

# More proposed reforms to small business taxation announced

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The federal government continues to implement its agenda in respect of tax changes for small and medium sized private businesses, [announcing](#) further measures to increase taxation of this vital sector of the Canadian economy. These proposals come on the heels of other measures, for example, the limitations to the small business deduction, which have already increased tax complexity and compliance costs for many small business owners. These new proposals are clearly an attack on entrepreneurs. Not good.

Three items are identified as the targets of the tax reforms announced:

## **1. Preventing income splitting or so-called “income sprinkling”**

Under the proposed changes, the so-called “kiddie tax” provisions in section 120.4 of the Income Tax Act will be extended to apply to adults in certain circumstances, most notably where individuals do not actively contribute to the business either in terms of labour or capital. As a result, these shareholders will pay taxes on income from the business at the highest marginal tax rates.

Additionally, in some cases, sometimes through direct shareholdings or through the use of family trusts, multiple members of a family may access their Lifetime Capital Gains Deductions, allowing them to each shelter a capital gain realized on the disposition of qualified small business shares up to a lifetime limit of \$835,716 and qualified farm property to a lifetime limit of \$1,000,000 in 2017. The proposed rules are aimed at disallowing this.

## **2. Prevent a deferral of tax when investing through a private corporation**

Currently, small business owners can achieve a deferral of tax when they hold investments inside their company rather than paying out the income on these investments as it is earned. These proposals would eliminate this tax deferral on passive income earned in private corporations.

The release outlines a number of potential approaches centered around changes to the refundable tax regime in order to end the deferral, and asks for feedback in respect of these approaches. While it appears the government intends to maintain the 50 percent inclusion rate for taxable capital gains, these proposals would see the elimination of the inclusion of the non-taxable portion of the capital gain in the capital dividend account for this “retained income”.

The briefing document released indicates that the proposed reforms are targeted to corporate owners who are using some of their profits for passive investment, and should not impact the amount of taxes payable by corporations with no passive investment income. We’ll have more to say on this topic in a later blog but suffice it to say that we do not agree with the need to change the status quo. This is clearly a tax grab.

## **3. Prevent conversion of private corporation’s regular income into capital gains**

Currently section 84.1 applies to ensure that most corporate distributions are taxed as dividends, but in

some cases may allow for corporate surpluses that would otherwise be distributed as dividends to effectively be converted to capital gains. The government proposes to shut down this type of planning.

It appears that the proposed changes will potentially eliminate post-mortem planning commonly known as “pipeline planning”. This planning is frequently used to eliminate the double – or even triple – taxation which often results when the primary shareholder of a private company dies, and their estate is distributed. However, it might also apply in other situations.

For all of the details on the proposed changes go to:

- [Summary Overview: Consultations on Tax Planning Using Private Corporations](#)
- [Consultation Document: Tax Planning Using Private Corporations](#)
- [Draft Legislation and Explanatory Notes](#)
- [PowerPoint Presentation on Tax Planning Using Private Corporations](#)

While further work and time is needed to fully analyze the proposals at a high level, our initial thoughts would be to advocate for rules which simplify rather than complicate the law in this area. These changes have the potential to add another layer of complexity to an already mind numbingly complex area. There is a need to remember that these are tax rules for small businesses, most of whom don't engage in complex tax planning, don't have dedicated tax people on staff, and do not have the resources to comply with overly complex tax laws. These rules risk increasing compliance costs, and distracting from the core businesses carried on.

Additionally, we have real concerns that in trying to broaden the tax base and “increase fairness” by bringing everyone down to the lowest common denominator, these proposals are making changes to rules that are commonly used to prevent double and triple taxation of the same income, so there is a very real danger that these changes may inadvertently create situations of double and triple taxation for some individuals.

Finally, we are a little disappointed by the rhetoric in the release. It reads like a rather sweeping condemnation of small business owners, and almost seems to accuse this group of mostly law abiding, tax paying, job creating Canadians of shirking their responsibilities. If these taxpayers were in fact cheaters, then it seems obvious there would be no need to change the law, but the language used in today's release seems to imply that business owners who have followed the law and paid the taxes they owe are “not contributing to our economy” and not paying their “fair share” of taxes. The Liberal rhetoric announcing this change ignores a key concept – risk. How many “wage earners” – as the Liberals so like to pontificate on – have worried about meeting payroll at the end of the month? Entrepreneurs and professionals all share this risk and perhaps the reward in their small businesses. We can assure you that Trudeau and Morneau don't, as the extent of their worry is likely what is in their trust fund account balances at the end of a month.

Statistics Canada [reports](#) that in 2015 the Canadian private sector employed over 11.6 million Canadians, with small and medium sized business accounting for 10.5 million of these jobs. Our firm has seen an uptick in Canadian business owners leaving Canada, and also changing their plans so that the growth of their business will occur outside of Canada rather than within it. We are concerned that these and other measures announced by the government will have exactly the opposite effect from that intended and effectively shrink the Canadian tax base rather than broaden it. Creating 300,000 new jobs, as the release indicates has occurred in the last year, is fantastic, but if in doing this we drive out the high income earning innovators and entrepreneurs who contribute so much to the Canadian economy, this would be sad indeed. The government is billing these proposed changes as “tax fairness for the

middle class”, but many of us in the middle class either own or work for a small business, and therefore we believe caution is warranted.

The rhetoric needs to go.