On July 18th, 2017, the federal Department of Finance released draft legislation, explanatory notes and a consultation paper on the system of taxation for private corporations. The consultation paper is open to a 75-day public consultation period, ending October 2nd, 2017.

The following is a high-level summary of the proposed changes:

Income Sprinkling Restrictions

Under the current tax system corporations have the ability to pay discretionary dividends to adult shareholders (age 18 and older) regardless of their level of involvement in the operations. This has allowed corporations to split corporate income with adult family members to save significant tax, assuming the adult family members are in low tax brackets. Also, under the current tax system if a minor child (under the age of 18) receives a dividend from a family owned corporation the minor child will pay tax at the highest marginal tax rate – this is referred to as “kiddie tax”.

The proposed system will extend the “kiddie tax” on split income earned by adult family members using a new “reasonableness” test that considers the degree to which a family member contributed labour or capital to the corporation.

If the individual is 25 or over, the reasonable amount will be based on what an arm’s length party would have agreed to pay considering labour contributions, capital contributions and previous remuneration.

If the individual is between 18 and 24, a reasonable amount would be restricted to an amount for labour only if the person is actively engaged in the business on a regular and continuous basis. They would also be limited to a prescribed maximum return on assets contributed. For example, if a child contributed $100 to a corporation to purchase shares, then the maximum allowable dividend would be limited to 1% of $100.

The new proposals will become effective for the 2018 calendar tax year of individuals. The end result would be higher rates of tax payable on split income than are currently being paid and current income splitting strategies would no longer be valuable. We will be evaluating what strategies should be implemented prior to end of 2017 to mitigate exposure to this new proposal.

Taxation of Corporate Reinvestment

Under the current system, corporations are taxed at lower rates than individuals on business earnings. This allows for a deferral of tax in the corporation of up to 38%. Once funds are fully distributed from a corporation, there is no tax difference between earning funds in a corporation or personally. The government perceives that the build-up of a passive investment portfolio through the deferral of tax to be unfair when compared to individuals that cannot defer the personal tax on their income.

Below is an illustrative example of the current taxation on initial business earnings of $100,000 eligible for the small business deduction and then distributed as dividends to the shareholder (no change under proposed system):

	Personal	**Corporate**
Business income	$100,000	$100,000
Corporate tax		(15,000)
		$85,000
Personal tax	(50,000)	(35,000)
After-tax funds	**$50,000**	**$50,000**

To illustrate the impact of the proposed system, assume that the after-tax income of the corporation of $85,000 and of the individual of $50,000 is invested in passive assets that have a 10% rate of return.

	Personal	**Corporate**
Passive Income	$5,000	$8,500
Corporate tax		(4,250)
		4,250
Dividend refund		N/A
Taxable dividend		4,250
Personal tax	(2,500)	(1,750)
After-tax cash	**$2,500**	**$2,500**
Effective tax rate	50.00%	71.00%

The proposed system would remove the refundable component of investment tax (i.e., the dividend refund) and result in a double-tax on distributed earnings. There will also be no more tax-free distributions from the Capital Dividend Account, which is the accumulation of the 50% of capital gains that are non-taxable.

The proposal would allow for the "grandfathering" of existing investments in corporations but no guidance on the details or how this will be implemented were provided. It was also noted in the proposal that "time will be provided before any such proposal becomes effective".

This proposal is subject to public input and draft legislation was not released. There is still a great deal of uncertainty on how this proposal will be implemented and the effectiveness of any potential tax planning opportunities will depend on the final form that this proposal takes, which is unknown at this time.

Lifetime Capital Gains Exemption (LCGE) Restrictions

Under the current tax system all individuals are entitled to a capital gains exemption of up to $835,000 on certain small business shares, as well as qualified farm and fishing properties (on which the limit can go up to $1,000,000). There are also no restrictions on the ability to claim the LCGE for minor children or spouses and they do not need to own the shares directly in the corporation that is being sold. Lastly, an indirect ownership and allocation of a taxable capital gain from a family trust is currently eligible for the LCGE.

The proposed system will include the following changes to restrict access to the LCGE:

- The LCGE will not be available on gains accruing in years that an individual was under 18.
- Limits will be imposed on the ability of spouses or other family members to claim the LCGE where they are not active shareholders or they did not contribute a large amount of capital to the business.
- The LCGE will no longer be available on capital gains incurred by a family trust and allocated to beneficiaries.

These changes will be applicable to sales after 2017 but the proposal does outline transitional rules whereby an election can be filed to trigger gains in 2018 and increase the tax cost of the property. This election will need to be filed before April 30, 2019.

We will be reviewing existing tax planning arrangements to determine if the use of these transitional rules would be beneficial. We will also be determining if the continued use of trusts within existing tax planning arrangements is advisable under the proposed rules.

Conversion of Capital Gains into Dividends

Under the current tax system, the personal tax rate on capital gains is much less than the personal tax rate on dividend income. As such, there are tax planning strategies allowable under the current tax system that convert income that would be taxed as a dividend into capital gains.

The proposed system would amend a section in the Income Tax Act that would disallow these tax planning strategies that are currently being used. This proposal will have a significant impact on the tax on death to private corporation owners. It could potentially result in 2.5 times the current rate of tax for these individuals. This would be effective for transactions entered into on or after July 18, 2017.

Many of our clients would be impacted by these changes and, while it is early in the process, we want to assure you that we are actively engaged in developing strategies aimed at protecting our small business clients from potentially damaging implications of the proposals as they are now proposed.

We will endeavor to share any additional information as it becomes available.