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DEPARTMENT OF FINANCE PROPOSES SIGNIFICANT TAX CHANGES FOR PRIVATE CORPORATIONS

In its 2017 Federal Budget, the Department of Finance announced that it was in the process of reviewing tax planning strategies that were used by private corporations and their shareholders to obtain "unfair tax advantages". The three areas of concern specifically identified in the Budget were: (A) using private corporations to sprinkle income and capital gains among family members; (B) earning passive investment income in a private corporation; and (C) converting corporate income into capital gains.

On July 18, 2017, Finance released a consultation paper on these issues, together with a number of proposed legislative amendments to address the policy concerns raised in the Budget. If implemented, the proposed changes will have significant effects on many private Canadian businesses, including family businesses and incorporated professionals, and will reverse many years of accepted tax planning for business owners.

Measures to Expand the Rules for Split Income

In the course of setting up or restructuring a private business, entrepreneurs often include other family members in the ownership of the business. When the income of the business is distributed among these corporate shareholders as dividends, family members that have little or no other income will generally pay tax on this dividend income at a relatively low rate. The *Income Tax Act* (the "Act") presently contains rules regarding "tax on split income" or "TOSI" (commonly referred to as the "kiddie tax"), which deny the benefit of these low tax rates to minors in certain situations.

The changes proposed by Finance significantly expand the scope of the TOSI rules by having them apply in cases where corporate income is distributed to adult shareholders as well, unless the payment is considered to be reasonable in the circumstances. Reasonability would be based on factors such as: (A) the extent to which the recipient is engaged in the business; (B) the assets contributed to the business by the recipient; (C) the risks assumed by the recipient in connection with the business; and (D) any amounts previously paid to the recipient out of the business. A stricter reasonableness test will be used for payments made to individuals who are between the ages of 18 and 24 years.

If enacted, these rules would be effective in respect of amounts that are received beginning in the 2018 taxation year.

Planning Tips: *If the new TOSI rules are enacted as proposed, 2017 may present one last opportunity for low-income shareholders to benefit from their marginal rates of tax for certain types of income received from closely-held private corporations.*

Beginning in 2018, business owners may have to keep closer records of the time and effort these individuals expend on the business in order to justify dividend distributions as being "reasonable" under the new rules.

Measures to Restrict the Lifetime Capital Gains Exemption

When a taxpayer realizes a capital gain on the disposition of qualified small business corporation shares ("QSBC Shares"), it may be possible to exempt some or all of the gain from taxation using the taxpayer's lifetime capital gains exemption ("LCGE"). If the QSBC Shares are owned by a trust, the Act currently allows the resulting capital gain to be allocated among the individual beneficiaries of the trust (including minors), such that each beneficiary can utilize all or part of his or her LCGE to shield a portion of the total capital gain realized on the sale.

The proposed legislative amendments would curtail the benefits of this planning strategy in a number of ways. Firstly, minors would no longer be able to claim the LCGE. Secondly, the LCGE could not be claimed in respect of any portion of the capital gain that accrued while the shareholder was a minor or while the QSBC Shares were held in a trust, subject to certain exceptions. And finally, the LCGE would not be available to the extent that the income from the gain would be considered "split income" under the expanded TOSI rules referred to above.

If enacted, these rules would be effective in respect of disposition made beginning in the 2018 taxation year.

Planning Tips: *The proposed legislation contains a set of transitional rules that will allow a trust to create a deemed disposition of QSBC Shares at fair market value prior to the end of 2018 in order to crystallize any gain that has accrued in the trust before it becomes subject to the new restrictions.*

However, in order for a trust to take advantage of this limited relief, steps may need to be undertaken prior to the end of the 2017 taxation year to ensure that the deemed gain will qualify for the LCGE.

Measures Aimed at Earning Passive Income Through a Corporation

Presently, active business income earned through a Canadian-controlled private corporation ("CCPC") in Ontario is subject to tax at a rate of 15% (on income up to the small business limit) or 26.5% (on income in excess of this amount). In contrast, the top personal income tax rate in Ontario is presently 53.53%. Accordingly, a corporation that earns the same amount of active business income as an individual in the top tax bracket will ultimately have more after-tax dollars to invest.

The Department of Finance's consultation paper asserts that low corporate income tax rates are intended to facilitate reinvestment for the growth of the business rather than the earning of passive income. Accordingly, the paper suggests that amendments are required in order to establish a greater degree of fairness as between the tax treatment of passive investment income earned through a corporation and passive income earned personally. Although no specific legislative amendments were proposed to address this concern, the consultation paper puts forth some approaches that would be aimed at achieving more neutral tax results.

These proposals include: (A) replacing the refundable tax on passive investment income with a non-refundable tax in cases where earnings used to fund the passive investments were taxed at low corporate rates; (B) characterizing corporate dividends paid out of passive investment income as either "eligible" or "non-eligible" based on the source of the earnings used to fund the passive investments (e.g. small business income, general business income, or capital contributions by shareholders); and (C) no longer allowing the non-taxable portion of a corporation's capital gain to be distributed to shareholders on a tax-free basis in cases where the capital investment was funded with earnings that were subject to a low corporate rate of tax.

To effectively implement these proposals, it would be necessary to identify and classify the type of earnings that were used in order to fund the acquisition of each passive investment by a corporation. The consultation paper suggests two alternative approaches. The first approach would apportion passive investment income among one of three "pools" (i.e. small business income, general business income, or capital contributions by shareholders), with corresponding tax results as dividends are paid out of each "pool". The second approach would assume that CCPC passive income is earned using funds that were taxed at the low small business rate unless the corporation elects otherwise.

Measures Aimed at Surplus Stripping

Given that only one-half of a capital gain is taxable, individuals can realize a significant tax advantage if the value of a corporation can be extracted as a capital gain as opposed to dividend income. Extracting corporate surplus as a capital gain instead of a dividend is commonly referred to as "surplus stripping" and the Act already contains a number of provisions that are specifically aimed at preventing surplus stripping transactions.

The consultation paper and related legislative proposal focus specifically on section 84.1 of the Act, which is an anti-surplus stripping provision that applies in the context of a transfer of shares to a non-arm's length corporation. Generally speaking, section 84.1 curtails the ability to extract corporate surplus as a capital gain by only recognizing a taxpayer's "hard" cost base in the transferred shares and not any "soft" cost base, which represents capital gains in respect of which no income tax was paid (e.g. capital gains subject to the LCGE).

In its paper, Finance identifies a specific transaction that could potentially facilitate the avoidance of section 84.1. The proposed legislative amendments address this type of avoidance transaction by expanding the scope of what the Act considers to be "soft" cost base for the purposes of section 84.1. Under the proposed measures, "soft" cost base would include any cost base arising from capital gains realized on previous dispositions of the shares by the taxpayer or non-arm's length individuals, regardless of whether the gains were subject to tax or sheltered under the LCGE.

If enacted, these rules would be effective as of July 18, 2017.

Planning Tips: *Although the consultation paper targets a specific type of avoidance transaction, the proposed legislative changes would effectively eliminate a common form of post-mortem planning known as the "pipeline", which has been used to mitigate the potential for double-taxation when an individual dies owning shares of a private corporation.*

The other common means of avoiding double taxation on death is subject to strict time limits, and so steps to implement this alternative should be taken as soon as possible in the event that "pipeline" planning is no longer available.

<u>How We Can Help</u>

The Department of Finance is accepting comments on these proposals until October 2, 2017, and the Tax and Estate Group at Robins Appleby is in the process of preparing a submission that will highlight some of the issues that we expect will arise if these legislative proposals are enacted.

Robins Appleby Tax Planning Seminar

We are also devoted to keeping our clients informed about how these proposals will affect the taxation of family businesses, professional corporations, and their shareholders. Robins Appleby plans to host a Tax Planning Seminar this Fall in which we will discuss these proposed tax changes in detail and how they could affect your business and tax planning strategies. Additional details will be circulated in the coming weeks.

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