A few months ago, I wrote about the cruel summer I was having trying to understand, explain and rationalize the new tax rules about private companies released on July 18. I had noted that there was a consultation period, which ended on October 2. My hope was that the government would listen to the public and take cues from the thousands of submissions (about 21,000 submissions, in fact).

Well, it appears that public opinion and feedback from constituents may have had some effect. Since October 2, 2017, there have been a number of releases by the Department of Finance, most of which are quite welcome. But before I summarize the changes as announced, let me recap the original proposals from July.

What was proposed...

Tax on split income rules (TOSI): The current “kiddie tax” rules are to be expanded to apply to all related persons (and not just minors, so that all family members who receive dividends from a family corporation will be subject to the top federal tax rate (unless such amounts paid are reasonably in light of the services or contributions (including financial) they provide to the company).

Capital Gains Exemption: The availability of the capital gains exemption on a sale of shares was to be restricted as follows:
1. Minors could no longer claim the exemption.
2. If a taxable capital gain was included in the split income rules, then the exemption was not available.
3. Trusts can no longer claim the exemption, and any gains accrued during the time that shares were held by a trust will no longer be eligible.

There was some transitional relief that allowed you to claim the exemption in a narrower scope until the end of 2018.

Surplus stripping: Effective July 18, 2017, capital gains triggered at the corporate level in certain circumstances would be re-characterized as a taxable dividend (and there would be no addition to the capital dividend account, which lets you pull the tax-free portion of a gain out of the company tax-free).

Passive Income: Although actual legislation was not announced on this point (like the others), Finance announced its intent to tax investment income earned by a corporation carrying on an active business at a top federal tax rate of 33 per cent

...is modified (sometimes)...

On October 16, the Department of Finance made three announcements:
1. The federal small business tax rate (currently at 11 per cent) is to be reduced to 9 per cent effective January 1, 2019. It will drop to 10 per cent on January 1, 2018. This tax rate applies to the first $500,000 of active business income each year for a company (to be shared among associated corporations).
2. With respect to the proposed tax on split income (TOSI), the government announced that it would be making changes to the proposals in order to simply them.
Although it did not release amended legislation, it did provide some examples as to how it would apply the rules. So, while not backing down from this proposal, the government stated that it will ensure the rules will not impact businesses to the extent that there are “clear and meaningful contributions” by the family members to the business. Reasonableness tests will be introduced as part of the revised legislation, and family members will need to have made contributions to the business through any combination of the following:

a. Labour contributions
b. Capital or equity contributions (i.e. actual financial contribution)
c. Taking on of financial risks of the business (i.e. co-signing a loan or other debt), and/or
d. Past contributions of the above.

The take-away from this announcement was that the government was going to try to reduce the compliance burden in trying to establish how a family member could make a contribution.

New revised legislation is to be released this fall (which means that technically they could have until December 20!). The changes are still to take effect January 1, 2018.

3. Happily, the government fully retracted the capital gains exemption proposals and announced it will not proceed with these measures. The reasoning behind this backtrack, as provided by them, was that it would have an impact on inter-generational transfers of family businesses. However, it is not clear how this announcement will impact the capital gains exemption proposals to the extent they are caught by the TOSI rules.

…and modified again (sometimes)

On October 18, 2017, Finance made another announcement that also eased the application of the July proposals, but this time in relation to the passive income rules. Although the government reiterated its intent to limit tax deferral opportunities as they relate to passive investments in a corporation, it did concede the following:

1. Any past and current investments (and future income earned thereon) in a corporation as at the date the new rules are announced will be grandfathered, and so will not be subject to the new rules.

2. The first $50,000 of passive income will not be taxed at the top rates.

3. It will allow for contingency funds or reserves, for the purchase of equipment, business expansion or hiring and training of staff.

4. Incentives will be in place for venture capital and angel investors to allow them to continue to invest “in the next generation of Canadian innovation.”

It also announced that new legislation will be released in the 2018 Federal Budget, such that the proposals will come into effect as of that date.

And the next day, on October 19, 2017, more good news was released by the government: It announced it was not going to move forward with the anti-surplus stripping rules, which would have converted capital gains into taxable dividends. However, it did note that it would continue to consult with farmers, fishers and other business owners to develop proposals that would better accommodate intergenerational transfers. This means that we have only had a stay of execution for now, as the issue of surplus stripping is still on their agenda.

Summary

We all talk about the power of the people and how it can change the world. In this instance, we saw the effect it had on the Canadian tax landscape. In light of the various roll-backs and backtracking by the government since the consultation period ended, one would think that the government should have taken the time to consult with the tax and business community before moving forward with such sweeping proposals. Had it done so, we would not have had the headaches and anxiety we have had since mid-July. Although the changes announced in October may not be a complete victory (we still have to wait for the actual legislation to be released before the end of the year and with the 2018 Federal Budget before I relax a bit), it definitely is a step in the right direction.