YOUR GUIDE TO CORPORATE TAX CHANGES

GOVERNMENT OF CANADA

SARNIA LAMBTON Chamber OF COMMERCE

On July 18, Finance Canada launched a public consultation on its proposal to change how owners of private corporations are taxed. Consultations end on October 2, 2017.

Why is the Government changing corporate tax rules?

In Budget 2017, the federal government committed to reviewing corporate tax legislation. It is now proposing changes that focus on owners of private corporations because, according to the government, business owners are unfairly shifting personal income to the corporate tax base, which is taxed at a lower rate, and the government believes owners should be taxed at the same level as other individuals.

What changes are in store?

The government has proposed changes to the following:

1. **Income splitting using private corporations** – when a business owner transfers a portion of their income (through wages, dividends or capital gains) to a lower-income family member. This includes when a business owner transfers to a family member some of the capital gains earned when the business is sold.
2. **Holding a passive investment portfolio inside a private corporation** – when a business owner invests his or her corporate earnings (which have been taxed at the lower corporate rate) passively over a period of time within the corporation instead of a personal account. Examples of passive investments may include rent, interest and securities.
3. **Converting a private corporation's regular income into capital gains** – when corporate income (dividends or salary) is converted and paid out as capital gains, resulting in a significantly lower tax rate.

Why is the government concerned about these?

Income splitting	The government is concerned that business owners can unfairly reduce their taxable income by splitting it with family members who are not directly involved in the business.

Passive investing	The government is concerned that business owners have more money available to invest and will therefore realize more personal savings than non-business owners. Currently, the income earned by a business owner from passive investment is taxed at the same rate (50%) as the highest personal income tax rate. However, the source capital used for that investment was taxed at the corporate rate, which is lower than what individuals pay. There are also concerns that compared to the passive investment tools available to individuals (e.g. RRSPs and TFSAs) there are no limits on the amount that corporations can passively invest nor are corporations taxed as highly on dividends or capital gains.
Converting to capital gains	The government is concerned that business owners are taking advantage of loopholes in Section 84.1 of the Income Tax Act to convert corporate income to capital gains, which are taxed at a lower rate. Section 84.1 requires that when, for example, a person sells shares from her company to her brother's company (i.e. on a non-arm's length basis), the income she earned from that sale must be treated as a taxable dividend. It cannot be claimed as a capital gain. However, there are loopholes. For example, if her brother's company purchases the shares and then sells them to a third sibling's business for cash at fair market value, section 84.1 doesn't apply and the cash is taxed as a capital gain (i.e. at 50%). Business owners would like to see Section 84.1 changed so they are eligible for the lifetime capital gains exemption (LCGE) when they sell their shares to a corporation owned by their adult children. This would ease the transfer of a business from one generation to another. Currently, the LCGE is only used when shares are sold to an arm's length corporation.

What is the basis of the government's concerns?

The number of corporations in Canada increased by 50% between 2001 and 2014. The Department of Finance states that this is due to more industries being eligible to incorporate, employers relying more heavily on self-employed consultants and the process of incorporation becoming easier.

The question is, how has the greater number of corporations impacted our economy? Has it resulted in more or less federal tax revenues? The Federal

Government has not conducted (or shared publicly) an analysis that demonstrates the economic impact.

What changes are being considered?

Income splitting	• Extending the Tax on Split Income (TOSI) to all Canadian resident individuals, instead of just minors, who receive a split income. TOSI will not apply to income received by an individual as salary or wages. • In cases of income splitting with an adult, the TOSI would apply when the amount received is not deemed to be "reasonable". Reasonableness will depends on the adult's level of engagement in the business, the amount of capital the adult contributed to the company and previous amounts paid to the adult through the business. The onus is on the tax payer to prove "reasonableness". The draft legislation can be read here: http://www.fin.gc.ca/drleg-apl/2017/ita-lir-0717-l-eng.asp
Passive investing	The proposed legislation has not been posted yet, but in its consultation guide, Finance Canada proposes: • Removing the eligibility of tax refunds on passive investment income • Changing how passive income is categorized so that it is taxed differently at the individual level when distributed as dividends • Taxing the earnings that are used to fund a passive investment so that it is equal to personal income tax levels.
Converting to capital gains	The proposed legislation has not been posted yet, but in its consultation guide, Finance Canada suggests: • Closing the loopholes in section 84.1 of the Income Tax Act • Making business owners who sell their company to a family member eligible for the LCGE if it can be proven that the seller has no interest or involvement in the transferred corporation after its sale.

How will this impact…

Government revenues	The Ministry of Finance estimates an additional $250 million in revenue per year once income dividing is addressed. The revenue impacts have not been calculated for the other two measures.

	However, to realize $250 million in revenue, the government will have to tax over $1billion in salaries, audit and litigate hundreds of thousands of businesses.
Privately Incorporated Small Businesses	The Government says it is targeting high income individuals, but the proposed changes apply across the board to all incorporated businesses – big and small and across sectors. Small businesses (97% of all businesses in Canada) and family farms (25% of all farms) will be particularly impacted because spouses and children contribute significant hours, savings and assets. The proposed changes will: • Expose business owners to rates of 93% or even more (Minden Gross LLP) • Create a crushing compliance burden • Undermine retirement and succession planning • Burden estates with double or more taxation • Negatively distort the market for private business owners seeking to sell their business

Is tax integration fair to business owners?

"Tax integration" is when income earned by a business owner is taxed at roughly the same level as if it was earned by an employee.

The income of business owners and employees are not relative because a business owner's expenses are inherently different than an employee's. Owners are entirely responsible for their own pension, health benefits, parental leave and vacation pay. They use their personal assets as collateral and invest their own money to get started. During tough times, they are the last to be paid. They must constantly re-invest in their business as they may have staff, family and customers dependent on their success.

If business owners were taxed the same as regular working individuals earning the same level of income, there would be one less incentive to starting a business. Corporate tax advantages are used to reduce the risk and make it easier for the business to succeed. The foundation of economic growth is an entrepreneur taking a risk and building a successful business. When there is less risk, entrepreneurship flourishes and the economy grows.

Income dividing/sharing recognizes that the entire family shares in the risk of operating a business. For example, many middle-income business owners must choose between spending money on their business over family expenses.

TAKE ACTION Canadian residents have until October 2 to:	
Write to the Minister of Finance, the Honourable Bill Morneau at:	fin.consultation.fin@canada.ca
Write to your MP	Marilyn Gladu, MP Sarnia-Lambton Marilyn.Gladu@parl.gc.ca Bev Shipley, Lambton-Kent-Middlesex Bev.Shipley@parl.gc.ca
Email the Chamber:	speakup@slchamber.ca
Read the consultation release:	http://www.fin.gc.ca/n17/17-066-eng.asp

RESOURCES

Consultation Guide: Tax Planning Using Private Corporations
http://www.fin.gc.ca/activty/consult/tppc-pfsp-eng.pdf

Technical Briefing
http://www.fin.gc.ca/n17/data/tppc-pfsp-eng.pdf

Is a 93% Tax Rate Fair to Canadian Small Business Owners?

http://www.mindengross.com/resources/news-events/2017/08/02/is-a-93-tax-rate-fair-to-canadian-small-business-owners#ANN2

Draft Legislation on Income Splitting

http://www.fin.gc.ca/drleg-apl/2017/ita-lir-0717-l-eng.asp

Canadian Chamber of Commerce 5 Minutes for Business: Hammering Business – Finance Canada's New Crackdown

https://slchamber.ca/wp-content/uploads/2017/01/170822_5MinsforBiz.pdf