2017 FEDERAL ANNOUNCEMENT
CHANGES TO SMALL BUSINESS TAXATION

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Today, on July 18, 2017, Finance Minister Bill Morneau released the much-anticipated consultation paper (the "Paper") regarding taxation of private corporations and their shareholders. In the Minister's opinion, owners of private corporations have enjoyed unfair tax advantages and the draft legislation included with the Paper represents the Liberal Government's proposed changes to eliminate those perceived advantages. These changes are some of the most significant that we have seen in the last 20 years and, if implemented as proposed, will negatively impact almost every incorporated private business in Canada. That being said, please bear in mind that these proposals are subject to a consultation period ending on October 2, 2017 and may not be enacted into law as proposed since changes are often made as a result of public consultations and subsequent debate in Parliament.

To say that these proposed rules are complex and difficult to administer would be a massive understatement. In our opinion, they make the recent changes regarding specified corporate income and specified partnership income look simple by comparison. And those rules were considered by many to be far too complex for ordinary taxpayers to self-assess correctly. Apparently, that was just a sign of much more to come…

The proposed changes can be broken down into three areas which we will detail in the commentary that follows:

1. Income sprinkling
2. Holding passive investments inside a private corporation
3. Converting income into capital gains

Income Sprinkling

There are rules currently in place to deal with certain kinds of income received from a business by non-arm's length persons. One of those rules involves certain income ("split income") received by minor persons which is taxed at the highest marginal tax rate. The Paper proposes to expand those rules to capture those same kinds of income received by adult persons, subject to a reasonableness test. Some types of income to which this would apply are as follows:

- Dividends from private corporations
- Income from a partnership or trust that is derived from a business, profession or rental activity of a related person

Note that salary and wages are not included as these are subject to a reasonableness test for deduction in the hands of the payor. Any unreasonable amounts paid can result in double taxation under the current rules. The Paper does not propose to change this.

The current rules do not impose a reasonableness test because all such amounts paid to minors are deemed to be split income. The Paper proposes a reasonableness test for amounts paid to adults based on the following factors

- Labour contributions – Those aged 18-24 must be actively engaged on a regular, continuous and substantial basis in the business activities, otherwise they must simply be involved in the activities of the business
- Capital contributions – Those aged 18-24 can only receive a prescribed rate of return on capital invested, otherwise they must have contributed assets or assumed risk in support of the business

- Previous returns/remuneration – All previous amounts paid to the individual in respect of the business (including dividends and salary)

To the extent that the payments are not reasonable, they would be considered to be split income and would be taxed at the highest marginal tax rate. This would result in a significant increase in the uncertainty associated with the taxation of such amounts received by individuals who are active in the related business because what the taxpayer thinks is reasonable may differ from what the Canada Revenue Agency believes to be reasonable. This would require documentation of services provided by individuals who receive these types of income and are not remunerated entirely by way of a reasonable salary.

The Paper proposes that adults would be subject to these new rules where they have a related individual resident in Canada who carries on a business over which that person exerts influence (a "connected individual"). The degree of influence could result from various factors:

- Strategic influence – connected individual (or related group) controls the business
- Equity influence – connected individual owns 10% or more of equity value
- Earnings influence – connected individual provides the services that generate the business profits
- Investment influence – 10% or more of corporation's property is derived from property acquired from the connected individual, or another corporation of which the person is a connected individual

The Paper proposes to expand the types of income that would be considered to be split income to include the following:

- Income from certain debt obligations issued by private corporations
- Gains on dispositions after 2017 of certain kinds of property, income from which would be split income (see below for additional commentary on this point)
- Income earned by individuals aged 0-24 on assets resulting from the receipt of split income (i.e. compound income) or income taxed in the hands of someone else under the attribution rules

The Paper proposes that an anti-avoidance rule be introduced that would prevent certain types of planning implemented to circumvent the existing split income rules.

1. Deny the LCGE in respect of any gain that accrued prior to the individual turning 18 years of age
2. Deny the LCGE where the gain is included in the individual's income as split income (see commentary above)
3. Deny the LCGE in respect of gains that have accrued while the property is held by a trust (see exceptions below)

The LCGE is a significant tax benefit in that up to $835,714 (in 2017) in capital gains realized on qualifying dispositions during an individual's lifetime can be exempt from taxation. The Paper proposes to limit access to the LCGE in the above-noted circumstances for dispositions occurring after 2017. The Paper also proposes an elective disposition at some time in 2018 for proceeds of any amount up to fair market value in order to utilize any LCGE that may be available under the current rules. For purposes of this election only, the holding period test of 24 months under the current rules will be relaxed to 12 months.

The Paper provides exceptions to these new rules where property is held by a trust in the following circumstances:

- Property held by a joint partner or common-law partner trust or an alter ego trust where the principal beneficiary is the individual claiming the LCGE
- Property held by certain employee share ownership trusts where the individual beneficiary entitled to the capital gain is an arm's length employee of the employer sponsor to the arrangement

Family trusts are notably absent from the exceptions above so those business owners who currently utilize a family trust to hold shares of the private company that carries on the business may need to take steps to retain access to the LCGE.

Finally, the Paper proposes some additional reporting requirements for trusts and partnerships commencing in 2018.

Holding Passive Investments Inside A Private Corporation
The Paper discusses the Government's concern with the ability of after-tax profits from an active business to be retained in a corporation and invested in passive investments rather than being reinvested in the active business, resulting in a continuing tax deferral that would not be available to an unincorporated business owner. The Paper proposes three changes to the taxation of investment income inside a private corporation as follows:

1. Elimination of the refundable portion of tax paid by a private corporation on its investment income derived from property acquired with after-tax profits from an active business
2. Elimination of the addition to the capital dividend account (CDA) to the private corporation in respect of capital gains realized on the disposition of property acquired with after-tax profits from an active business
3. Treatment of dividends received from portfolio investments as non-eligible dividends where those investments are property acquired with after-tax profits from an active business

The net effect of each of these changes would be to increase the effective tax rate paid by a shareholder of a private corporation on the investment income derived from investments made with after-tax profits from an active business. This would bring an end to the integration of this type of income as has existed for decades since the effective tax rate could now be as high as 70% in some cases! The Paper does not propose to eliminate the tax deferral enjoyed by the shareholder on the original profit from the active business, but would penalize the shareholder for investing those after-tax profits in anything other than an active business. As a result, shareholders would need to value the tax deferral and decide whether or not that value exceeds the additional tax cost on the investment income. In many cases, this would require making certain assumptions about when the funds would be required by the shareholder for personal use, which may not be an easy task.

The Paper proposes two possible methods to apportion investment income in a manner that attempts to achieve tax neutrality for the shareholder:

1. Apportionment method:
   - Private corporations would keep three separate pools for income taxed at the small business tax rate, income taxed at the general income tax rate, and income arising from investments that were contributed by the shareholder
   - Investment income for a year would be apportioned and added to each pool based on the pool balances at the end of the previous year
   - Dividends would be designated to be paid out of each pool, either as ordinary dividends (small business tax rate), eligible dividends (general tax rate), or tax-free capital dividends (shareholder contributions)

2. Elective method:

- Default treatment for distributions would be taxation as non-eligible dividends
- Private corporation could elect to treat all distributions as eligible dividends but would have to forego access to the small business deduction

The Paper proposes a further potential election for private corporations that do not carry on an active business and were financed entirely by shareholder contributions where they can be taxed in a manner consistent with the current refundable tax regime. Where the election is made, and to the extent that the corporation receives amounts from another corporation (e.g. dividends), there will be an additional refundable tax levied on those dividends to ensure that a tax deferral is not enjoyed.

Converting Income Into Capital Gains

The Paper proposes to include non-arm's length taxable transactions in the list of items that cannot be considered to be "hard basis" eligible to be removed from a corporation by way of a tax-free extraction of surplus. Currently, any transaction that increases the tax cost (i.e. ACB) of shares of a corporation in a transaction that does not utilize the LCGE of a related person, and that does not represent pre-1972 value (i.e. V-Day value), can be used to extract surplus from a corporation without additional tax. The Paper proposes to exclude ACB created by way of a transaction involving a non-arm's length person. The Paper acknowledges that this may result in double taxation in that the same value could be taxed as a capital gain and again as a dividend.

Finally, the Paper sought input from the public on whether, and how, it would be possible to accommodate inter-generational business transfers allowing business owners to utilize the LCGE in the same manner that they could on an arm's length sale. Under the current rules, a shareholder cannot utilize the LCGE (or that of a related person) to extract corporate surplus on a sale of shares, but the Government seems willing to consider allowing this in circumstances where a genuine inter generational transfer of a business exists. It is not surprising that this was the final paragraph in the Paper. Always end on a positive note, right?

Summary

While the proposals made in the Paper are for consultation only, the Liberal Government is articulating its intentions with respect to taxation of private corporations and their shareholders. They clearly intend to bring an end to many of the tax benefits that have been enjoyed by business owners for many years. The public consultation process will play out over the next couple of months and hopefully we will see a softening of some of the proposals that are the most onerous by the time final legislation is passed.

These proposed changes are extremely complex, and we expect that they would have a very significant impact on our clients, so we encourage you to reach out to your Johnsen Archer advisor as soon as possible and discuss how these proposals may impact your personal circumstances.

Thank you for your business!