PRIVATE CORPORATION TAX PROPOSALS: "STRIKING A BALANCE" OR INTRODUCING GREATER COMPLEXITY?

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Background

On July 18, 2017, the Department of Finance ("**Finance**") introduced a number of proposed technical amendments to the Income Tax Act (Canada) (the "**Tax Act**") specifically targeting:

1. Arrangements used to "sprinkle" income earned by private corporations among shareholders;
2. Structures employed to maximize the utilization of the lifetime capital gains exemption (the "**capital gains exemption**") within a family unit; and
3. Tax planning strategies that have the effect of converting regular or dividend income into capital gains.

The proposed technical amendments include (i) an extension of the "tax on split income" to capture "unreasonable" amounts paid to Canadian resident individuals, regardless of their age, (ii) measures aimed at severely curtailing access to the capital gains exemption, and (iii) revisions to the "surplus stripping" rules in the Tax Act (the "**July Proposals**").

In addition to the July Proposals, the Government also released a discussion paper (the "**White Paper**"), which set out a number of potential policy options for neutralizing what the Government perceives to be undue tax benefits arising from private corporations passively investing after-tax earnings rather than immediately distributing such earnings to shareholders (the "**Passive Income Proposals**"). The Passive Income Proposals, although only presented in conceptual form, call for materially heightened taxation of passive income earned by private corporations.

The release of the White Paper and the July Proposals was followed by a 75 day consultation period, during which the tax community and other stakeholders were invited to submit comments to the Government. By October 2, 2017, over 21,000 submissions were made to the Government from a broad array of industry groups, professional organizations, and private interests. Many detailed and thoughtful analyses were submitted to Finance, including a lengthy submission made by the *Joint Committee of the Canadian Bar Association and CPA Canada*.

This week, Finance released three responses to the submissions received during the consultation period. On October 16 and 19, 2017, Finance addressed several of the concerns raised in respect of the July Proposals. On October 18, 2017, Finance released amended policy options to address what the Government continues to perceive to be deficiencies in the taxation of passive income earned by private corporations.

The October Announcements (A Play in 3 Acts)

Act I: A Partial Retreat

On October 16, 2017, Finance announced its intention to lower the federal small business tax rate from 10.5% to 9% over the next 14 months.

In addition, citing potential unintended consequences associated with the July Proposals, Finance announced that it will not be moving forward with proposed measures to limit access to the capital gains exemption.

Finally, Finance confirmed its intention to extend the tax on split income, while indicating its preference for any amended legislation not to impact businesses to which there are clear and meaningful "contributions" made by spouses, children and other family members. However, Finance did not elaborate on how the July Proposals would be modified to more effectively accommodate and recognize contributions made by family members to private corporations.

Act II: Revised Passive Income Proposals

On October 18, 2017, Finance released revised policy options for reforming the taxation of passive income earned by private corporations (the "**New Proposals**").

The New Proposals do not provide additional clarity on the technical elements of the legislation that will enact the Passive Income Proposals. However, Finance did announce that the first $50,000 of passive income earned by a private corporation each year will not be subject to the heightened level of taxation contemplated by the Passive Income Proposals. Finance indicated that the new $50,000 "safe harbour" is aimed at allowing private corporations to earn a 5% "nominal" return on an acceptable level of passive investments without being subject to the new tax regime.

The New Proposals were accompanied by an assurance from Finance that any new rules would only apply on a "go-forward basis" (i.e., investments already made by private corporations, including future income earned from such investments, will not be affected by the rules that are ultimately enacted into law).

Finance has indicated that draft legislation to implement the revised Passive Income Proposals will be released as part of the 2018 federal Budget (which will likely be tabled in March or April of 2018). Given that Finance has stressed that the revised Passive Income Proposals will "only apply on a go-forward basis", one might be inclined to infer that investments made prior to the tabling of Budget 2018 will not be subject to the new taxation measures. However, the New Proposals are not entirely clear in this regard.

Act III: Further Backtracking

On October 19, 2017, Finance announced that, in light of several unintended consequences of the July Proposals identified during the consultation period, the Government will not be moving forward with the elements of the July Proposals relating to the conversion of income into capital gains.

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While the reduction of the small business tax rate, the decision not to move forward with proposed amendments relating to the capital gains exemption and the conversion of income into capital gains, and the recognition that earnings may be retained by a private corporation for non-tax reasons are all positive developments, the New Proposals nevertheless introduce further complexity, and potentially distortive economic effects, into a set of contemplated legislative changes that are already burdened by several challenges.

Additional Concerns

The New Proposals give rise to several additional concerns beyond those that were associated with the initial Passive Income Proposals.

How is Passive Income to be Recognized under the New Proposals?

The New Proposals appear to be predicated on the notion that investment returns are predictable and are earned on a consistent basis in each taxation year (such as interest earned on amounts deposited in a bank account). However, many investments do not have a fixed rate of return, and returns earned on investments may not be realized until future periods.

The assumptions implicit in the New Proposals raise a number of practical issues. For instance, the New Proposals do not appear to address whether the unused portion of the proposed $50,000 "safe harbour" in any year may be carried forward or back so that a corporation that earns the same amount of passive income each year will be treated the same as a corporation that earns nil passive income in one year, $150,000 of passive income in the next year, and nil passive income in the third year. Similarly, where a corporation earns passive income in certain years, and incurs losses on investments in subsequent years, it is unclear how recognition of such losses will be integrated into the contemplated legislative amendments.

The New Proposals also do not provide any guidance as to how the realization of gains, that may have accrued over several years, will be taxed.

Will the New Proposals Create Unintended Economic Distortions?

Absent express policy motivations to the contrary, it is generally accepted that tax measures should not divert a taxpayer's resources from their perceived highest and best use.

Unfortunately, the New Proposals appear to create an unintended bias in favour of fixed income investments (with a predictable, yet limited, return) over equity investments.

Potential returns on equity investments are naturally higher in recognition of the risks associated with such investments. Yet, if a portion of the returns on equity investments (which cannot be predicted in advance) may be subject to a heightened level of taxation under the Passive Income Proposals, an unintended incentive favouring fixed income investments may be created, which will be economically inefficient.

Will the "Safe Harbour" be Inflation Adjusted?

The New Proposals carve-out the first $50,000 of passive earnings from the ambit of the new taxation measures.

Finance has reported that the $50,000 income threshold is predicated on a 5% "nominal" rate of return on an acceptable $1,000,000 investment base. However, the chosen $50,000 threshold is based on a nominal rate of return that has been formulated in the context of an historically low inflationary environment.

Rates of return naturally have two components: (i) a return for the use of funds, and (ii) a return to offset inflation that arises during the period of the investment. In simplified terms, the "real" return on an investment is equal to the stated rate of return less the applicable rate of inflation.

If inflation rates were to materially increase, a 5% nominal rate of return would not allow private corporations to earn any substantive returns on their investments. In fact, if inflation rates increase to 5%, private corporations will not be permitted to make investments that generate any "real" returns without triggering the heightened taxation of the resulting passive income.

Will the Additional Tax Revenue Generated by the New Proposals Outweigh the Added Administrative Costs of Compliance?

The New Proposals will introduce additional administrative reporting and record keeping burdens on small businesses. With the range of taxpayers that may be subject to the heightened tax under the New Proposals reportedly having been narrowed, it will be instructive to compare the anticipated tax revenue emanating from the enactment of the contemplated proposals with the added administrative costs that will be imposed on all private corporations that must comply with the new rules. To date, the Government has not released projections of the anticipated tax revenue to be generated by the contemplated legislative amendments.

Looking Forward

We are pleased that Finance has retreated from, or revised what were, problematic proposals; however, any further proposals or legislative amendments will continue to require significant scrutiny to ensure that they conform with sound policy objectives, and do not add unnecessary complexity to the Canadian tax landscape.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.