#ProtectGrowth

Small Business Tax Changes – Update

November 2017

On October 16, Finance Minister Bill Morneau announced the federal government's response to the more than 21,000 submissions it received during the previous three months with regard to the government's proposed changes to the tax treatment of small business.

The key provisions contained in his announcement and the Canadian Chamber's messaging with regard to each are summarized below.

In addition to responding to the government's new proposed tax changes, the Chamber has called on the government to undertake a comprehensive review of the tax system recommending that it establish a Royal Commission to do so. In light of mounting regulatory compliance costs imposed by all levels of government, proposed carbon taxes, and the prospect of US tax reform, the Chamber will launch its own competitiveness assessment of Canada's business tax system in 2018. The findings of our review will help to shape the priorities for tax reform.

Dates to look out for:

- **December 15** – The Senate Finance Committee will release its report on the Small Business Tax changes based on the cross-country consultations it undertook during the fall in which many Chambers took an active role.
- **Sometime before Christmas** (our bet is just before Christmas) – The government's new rules on income sprinkling need to be tabled if the government is to meet its January 1 date for implementation.
- **March** – Budget 2018 will most likely contain draft legislation on passive investment.

Key Messages to MPs

1. Chambers are still very concerned about the potential negative impacts the government's small business tax changes are likely to have on small business investment and growth.
2. Tax changes should be postponed until their full economic impacts can be taken into account.
3. The government must urgently address the broader issue of the competitiveness of Canada's tax system.

4. The government should establish a Royal Commission to undertake a comprehensive review of the tax system.

Changes announced by Finance Minister Morneau

1. The Small Business Corporate Tax Rate will be reduced

The government will reduce the federal small business tax rate from its current level of 10.5% to 10% as of January 1, 2018 and 9% as of January 1, 2019. This measure reinstates the gradual rate reduction to 9% announced by the previous government but halted in Budget 2016. The tax rate reduction was included in a Notice of Ways and Means Motion tabled as part of the government's Economic Update on October 24.

This reduction will save companies earning $500,000 in income eligible for the small business deduction $2,500 in 2018 and $7,500 annually from 2019 on.

The Canadian Chamber has welcomed this move.

2. Higher taxes on Ordinary Dividends

In conjunction with the small business rate reduction, the personal tax rate applied to ordinary (non-eligible) dividends will increase. The purpose is to maintain the integrative nature of the personal and corporate tax systems, ensuring that the aggregate level of tax paid on dividends will remain the same regardless of whether income is earned as an individual or through a corporation. However, this change could result in an overall tax increase for some small business owners, which for some might exceed the savings associated with a reduction in the small business tax rate. Personal tax rates will increase on dividend distributions from earnings that were taxed at a higher rate (like distributions of earnings taxed at a higher small business or manufacturing and processing rate or future distributions of passive investment income). There will be no grandfathering of lower personal dividend tax rates on distributions of these accumulated retained earnings.

The Chamber has proposed that a grandfathering mechanism be introduced.

3. Rules related to "Income Sprinkling" will be simplified

Widespread and serious concerns were raised during the consultation period with respect to the complex rules the government was proposing to introduce aimed at restricting the payment of income to adult family members unless the amounts were determined to be reasonable. The government also proposed that it would treat some capital gains as ordinary dividends.

The government received thousands of submissions detailing concerns about how these proposed rules could result in nearly doubling the tax rate on inter-generational family business transitions or other legitimate business transfers to related parties. The complexity and uncertainty of the proposed changes was also an issue of common concern, as was the likelihood of the proposed measures unleashing an army of CRA tax auditors working on different interpretations of what reasonableness actually means.

In response to the consultations, the government confirmed that the measures related to income sprinkling would be simplified in order to provide greater certainty for family members who contribute to a family business. No further details have been provided since October 16.

There are still many uncertainties about these proposals. What does simplification and clarification mean? What does a reasonable contribution to a business mean? Will the conversion of capital gains to ordinary dividends remain in the simplified legislation? And, when will the simplified draft legislation be released? (The previous version was to come into effect January 1, 2018. The government will need to table its simplified version before then if the effective date is to remain unchanged – ***Look out for the rule changes to be announced just before Christmas***.)

The Chamber remains concerned that the changes when they are announced will not take into consideration all of the ways that family members contribute to a small business and that the reasonableness test that will be applied by CRA will still be intrusive and complex. ***We have called for the government to:***

- ***Announce its simplified rules as soon as possible and allow ample time for input from business;***
- ***Consider at a minimum an exemption from the rules for spouses; and,***
- ***Postpone the implementation of the changes until January 1, 2019 at the very least.***

4. Access to the Lifetime Capital Gains Exemption will not be changed

The Finance Minister announced that the government will not proceed with its proposal to restrict access for certain shareholders to the Lifetime Capital Gains Exemption (LCGE).

The Chamber welcomes this change.

5. Rules governing the Conversion of Capital Gains into Dividends will not be changed

The Finance Minister also announced that the government will not proceed with draft legislation tabled last July that would convert capital gains into taxable dividends.
The Chamber welcomes this change.

6. The government will work to make it easier and less costly to transfer business to the next generation.

The Chamber welcomes the government's willingness to improve the tax treatment of intergenerational transfers and looks forward to working with the government to this end.

7. Proposals for the tax treatment of Passive Income will be revised.

The government intends to proceed with proposals to increase tax on corporate passive investments funded from after-tax business earnings, effectively double taxing the eventual distribution of passive investment earnings. However, the government now proposes that the new tax increases will only apply to passive income in excess of an annual threshold of $50,000 and will be applied only on a go-forward basis. It is expected that the draft legislation will be tabled along with the federal 2018 budget.

There are many concerns and uncertainties that still surround this proposal. Such as: Will the threshold apply to individual companies or to groups of companies? What is being grandfathered? Investment assets or retained earnings? Current working capital or future liquid assets from the disposal of other assets? How long will the grandfathering be permitted? Are investments in other companies considered passive investments? The threshold will be insufficient for many small businesses saving to make future investments. There are also serious concerns that the taxation of passive investments will be a disincentive to venture or angel capital.

The Chamber's position with respect to the government's new proposals to tax passive income is that:

- ***The $50,000 threshold is inadequate for small businesses that are saving in order to make larger investments in innovations or business growth;***
- ***The threshold is too small to provide business owners with long-term earnings security;***
- ***The government should not proceed with its passive income rules until a full economic impact assessment has been carried out and an approach has been developed that can ensure there will be no unintended negative consequences to business investment.***