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COMMENTARY ON ANNOUNCEMENT MADE BY THE DEPARTMENT OF FINANCE ON OCTOBER 16, 2017

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Subsequent to the consultation paper released on July 18, 2017 and the conclusion of the consultation period on October 2, 2017, an announcement was made by the Department of Finance on October 16, 2017.

July 18, 2017 Consultation Paper

The July 18, 2017 consultation paper was accompanied by extensive and complex draft legislation that addressed the targeted strategies:

1. Income Sprinkling

Income sprinkling involves directing income from a high-income individual to family members who are in a lower tax bracket. There are existing tax rules that must be followed to achieve effective income sprinkling. In addition to the existing rules, it was proposed that dividends paid to family members (regardless of age) be subject to a reasonableness test based on labour and capital contributions to the business. It was proposed that the reasonableness test be age specific with stricter tests applying to individuals under the age of 25.

The proposals also address the multiplication of the lifetime capital gains exemption (LCGE). Specifically, the following capital gains would no longer qualify for the LCGE:

- Those realized or that accrue while the individual is a minor
- Those included in the individual's "split income"
- Those accrued while the shares are held by a trust, even after the shares are distributed to a beneficiary

2. Holding a passive investment portfolio inside a private corporation

The government noted that some individuals gain an unfair tax advantage by retaining passive investments (rather than operating assets) in a corporation, taking advantage of the fact that corporate income tax rates are in general lower than the personal tax rates. To eliminate this perceived unfair tax advantage, the government suggests a number of approaches. The consultation paper did not provide legislative proposals but requested public input on the approaches.

3. Capital gains conversion

While income from a private corporation is normally paid to the principal in the form of salaries or dividends, there are strategies to convert that income to capital gains, resulting in a tax saving. The draft legislation added restrictions to surplus stripping and therefore access to these strategies. The measures were proposed to be effective as of July 18, 2017.

October 16, 2017 Announcement

The October 16, 2017 announcement states that:

1. The Government intends to lower the Federal small business tax rate, which is currently at 10.5% to:
    - 10%, effective January 1, 2018
    - 9%, effective January 1, 2019
2. The Government intends to move forward with the measures to limit income sprinkling. The rules will not impact businesses to the extent there are clear and meaningful contributions by family members. The Government will introduce reasonableness tests for adult family members aged 18 to 24, as well as those 25 and older, based on four basic principles:
    - Labour contributions,
    - Capital or equity contributions to the business,
    - Taken on financial risks of the business, such as co-signing a loan or other debt, and/or
    - Past contributions in respect to previous labour, capital or risk
3. The Government recognizes the unintended consequences regarding the proposed measures on the conversion of income to capital gains, and the multiplication of the Lifetime Capital Gains Exemption. As such, the Government will not be moving forward with proposed measures to limit access to the Lifetime Capital Gains Exemption.
4. The Government acknowledged the way in which passive investments within a private corporation are used by business owners, particularly small and medium-sized businesses, to manage personal income risk in the case of a downturn, sick leave or maternity or parental leave. In many cases passive investments are used as a retirement tool for small business owners as other savings vehicles such as Registered Retirement Savings Plan are not sufficiently flexible and adaptable to address business volatility. The Government did not explicitly state its intended course of action.

Later this fall, the Government will release revised draft legislative proposals outlining the proposed changes, which will be effective for the 2018 and subsequent taxation years.

Comments and Conclusion

While the announcement contains welcome changes, it is clear that income sprinkling rules, effective January 1, 2018, will be carried out. To the extent that it is appropriate, we recommend maximizing income splitting with family members in 2017. Please consult with us to determine the timing of any actions.

Although the announcement acknowledged legitimate reasons for holding passive investments within a private corporation, the announcement is silent as to whether any changes will be proposed. Further clarification from the Government should be expected in the coming months.

We at MDP will continue to monitor the status of the legislation and advise accordingly. If you would like to discuss the above in regards to your specific situation, please contact us.