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TAXATION OF CANADIAN PRIVATE CORPORATIONS

November 30, 2017

On July 18, 2017 the Federal Government announced the most significant proposed changes to the taxation of Canadian Private Corporations in over 40 years.

The government promoted these changes as minor "tweaks" to the system. However, as the details were analyzed, they emerged as fundamental changes to how income will be taxed in private corporations. There was a dramatic and strong negative reaction to these proposals from the business community, tax practitioners and taxpayers directed to Finance Minister Bill Morneau's proposals.

As a result of the negative reaction to the changes, the government in a series of news releases made pronouncements that will adjust the original proposals. For clarity there has been no new draft legislation since the July 18, 2017 proposals. There remains a great deal of uncertainty as to what the actual rules will be as of January 1, 2018.

1) Multiplication of Capital Gains Exemption

In the initial proposals, there were rules that would eliminate the ability for family members to claim the capital gains exemption on shares of a private corporation where those family members were not active in the business or shares were held by a Trust. By way of a news release, these proposed rules have been removed.

2) Conversion of Income into Capital Gains

There were a number of rules that proposed to re-characterize capital gains into dividend income. As well, they affected the ability to pay out a capital divided account when assets were sold to a related corporation. Both of these proposed rules have been removed by way of a news release.

3) Dividend/Income Sprinkling

These rules are some of the most detailed and far ranging rules that we have ever seen.

The government's goal with these proposed rules is to tax family members at the highest marginal tax rate on dividends or income received from certain private corporations for all family members who have not worked in the business or contributed capital to the business.

These new rules propose a "reasonableness" test to determine if the amounts paid to the family members should be taxed at the highest rate or their individual marginal tax rate.

The notion of reasonability is being proposed to include all sources of income from the corporation to determine if the dividend or interest income would be reasonable with regard to the entire remuneration received by the family member. This obviously is very subjective and we have many concerns about how these rules could be applied by CRA.

In the draft legislation these rules were to be effective January 1, 2018. As a result, we are suggesting that clients should consider paying larger than usual dividends to any family members that are over 18 in order to maximize funds available to the family members as of December 31, 2017. If you are considering implementing this plan please contact us prior to paying the dividends in December so we can explain the consequences of your unique individual circumstances.

In the press release the government indicated they would be releasing the revised draft legislation in the "Fall". To date no draft legislation has been issued.

4) **Taxation of Passive Income**

In the past, an active business could accumulate funds after paying corporate tax and invest those funds in whatever manner decided upon by the shareholders. The new rules are proposing to set a limit on the amount of investment income that can be earned using active business income. At present, the government has proposed a $50,000 annual limit. It must be stressed that there has been no draft legislation on this matter. As well, the government has indicated that they will table the draft legislation in their 2018 budget. The date of this is unknown.

The general concept is that the income on any assets owned before the rules come out would not be subject to these new rules. At this point, there is no clarity from the government on what the cutoff time will be. We are suggesting that clients maximize their retained earnings and assets as of December 31, 2017 to maximize the amount of investment income that can be earned on these assets in the future. This suggestion is in contradiction to the suggestion above of paying larger than normal dividends to family members. An analysis must be done to determine what the actual dividends should be and what the maximum amount of assets that should be retained in the corporation.

The proposed rules would be that there is a tax of approximately 50% in the corporation and then full personal dividend tax upon payment out of the corporation. The difference between the proposed rules and the current rules is that under the current rules, the corporation would get a refund of a portion of the corporate taxes paid when dividends are paid. The net effect is that an individual taxpayer would be indifferent to earning investment income in a corporation versus personally.

However, under the new rules the effective tax rate in Ontario would go from 56% to 73% when considering the corporate and personal taxes.

Given the extremely high tax rate noted above, there has been a significant response to the government about changing these rules. However, there is currently no draft legislation and there is no effective date.

As of now we are waiting for the rules on passive income which may not be released until March or April 2018.

Other Changes

Both the Federal and Ontario governments have announced corporate tax rate reduction for small business corporations. The Ontario rate will be reduced by 1% effective January 1, 2018. The Federal rate will decrease ½% effective January 1, 2018 and an additional 1% effective January 1, 2019. In 2018 small businesses will pay 13 ½ % corporate taxes and 12 ½% in 2019 on its first $500,000 of taxable income .

Although these tax cuts will benefit small business corporations, they will have a detrimental effect to the shareholders, as there will be a corresponding increase in the personal tax rates on dividend income. Consequently, individual shareholders receiving dividends after 2017 will be facing a higher personal tax rate.

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A newsletter of this nature cannot be all-encompassing and is not intended to replace professional advice. This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with us before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.

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