TAX FLASH BULLETIN

OCTOBER 2017 ECONOMIC STATEMENT AND FEDERAL CORPORATE TAX ANNOUNCEMENTS

On October 24, 2017, Federal Minister of Finance Bill Morneau released the country's Economic Statement titled Progress for the Middle Class. The statement contained a few measures that impact individual taxpayers which we have highlighted below. We have also summarized the corporate tax announcements that were released the previous week, following consultations with the public regarding the Tax Planning Using Private Corporations paper released on July 18, 2017.

INDIVIDUALS

Increase to Canada Child Benefit (CCB)

The government announced they will start indexing the tax-free Canada Child Benefit amounts for families starting July 1, 2018 to keep pace with the cost of living. Indexing was originally scheduled to begin on July 1, 2020.

CCB Amounts and Phase-Out Thresholds	Current Benefit Year	2018-2019	2019-2020 projected
Maximum amount per child under age 6	$6,400	$6,496	$6,626
Maximum amount per child aged 6 to 17	$5,400	$5,481	$5,591
First income threshold	$30,000	$30,450	$31,059
Second income threshold	$65,000	$65,975	$67,295

TIP: Invest CCB amounts in an "in trust account" for the child so that investment income earned is taxed in the child's hands. Income on CCB deposits is not attributed to the parent for income tax purposes

Increase to Working Income Tax Benefit (WITB)

The Working Income Tax Benefit will be increased starting in the 2019 taxation year to roughly offset increased contributions by employees to the Canada Pension Plan (CPP). The WITB is a refundable tax credit equal to 26% of income earned over $3,000, to a maximum credit of $2,165 for families and $1,192 for individuals. The benefit is reduced at a rate of 14% of income above $16,925 for families and $12,256 for individuals. The WITB is eliminated at $32,390 of income for families and at $20,770 for individuals. These figures are based on projected indexing for 2019.

CORPORATIONS

During the week of October 16 to 19, 2017, the Minister of Finance trickled out a number of announcements in response to the wrath created by the tax changes proposed by the Department of Finance on July 18, 2017. During the consultation period which ended on October 2, 2017, the government received over 21,000 submissions from the public and multiple professional organizations vehemently protesting the tax proposals and the Liberal Party's plan to create so-called tax fairness for middle-income Canadians. Despite the criticisms, the government confirmed that it is moving forward on certain proposals to "fix a tax system that encourages the wealthy to incorporate so they can get a better tax rate."

Moving Forward with Tax Changes on Passive Income

The initial July 18, 2017 consultation paper did not contain specific proposals or draft legislation regarding passive investment income earned by corporations. Rather, it contained ideas and approaches about how to address the perceived advantages that corporate investors have over individual investors. The Department of Finance was open to suggestions from the public as to how to solve the imbalance of an incorporated individual having more after-tax capital to invest versus an individual earning a salary.

The government announced on October 18, 2017 that small business corporations are permitted to build up their investment reserves so that a corporation can earn up to $50,000 of passive income without being subject to an income tax increase. Presumably, this means that existing tax rates, tax balances, and corporate integration will continue to apply to investment income under the $50,000 threshold. The government did not provide draft legislation in relation to the threshold, nor the new rules that would apply to passive income in excess of the threshold. The details of the proposed rules will be released in Budget 2018.

The announcement also assured taxpayers that investments already made inside a private corporation, including the future income earned from such investments, will be protected from the new tax measures. Therefore, it is unecessary to divest current investment holdings to reduce income levels below the $50,000 threshold. It also assured that incentives will be maintained to enable Canada's venture capital and angel investors to support investment in the next generation of Canadian innovation.

At this point in time, the lack of details raise more questions than answers:

- What is the effective date of the proposal?
- How will existing investments be grandfathered?
- What is the definition of "investments already made"? Are cash balances included?
- Will there be a valuation date?
- If so, what date will be used for valuation? July 18, 2017 or October 18, 2017 or sometime in 2018?
- Will there be a requirement to separate investment accounts or will there be a proration of total investment income to determine the grandfathered income?

- How will business owners track the grandfathered assets? Should they move the grandfathered assets into a separate company to ease administration?
- Should corporate investors open separate sub-accounts for their investments to deposit new low-taxed active business profits to avoid co-mingling funds with grandfathered assets?
- What if the grandfathered investment balances are drawn down, can the funds be replaced at a later date and continue to produce grandfathered passive income?
- Does the $50,000 passive income threshold apply for each corporation or does it have to be shared amongst a corporate group?
- How is passive income defined? Is it the existing definition of aggregate investment income reported on Schedule 7 of the T2 tax return, i.e. all non-incidental passive income?
- Will corporate-owned insurance policies be pulled into the new passive income rules?
- Are capital gains from the sale of business assets included in the definition of passive income?
- How will passive income above the $50,000 threshold be taxed?
- Do the existing rules for refundable dividend taxes (RDTOH), the capital dividend account (CDA), and the general rate income pool (GRIP) still apply to grandfathered income? What about income above the threshold?
- Will grandfathering of investment assets end when the corporation's shares change owners?

We hope the answers to these questions will be provided when Budget 2018 is revealed in February or March next year and that a proper consultation period will follow to allow for constructive commentary. The one certainty is that any pending tax rules create more complexity for business owners and their tax accountants to track and report taxable passive income.

Moving Forward with Tax Changes to Income Sprinkling

The original July 18, 2017 draft rules proposed to expand the tax on split income (TOSI) rules (or "kiddie tax") to related adults (not only minors under age 18) in order to quell dividend and income sprinkling to the 18 to 24 age group and non-working spouses. Amounts received by related adults from the corporation as a shareholder or beneficiary of shareholder trust in excess of a "reasonable" amount would be taxed at the top marginal tax rate in the individual recipient's hands. The reasonableness test was not defined and received a lot of backlash from the tax and small business communities.

On October 16, 2017, the government announced it will move forward with the proposals to limit income sprinkling to family members who do not make "meaningful contributions" to the business. In an attempt to simplify the measure, rather than using a "reasonable test," adults will be asked to demonstrate their contribution to the business based on their current and past labour, capital and equity contributions to the business as well as financial risks taken on for the business, such as co-signing a loan. It is unclear how the "meaningful contribution" definition simplified the original proposal. The government will release draft legislative proposals later this fall which are intended to be effective for the 2018 and subsequent taxation years.

The effective date of January 1, 2018 leaves little time to plan for extra dividend and income sprinkling to family members who are definitely not working or participating in the business activities of the corporation. Business owners in this situation should contact their corporate tax accountant to determine if it makes sense to pay out extra dividends and income distributions before December 31, 2017. It may also make sense if provincial tax rate hikes are expected in 2018, such as in British Columbia (taxable income over $150,000).

It is important to note the revised income sprinkling rules do not affect reasonable salaries paid to family members working in the business.

Reductions to Small Business Income Tax Rates

On October 16, 2017, the government announced the reduction of the small business tax rate from 10.5% to 10% effective January 1, 2018 and then to 9% effective January 1, 2019. These reductions were previously introduced by the Conservative Party, but were frozen by the Liberal Party in last year's federal budget. The small business tax rates are prorated for taxation years that straddle the calendar year

Calendar Year	2017	2018	2019
Small business income tax rate for income <$500,000	10.5%	10.0%	9.0%

The annoucements and economic statement did not include any changes to the $500,000 active small business income threshold. However, the government is "making changes to address tax advantages that disproportionately benefit the wealthiest Canadians so that taxes can be cut for the benefit of the middle class." It is unclear if there are futher changes on the horizon regarding new requirements for corporations to be entitled to claim the small business tax rate, such as minimum employment hours or reinvestment in the business. Again, we will have to wait until Budget 2018 to find out if there will be changes to existing small business tax rules.

Non-Eligible Dividend Tax Credit Rate Changes

As a result of the reductions to the small business tax rate, the non-eligible dividend gross-up and tax credit rates will be adjusted from January 1, 2018 until January 1, 2019.

Calendar Year	2017	2018	2019
Dividend gross-up rate	17%	16%	15%
Dividend tax credit factor based on gross-up amount	21/29	8/11	9/13
Dividend tax credit rate as a % of actual dividend	12.31%	11.64%	10.38%

Abandoned Proposals

The government abandoned two of the corporate tax proposals after realizing the far-reaching and detrimental impacts they would have on the taxpayers the government claimed to be helping. The government will not be moving forward with the following proposals:

- Limiting access to the lifetime capital gain exemption (LCGE) where capital gains accruing to shareholders or trust beneficiaries while they are minors would not have been eligible to claim the $835,714 LCGE (indexed) for qualified small business shares and $1,000,000 for farming and fishing properties.

- Measures relating to the conversion of income to capital gains which would have affected post-mortem tax planning to prevent double taxation of corporate asset distributions subsequent to the death of a shareholder (known as pipeline planning).

Corporate shareholders should proceed with caution. The minister's statements were very vague and it is unclear if Finance has completely abandoned the idea of preventing multiplication of the LCGE or if it only dropped the proposals as drafted. The government indicated it will continue to reach out to farmers, fishers and other business owners to better accommodate intergenerational transfers of businesses.

Further uncertainty was created about potential changes as evidenced by this statement: "Consideration will be given as to the appropriate scope of the new tax regime with respect to capital gains, including whether in certain circumstances the new rules should exclude capital gains realized on the sale of shares of a corporation engaged in an active business." There may be plans to alter the treatment of capital gains or pipeline planning which could be revealed in Budget 2018.

Please contact your corporate tax professional if you have any questions about the impact of the proposals on your corporation and to take action before the end of 2017 to minimize your family's overall taxes.

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