Inside the Liberals' controversial tax changes: What's proposed, why they're doing it and what comes next

By Chris Hannay and Bill Curry
September 22, 2017 – *The Globe and Mail*

The hottest political topic in Ottawa this fall is the Liberal government's proposed changes to corporate tax rules.

Well-organized campaigns led by business and professional organizations are urging the government to back down. Other voices, including prominent academic economists and labour leaders, say the government's proposals are on the right track.

The changes, which were announced on July 18, are highly complex. Consultations are scheduled to close on Oct. 2.

Below is a summary of the proposed changes, an overview of the arguments for and against the proposals and the government's rationale.

Who is affected?

This is not an exhaustive list, but your taxes could be affected if:

- You (or a member of your family) own a private corporation, and you (or they) pay out dividends to family members or to a trust;
- Your family corporation keeps some excess earnings within the business's accounts, which are put towards passive investments;
- Your family corporation pays out surplus earnings as capital gains.

Proposal one: 'Income sprinkling'

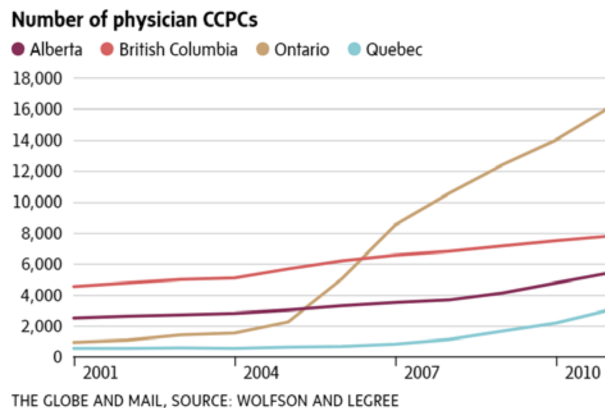
What it is: Business owners can distribute income to family members (such as a spouse or adult children), whether or not they directly contribute to the running of the business. If the business owner, which can be a professional, is in a high personal-income tax bracket and the family member is in a lower bracket, the overall amount of tax paid by the family is lower than if all the income was reported by the professional.

What the government would change: Currently, tax rules discourage the paying of dividends to children under the age of 18 for the purpose of lowering the tax burden. This provision is known in accounting circles as the "kiddie tax." The new rules would extend this to older children and other family members. The Canada Revenue Agency would apply a "reasonability" test to see if family members were contributing to the business. Otherwise, the family members could face a higher tax bill.

Business response: Small businesses that pay dividends to family members or trusts say that the policy recognizes the informal contributions that family members often make to a business. They also say that the new reasonability test means more work for the businesses – red tape – to show they are complying with regulations. More than half of doctors – who work as private contractors and bill the government for the work they do – use this corporate setup, according to the Canadian Medical Association. As The Globe's Campbell Clark reported, past governments have promised doctors lower tax burdens through mechanisms such as income sprinkling as a way to compensate for not paying as much directly.

Analysis: Owners of private corporations benefit from income sprinkling under very specific conditions: they have adult children (minors are not allowed to be part) and/or a spouse that make significantly less money than the principal owner. Kevin Milligan, an economist at the University of British Columbia who has advised the government on tax policy, says that in principle this measure

makes sense as a way to raise tax revenue because it is framed as an extension of current regulations. The Canadian Federation of Independent Business surveyed its members who own small businesses and found a majority currently pay compensation to family members. The CFIB is part of a coalition of business groups calling for an extension of the consultation deadline and a reconsideration of the entire plan. The Canadian Centre for Policy Alternatives released a study that suggests ending income sprinkling will affect mostly professionals who make more than $216,000 a year.



Proposal two: Passive investments

What it is: Instead of taking all profits from a business, the owner can choose to keep some of the money within the corporation's accounts and put it in passive investments such as stocks. Money kept inside the business is taxed lightly, so the investment gets a head start on growing compared with saving outside the business. The government says this investment plan primarily benefits people who have already maxed out other savings vehicles, such as Tax-Free Savings Accounts or a Registered Retirement Savings Plans.

What the government would change: The government is looking at a few options that are aimed at making the passive investments made in corporate accounts face the same overall tax bill as those made through personal accounts. The government says investments from the corporation that are directly related to the business – such as the purchase of new equipment – would not be affected by the change.

Business response: Entrepreneurs say the money that is held in the business – instead of being distributed as salary or dividends – and invested passively creates capital that could be used to grow and invest in the enterprise long-term. It also makes up for the savings and pension that a salaried employee would receive, but that entrepreneurs would not receive. Startup owners say it's a way of balancing the risk involved in launching your own company. Some CEOs of tech startups say this change would reduce some of the incentive to creating your own company. They also say the higher tax rate on passive investments unrelated to their business would leave them with less money to support other business startups through what is known in tech circles as angel investing.

Analysis: This may be the change that is most difficult for the government to make. This is partly because the intention is for the new measures to only apply on a go-forward basis, meaning existing investments would not be affected. Tax experts say accomplishing that goal would be technically challenging. Unlike the other measures, the government does not have draft legislation ready. The Finance Minister recently told a gathering of accountants that his department will ultimately release draft legislation on passive investments for comment before any measures are introduced in Parliament.

Proposal three: Capital gains

What it is: A capital gain is the amount of profit you would make if you sold an asset for more than you originally bought it for. Only half of a capital gain is taxable. Under certain conditions, it is possible to move dividend income (which has a higher tax rate) through

multiple corporations and report it as capital gains (which is taxed at a lower rate).

What the government would change: The Income Tax Act already has a section that discourages this activity, but it doesn't cover every possible way dividends can be transformed into capital gains. The government wants to extend the current rules to cover all possible transactions of this type.

Business response: Some family-owned businesses worry this change could make it more expensive for them to pass on their enterprise to their children. The president of the Canadian Federation of Agriculture told The Globe that farm families are concerned about the new rules, though they've been told the government does not intend to negatively affect them.

Analysis: The change is about clarifying an activity that already wasn't supposed to be available, tax specialist Tim Cestnick writes in The Globe. But depending on how the final legislation is worded, it could affect other uses of the lifetime capital gains exemption (LCGE). "For example, where a family trust holds shares of a private company, the LCGE will be unavailable even in cases where the gain is allocated to a beneficiary who is involved in the business, or the shares are distributed to a beneficiary who is involved in the business prior to the sale," partners at Clark Wilson LLP write.