TAXTALK

OVERVIEW OF THE PROPOSED TAX RULE CHANGES RELEASED BY DEPARTMENT OF FINANCE ON JULY 18, 2017

On July 18, 2017, Finance released a discussion paper and draft legislation to amend the Income Tax Act which targets tax planning using private corporations. It addressed three primary issues:

(i) Income splitting
(ii) Tax deferral using private corporations
(iii) Conversion of dividends to capital gains

It is Finance's view that the use of private corporations gain an unfair advantage for high-income individuals.

INCOME SPLITTING (SPRINKLING)

Some of the proposed measures being introduced by Finance target income splitting using private corporations between family members. Income splitting describes a range of tax-planning arrangements that result in income that would have been taxed in the hands of high-income individuals being taxed in the hands of a lower-income individual, typically a family member of the high-income individual. Income splitting minimizes the overall amount of personal tax paid on this income by accessing tax attributes of the lower-income individual, including the individual's lower marginal tax rates, personal tax credits (such as the basic personal amount), and in some cases, certain deductions (such as the lifetime capital gains exemption).

Tax on Split Income

Canada already has a "tax on split income" (TOSI or more often referred to as "kiddie tax") but is only restricted to "specified individuals" (minor child under the age of 18 years old and resident in Canada). "Split income" is usually in the form of dividends paid on shares of private companies and a child is subject to TOSI at the highest marginal tax rate (which is over 50% in most provinces). This provision effectively stops income splitting with minor children.

The proposed changes announced on July 18, 2017 by Finance proposes to extend the TOSI rules to apply to any Canadian resident individual, regardless of their age, who receives split income. However, for adults 18 years or older, only the amount that is considered to be "unreasonable" in the circumstances would be subject to TOSI. This reasonableness test will apply differently based on the age of the adult and is even more restrictive for adults age 18-24 as opposed to those age 25 or older.

An amount paid to an adult family member will be considered reasonable if it is consistent with what a person who is not an adult family member would receive having regard to:

- The labour contributions of the individual to the activities of the business
- The assets contributed or risks assumed by the individual in respect of the business, and
- The previous returns and remuneration paid to the individual in respect of the business

If the amount is not reasonable, the top-rate tax will apply to the split income. For instance, under the proposed rules, if a dividend is paid to a shareholder of a company and they do not work for the company they could be subject to TOSI at a rate of about 45% (Ontario's highest dividend rate).

In addition, the proposed measures would expand the types of income that are considered to be split income, such as interest income earned on loans with private corporations.

These measures would generally apply for the 2018 and later taxation years.

Lifetime Capital Gains Exemption

To address income splitting by multiplying the lifetime capital gains exemption across multiple family members, the Finance proposes to no longer allow individuals to qualify for the exemption for capital gains that are realized, or that accrue, before the taxation year in which the individual turns 18. Further, gains that accrued during the time that property was held by a trust would generally no longer be eligible for the exemption, subject to limited exceptions. In addition, the lifetime capital gains exemption 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.

These proposed measures would generally apply to dispositions after 2017. However, special transitional rules would allow affected individuals to elect to realize, on a day in 2018, a capital gain on eligible property by way of a deemed disposition for proceeds up to the fair market value on the property. The election would be available for property owned by the individual 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 lifetime capital gains exemption using the current tax rules.

TAX DEFERRAL USING PRIVATE CORPORATIONS

Corporate business income is taxed at lower rates than personal income, giving businesses more money to invest in order to grow their business. In the case where the business earns income beyond what is needed, the business owner has the opportunity to hold passive investments inside the corporation. This may result in the realization of after-tax returns that exceed what an individual investor saving in a personal investment account can achieve.

Finance believes that the current system does not remove incentives to holding passive investments within a corporation which, in many instances, lead to what they perceive are unfair tax results.

For instance, if an individual with a salary of $250,000 receives an additional $100,000 of income in the form of an employment bonus and decides to invest the after-tax amount passively, they will have roughly $50,000 in after-tax income to invest (assuming a 50% marginal tax rate). In contrast, an entrepreneur earning an extra $100,000 of business income through their private corporation after paying themselves $250,000 in employment income will have about $85,000 after-tax to invest passively, if kept in the corporation (assuming the income is eligible for the lower corporate tax rate of 15% in Ontario on small business income). While the current system aims at ensuring that both corporations and individuals pay approximately the same combined tax rate on the passive income generated by their investments (about 50 percent), it does not recognize that the individual using their private corporation has more capital to invest than the employed individual.

Finance has not yet proposed draft legislation to prevent this perceived unfair advantage, but they have offered a plan which is open for comment. The goal under the new system is that the value of the after-tax portfolio of a business owner

investing through their corporation would be equal to that of a salaried individual taxed at the top personal income tax rate who invests in a personal savings account.

As an alternative, Finance contemplates that the current regime of refundable taxes on passive investment income could be replaced with a system of non-refundable tax on passive investment income at a rate equal to top personal tax rates.

The new approach entails changes to how passive income is categorized, and subsequently taxed at the individual level when distributed from the corporation as dividends to shareholders. In essence, the tax treatment of passive income distributed as dividends would need to take into account how the earnings used to fund the passive investment were initially taxed, in order to properly eliminate the resulting tax advantage. As such, it would be necessary to track the source of these funds for the purpose of determining how dividends paid by the corporation would be taxed personally in the hand of the shareholders. Two broad methods are being contemplated to determine the tax treatment of dividends paid from passive investments: an apportionment method and an elective method. A discussion of these two methods and various elections that may be available is complex and beyond the scope of this article but will be discussed in more detail to the extent these proposed measures are enacted into law.

For shareholders with excess money in their corporation it's not uncommon to invest it, which is usually a good idea in case the money is needed at a later time. Under the proposed rules the tax rate on this income generated from these investments may be in the 70% range when finally paid out to the shareholder. If the funds are not distributed there is still going to be a 50% (non refundable) tax on the investment income.

This new regime could also affect dividends from publicly traded stocks, which can currently be distributed as eligible dividends. Finance notes that in some cases, dividend income from publically traded stocks may no longer be treated as eligible dividends, but would instead be treated as a non-eligible dividends.

Finance also contemplates that the non-taxable portion of capital gains would no longer be credited to the capital dividend account where the source capital of the investment is income taxed at corporate income tax rates, such as capital gains from the sale of portfolio investments. Finance says it will consider 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 earning active income.

It is Finance's intent that the new rules will apply on a go forward once an approach is determined. Finance also mentioned that it will consider how to ensure that the new rules have limited impact on existing passive investments.

If the proposed system is implemented, there will be less incentive to accumulate passive investments in a private corporation. In such cases, consideration towards other saving alternatives such as an Individual Pension Plan, RRSP and /or TFSA will increase.

CONVERSION OF DIVIDENDS TO CAPITAL GAINS

Finance proposes changes to prevent individual taxpayers from using non-arm's length transactions that "step-up" the cost base of shares of a corporation and avoid the application of section 84.1. The anti-surplus stripping rules in section 84.1 are generally intended to prevent corporate surplus from being extracted at the lower capital gains tax rates instead of the higher

dividend tax rates where an individual sells shares of the corporation to a non-arm's length corporation. If certain conditions are met, then the purchaser corporation is deemed to have paid, and the individual taxpayer is deemed to have received, a dividend. This effectively prevents capital gain treatment if the taxpayer receives non-share consideration that exceeds the shares' tax attributes.

The proposed measures extends the current rules to cases where the shareholder's adjusted cost base (ACB) is increased in a taxable non-arm's length transaction. The objective is to reduce the ACB of the taxpayer's share by the amount of any capital gain realized by non-arm's length individuals. This is to ensure that a taxpayer cannot extract corporate surplus as a return of paid-up capital or non-share consideration to the extent that the ACB relied upon results from capital gains previously realized by non-arm's length individuals.

The introduction of this measure appears to have a negative impact on the commonly used "pipeline planning technique". Pipeline planning helps to avoid the double taxation that could occur when a shareholder of a private Canadian corporation dies and their shares of the corporation are deemed disposed. This post-mortem planning essentially reduces the tax on the removal of corporate surplus to the capital gains tax rate on the death of the shareholder.

Finance also proposes a new anti-avoidance provision intended to prevent the distribution of corporate surplus to an individual shareholder resident in Canada, which would otherwise be distributed as a taxable dividend, on a tax-reduced or tax-free basis in a non-arm's length context. If applicable, the tax reduced or tax free distribution would be treated as a taxable dividend.

According to Finance, these changes would apply to shares disposed of, and amounts received or that become receivable, on or after July 18, 2017.

SUMMARY

These are significant changes that will surely affect many owners of private corporations across Canada. We are following the progress of the proposed changes and will be working closely with our clients over the coming weeks to ensure they are aware of what the impact will be for their businesses and family members.

A memorandum of this nature cannot be all-encompassing and is not intended to replace professional advice. Its purpose is to highlight tax planning possibilities and identify areas of possible concern. Anyone wishing to discuss the contents or to make any comments or suggestions about this TaxTalk is invited to contact one of our offices.

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