November 2017

Changes proposed to taxation of private corporations and their shareholders

Bill Crowther, CPA, CA, TEP, FEA, *is a partner, tax, in the Peterborough office of Collins Barrow*

On July 18, 2017, the federal government of Canada introduced proposals ("announcements") curtailing the use of private corporations to gain tax advantages over other individuals in Canada who do not utilize such corporations. The proposals were positioned by the government as measures to ensure that the wealthy pay their fair share and the Canadian tax system is applied in a manner that is fair for all Canadians. If enacted as introduced, these proposals represent arguably the most significant changes to the taxation of private corporations in over 40 years.

Thankfully, the government retracted some of the proposals, but has stated its intent to proceed with others. As there have been countless releases from Finance in October and November, we thought it would be useful to summarize the government's intent and where we are right now. We say "right now," as there is a significant amount of clarification and actionable tax legislation required before any of the new measures can be enacted into law in a manner that allows taxpayers to reasonably comply.

There is planning that taxpayers should consider in 2017. When the final rules are determined, compensation and ownership structures should be revisited to determine if changes are required. Your Collins Barrow advisor can lead taxpayers though this planning process.

What was Intended?

In the March 2017 budget, the government announced a review of tax planning strategies using private corporations. Specifically, it identified the following:

i. Sprinkling income among related individuals to reduce tax otherwise payable;

ii. Converting income (very often dividends) into capital gains, which are generally taxed at a much lower rate than regular income and dividends; and

iii. Individuals holding passive investments indirectly through a corporation versus personally.

The budget papers indicated that a consultation paper would be released shortly.

What was in the announcements?

The announcements targeted four primary areas:

i. Income sprinkling in a family context – The announcement eliminated planning strategies under which income otherwise earned by a founder/parent would be realized and taxed in the hands of lower-income adult family members, who are not involved in the business. Currently, there are rules which tax income earned by a minor at the top marginal rate, if such income is derived from certain related sources. This tax is often referred to as "kiddie tax". The announcements extend kiddie tax so that it applies to both minors and all adults receiving income sufficiently linked to a business controlled – or significantly influenced – by a related source. The expanded rules will not apply to income received by a family member if the amount is "reasonable," having regard to the labour and capital contributions made to the business by that family member. In this regard, the proposals contain provisions which would codify multi-level reasonableness tests.

November 2017

Changes proposed to taxation of private corporations and their shareholders

ii. Restrictions to multiplying the lifetime capital gains exemption (LCGE) – The announcements eliminated the ability for multiple family members not involved in the family business from accessing the LCGE upon the sale of eligible assets (shares of qualified small business corporations and qualified farming and fishing assets). The ability to realize capital gains allocated from trusts, which could be sheltered with the LCGE, was also eliminated, even in circumstances where the recipient is involved in the business. The current tax regime provides limited restrictions from multiplying such gains to include many family members.

iii. Conversion of dividends into capital gains – The announcements introduced an anti-corporate surplus stripping theme in the act to eliminate planning to cause certain amounts extracted from a corporation, in a family context, to be taxed as a capital gain and not as a taxable dividend. The top rate of income tax in Ontario on taxable dividends realized by individuals is generally 45.3% (in 2017) or 39.34% versus 26.765% for capital gains. The savings from this type of planning, if the Canada Revenue Agency is not successful in assessing such transactions otherwise, is significant: 18.5% or 12.6%.

iv. Perceived tax advantages to using private corporations to earn passive investment – The announcements were, in large part, an academic discussion providing a number of ways this perceived advantage could be eliminated. At the root of the government's concern is the fact that our system taxes business income earned in a corporation at a rate which, on the surface, is much less than the rate an individual might pay if that business income were to be earned directly. When that corporation distributes its tax-paid income by way of dividends to its individual shareholders, that deferral is eliminated since the shareholder pays a second level of tax (personal income tax) on that dividend. (This is why we say "on the surface.")

In general terms, the government's issue relates to this deferral. By way of example, in Ontario in 2017, the top rate of tax an individual would pay on business income is 53.53%. For every $100 of such income, he/she would have $46.47 to invest. In 2017, business income earned in a private corporation in Ontario is taxed at 15% or 26.5%. For every $100 of such income, the corporation has either $85.00 or $73.50 to invest. Therefore, tax deferral (and additional monies left to invest) in favour of corporately earned income is $38.53 or $27.03. The larger investment pool can be invested inside the corporation. Specifically, it is the income earned on that deferral that is the issue for the government. The announcements provide, in general terms, various options to remove this perceived advantage through additional taxation.

The government also announced a 75-day consultation period inviting comments on the proposals.

What happened between July 18, 2017 and October 2, 2017?

The announcements were more than a "consultation" or a "proposal" in respect of the first three areas, as they included very complex draft legislation (23 pages of legislation accompanied by 47 pages of explanatory notes). The provisions for the income sprinkling and LCGE restrictions were to be effective January 1, 2018. The conversion of income into capital gains rules were effective on July 18, but, in many cases, had retroactive application. As was subsequently demonstrated, this draft legislation would have caused many unintended consequences. As for the fourth area dealing with passive investment, the concepts were also very complicated – and largely incomplete – leading to many significant concerns.

When the Canadian business community and their tax advisors worked their way through the announcements, the result was

November 2017

Changes proposed to taxation of private corporations and their shareholders

over 21,000 submissions made to the government. The many unintended consequences and the problems in administering the proposals were pointed out in those submissions.

What was abandoned and where are we now?

The government has stated that it carefully considered the consultation period submissions and discussions it had with Canadians across the country. Thus, in various releases over the latter half of October 2017, the government:

i. Abandoned the proposals relating to restrictions to the LCGE.

ii. Abandoned the proposals relating to the conversion of income into capital gains.

iii. Confirmed its intent to proceed with rules to eliminate income sprinkling in favour of family members not making a reasonable labour or capital contribution to the business. However, it also announced that it will revisit the complexity of the rules and ensure they can be applied with more certainty. The next round of legislation is expected in the fall of 2017, and it remains to be determined if the new rules will be less complicated and certain enough to be fairly applied to taxpayers.

iv. Confirmed its intent to proceed with some method of eliminating the perceived tax advantages of deferrals available by earning business income in a private corporation. However, the government also clarified that investments in existence at the time new rules become effective will be grandfathered and continue to be taxed under the current income tax regime. In addition, the government announced that the first $50,000 of investment income will be taxed under the current regime and only income in excess of that threshold will be taxed under a new regime. The outstanding questions and concerns, even with these announcements, that have been raised by the tax community are significant and too numerous to mention here. The government has indicated that the 2018 federal budget will contain more details as to how it intends to proceed. As with the revisions to the kiddie tax proposals, this is still very much a wait and see situation.

Bill Crowther, CPA, CA, TEP, FEA, *is a partner, tax, in the Peterborough office of Collins Barrow.*

An independent member of BAKER TILLY INTERNATIONAL

Clarity Defined.
collinsbarrow.com

COLLINS BARROW

Collins Barrow periodically publishes *Tax Alert* for its clients and associates. It is designed to highlight and summarize the continually changing tax and business scene across Canada. While *Tax Alert* may suggest general planning ideas, we recommend professional advice always be sought before taking specific planning steps.