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PRIVATE CORPORATION TAX PROPOSALS

WESTWARD ADVISORS

WESTWARD'S VIEW

On July 18, 2017, Finance Minister Morneau announced tax changes aimed at eliminating significant private corporation tax benefits currently available in the *Income Tax Act*.

The changes target three areas of benefits:

1. Corporate income sprinkling
2. Corporate tax deferral
3. Corporate income conversions into capital gains

None of these measures directly affect the taxation of our clients' life insurance policies or interest deductibility on loans secured by their life insurance policies.

However, the changes could significantly affect our clients' income tax planning and consequently may affect the structure of our clients' insurance planning.

The proposed changes are subject to a "consultation period" that ends October 2, 2017, and final legislation is expected later this year. Westward is participating in the consultation process and when the tax changes are finalized, we will contact clients and their advisors regarding the impact of the tax changes on our clients' insurance plans.

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Corporate Income Sprinkling

Corporate income sprinkling legally shifts the distribution of corporate income from an individual in a high tax bracket to a family member in a low or zero tax bracket. The Act already includes measures that restrict income sprinkling to minors, and the reasonableness of salaries paid to family members.

The changes will significantly restrict income sprinkling to adult family members, and expand the restrictions on income sprinkling to minors. Income sprinkling will only be permitted if reasonableness tests are met. Reasonableness will be a function of the family member's contribution of labour, capital and risk to the activities of the business, and will be stricter for 18-24 year olds. Sprinkling capital gains to family members to multiply the lifetime capital gains exemption will also be restricted.

Corporate Tax Deferral

Corporate tax deferral applies a low rate of tax to business income. If the low-taxed business income is not re-invested in business operations, it can be re-invested in a corporate passive investment portfolio. Consequently, the corporate tax deferral allows the business owner to legally invest roughly twice the amount of capital in a corporate owned passive investment portfolio than if the income was received and invested personally. The government now considers this an unfair advantage because the business owner can accumulate roughly twice the amount of passive investment capital than an individual who cannot benefit from corporate tax deferral.

Going forward, the benefit of the corporate tax deferral will be eliminated on passive investment income earned by corporations. Corporate tax deferral will continue to benefit corporate income that is re-invested in active business operations. The changes promise grandfathering protection for existing passive investment assets, but how that will work is not known.

Corporate Income Conversions into Capital Gains

A private corporation's capital gains are taxed at half the tax rate of the company's regular income. The non-taxable half is then available to pay as a tax-free dividend to the shareholder. The government has targeted strategies that legally convert regular income to capital gains, and will eliminate those tax planning opportunities.

Summary

The proposed changes are the most significant tax reform since 1972, yet the length of the "consultation period" is so short that many believe the government has already made up its mind. While the specifics of the new tax rules remain uncertain, there is no doubt that owners of private corporations face larger tax burdens going forward. Consequently, tax effective insurance planning is now an increasingly valuable tool to protect the financial security of the entrepreneur and his/her family.