TAX FLASH

July 2017

Finance targets tax planning for private corporations

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On July 18, the Department of Finance released a consultation paper outlining a number of measures designed to close down various tax planning strategies currently available to owners of private corporations in Canada with hopes to halt "unfair advantages." The paper was accompanied by draft legislation and explanatory notes for some of the proposed measures. The Government had previously signaled its intent to change how Canadian-controlled private corporations ("CCPCs") were taxed in its March 2017 budget.

In particular, the proposed measures are focused on strategies that allow an owner of a private corporation to reduce their overall tax cost by (a) sprinkling income or capital gains amongst various members of the owner's family, (b) converting corporate income into a capital gain and (c) earning investment income inside the corporation.

In announcing the release of the discussion paper and other documents, Canada's Finance Minister, Bill Morneau, reiterated that CCPCs engaged in active businesses make a significant contribution to the Canadian economy and noted that the proposed measures were not targeted at active operations. As further discussed below, one of the proposed mechanisms to identify problematic transactions will be a reasonability test. It is important to note that previous attempts to enshrine reasonability in the Income Tax Act (Canada) ("Act") have been problematic due to their inherent subjectivity and the related increase in taxpayer uncertainty.

Measures related to income sprinkling

Expanding the concept of split income

Income sprinkling allows owners to take advantage of Canada's graduated tax rates by reallocating income that would be taxed at the highest personal rates if earned by them, to various family members that are subject to lower personal tax rates. Currently, the Act contains rules that apply to minors and the taxation of split income (the "kiddie tax"). The intent now is to extend these rules to apply to certain adult individuals where the amount of split income is unreasonable under the circumstances. Among other things, reasonability will depend on the level in which the recipient contributed labour or capital to the business, whether the recipient assumed any risk and the amount and frequency of previous income allocations. The highest marginal tax rate would then apply to any unreasonable amounts.

This measure would apply for the 2018 and subsequent tax years.

Eliminating or reducing the benefit from the capital gains exemption

Tax planning strategies often incorporate the use of a trust or other structures in order to multiply the number of lifetime capital gains exemptions available to members of a family so as to shelter a capital gain arising on the sale of their company. The proposed measures would limit the use of the exemption by an individual to only shelter the portion of the capital gain attributable to the period that commences with the taxation year in which they turn 18 until the date of disposition.

The exemption would also not be available for any capital gains attributable to periods where a trust held the shares (with some limited exceptions) and for those gains that are included in an individual's split income.

While these proposals are intended to apply to post 2017 dispositions, the Department of Finance has provided a set of transitional provisions which will allow an individual to elect to realize a capital gain on an eligible property by way of a deemed disposition for proceeds up to fair market value of the property. The election would be available for property owned by the individual continuously from the end of 2017 until the day of

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the deemed disposition in 2018. The resulting capital gain would qualify for the lifetime capital gains exemption under the current rules.

Changes in reporting requirements for trusts

The measures would establish similar reporting obligations for trusts as exist for corporations and partnerships, including the issuance of a Business Number and specific T5 slip-related filing requirements.

Measures related to conversions of income into capital gains

Where an individual owner of a private corporation receives a distribution from their company structured in the form of a capital gain rather than salary or dividend income, a lower rate of tax would generally apply. The highest marginal tax rates applicable to an Ontario resident in 2017 on the various sources of income are as follows:

Regular income (including salary)	53.53%
Non-eligible dividends	45.30%
Eligible dividends	39.34%
Capital gains	26.76%

Extending impact of existing anti-surplus stripping rules

Surplus stripping involves the extraction of corporate surplus in a manner that will result in a capital gain for the individual instead of a dividend. The related planning will generally include a sale of the individual's shares to a non-arm's length corporation.

The proposed measures would reduce the cost base of an individual's shares by an amount equal to all capital gains that were realized on previous dispositions of the shares by the individual and any non-arm's length individuals regardless of whether such gains were sheltered by their capital gains exemption. Currently, a reduction in cost basis would only occur where the capital gains exemption was previously claimed on the share.

New anti-surplus stripping rule

The Department of Finance also plans to introduce an additional rule with respect to those situations where it is reasonable to consider that one of the purposes of a transaction or series of transactions was to provide an individual with non-share consideration in a manner that caused a "significant disappearance" of the corporation's assets. In such a case, the non-share consideration would be treated as a taxable dividend. Once enacted, these rules would apply to share dispositions and amounts that were received or became receivable on or after July 18, 2017.

Intergenerational transfer of shares

The Department of Finance is seeking input regarding ways to differentiate a genuine intergenerational transfer of a business to an adult-child from the tax avoidance types of transactions targeted by the proposed measures.

Measures regarding the holding of passive investment portfolios by a corporation

Owners of private corporations may accumulate earnings when they hold a passive investment portfolio inside a private corporation, since the corporate income tax rates are generally lower than personal tax rates. The proposed reforms would generally affect private corporations which are setting aside some of their corporate profits for passive investments. Proposed legislation has not yet been released to address the tax treatment of passive investment income inside a private corporation. The Department of Finance is requesting input from the public (with submissions to be made by October 2, 2017) on possible approaches to aligning different sources of income earned in a corporation, with taxes at the personal level.

The proposal outlines two possible approaches to taxation which eliminate the refundable tax system currently applicable to investment income earned by private corporations.

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The suggested approach would also eliminate the inclusion of the non-taxable portion of capital gains in the capital dividend account for those gains related to an investment acquired using active business income. The Department of Finance will be considering whether additions to the capital dividend account should be preserved in certain limited situations, such as a capital gain realized on the arm's length sale of a corporation controlled by another corporation where the corporation being sold is exclusively engaged in an activity earning active income.

The intention is for the rules to apply on a go forward basis and that the new rules will have a limited impact on existing passive investments. The Department of Finance will bring forward a detailed proposal following consultations with the public.

Summary

The proposed legislation and the additional proposals contained within the discussion paper will have a significant impact on how private corporations and their owners are taxed in future years. With the Department of Finance's attempt to eliminate "unfair advantages," the proposals may in fact lead to double taxation for many private companies and entrepreneurs. Owners of private corporations would be well advised to review their current structure and sources of income in order to assess the potential impact of these proposed measures.

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