tax on passive earnings above a threshold

In response to the submissions, the government has proposed that the new tax increases will only apply to passive income that exceeds an annual threshold of $50,000 (illustrated in the Department of Finance news release as a hypothetical 5% rate-of-return on a $1m savings amount).

The government confirmed its intent that the proposals will only apply on a "go-forward basis". No draft legislation has yet been released on the corporate reinvestment proposals, and it is anticipated that draft legislation will be released concurrent with the March 2018 federal budget.

What does "go-forward" application mean, and other uncertainties

Both the original proposal documents and the October 2017 backgrounder documents outline the government's intent that the measures should only apply on a "go-forward" basis. Due to the lack of guidance in the backgrounder documents, and the absence of draft legislation, Canadian taxpayers face many questions as to how the measures may impact their businesses, including:

- Will the proposed measures apply equally to public companies and foreign-controlled private companies? The measures as proposed would only apply to Canadian-controlled private corporations.

- For what specific tax year will these measures apply, and will taxpayers be given time to rearrange their affairs? The original proposal documents outlined that a reasonable time to reorganize affairs would be permitted, but such commentary was not reiterated in the October 2017 releases.
- Will the $50,000 annual threshhold be available to each corporation within a group, or will some mechanism require "sharing" the passive income limit? If applicable, what will the sharing mechanism be?
- What is being grandfathered, i.e., what will the rule reference (actual investment assets or accumulated retained earnings)? For example, a corporation that finances the acquisition of investments with borrowed money may own significant assets on the future implementation date, but have limited retained earnings. If future business-taxed earnings are used to pay down debt that was, in turn, used to acquire passive investments prior to the implementation date, will such an arrangement be grandfathered? Alternatively, a corporation may have significant business-taxed retained earnings on the future implementation date, but its corporate assets are tied-up in working capital; if future investment assets are purchased on the monetization of existing retained earnings, as the working capital becomes liquid, will such investments be grandfathered?
- For how long will grandfathering be permitted? Will a forced draw-down of the grandfathered investment be required as the corporation distributes dividends in the future?
- What will be considered a "passive investment", particularly when investments are made in other private corporations, or considering the corporate ownership of permanent life insurance?
- Will investments in other active companies be excluded from the rules? The fall economic statement confirmed that the government will consider whether, in certain circumstances, the proposed passive investment rules should exclude capital gains realized on the sale of shares of a corporation engaged in an active business. No further details were provided.

Next steps and consultations with "venture capital and angel investment"

The tax measures on corporate reinvestment in passive assets are meant to eliminate the advantage of corporations (as opposed to individuals) initially having higher funds available for investment. It's unclear what long-term economic impact will arise from these measures, particularly on the capital and real estate markets, as well as the incentives available for investing in Canadian businesses.

Due to the potentially harmful impact of disincentivizing venture or angel investment in Canadian businesses (although an investment in an "active" business, it may be considered passive when viewed from another private corporation's perspective), the government

announced it "will ensure that incentives are maintained so venture capital and angel investors can continue to invest in the next generation of Canadian innovation. The Government will work with the venture capital and angel investment sectors to identify how this can be best achieved."

No details or specific measures were announced on what incentives will be provided or when they would be available.

Small business taxation: proposal to decrease AND increase taxes

Proposal to decrease corporate taxes

In response to the submissions, the government has proposed to reduce the federal small business rate rate from its current 10.5%, to 10.0% on 1 January 2018, and to 9.0% on 1 January 2019. This reduction is essentially a reinstatement of the gradual rate reduction to 9% that had been enacted in 2015 by the previous government, but was halted by the current government in its 2016 budget.

A calendar period business that earns and corporately retains $500,000 of active business earnings eligible for the small business deduction may realize maximum tax savings of $2,500 and $7,500, respectively, in 2018 and 2019+.

It remains to be seen whether the provinces will adjust their small business tax rates in response to the federal rate reduction. It is possible that provincial tax rates may increase to "soak-up" the federal reduction.

Proposal to increase personal taxes

In connection with the proposal to decrease small business tax rates, the taxation of non-eligible dividends will be adjusted (increased) in order to maintain the integration of corporate and personal taxes. For distributions to individual shareholders in the form of dividends on go-forward small business earnings, it is anticipated that no net-savings will result if the system of integration is maintained; additionally, the actual net tax result of the measures will depend on provincial tax rate adjustments yet to be announced.

However, a proposal to increase non-eligible dividend tax rates would presumably increase taxes applicable to distributions of previously taxed small business earnings (when small business tax rates were higher), as well as distributions of passive investment income.

Certain corporations and businesses may find the tax increase associated with non-eligible dividends could exceed the savings associated with the reduction in small business tax rates.

Income sprinkling: proceeding with proposal to increase taxes

Original proposals to increase tax

The 18 July 2017 proposals outlined draft legislation with the intention of broadening the base of individuals affected and increasing the types of income subject to rules already in place commonly known as "the kiddie tax". The pages of complex legislation attempted to introduce a tax at the highest marginal rate on several types of income paid to adult individuals, unless the amounts were determined to be reasonable in the circumstances. In addition, the draft legislation also introduced further complexity by proposing to recharacterize some capital gains into non-eligible dividends.

If implemented, the draft proposals could result in nearly doubling the tax rate on death, or on legitimate business transfers to related parties, if a shareholder became subject to the expanded proposals. Further, there are have been numerous examples provided during the consultation process that outline concerns of additional double taxation on inter-generational family business transitions as a result of the income sprinkling rules.

Concerns with the complexity of the legislation as drafted were raised during the consultation process. Further, it has been reported by the government that the annual tax revenue from implementing the proposals would be a relatively small amount. Many submissions to the proposals have questioned whether the tax generated from these proposals is significant enough to warrant such complexity and uncertainty.

Updated proposals to increase tax on income sprinkling

In response to the consultation period and submissions, the government confirmed "the proposed measures related to income sprinkling will be simplified with the aim of providing greater certainty for family members who contribute to a family business, including a family farm." No further details were provided.

What does "simplify" mean, and other uncertainties

It is certainly a step in the right direction that the government has recognized that some simplification and clarification was required to the draft legislation as presented on 18 July 2017. Based on the information provided in the recent announcements, it's difficult to predict in what manner the rules will be simplified. The following questions on the income sprinkling proposals remain:

- What parts of the legislation will be simplified? The previous rules had the potential to apply to all members of a family, even if all were involved in the business. Will the number of individuals caught by the new rules be reduced? Will certain businesses be exempt from the rules? Will further guidance be provided on what amounts are reasonable?

- When will simplified draft legislation be released and effective? Previous draft legislation was to be effective on 1 January 2018. Will revised legislation be available prior to this effective date? Will the effective date be changed?

- The recent announcement referred to certainty for family members that "contribute" to a family business. What is meant by "contribute"? There are many levels of contribution by family members in a closely held business. Often, one or more members may not be at the office for 40 hours a week but certainly are involved in most of the major business decisions and the risks of the business.

- Will the conversion of capital gains to ordinary dividends remain in the simplified legislation? Without such certainty, taxpayers may have a difficult time determining how a business transaction should be reported in their tax return.

Lifetime Capital Gains Exemption (LCGE): some relief

The 18 July 2017 proposals introduced draft legislation to limit the ability for certain direct and indirect shareholders from claiming the LCGE. Generally, the proposals were intended to limit the exemption on shares held in family trusts, where shares were held by a minor, or where the capital gain would otherwise be subject to the new income sprinkling provisions. The legislation was to be effective in 2018, with some elective relief provisions also applicable for 2018.

In part of the recent tax announcements, the government has indicated that it will not go ahead with the proposals to restrict access to the LCGE.

It is not clear from the announcements whether business owners will still need to be concerned with the conversion of capital gains to dividends (as discussed in the income sprinkling section) as a restricting factor on claiming the LCGE. Further, the 18 July 2017 draft legislation contained some elective provisions that would shorten the time period necessary to hold a qualifying asset (from 24 to 12 months) such that the LCGE could be claimed in 2018. Some business owners may have contemplated or planned for a transaction in 2018 using this shorter holding period test. This type of planning may now not be available. A review of the new legislation will be required to determine exactly what portions of the 18 July 2017 proposals are being removed.

Converting capital gains into dividends: some relief

The 18 July 2017 proposals introduced draft legislation to convert what otherwise would be a capital gain into a taxable dividend. In addition, a new rule was added to limit a corporation's addition to the Capital Dividend Account (permitting the distribution of the tax-free portion of a capital gain) in certain circumstances. The provisions were intended to curtail planning that effectively removed corporate surplus at a tax rate lower than the dividend tax rate. The new provisions were broadly drafted, possibly retroactive and increased taxes for business owners

transferring their business to other related family members during life or at death, compared to an arm's length sale.

Submissions made during the consultation period pointed out significant examples where the new provisions resulted in negative or unintended consequences for the sale or transfer of a private business. Those examples included transfers on death or simply selling the business at retirement.

The government has announced that it does not intend to pursue the draft legislation with respect to converting capital gain into dividends, and specifically referenced in the fall economic statement it will not proceed with the proposed 18 July 2017 effective date in respect of these proposals. Given the difficulty the draft legislation would have presented on estate planning and sales transactions, the announcement is good news for business owners.

It is understood that the concept of surplus stripping is an area of focus for the government. The fall economic statement confirmed that "[i]n the coming year, the Government will continue its outreach to farmers, fishers and other business owners to develop proposals to better accommodate intergenerational transfers of businesses while protecting the fairness of the tax system".

It is not clear from the announcements if or when new legislation will be released to focus on the transactions the legislation intended to target. Given that the current draft legislation could have resulted in a retroactive change, uncertainty remains for transactions that might be in process if new legislation is released on a retroactive basis.

Conclusion: are private business owners better off?

In the current environment of private company tax reform, many uncertainties still exist and many questions are yet to be answered. Overall, based on what we currently know, it's likely that many private business owners may pay more tax than they would have prior to the 18 July 2017 announcements.

Some quick takeaways would be as follows:

- Passive investment income proposals – still proceeding, draft legislation expected March 2018
- Small business tax rate reduction – to be offset with increase to personal tax on dividends; for many taxpayers there will be an overall integrated tax increase
- Income sprinking – simplified version moving ahead; consider option to sprinkle as much as possible in 2017; however, caution that revised legislation is being drafted with an unknown implementation date
- LCGE – 18 July 2017 proposal abandoned

- Conversion of capital gains to dividends – 18 July 2017 proposals abandoned; watch for new proposals
- As we continue to navigate a changing and more complex environment for private businesses, it will be important for owners to be aware of pending changes and what the next steps should be. All owners should be encouraged to talk to their tax advisors for advice on how these ever-changing proposals may impact their business.

Learn more

To learn more about how these changes may impact your private business, contact your local Private Client Services professional at ey.com.ca/private.

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