Important changes proposed for the taxation of Canadian private corporations

Tax Alert

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By: Kevin Fritz | Sandra Mah

On July 18, 2017, the Canadian federal Finance Minister, Bill Morneau, announced the release of a consultation paper and draft legislation which, if enacted, will have a dramatic impact on the taxation of Canadian private corporations and business structures that Canadian entrepreneurs have had in place for decades. An announcement was expected, as the federal government had indicated in its 2017 Budget that proposals would be put forward to address perceived inequities in the Canadian corporate tax system. However, the scope of the proposals went beyond the expectations of most tax professionals and will affect most Canadian business owners who carry on business through a private corporation.

In this legal update, we will provide an overview of the government’s proposals which target (1) income splitting strategies, (2) access to the lifetime capital gains exemption, (3) the tax treatment of passive investment income earned in a private corporation and (4) strategies to convert income into capital gains.

Income splitting

It is common for entrepreneurs who control private Canadian corporations to make use of ownership structures involving multiple family members. This can be achieved by either having family members hold corporation shares directly or through a family trust. Under these structures, family members (or the family trust) often hold different classes of shares which allow for dividends to be paid to the different family members at the discretion of the corporation’s directors or the family trust’s trustees. This share structure permits dividends to be paid to family members who are in a lower tax bracket than the family member who controls the business. This is referred to as...
“income splitting” or “dividend sprinkling” in order to reduce the overall tax burden of the family.

Since 1999, tax rules (known as the tax on split income or “kiddie tax”) have been in place to prevent this type of tax planning with children under the age of 18. Under these rules, minor children are subject to tax at the highest marginal tax rate on, amongst other things, dividends received from private corporations. In its release, the government proposes to extend the kiddie tax (now referred to as the “TOSI”) to apply to adults in respect of a business of which a family member is a principal. An exception from this tax treatment is proposed where it is “reasonable” for the adult individual to have received income from the corporation. The reasonableness standard is intended to exempt adults from the increased tax rate where amounts that are paid by the corporation are consistent with what it would have agreed to pay an arm’s length person. The proposal specifies the following factors to be considered in making a determination of reasonableness: (1) contribution of labour, (2) contribution of capital and (3) previous returns/ remuneration. A higher standard of reasonableness is proposed for individuals between the ages of 18 and 24 rather than those over the age of 24, as the government has expressed particular concern with splitting income with young adults who are more likely to be in a lower tax bracket.

The proposals to address income splitting strategies with private corporations also expand the application of the TOSI to include (1) income from certain debt obligations, (2) capital gains from the sale of shares the income from which is subject to the TOSI and (3) compound income on property that is the proceeds from income previously subject to the TOSI rules or the income attribution rules. However, this third type of income will only apply to individuals under the age of 25.

The new anti-income splitting rules are to be effective starting in 2018.

**Lifetime capital gains exemption**

Since 1988, Canadians have been able to shelter capital gains from the disposition of “qualified small business corporation” shares from tax up to a lifetime limit. The current personal limit is a cumulative total of $835,716 (indexed to inflation annually). The government has identified concerns with common ownership structures that allow multiple family members to make use of their capital gains exemption on the sale of a family-owned business. Under the proposals, the capital gains exemption will be denied in the following circumstances:

1. individuals under the age of 18 will not be allowed to make use of the capital gains exemption;
2. beneficiaries of trusts will no longer be permitted to make use of the capital gains exemption with respect to gains on the value of shares that accrue during the period in which the trust holds the shares; and
3. individuals who are subject to the TOSI with respect to a share will not be able to make use of the capital gains exemption on the sale of such shares.

These new rules are to be effective starting in 2018. However, the proposals include a transitional rule that will allow an election to be made by the end of 2018 to crystallize a capital gain and claim the capital gains exemption so as to increase the adjusted cost base of the “qualified small business corporation” shares. Making such an election will reduce the individual’s capital gain on a subsequent sale of the shares.

**Passive investment income**

The consultation paper identifies a concern with respect to a potential advantage that arises from earning business income through a corporation rather than individually. Corporations are taxed at a much lower rate than individuals on business income. In Ontario, the highest marginal tax rate for individuals is 53.53%, while the corporate tax rate is either 15.0% (small business tax rate on business income up to $500,000) or 26.5% (general corporate tax rate). As a result, more after-tax dollars are available for investment if earned through and retained in a corporation. This is an intentional tax policy decision to encourage reinvestment of business profits to broaden the tax base and increase employment. However, the government has expressed concern that this fact of the Canadian corporate tax system is unfair if the surplus funds are used for passive investment rather than reinvestment in the business. The consultation paper indicates that the lower rate of corporate tax on business income was never intended to be used to realize higher personal savings.

The consultation paper does not specify the measures that are to be introduced to address the government’s
concern. Rather, it identifies possible approaches and invites input from interested taxpayers as to how to design new rules “to tax corporate passive income in a way that is more fair for Canadians”.

Converting income into capital gains

Lastly, the consultation paper addresses a far less common tax planning technique which is intended to allow a shareholder to extract retained earnings from a private corporation as a capital gain rather than as a dividend. This is beneficial to the shareholder, as capital gains are taxed at a lower rate than dividends. Amendments are proposed to the anti-surplus stripping rule in section 84.1 of the Income Tax Act to shut down this type of planning. These changes would apply on or after July 18, 2017.

Next Steps

The consultation paper asks for input from interested parties by October 2, 2017. Notwithstanding the consultation period, it is expected that all proposals other than those with respect to passive investment income will be in force in 2018. If and when enacted, the changes described in the consultation paper and draft legislation will increase the tax exposure for all Canadian family-owned businesses. The new rules are complex and will undoubtedly have consequences that were not intended by the government. Family business owners should seek advice well in advance of the end of 2017 to assess how the proposals will impact them.

AUTHORS

Kevin Fritz
Partner
Toronto | T: +1 416 365 3500
[email protected]

Sandra Mah
Associate Counsel
Calgary | T: +1 403 296 4470
[email protected]