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Private Company Tax Proposals - An Update

It has been a busy week for Finance Minister Bill Morneau. He has made four separate announcements in respect to the proposals that were initially released on July 18th. Included in those announcements was a 1.5% reduction to the small business tax rate.

Our summary and comments on the three tax planning strategies that were targeted and their current status are below.

The Proposals and Our Comments

1. Income splitting prevention

This portion of the proposal has two aspects: limitations on income sprinkling and measures to limit the multiplication of the lifetime capital gains exemption ("LCGE").

The Minister has announced that the Government will not be moving forward with proposed measures to limit access to the LCGE.

The Minister has announced the measures on income sprinkling are intended to proceed, albeit in a simplified form.

The criticism on the income splitting provisions has been largely based on the complexity of the provisions, the uncertainty in respect to determining what amounts would be considered 'reasonable', and finally the rules applying in situations where it would be 'unfair'.

The Government has stated that they will release revised draft legislative proposals later this fall which will be effective for 2018 and subsequent taxation years. It remains to be seen if the revised legislation will eliminate the concerns identified by the tax community. An update will follow after the release of the draft legislation.

2. Conversion of dividend income to capital gains

The Minister has indicated that the Government will not be moving forward with the measures relating to the conversion of income into capital gains.

It is unclear if further action will be taken by the Government to stem the conversion of income that some taxpayers have undertaken. One solution could be an increase in the capital gains inclusion rate. This is something that some have predicted in the past, but has not materialized to date.

3. Holding passive investments in private companies

The Minister has outlined the Government's intention to move forward with measures to limit the tax deferral opportunities related to passive investments.

In further developing these measures, the Government has stated:

- All past investments and the income earned from those investments will be protected;
- Businesses can continue to save for contingencies or future investments in growth;
- A $50,000 threshold on passive income in a year (equivalent to $1 million in savings, based on a nominal 5-per-cent rate of return) – an amount that is exceeded by only 3 per cent of corporations - is available to provide more flexibility for business owners to hold savings for multiple purposes, including savings that can later be used for personal benefits such as sick-leave, maternity or parental leave, or retirement;
- The measures will only have implications at the time when money is paid out to shareholders; and
- Incentives are in place so that Canada's venture capital and angel investors can continue to invest in the next generation of Canadian innovation.

The Government has indicated that it will release draft legislation as part of Budget 2018. Any proposals will apply on a go-forward basis.

Much is uncertain in respect to how the final legislation will apply and how transitional rules will work to protect current investments. Some of the recurring comments made in the many submissions in respect to this part of the July 18th proposals are as follows:

- The Passive Income Proposals should not be enacted. The current taxation of passive income is already punitive.
- The complexity of the proposals do not justify the policy concerns. The burden on business to comply would be significant.
- Complicated transitional rules would be required to ensure accumulated assets are not subject to the new regime.
- The tax changes would lead to a change of behaviour, including the flight of capital from Canada.
- The change in behaviour could lead to other unforeseen and undesirable consequences.
- This is a fundamental tax policy change and should only be considered in conjunction with an overall review of the tax system.
- There are insufficient details at the current time to provide adequate consultation. 75 days was not enough.

It remains to be seen to what extent the Government will address the concerns and whether it will open this up for further consultation. Certainly, the debate on the passive income proposals will continue and there will be corresponding pressure on the government to adjust the final form of the legislation.

Final Thoughts

While the removal of some of the proposals is welcome news, the decision to move ahead with the passive income rules is concerning. Overall, the way in which the past three months have transpired is disconcerting to say the least. Has this government lost the trust of private company owners and their advisors? That answer may come in 2019 when we have our next federal election. For now, uncertainty will continue for private company owners.

We can help

For a more in-depth discussion of how these proposed tax measures may affect your private business and determining what planning may be available, please contact your advisor or tax accountant.