COMMENTARY ON THE FALL ECONOMIC STATEMENT

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The Fall Economic Statement is out. So what's new? So glad you asked! The political rhetoric is not new, so we will not reiterate it here. That, and economic data, makes up the bulk of a 78 page document tabled October 24th. You may read it at http://www.budget.gc.ca/fes-eea/2017/docs/statement-enonce/fes-eea-2017-eng.pdf, if you are so inclined.

In summary, the last few weeks, since the Department of Finance's submission deadline for the proposed tax changes, has been a real battle! The Finance Department came up against the Canadian tax and small business communities who returned fire aplenty. The subsequent retreat by Finance is reminiscent of the battle of Dunkirk during World War II. Hats off to the Canadian tax and CPA community and in particular to two of KRP's senior management; Allan Sawiak, CPA, CA, CAFA, TEP and Hugh Neilson, FCPA, FCA, TEP who have worked tirelessly on behalf of the public in soliciting changes to the proposed rules.

The Economic update confirmed some of the changes that were announced in the various releases made during the prior weeks. Although Finance has backed down on some of the changes, they still need to provide details.

WHAT WE KNOW

- The income sprinkling restrictions will proceed; "the Government intends to move forward with measures to limit income sprinkling using private corporations, while ensuring that the rules will not impact businesses to the extent there are clear and meaningful contributions by spouses, children and other family members." Reasonableness tests for adults age 18-24, and age 24+, will be introduced. The three hallmarks of labour contributions, capital/equity contributions and assumption of risk (all past or present) continue to be reiterated. 2018 is still planned as the effective date.
- The component of the income splitting proposals limiting access to the lifetime capital gains exemption will not proceed.
- Passive investment proposals remain unclear, however commitments have been made to the extent that existing investments (including future income from these investments) will be exempted, an annual passive income threshold of $50,000 will apply (below this, any new rules for passive income will not apply) and somehow venture capital and angel investing will not be dis-incented (consultation with those sectors to come). Income incidental to active business is not "passive".
- Proposals on "conversion of income into capital gains", aka surplus stripping, *will not* proceed. These were provisions which potentially blocked pipeline estate transactions, and created concerns for capital dividends.
- The small business federal tax rate will be reduced by 0.5% in calendar year 2018 to 10.0% and will reduce a further 1.0% in calendar year 2019 to 9.0%.
- The Canada Child Benefit will be strengthened – inflation indexation will apply commencing July, 2018, two years earlier than previously committed. Benefits will be enhanced by 1.5%.
- The Working Income Tax Benefit gets a $500 million enhancement to start in 2019 – details to come in the 2018 Budget.

WHAT WE BELIEVE

- Legislation regarding the changes is to be released “later this fall”. This might mean “not before December 20”; (Happy Holidays), but 2018 is still planned as the effective date for the new income splitting rules.
- A change in the small business tax rate typically comes with an offsetting adjustment to the tax rate on dividends, to achieve “tax integration”. The Economic Statement includes proposals to this effect which will increase the Federal marginal tax rate on ineligible dividend income for an individual in the highest personal tax bracket by 0.34% in 2018 and a further 0.92% in 2019. Typically, provincial tax rates on dividends are amended following a Federal change, to maintain the provincial tax rates given there has been no change to provincial corporate taxes, however these amendments typically are not released for months after a Federal change.

WHAT WE DON’T KNOW

- The form the passive investment proposals will ultimately take, including when these will become effective. The recent announcements indicate further details will be included in the 2018 Federal Budget. Exactly which assets will be “grandfathered” and how these assets and relative income will be tracked in the future?
- The mechanism for taxation of future passive income over the $50,000 threshold.
- Details on how the “reasonableness tests” for income splitting will be applied. Promises have been made to simplify the rules (we can only hope).
- What anti-avoidance rules will be implemented to prevent “tax planning” to take advantage of the new rules.
- Finance has made a commitment, over the next year, to consult with the business community in search of a means “to better accommodate intergenerational transfers of businesses”. These details are yet to be announced.

Although the retreat by Finance is welcomed, there are still a lot of details to be announced, some of which may not be known until the release of the 2018 Budget sometime in the spring, and others even later than that. As in World War II, after the Dunkirk retreat, there were new battles and advances that shaped the outcome of the war.

Should you have any questions regarding these proposed changes, please contact your KRP partners and staff as each client situation is unique and the impact varies.

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