Wealth Management

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Update on private company tax proposals

Annouced October 2017

On July 18, 2017, the Department of Finance released a consultation paper, along with explanatory notes and draft legislation, proposing a number of tax changes that were aimed at private corporations. The changes were intended to remove the perceived unfair tax advantages available to owners of private corporations. The government provided a consultation period and requested comments on their proposals by October 2, 2017. Following a review of the submissions received during the consultation period, the government announced a number of changes to the original proposals, some of which they will not proceed with.

Please contact us for more information about the topics discussed in this article.

Proposals not being implemented

Lifetime capital gains exemption

The government has decided to not move forward with the proposals that were intended to constrain the ability to claim the lifetime capital gains exemption (LCGE). The proposals would have limited access to the LCGE by denying the exemption to individuals under the age of 18 or where property was held by a trust, for example. Concerns were raised that the measures had unintended consequences on intergenerational transfers of family businesses.

Converting regular income into capital gains

The government has also decided to not move forward with the proposals that addressed converting regular income into capital gains. These proposals would have prevented certain advanced tax planning strategies that involved shareholders extracting surplus cash from a private corporation at lower tax rates. During the consultation period, concerns were raised that these measures were too broadly worded and had unintended consequences.

If you currently use your private corporation to split income with family members, you may be affected by these rules.

Proposals being implemented

Small business tax rate decrease

Currently, the small business deduction reduces the federal corporate income tax rate to 10.5% on the first $500,000 of active business income earned by a Canadian Controlled Private Corporation (CCPC). On October 16, 2017, the government announced that it intends to decrease this rate to 10%, effective January 1, 2018 and to 9%, effective January 1, 2019. The effect of this measure will allow corporations to retain more funds for reinvestment.

In conjunction with the proposed reduction in the small business tax rate, the government has announced that it will adjust the gross-up factor and dividend tax credit applicable to "non-eligible" dividends in order to maintain integration of corporate and personal taxes. As a result, the effective non-eligible dividend tax rate will increase in future years.

Income splitting using private corporations

Currently, the "tax on split income" (TOSI) rules, commonly referred to as "kiddie tax" rules, limit splitting certain types of income with minor children. The proposals announced on July 18, 2017 expanded the types of income on which TOSI applies, as well as who it would apply to. On December 13, 2017, the government announced changes aimed at simplifying the proposed rules specific to income splitting using private corporations. Please refer to our article "Update on proposed measures addressing income splitting measures through private corporations" for more information on these changes.

Holding passive investments inside a private corporation

Currently, there is a perceived tax deferral advantage for business owners who retain after-tax income in their corporation. This is because corporate business income is generally taxed at lower rates than income earned personally. As a result, incorporated business owners may have more after-tax money to invest. The government intends to introduce tax changes that will make the value of the after-tax portfolio of a business owner investing within a corporation equal to that of someone investing in their personal account who is taxed at the top marginal tax rate.

On October 18, 2017, the government announced that they are moving forward with the measures to limit the deferral benefits of holding passive investments within private corporations. However, there will be no tax increase on $50,000 of passive income earned annually.

This $50,000 threshold is intended to provide flexibility for business owners to hold savings for business contingencies or future investments such as the purchase of equipment, hiring staff or business expansion, as well as savings that can be used for personal benefits such as sick leave, parental leave, or retirement. Further, the government pointed out that only 3% of CCPCs with taxable passive income were above the $50,000 threshold in 2015 so that the majority of businesses will not be affected by these tax proposals.

The government reiterated that these measures will not apply to existing passive investments inside a private corporation as well as the future income earned on those investments. It seems as though this will require some sort of tracking mechanism of the grandfathered and non-grandfathered investments.

As of now, there is uncertainty as to how the $50,000 threshold will apply. We do not know if the threshold will increase each year to account for the accumulation of the investment income. We do not know if the threshold applies only if the investment portfolio is derived from income subject to the small business tax rate. We do not know how the threshold will apply if you own multiple corporations. There are also questions as to whether withdrawals from the investment portfolio will be considered to be made from past investments, which are grandfathered, or those investments which are not grandfathered.

The government announced that draft legislation will be released at the 2018 federal budget. When introduced, the passive investment measures will apply only on a go-forward basis.

Passive income planning considerations

The proposed changes will generally affect business owners who are using some of their corporate surplus for passive investment.
It is likely pre-mature to consider removing passive assets from your corporation or winding up your corporation before these proposals are better understood. Any type of asset transfer or sale could create a prepayment of taxes. At this point, it would be prudent to review the level and the types of passive investments held within your corporation and consider if these investments serve a business purpose.

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If the reason for keeping excess funds in your corporation is to save for retirement, you can consider retirement vehicles that are set-up within the corporation, such as an Individual Pension Plan (IPP) or Retirement Compensation Arrangement (RCA). These retirement vehicles allow you to use surplus corporate assets while deferring tax and they should not be affected by the proposed changes.

In addition, you may want to consider the benefits of re-allocating some of the excess funds in your corporation to a tax-exempt life insurance policy. Speak with a licensed life insurance advisor to determine if holding insurance in your corporation is right for you.

Conclusion

If you are involved either directly or indirectly in a private corporation, we strongly recommend that you reach out to your tax and legal advisors to determine how the proposed legislation could impact you and your future plans.

This article may contain several strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal or tax advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax and/or legal advisor before acting on any of the information in this article.

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