Proposed Tax Changes for Family Businesses

Your Questions Answered

On July 18, 2017, the Government of Canada's Department of Finance announced proposed changes for the taxation of family businesses. These changes will affect private Canadian corporations and their shareholders – including those in the real estate and construction industries. If enacted in law as currently proposed, the following tax benefits will no longer be available:

1) Family businesses have benefitted in the past by paying dividends to either family members or trusts as shareholders of their private corporations. By paying dividends to family members, owners of family businesses were able to reduce their overall taxes, allowing them to support others in a tax-efficient manner. This strategy was often used, for example, to help finance post-secondary education and to support aging parents.

2) Family business have been able to take advantage of deferring income taxes on excess earnings by retaining these excess earnings within the corporation. Since the corporate rates of tax are significantly lower than the highest personal marginal rates of tax, the corporation has a larger pool of capital to either reinvest in the business or to invest in passive investments.

3) Individual shareholders of family businesses typically receive salaries, dividends or a combination thereof as remuneration. In recent years, tax planning has allowed shareholders to withdraw corporate surplus as capital gains. As only 50 per cent of a capital gain is subject to tax, this allowed shareholders of family businesses to realize significant tax savings when withdrawing funds from their corporation.

Impacts will be significant and felt by most family businesses operating through a corporation. To provide clarity and help you prepare, MNP has compiled some of the most frequently asked questions we have received from our clients.

Q: The proposed changes call for a "reasonability test" for dividends paid to an adult family member. What is considered a 'reasonable' dividend amount to pay?

A: The legislation proposes a subjective reasonability analysis. It will consider three factors:

(i) The labour contributions of the individual receiving the dividend
(ii) The individual's capital contributions to the business
(iii) Whether the individual receiving the dividend is between ages 18-24 or if they are aged 25 and older

Individuals aged 18-24 must be "actively engaged on a regular, continuous and substantial basis in the activities of the business" for the dividend to be deemed reasonable. However, an amount could still be deemed unreasonable if it exceeds a legislatively prescribed maximum rate of return on assets contributed to the business by the individual.

Individuals aged 25 and older will need only to have been involved in in the activities in the business. That involvement, however, need not be on a regular, continuous and substantial basis. There will be no legislatively prescribed maximum rate of return, but the individual will need to have contributed assets or assumed risk in support of the business.

Guidelines for how the Canada Revenue Agency (CRA) plans on administering this "reasonability test" are not yet clear. Therefore, it is recommended the duties and contributions of each shareholder be thoroughly documented. In the event a dividend paid to a family member is challenged by the CRA, it will be helpful to provide as much support as possible to satisfy these requirements.

Note: Because dividends paid in (or declared before the end of) the 2017 calendar year will not be affected by the new regulations, it may be advantageous in some cases to pay a significant dividend to family members prior to December 31, 2017.

Q: The proposed changes give the CRA the ability to deem a dividend paid to a family member as "unreasonable" and therefore subject to the highest individual marginal rate of tax. My family's shares are held through a family trust. How is the trust affected?

A: Income distributed through a family trust to the beneficiaries will be subject to the same "tax on split income" (TOSI) as though the dividend had been paid directly to the individual. As a result, this will render a family trust ineffective for splitting income among family members unless it could be shown that the amounts distributed to individuals were reasonable based on the tests discussed above.

The proposed changes no longer permit individuals to claim the lifetime capital gains exemption (LCGE) on capital gains that accrued during a period where the shares were owned by a trust. While certain trusts are exempt, most family trusts will not meet these exemptions. This measure will apply whether the capital gain is realized directly by the trust, or if the shares were distributed to individual beneficiaries who realized the capital gain on a disposition.

Q: Will family businesses that earn real estate rental income still be able to pay dividends to family members?

A: Generally speaking, all dividends received by an individual from a private corporation will need to satisfy the "reasonability test." However, where the principle purpose of the private corporation is to earn income from property (e.g., rents), the labour contribution by the family member is disregarded and the "reasonability test" is based solely on the capital contributed. This means that the provision of labour to a corporation in respect of its rental activities may never satisfy the "reasonability test."

Q: How will the proposals apply to holding passive real estate investments or to surplus cash from the refinancing of existing real estate in a corporation?

A: There is currently no draft legislation with respect to these measures. However, the federal government is currently exploring several options, including removing the refundable tax regime, which would increase the overall tax rate on such income to well in excess of 50 per cent. That said, the federal government has indicated it intends for these changes to apply on a go-forward basis, which should not impact existing passive investments.

Q: Will land held for future development and sale be considered a passive investment?

A: Under current rules, if the primary intention is to sell the land in the future to generate profit, the land is treated as a business asset and the resulting profit or loss is treated as business income or loss. Accordingly, the land would not be considered a passive investment.

Q: Is it still beneficial to incorporate a family business?

A: Under the right circumstances, there are still many situations where incorporating would be advantageous. Some examples are:

- Ability to pay down business debts using corporate dollars that have only been subject to corporate rates of tax
- Splitting income among family members when amounts are considered reasonable
- Alternative retirement and estate planning strategies, such as individual pension plans, retirement compensation arrangements and permanent life insurance
- Access to the LCGE on the future sale of the business

Every situation will be unique and will require evaluation before deciding whether incorporating is still beneficial.

Q: What will happen with my current share structure, in which my spouse and adult children are shareholders?

A: If the proposed changes are passed, some of the benefits of your current structure may no longer be available. Once final legislation is passed, we recommend meeting with your tax advisor to determine the implications of these changes. At that time, you will be able to determine if it will be necessary to make changes to your share structure.

The measures introduced on July 18, 2017, will likely have a significant impact on tax planning for family businesses. For more information on how they will affect you and your business, please contact your local MNP tax advisor.