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MAJOR PROPOSED CHANGES TO THE TAXATION OF PRIVATE CORPORATIONS AND TO SEVERELY LIMIT INCOME SPLITTING

By Shaun Doody and Ian MacInnis

The Federal Government released a set of proposals on July 18, 2017 that, in the government's words, are designed to "improve fairness in the tax system by closing loopholes and addressing tax planning strategies" and to ensure "that the richest Canadians pay their fair share of taxes and that people in similar circumstances pay similar amounts of tax" (a summary of the proposals and related documentation can be found at http://www.fin.gc.ca/n17/17-066-eng.asp). While this type of language has been relatively commonplace with this Liberal government, the proposals put forward are some of the most extensive changes to the taxation of private corporations in decades.

The proposals are contained in a discussion paper released by the Department of Finance and also include draft legislation relating to some of the matters discussed in the paper. The Department of Finance has requested comments on the discussion paper by October 2, 2017. In the 2017 Federal Budget, the Department of Finance announced that it would be releasing a paper for the consultation on the taxation of private corporations. Some of the items in the discussion paper had been expected, but the far-reaching extent of the proposals was likely not anticipated by most in the tax community. If enacted, these proposals will affect most Canadian businesses carried on through private corporations. They will also significantly increase the complexity of the tax rules applicable to private corporations and introduce new uncertainties as to the application of the rules.

The government's proposals are designed to address three areas of perceived inequality:

1. The "sprinkling" of income or capital gains among family members.

    - The government is concerned about structures that allow income earned by certain business vehicles (including private corporations, partnerships and trusts) to be distributed (either as dividends, including distributions from trusts, or through the realization of capital gains) to family members who are taxed at lower rates but who do not sufficiently contribute to the business (through labour


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or capital) to "justify" such distributions. An area of further concern is the "multiplication" of the lifetime capital gains exemption (LCGE), i.e. the use of the LCGE by multiple members of a taxpayer's family to shelter a larger capital gain arising on the sale of certain qualifying property, including the sale of shares of certain qualifying small business corporations (for which the exemption limit per individual in 2017 is $835,716).

2. The deferral of tax on corporate income that is not reinvested in the corporation but is instead used to earn passive investment income in the corporation.

    - When a corporation earns active business income, it is generally taxed at a rate that is significantly less than that of an individual who earns income directly, meaning that the corporation has significantly greater after-tax funds to invest than would the individual on the same amount of income. If the corporation does not reinvest this after-tax income in the business, but instead uses it to earn passive investment income, it will start out with a larger sum to invest (which will grow to an even-larger pool of investments over time, even accounting for the shareholder level tax that will ultimately be paid when the investments are distributed as dividends) as compared to the individual starting with the same amount of income earned directly.

3. The conversion of income that should be taxed as a dividend or as employment income into capital gains.

    - When an individual receives distributions from a corporation in the form of dividends or salary the individual pays a relatively high rate of tax. Some individuals have established structures, however, that allow them to effectively receive distributions from a corporation while only paying tax at capital gains rates (which are significantly lower than dividend or salary rates). The government is also concerned with situations where a taxpayer realizes a capital gain on a sale of corporate shares to related individuals.

The government proposes to address such perceived inequalities as follows:


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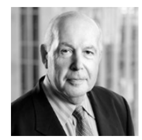
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Income Sprinkling/Multiplication of the LCGE (Detailed Legislative Proposals Have Been Released)

The government proposes to extend what is commonly referred to as the "kiddie tax" (more properly referred to as the "tax on split income") to related adults in certain situations. The tax on split income currently applies the top personal tax rate to certain dividends distributed by private corporations to minor children (as well as to certain capital gains realized by minor children) in an attempt to prevent top-rate taxpayers from ‘diverting’ income to lower-rate minor family members.

The new rules would extend the tax on split income to dividends received or capital gains realized by any family member (regardless of age) in situations where the family member has not made what the government sees as a sufficient "contribution" to the corporation (in the form of labour or capital) to justify the distribution or gain. The rules would also extend such tax to distributions of trust or partnership income to related individuals in similar circumstances. In addition, the government is proposing more stringent "contribution" tests for adults aged 18-24 and is further extending the tax on split income such that it will apply to "compound income" (i.e. income derived from the investment of previously-received split income). Compound income is not captured by the current tax on split income.

In order to deal with the so-called multiplication of the LCGE by family members of the principal of a business, the government is proposing the following measures:

- individuals would no longer qualify for the LCGE in respect of capital gains that are realized, or that accrue, before the taxation year in which the individual attains the age of 18 years;
- the LCGE would generally not apply to the extent that a taxable capital gain from the disposition of property is included in an individual’s split income; and
- subject to certain limited exceptions, gains that accrued during the time that property was held by a trust would no longer be eligible for the LCGE (whether the gain is realized by the trust or whether the property is ‘rolled out’ to a beneficiary who then realizes the gain).

We note that, while there is generally no grandfathering with respect to any of the measures mentioned herein, the government has provided transitional rules allowing affected individuals and trusts to elect to realize, on a day in 2018, a deemed capital gain for proceeds up to fair-market value in respect of certain property if such property has been owned by the individual or trust continuously from the end of 2017 until the day of the deemed disposition. Capital gains realized under the election would generally be eligible for the LCGE using the current tax rules (i.e. the rules as they apply to dispositions before 2018).

Deferral of Tax on Invested Corporate Income (Government Currently Seeking Input on Possible Approaches)

While the government has not released detailed legislative proposals to deal with this issue, it has put forward certain possible approaches, including:

- the replacement of the current refundable investment tax regime for private corporations with one where such additional tax would not be refundable if the earnings used to fund such passive investments came from income taxed at corporate rates. The government has proposed both an apportionment method and an elective method to determine the source of the income;
- eliminating access to the lower "eligible dividend" tax rate for passive investments of a private corporation that were funded out of active business income; and
- changing the definition of "capital dividend account" such that it would no longer include the non-taxable portion of capital gains funded from active business income.

The government has invited public input on the possible ways to implement these measures.

Converting Income Into Capital Gains (Detailed Legislative Proposals Have Been Released)

In its commentary, the government discussed current section 84.1 of the *Income Tax Act* (Canada) (which is designed to convert what would otherwise be a capital gain into dividend income in certain situations), noting that its wording is "problematic" due to the ease by which it can be avoided. The briefing document further noted that, while some have suggested that the General Anti-Avoidance Rule could be applied to situations where section 84.1 is deliberately avoided, the Canada Revenue Agency has not had sufficient success in the courts in attempting to do so.

While the main impact of current section 84.1 is with respect to situations where a taxpayer has used their LCGE to shelter the capital gain arising on a transfer (in such a situation section 84.1 creates so-called "soft" cost base which is not able to be accessed by a related purchaser of the shares on a later resale), the government proposes to extend the application of section 84.1 (and the creation of "soft" cost base) to any situation where cost base is increased in a taxable non-arm's-length situation. The government notes that "it is recognized that in some instances this change might give rise to both a capital gain on a 'step-up' transaction and a taxable dividend on a subsequent non-arm's length disposition", but goes on to say that "this is consistent with discouraging taxpayers from entering into schemes that seek to avoid section 84.1."

The government is further proposing a similar "anti-stripping" rule that would apply where a corporation bumps up the cost base of a shareholder's shares (resulting in a capital gain to the shareholder) using surplus corporate funds (i.e. effectively allowing the shareholder to extract surplus corporate funds at capital gains rates instead of dividend rates). The rule would apply where it is reasonable to consider that one of the purposes of such purchase is to pay the individual shareholder cash out of a private corporation's surplus assets in a manner that involves a "significant disappearance of the corporation's assets."

It is proposed that both of these amendments will apply in respect of transactions occurring after July 18, 2017.

Next Steps

Given the breadth of the proposals and the obvious negative impact on common tax planning entered into by business owners and professionals, it can be expected that there will be significant lobbying efforts to have the government reconsider the scope of proposals. It has become "garden variety" tax planning for owner-managers operating an active business to employ an estate freeze structure involving a discretionary family trust as a shareholder of the corporation. It would often be possible with such a structure to achieve income-splitting tax savings by allocating dividends from the corporation through the trust to adult-aged children or a spouse in a lower tax bracket. Also, if the shares of the corporation qualify for the LCGE, such exemption could be multiplied on a sale of the shares among the beneficiaries of the trust. If enacted, the proposals would, in most cases, put an end to this common planning commencing in 2018.

There is still, however, a final opportunity to maximize income-splitting tax savings in 2017. Also, as noted above, there will be a one-time opportunity in 2018 to allow individuals (and trusts) to trigger a capital gain on property eligible for the LCGE and thereby step-up the tax cost of such shares and lessen the taxable capital gain on an eventual sale.