Government announces changes for private companies in response to recent tax proposals

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The government announced a number of changes in response to the public backlash received since they released their tax proposals affecting private companies on July 18, 2017. The government received over 21,000 submissions during the 75-day consultation period which ended on October 2, 2017—Grant Thornton participated in this process, you can read our submission to the Department of Finance **here**.

Based on what it heard from Canadians, the government stated that this week it will outline a new approach to better target the relatively small number of high-income individuals who it believes receive the biggest advantage from the existing tax rules.

In the meantime, the government announced that it intends to make the following changes:

Small business tax rate reduction

The federal small business tax rate will be reduced from 10.5% to 10% effective January 1, 2018, and will be further reduced to 9% effective January 1, 2019. This rate will apply to the first $500,000 of active business income earned by a Canadian-controlled private corporation.

Although this was not part of the July 18th proposals, the previous government had legislated a gradual reduction in the rate from 11% to 9%. However, in the 2016 federal budget the current government froze the small business tax rate at 10.5%.

This change, when fully implemented, is expected to provide a tax savings of $7,500 for eligible small businesses.

Income sprinkling

The government stated that it intends to move forward with the measures to limit income sprinkling using private corporations, while ensuring that the rules will not impact businesses to the extent there are clear and meaningful contributions by spouses, children and other family members. Specifically, the government will introduce reasonableness tests for adult family members aged 18 to 24 years old, as well as those 25 years and older. These adults will be asked to demonstrate their contribution to the business based on four basic principles:

- labour contributions;
- capital or equity contributions to the business;
- taking on financial risks of the business, such as co-signing a loan or other debt; and/or
- past contributions in respect to previous labour, capital or risks.

To address concerns over the complexity and potential unintended consequences, the government intends to "simplify" the proposed measures with the aim of providing greater certainty for family members that contribute to a family business.

Revised draft legislative proposals reflecting these changes to the income sprinkling proposals, which will be effective beginning January 1, 2018, is expected to be released later this fall.

Lifetime capital gains exemption

The government also announced that it will not proceed with the measures that address the multiplication of the Lifetime Capital Gains Exemption (LCGE). Presumably this means that minors and family trusts can still be used to gain access to the LCGE, however, it is not clear whether the LCGE will be subject to a reasonableness test given the government intends to proceed with the income sprinkling measures.

Concerns had been expressed that estate planning and intergenerational transfer of farms and small businesses could be adversely affected by this measure. While we welcome the withdrawal of this measure, we will need to wait until further details are released to understand how the withdrawal of this measure will address these concerns.

Passive income

The government stated that it intends to move forward with the measures to limit the deferral opportunities related to passive investments while ensuring the following:

- the measures will only apply on a go-forward basis i.e., that investments already made by private corporations' owners, including the future income earned from such investments, are protected;
- the ability of businesses to save the funds they need or contingencies or future investments, such as the purchase of equipment, hiring and training of staff or business expansion will be protected;
- a passive income threshold of $50,000 per year 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, parental leave, or retirement;

- incentives are maintained so that Canada’s venture capital and angel investors can continue to invest in the next generation of Canadian innovation. The government is expected to work with the venture capital and angel investment sectors to identify how this can be best achieved.

The government intends to release draft legislation as part of Budget 2018. The government will continue to assess key design aspects and considerations as to whether, in certain circumstances, the new rules should exclude capital gains realized on the sale of shares of a corporation engaged in an active business.

The government has also stated that the proposed changes will not apply to income from AgriInvest, which is a self-managed producer-government savings account that allows producers to set aside money which can be used to recover from small income shortfalls, or to make investments to reduce on-farm risks. Currently, investment income in an AgriInvest account is treated as active business income and the government intends to maintain this approach.

Conversion of income to capital gains

Finally, the government stated that it intends to address the unintended consequences of its proposed measures on the conversion of income to capital gains which could impair estate planning and intergenerational transfers of farms and small businesses.

No further details have been provided so we will need to wait and see what the government plans are.

Further changes and announcements expected

These changes are a step in the right direction for the small and medium-sized business owners since these proposals were first announced in the summer. It is expected that the government will release revised draft legislative proposals affecting private corporations as part of the upcoming fall economic update, with the exception of the proposals related to passive income, which the government is expected to release draft legislation as part of Budget 2018.

We will keep you informed of the status of these proposals as they are announced. Please contact your Grant Thornton advisor with your questions and any concerns you may have.

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