KPMG

TaxNewsFlash Canada

Small Business Tax Rate Drops to 9% by 2019

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Prime Minister Justin Trudeau and Finance Minister Bill Morneau announced that the small business tax rate would decrease to 9% (from 10.5%) by 2019 as part of new changes to the private company tax proposals. In particular, the small business tax rate will decrease to 10% effective January 1, 2018 and to 9% effective January 1, 2019. The government also said it has planned additional announcements in the upcoming week to provide further details of changes that it intends to make in response to Finance's recent public consultation on these controversial proposals. While the government stated that it is committed to its proposed private company tax measures to address tax planning involving income sprinkling effective January 1, 2018, it is cancelling changes to limit access to the Lifetime Capital Gains Exemption (LCGE). The government also indicated that it will address certain issues in its passive income proposals.

The government is considering the recommendations of KPMG and other concerned taxpayers before finalizing any planned changes to private company taxation. Draft legislation has not yet been released to implement the small business tax rate changes, and Finance stated that, later this fall, the government will release revised draft legislative proposals on its private company tax measures. It is expected that these measures could be released as part of Finance's upcoming fall economic update.

Background
The government released a consultation paper and complex proposed rules and approaches to address certain tax planning involving private corporations on July 18, 2017. The consultation paper, "Tax Planning Using Private Corporations", looks at

strategies that Finance believes “inappropriately reduce personal taxes”. Specifically, the consultation paper outlines proposals to address tax planning involving:

- Income sprinkling using private corporations
- Converting a private corporation’s income into capital gains
- Holding a passive investment portfolio inside a private corporation.

Most of the proposed measures generally apply to the 2018 and subsequent tax years, except for certain measures dealing with the proposed anti-surplus stripping rule which would apply to shares disposed of, and amounts received or that become receivable, on or after July 18, 2017 (i.e., the consultation paper’s release date).

For full details on the consultation paper, see *TaxNewsFlash-Canada* 2017-38, “Finance Targets Private Company Tax Planning”.

KPMG prepared a submission on the consultation paper that advised the government to delay implementing its proposed tax changes, and recommended certain technical fixes (see *Consultation on Private Company Taxation — KPMG Submission to Canada’s Department of Finance* and *TaxNewsFlash-Canada* 2017-44, “Private Company Tax Changes — What’s Canada’s Next Move?”).

Small business tax rate drops to 9%

The government announced that it would decrease the federal small business income tax rate that applies to the first $500,000 of qualifying active business income of a Canadian-controlled private corporation to 9% (from 10.5%), to be phased in as follows:

- 10% effective January 1, 2018
- 9% effective January 1, 2019.

Finance states that the taxation of non-eligible dividends will be adjusted to reflect the lower small business tax rate in order to maintain integration of corporate and personal taxes. The government has not yet specified how it will make this adjustment.

Income sprinkling proposals

Finance looking at simplifying reasonableness tests

In a press release, Finance reiterates that it intends to proceed with its proposals to address income sprinkling using private corporations, but that it will make amendments to “simplify” these planned changes. Finance says that businesses with family members who “meaningfully contribute” to the business will not be affected. Specifically, Finance confirms that it will introduce "reasonableness" tests for adult family members aged 18-24, as well as those 25 and older. The tests will consider whether these individuals made contributions to the business through any combination of the following:

- Labour contributions
- Capital or equity contributions
- Financial risks, such as co-signing a loan or other debt
- Past contributions in respect to previous labour, capital or risks.

Finance also states that it plans to reduce the compliance burden for establishing these contributions and address double tax concerns. Although it is not yet clear how Finance intends to achieve this, Finance is expected to provide more details on its income sprinkling proposals soon.

Finance will not proceed with LCGE measures

Finance is cancelling proposed measures to address income sprinkling by multiplying the LCGE across multiple family members. Specifically, Finance notes that feedback from its consultation paper has identified unintended consequences of these measures, including the potential impact on intergenerational transfers of family businesses. As a result, the government says it "will not be moving forward with measures that limit access to the LCGE".

KPMG observation
Previously, Finance released draft legislation that proposed to no longer allow individuals to qualify for the LCGE for capital gains that are realized, or that accrue, before the taxation year in which the individual turns 18. Further, the proposals provided that gains that accrued during the time that property was held by a trust would generally no longer be eligible for the LCGE. Also, the LCGE proposals would generally not apply to the extent that a taxable capital gain from the disposition of property is included in an individual's split income.

Although the government states that it will not proceed with the LCGE proposals, it is unclear whether the tax on split income rules will still apply to limit the LCGE. This is because the government intends to proceed with the tax on split income rules.

Passive income proposals

Finance further notes that it intends to address unintended consequences of its passive income proposals. In response to feedback from its consultation paper, Finance says it recognizes that private corporations use passive investments to manage personal income risk in the case of a downturn, sick leave or maternity or parental leave, and for retirement savings. Finance recognizes that other savings vehicles, such as RRSPs, are not "sufficiently flexible and adaptable to address business volatility". Finance has not yet provided further details on how it will address the unintended consequences that were identified.

We can help

Your KPMG adviser can help you assess the effect of any potential changes to the taxation of private companies. For details on the implications for your company, contact your KPMG adviser.