

The Federal Budget - Some Bad Omens

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While Finance Minister Bill Morneau, in his recent federal budget, did not propose an increase in either personal or corporate tax rates, and while the feared increase in the portion of a capital gain that is taxed (capital gains inclusion rate) did not come to pass, there were some troubling signs for owners of private businesses and investment companies.

One is actually a proposed change to the income tax rules; the second is an announcement of a review of a number of common planning strategies.

Under the guise of “closing loopholes and addressing tax planning,” the Budget documents state that “the Government will identify and close tax loopholes and tax planning schemes that disproportionately favour the wealthy - including tax planning strategies that involve private corporations”. As is often the case, what is originally described as an incentive when introduced into tax legislation is later labelled, when it is politically expedient to do so, as a loophole that disproportionately favours the wealthy. In this context, one can imagine an all-out attack on the use of private companies.

The measure that is proposed in the Budget targets the small business deduction, which is the ability of Canadian-controlled private corporations to earn up to \$500,000 per year of active business income at lower tax rates.

Tax planners have spent considerable time developing ways for family groups to access more than one small business deduction by ensuring that two or more corporations are not “associated” for the purposes of the *Income Tax Act*. One such method is to require that a person who controls one corporation does not have “factual control” (as opposed to legal control) of a second corporation.

A recent Federal Court of Appeal decision restricted this factual control test to one where the person had a legally enforceable right to effect a change of the Board of Directors of the

corporation. Revenue Canada clearly did not like this decision, as it drew a clear line for planners as to what would or would not constitute factual control.

Hence, the Budget resolution proposes that the *Income Tax Act* be amended to clarify that the test for factual control not be limited in the manner outlined in this Court decision and that other factors may be taken into consideration.

Thus, Revenue Canada takes us back to a murky test which leaves planners unsure as to where CRA may or may not choose to reassess.

The Budget also proposes a review of tax planning using private corporations. Again, in the Budget documents, the Government cites the use of tax planning strategies using private corporations which can result in high-income individuals gaining unfair tax advantages. Specifically, the Government mentions three common strategies, including:

1. Using private corporations to sprinkle income among family members who are in lower personal tax brackets;
2. Holding a passive investment portfolio inside a private corporation which may be financially advantageous for owners of private corporations compared to other investors due primarily to the fact that income, once taxed at a lower rate, can be accumulated in private corporations before being paid out as dividends to the shareholders; and
3. Converting a private corporation's regular income into a capital gains, presumably through selling the shares of the corporation rather than distributing its income.

The common sin in all these strategies is the intent to arrange one's affairs so that income is taxed at anything other than the highest possible marginal rate. The Budget states that the Government intends to release a paper in the coming months setting out the nature of these issues in more detail and proposed policy responses.

So, again, the news the Government wants you to hear is that personal tax rates are not going up - they are already as high as 53.5% in Ontario.

What is also apparent is that there is a very clear intention to raise revenues by once again "taxing the rich".

The question is, will the incremental revenue the government raises be anywhere near the political benefit it hopes to achieve?

Paul Schnier practices corporate and personal income tax law with an emphasis on tax planning and implementation. He provides advice on the consequences of proposed transactions and the

development and implementation of tax efficient corporate structures for multinational operations. He also advises individual clients on estate planning matters. Paul chairs Blaney McMurtry's tax practice.

Paul may be reached directly at 416-593-3956 or pschnier@blaney.com