Five unanswered questions about the Liberals' proposed small-business tax changes

Business owners, along with their accountants and financial advisers, have a lot of questions about how Ottawa's proposed tax changes will work.

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SPECIAL TO THE GLOBE AND MAIL
OCTOBER 26, 2017

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Small-business owners remain in limbo over how Ottawa's latest proposed tax changes will affect their livelihoods. While the federal Liberal government recently removed some of the controversial proposals tabled in July, there's still uncertainty around pending changes to income sprinkling and a cap on passive investments.

Ottawa says it's moving ahead with plans to stop income sprinkling for family members who aren't "meaningfully" contributing to the business and promises to "simplify" the proposal in the weeks ahead. The government is also planning to put a higher tax on passive investment income in an incorporated business that exceeds $50,000 each year. Ottawa wants the income sprinkling rule to start on Jan. 1, 2018 and says the draft legislation for the passive income changes will be released in the upcoming federal budget, which is usually released in between February and April.

how the potential changes will work. Below are some of the unanswered questions about what Ottawa has on the table.

How will the new income sprinkling rules work, exactly?

The government says it plans to simplify the proposal and introduce a "reasonableness test" for family members to prove they're active in the business and qualify for the tax benefit. Business owners are looking for more details on how that test will work and what will be simplified – and time is running out. "We're now two months away from rules that we have to play by, and we don't even know what the rules are," says Michael Gorniak, a partner at Saskatoon-based accounting firm Thomson Jaspar. Business owners are trying to figure out if they need to take full advantage of existing income sprinkling rules before the end of the year.

When will the new passive rules begin?

The government says it will introduce draft legislation with its 2018 budget, but what everyone is trying to figure out is when they'll kick in. Ottawa has said all past investments will be protected and the new $50,000 annual threshold will be on a "go-forward basis." When does the future start? Marc Lamontagne, founding partner at Ottawa-based financial planning firm Ryan Lamontagne Inc., says business owners are wondering if they should be acting now to maximize the grandfathering rules. "Does that mean I have to invest as much money as I can before Dec. 31 or the budget date? Should I go and borrow and invest?" Mr. Lamontagne asks, on behalf of his clients. He says some of these strategies could leave business owners stretched financially. It could also delay investments in their active business.

What does the $50,000 threshold include?

Does it include income on interest, dividends and capital gains – each of which is taxed differently? The government says it's considering whether "in certain circumstances, the new rules should exclude capital gains realized on the sale of shares of a corporation engaged in an active business." Still, that leaves business owners scratching their heads. "$50,000 of what? Capital gains, interest or dividends? Nobody knows. They have to get back to us on that," says Jennifer Weeks, a Vancouver-based certified financial planner with Springtide North Wealth Advisory. She says that will affect how people will want to invest their money, "so they're not double taxed."

How will asset changes be treated under the grandfathering rules?

Ottawa says existing passive investments will fall under the new rules, but what happens if you sell that asset and buy a new one under the new rules? Mr. Gorniak uses the example of a business owner that sells an apartment building bought under the old rules to buy GICs under the new rules. "Does it have to stay as the same asset?" he asks.

Some investors argue that higher tax rates on passive investments will mean less capital being reinvested in startups. Ottawa says it will make changes to passive investment rules to "maintain incentives" that will encourage venture capital and angel investors to invest in Canadian startups. Ottawa says it will work with the sector to "identify how this can be achieved." The startup community is still waiting to see what options are on the table.

"We have outstanding questions about how the regulations will be written, since our concerns about the impact of the proposal on angels who are making startup investments through private corporations have not yet been fully addressed," says Yuri Navarro, executive director and CEO of National Angel Capital Organization. He argues that angel investing should be characterized as active investing, and not passive. "Our goal is to work closely with the government on making sure the regulations are done in such a way that they don't create additional barriers to risk capital."

While financial experts wait for the legislation to be clarified, they are cautioning clients not to make dramatic moves. While we may think we know what's coming, Mr. Lamontagne says, it's wise to wait before making decisions. "Taking drastic action now may end up hurting you."

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Bill Morneau announces $50,000 passive income threshold
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