Significant Changes to Small Business Owners

Earlier this week the Department of Finance released a consultation paper proposing new tax rules that target private businesses in how they accumulate capital and remunerate family members. These proposed changes are some of the most significant changes to the taxation of private businesses in decades.

As discussed in our Budget 2017 Blog, the federal government intended to "crack down" on some common tax planning techniques as they relate to private business. The consultation paper released this week has identified three tax-planning techniques:

1. Income Sprinkling

Under the current tax regime, a commonly used tax-planning technique is where a family-held private corporation pays dividends evenly amongst the active shareholder, the non-active spouse and their adult children. The sprinkling of dividend income between all family members results in significant annual tax savings.

The proposed legislation intends to close this dividend sprinkling ability by imposing a reasonability test to dividends a family member receives. A dividend can be deemed unreasonable if the amount received does not reflect that family member's contribution in terms of labour and capital. Any dividend deemed unreasonable will be taxed at the highest effective tax rates. It will be interesting to see how the CRA goes about determining reasonability, as well as tracking dividends to the various family shareholders. We suspect the reasonability determination will closely follow the CRA's current policy surrounding remuneration of family members by means of salary.

The proposed legislation also intends to disallow the use of the lifetime capital gains exemption (LCGE) on any capital gains realized or accrued by individuals before they reach age 18, or to any individual, if their interest in the private business is held through a trust. Transitional rules are proposed for taxpayers who already have a trust structure in place. Taxpayers can elect to realize a deemed disposition on their qualified small business shares so as to trigger a 2018 capital gain eligible for LCGE purposes, and re-acquire the shares at the higher cost base. This election will be in place for the 2018 taxation year, and must be filed by April 30, 2019.

The proposed changes would be effective in the 2018 taxation.

2. Passive Investments inside of Private Corporation

Corporate tax rates are significantly lower than personal tax rates. Given this rate spread, tax advisors usually suggest private businesses retain cash in their corporate structure and build up a passive investment portfolio. The Department of Finance sees this tax-planning approach problematic as shareholders use their private business tax rates to build up retirement savings faster than an unincorporated individual.

The Department of Finance's consultation paper does not propose legislation at this time, but they do provide alternative approaches on how they can remove this perceived imbalance. These include making all passive investment taxes non-refundable, and limiting capital dividend account additions. Any rules eventually imposed will not apply to capital retained in the corporation for growth of the business, but only to excess capital that is retained for passive investments.

3. Converting Regular Income into Capital Gains

The proposed legislation intends to expand the surplus stripping anti-avoidance rules. These rules limit the ability of shareholders to strip out excess capital at preferential capital gain tax rates versus dividend tax rates. Current legislation does capture surplus strips on transactions between an individual taxpayer and a non-arm's length corporation; however, it does not address transactions between non-arm's length corporations. As such, the surplus stripping rules can be circumvented by inserting a second non-arm's length corporation into the transaction. The proposed legislation imposes a new anti-avoidance rule to capture transactions between non-arm's length corporations.

Overall these proposed changes are disappointing. The Department of Finance with this update and the 2016 budget have continually attacked small business owners, while making the tax act surrounding small businesses more complex and burdensome to remain compliant.

Our firm is working with a network of tax professionals to determine how our clients' current structures will work within the proposed legislation as well as research and planning of new remuneration structures that work within the proposed legislation.

WHAT'S NEXT?

If you have any questions on how these proposals will affect your business, please drop us a line: info@nuvero.ca // 587.320.3940.

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