Dramatic Tax Changes that will Have a Negative Impact on All Small Business Owners

July 18, 2017

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After reading this document, please call us to discuss the specific implications relating to your business.

On July 18, 2017 the Minister of Finance Bill Morneau released a discussion paper that includes draft legislation and proposals that will have a significant impact on small and mid-size businesses.

The government is concerned that private corporations to gain tax advantages are using the following tax practices:

Income Sprinkling

The government believes that private corporations allow the primary business owner to sprinkle income to family members that have lower personal tax rates, or not be taxable at all.

The proposal released targets wages and dividends paid to family members that are related to the primary business owner. The proposal introduces a reasonableness test, to determine if the wage or dividend paid to a family member is reasonable. The reasonable test is stricter for family members that are 18 to 24 years old. The proposal indicates that reasonableness should consider factors such as the amount of labour and capital the individual had contributed, the risk assumed, and previous remuneration. **To the extent that the amount paid to the family member is not reasonable, the portion of the wages or dividends that was paid will be taxable at the top tax rate.**

These measures may impact existing tax planning strategies as it relates to wage payments and dividend sprinkling. **The proposed legislation will be effective for 2018 taxation years. Hence 2017 may be the last year to implement certain tax strategies.**

Multiplication of Lifetime Capital Gains Exemption

The government believes that the ability to access multiple Lifetime Capital Gains Exemption (LCGE) through a family trust, i.e. sprinkling capital gains to family members is a tax loophole. **Effective for 2018 and subsequent tax years it is proposed that the LCGE not be permitted for individuals that are under 18 years of age and, the LCGE will not be available for any gains that have accrued on shares of a private corporation which have been owned by a family trust.** The proposals allow transition rules that should allow those affected by these changes to elect to realize on a day in 2018 a capital gain on eligible property.

Converting Income into Capital Gains

The government feels that the current tax system allows owners of a private corporation to convert what would be regular income into capital gains. The government feels that tax planning under the current rules could allow regular income to be converted so that the business owner could realize capital gains, resulting in significantly lower taxes. **The proposals address the current tax rules with the aim to eliminate this tax planning.**

Passive Investments in Private Corporations

The proposals include various alternative tax changes to address the ability of corporations taking advantage of lower corporate tax rates compared to personal tax rates. The government has an issue with allowing a private corporation to retain earnings that the business does not use to help it grow, but instead uses to invest in passive investments (passive investments include mutual funds, a portfolio of public company shares, investment certificates, etc.). The issue that the government has with this is that the money invested by the private corporation is being done to shield the money from higher personal tax rates (i.e. there is a tax benefit by deferring payment of the money to the business owner).

The alternatives being considered by the government and noted in the proposal include changes to the current refundable tax, the capital gain account calculation, and the General Rate Income Pool (GRIP) systems.

The current refundable tax system under all the alternatives noted by the government would be changed. The government believes that the current system allows a tax advantage and that this tax advantage could be eliminated if the tax would no longer be refundable. The current system taxes passive income at a rate of approximately 50% which approximately 30% is refundable when the corporation pays a taxable dividend to the shareholder. The government feels that the current system allows private corporation owners the ability to gain a tax benefit by controlling the timing of when taxable dividends are paid, i.e. the business owner(s) could defer taking dividend income to a year where their personal income is lower thus gaining a tax advantage. **To discourage this behaviour the government is considering eliminating the 30% refund of taxes. Thus passive income will be taxed at 50% and the removal of the income via dividend will attract additional personal taxes.**

In addition, the government does not like the ability of a private corporation to earn regular income subject to taxes at the small business rate and then retain the earnings to invest in passive investments. The reason for this is that in Ontario the small business tax rate is 15%, which would leave 85% of the earnings that could be reinvested in the business to grow it however, some business owners use this money to invest in passive investments. The government would rather see that the 85% of earnings that are not required by the business be paid out to the business owner and have it subject to personal taxes (which in Ontario could be subject to personal tax rates as high as 51%) and then the net after tax cash could be invested personally by the business owner. Therefore, the government is considering alternatives to the current system and one alternative being considered is to allow a corporation to file an election to have all of the income generated be taxed at passive income tax rates. If an election is filed then the refundable taxes could be refunded later when a taxable dividend is paid to the shareholders. The government is considering this legislation to eliminate the tax benefit between the low rate of corporate tax (i.e. 15% in Ontario) and the passive tax rate (50%). Under this alternative, all income would be subject to the passive tax rate, which should generate the same tax result as if the earnings are paid out to the business owner.

Also, the current system allows corporations that have realized capital gains to be taxed on 50% of the gain and the other non-taxable portion (50%) be treated as an addition to the capital gains account which could allow for a tax-free dividend to be paid. Under the current system, additions to the capital gains account may be paid out as a tax-free capital dividend to the shareholder(s). In the proposal the government has noted that the current system of having realized capital gains earned on passive investments allowed as an addition to the capital gains account does not provide neutrality. **The proposals being considered look to limit the ability to add the non-taxable portion of any capital gains realized on passive investments to the capital gains account.**

Another component of the current tax system that the government is considering changing is the calculation of the General Rate Income Pool (GRIP). A corporation that has a GRIP balance can pay out eligible dividends to the shareholders, which are subject to lower personal tax rates than the payment of non-eligible dividends. Under the current system, GRIP is generated two ways. The first way is when a small business corporation has income that is subject to the general corporate tax rate, a portion of this income is added to GRIP. The other way GRIP is generated is when a small business corporation receives an eligible dividend. Once a small business corporation has a GRIP balance it has the ability to designate and pay eligible dividends equal to the GRIP balance. The proposals that the government has issued consider eliminating the ability of generating GRIP when a small business corporation receives eligible dividends from passive investments.

It is clear under all the options proposed by the government relating to passive income that the effective tax rates are increasing significantly and significant sections of The Tax Act will be amended to accommodate this objective.

Timing

Legislation relating to the Converting of Income to Capital Gains has been drafted and when passed into law will be effective back to July 18, 2017. Legislation regarding dividend sprinkling and payment of wages (income splitting) has been drafted and when passed **will be effective for 2018 tax years.** Passive income legislation has not been drafted but will likely be enacted in the fall and will **likely be effective for 2018 tax years.**

The proposed changes can impact future tax planning, use of family trusts, estate planning and could also have a significantly negative impact on existing retirement plans.

Feedback

The government has requested comments and feedback on the proposals, which will be accepted up to October 2, 2017. The comments and feedback may be sent to fin.consultation.fin@canada.ca.

Vine and Partners LLP is reviewing the proposals and determining how these proposals will affect our clients. As more information becomes available, we will be contacting our clients.

If you have any questions on this material or any other tax matters please feel free to contact Vine and Partners LLP.