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PUBLICATION

The New Tax Proposals - Where Are We Now?

Date: December 05, 2017
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Original Newsletter(s) this article was published in: Blaneys on Business: December 2017

Blaneys on Business readers may recall that we commented on Finance Minister Morneau's recent tax proposals affecting private corporations when he first mentioned them in the Federal Budget earlier this year. Those proposals, introduced in July, have since undergone a series of amendments and revisions, leaving many confused as to where exactly things stand and what, if any, planning should be undertaken.

To recap, the proposals first introduced in July addressed:

(i) income sprinkling among family members of the principal shareholders of private corporations (including multiplication of the capital gains exemption, which allows a number of family members, in addition to the principal shareholder, to claim the exemption, thereby reducing the tax owing on the capital gain if shares are sold;

(ii) earning passive investment income in private corporations, and

(iii) surplus stripping, or converting what would be regular income into capital gains, which are taxed at a lower rate than regular income.

The government has since announced several new measures and revisions:

First, the small business tax rate will be reduced from its current 10.5% to, ultimately, 9 per cent. When this reduction is combined with the new proposed Ontario 1 per cent reduction, it is difficult to see how Ottawa's stated concern -- the extent of the gap between relatively low corporate tax rates and relatively higher personal tax rates -- is alleviated;

Second, the income sprinkling measures will be kept but amended to clarify who they will affect. At the same time, the proposal to limit the multiplication of the capital gains exemption will not go forward.;

Third, the government will move ahead with proposals affecting passive investment income in private corporations;

Fourth, the government will not proceed with the surplus stripping measures.

Understandably, many taxpayers are puzzled over what this all means going forward. The question asked most often, by far, deals with earning investment income in private corporations. We know that existing accumulated after-tax earnings in private corporations will not be subject to the new regime. That is, a corporation's existing retained earnings and the income earned thereon will be subject to the same taxation as before the new rules came into effect. In addition, $50,000 per year of investment income (roughly 5 per cent of the first $1 million of retained earnings accumulated under the new regime) will similarly be exempt from the new rules.

What happens with future accumulations of after-tax business income remains a large question, as there are numerous issues to be addressed. For example, business income is taxed at two rates, namely the low small business rate and the higher general corporate tax rate. Even the higher general corporate rate is significantly lower than the highest personal tax rate.

So, the question remains as to how income taxed at this higher rate will be treated. One can envisage legislation providing for numerous pools of corporate income, each taxed in a different manner, but one is left to wonder how such a regime would work.

Furthermore, there is a question as to whether income earned at this business rate and distributed to a holding company which merely earns passive income will be traced so that it is subject to the new regime, even if earned in a corporation that has no business income at all.

Unfortunately, while so many questions remain up in the air, it is impossible to do effective planning on a go forward basis. The best advice may be to remove existing surplus retained earnings (not required for business operations) to a holding company in order to avoid the confusion of whether or not this new regime will affect it.

There are other advantages to doing this, such as for creditor protection purposes and for preserving access to the capital gains exemption.

Only time will tell what other measures might be effective but we will be monitoring the issue as it continues to take shape and share new developments with you as they arise.

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