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Franchisors take note: Proposed changes to the tax treatment of private corporations may restrict flexibility in franchise systems

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Franchise systems that rely on family owned and operated franchisees should take note of certain proposed changes to the taxation of Canadian private corporations. Following up on a commitment made in the March federal budget, on July 18, 2017, the Department of Finance released draft legislation and explanatory materials. The stated goals of the government's proposals are to reduce certain perceived advantages, which may be available to private corporations and may not be available to individual employees or sole proprietorships. The changes proposed by the draft legislation are complex and far reaching. The descriptions below provide only a brief overview of some of the proposed changes that may be relevant to franchisees.

Income sprinkling proposals

Under current rules, "tax on split income" (TOSI) generally applies to limit the ability to split income with minors under the age of 17.

Under the proposed changes

- the scope of TOSI will be expanded to apply to both minors and adults, and the list of "related persons" will include aunts, uncles, nieces and nephews;
- the types of income to which TOSI will apply will be expanded to include additional types of income, including compound income; and
- a "reasonableness test" will be added to ensure that amounts received by adults are taxed at the highest possible tax rate unless the amount received is "reasonable" in circumstances.

Lifetime capital gains exemption (LCGE) proposals

Under current rules, certain taxpayers may be entitled to claim the benefits of the LCGE, which allows taxpayers to realize a certain amount of capital gains "free of tax" on the sale of certain small businesses.

Under the proposed changes

- the availability of the LCGE to beneficiaries of trusts may be reduced or eliminated;
- the availability of the LCGE will be eliminated for individuals under 18 years of age; and
- a "reasonableness" test will be introduced to determine the availability of the LCGE for

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taxpayers who are not subject to the age or trust-related limitations.

The draft proposals also introduce changes to the rules that are applicable to extracting retained earnings from a private corporation and the rules with respect to the treatment of earning passive investment income inside a private corporation.

In highly competitive markets where margins are small and shrinking, these measures could make it more difficult to create an attractive investment model for franchisees. For the last couple of decades, the ability to rely on the LCGE to maximize the benefit of the sale of the franchise at the end of a career or to realize incremental value gains has been an important part of the appeal of franchising for a certain segment of small business investors. The changes in the capital gains exemption could have a significant impact on the fluidity of franchisee capital and the willingness of franchisees to move on in circumstances where franchisor and franchisee no longer see eye to eye.

Your franchisees may have included the LCGE and income splitting in their operational and retirement planning. It appears that the federal government intends to move quickly with these changes. The consultation period was short and it ended on October 2, 2017. If adopted, some of the measures will have a retroactive effect. Anyone potentially affected by these changes should seek qualified professional advice soon, and franchisors would be well advised to consider the short and longer term impact of these changes on their systems.