MNP's Summary Analysis of the Proposed Changes for Private Corporations

July 19, 2017

DEPARTMENT OF FINANCE PROPOSED CHANGES FOR CANADIAN ENTREPRENEURS

As announced in the 2017 Federal Budget, the Department of Finance has been working on legislative changes that target tax reduction strategies employed by private Canadian corporations. On July 18, 2017, the Honourable Bill Morneau released proposed changes to the following three areas of tax planning using private corporations:

1) Income Sprinkling

Many family owned businesses involve the entire family in the ownership of the corporation, either directly or through a trust. This has many benefits, both from a tax perspective and for the long-term succession of the business. The proposed changes significantly expand the rules surrounding income splitting among family members.

- **Tax on Split Income (TOSI)**

Previously, this concept was often called the kiddie-tax, as it resulted in a high tax rate on minors receiving dividends from private companies, selling shares of a private company to a non-arm’s length purchaser or certain business income generated through trusts and partnerships.

TOSI causes someone to be taxable on the income at the highest marginal rates, which can exceed 50 per cent in many provinces.

The tax on split income has now been expanded. There are now specific exemptions for minors and adult children who have income due to the death of a parent or any person who is disabled or attending full time school.

In addition to minor and adult children, the TOSI can apply to any related persons, including spouses, siblings, parents, in-laws and extended family.

Expansion of What is Split Income:

The draft legislation proposes to expand the definition of what is included as split income to include interest on loans, taxable capital gains if the income on the shares would have been split income and second-generation income if it is earned on income that was itself split income.

Reasonability of Income:

In order for the income to not be subject to TOSI, it must be considered reasonable in the circumstances. To be considered reasonable, it cannot exceed what would have been paid or payable to an arm’s length person for the same activities, considering the following:

- Work performed
- Capital contributed
- Risk assumed
- Compensation for services already completed

- **Adjustments to Credits**

Due to the changes in split income, there are also changes proposed to various tax credits such as the age credit, GST credit, Canada Child Benefit, Working Income Tax Benefit and Tax on Old Age Security (OAS) benefits to ensure that income that is taxed as split income is not taxed a second time as regular income.

- **Capital Gains Deduction**

  The capital gains deduction allows entrepreneurs, farmers and fishermen to shelter a lifetime maximum of capital gains on the disposition of qualified small business corporation shares, qualified farming property and qualified fishing property from taxation. Changes announced to the capital gains deduction were as follows:

  Eligible Lifetime Capital Gain Exemption Trust:

  This is a qualifying beneficiary trust or an employee share ownership trust where a trustee owns shares for employees who deal at arm's length with the corporation. These types of trusts are now eligible for the capital gain deduction where certain conditions have been met.

  An eligible employee beneficiary is a beneficiary under a trust where the individual acquired their beneficial interest in the trust because of his or her employment, as part of a stock option arrangement, they are not a specified employee or connected individual and is not related to a specified employee or connected individual.

  Limitations on Dispositions after 2017:

  There are new limitations on the ability to access the capital gain deduction of qualified farm property, qualified fishing property and qualified small business corporation shares for dispositions after 2017. They are as follows:

  <u>Minors:</u> The capital gains deduction will no longer be available to minors.

  <u>Employee Profit Sharing Plans (EPSPs):</u> The capital gains deduction will not be available for capital gains allocated to an individual by a trust governed by an EPSP.

  <u>Gains Accruing while a Minor:</u> If the individual held the shares while they were a minor, any portion of the captain gain accruing during that time is not eligible for the capital gains deduction.

  <u>Split Income:</u> If the taxable capital gain is considered split income, it will not be sheltered by the capital gains deduction.

  <u>Gains Accruing Prior to Rollout from Trust:</u> If a personal trust holds the shares, any capital gain accruing while the shares were held by the trust will not be eligible for capital gains deduction.

  Planning Opportunity

  There will be an opportunity to create a deemed disposition in 2018 of qualified farm property, qualified fishing property and qualified small business corporation shares to create a disposition of the property and shelter the capital gain with the capital gains deduction. This will allow individuals and trusts to use the capital gain deduction before it is lost to them. They will be deemed to re-acquire the property at this stepped-up cost base, therefore reducing future capital gains on sale.

  This election will be due on the due date of filing the personal or trust tax return for 2018.

2) Holding Passive Investments Inside a Private Corporation

The Government has discussed changing the rules to prevent the use of the corporate tax deferral to hold passive investments inside a corporation.

If we reconsider the integration example above, the shareholder can decide when they receive dividends, thus can control when the personal taxes are paid. As such, there is a potential deferral of tax of $27,030, being the difference between the personal income on salary versus the corporate income on business activity.

This tax deferral was originally intended by the Government as an incentive for Canadian-controlled private corporations (CCPCs) to invest in their businesses. However, some CCPCs are in low-capital industries or have made all necessary capital and labour investments and are left with significant after-tax cash inside their corporate structures which is being invested passively (e.g. bonds, shares, rental properties).

The Government opines that the current system does not remove incentives to hold passive investments within a corporation, leading to unfair tax results, as an individual earning business income in a corporation will have more money to invest than an individual earning income personally. For example, on $100,000 of income earned, the corporation will have between $85,000 to $73,500 to invest, depending on their eligibility for the small business deduction, while an individual will only have $46,470 available.

In their paper, the Department of Finance indicates that the corporate tax deferral should not be used to accrue passive investments inside a corporation, discussing several options to eliminate this perceived benefit and speculating on various options to mitigate the deferral. The first option discussed would see a refundable corporate tax levied when preferentially-taxed business income was retained in the company and used to fund passive investments. Although discussed in significant detail, the Government indicates that it is not seriously pursuing this option.

The second and third options involve changing the taxation structure of investment income earned by a corporation, along with the tax paid by individual shareholders when dividends are paid out of the corporation. In general terms, the proposal involves the following:

- Investment income earned by a CCPC will be taxed at the highest personal rate of 33 per cent federally with the elimination of the refundable mechanism. Capital gains will still only be 50 per cent taxable to a CCPC, but the non-taxable portion will no longer be paid tax-free to the individual shareholders. This would be a significant deterrent as there would be a significant punitive impact to having capital gains inside a company.
- Dividends will be taxed to the individual shareholders based on the source of the funds to make the investments (income taxed at the small business rate vs income taxed at the general corporate rate vs after-tax funds contributed by the shareholders)

The difference between the second and third options is how the determination of the source of the funds to make the investments would be calculated. The Government proposes to either calculate based on the percentage of capital in the company from each source above (naming this the apportionment method) or to allow the CCPC to make an election to have all dividends related to investment income taxed in the same manner (naming this the elective method). Both methods appear to be rather complex and may be difficult to implement smoothly when considering the many nuances of compliance reporting.

Unlike the other two issues addressed in this paper, the Government has not released any draft legislation related to the passive investment income proposals, indicating that they will begin drafting legislation once the consultation period is complete.

3) Converting Income into Capital Gains

The Government has proposed new measures which seek to eliminate tax plans that convert dividend income into lower-taxed capital gains. Current anti-avoidance legislation did not completely curtail this planning; therefore, Finance is now broadening the scope to target taxpayers who pay tax at capital gain rates when extracting funds from the company.

If we revisit the concept of integration, income earned in a corporation is taxed originally at the corporate level and once again when the individual shareholder receives a dividend. The after-tax amount in the individual's hands, after removing the funds from the corporate structure, should be the same as if the individual earned the funds directly as a salary.

In the context of this paper, the Government is concerned with the ineffectiveness of integration in situations where corporate surplus is paid out in the form of tax-exempt or lower-taxed income. Specifically, the proposals are targeting the conversion of salary or dividends into capital gains. Legislation has been amended to eliminate this conversion and a new anti-avoidance rule has also been added.

If introduced into law by the Government, the new measures will change the above results for any transaction that occurs on or after July 18, 2017.

Intergenerational Business Transfer

Section 84.1 of the Income Tax Act applies on the sale of shares of a corporation to another corporation to which the vendor is related. The historical purpose of this section is to prevent a person from selling shares of a corporation to another corporation owned by a related person, for the purposes of removing corporate surplus on a tax-free basis by utilizing the lifetime capital gains deduction or adjusted cost base that exists based on Valuation Day value. Although the sale can be a legitimate transaction where the vendor has disposed of his or her interest in the corporation, tax avoidance transactions to remove surplus tax-free would be possible absent Section 84.1.

If Section 84.1 applies to a sale of shares, the proceeds will be a taxable dividend rather than a capital gain. This is problematic in situations where family members are legitimately buying each other out. The use of a purchasing corporation that is available in arm's length situations is not available for legitimate buyouts between related parties. The use of the purchasing corporation is more tax efficient that purchasing the shares individually.

It was rumored that the Government would propose changes to Section 84.1 that would mitigate the problems in certain related party situations. The measures introduced on July 18, 2017, did not include any such proposals; however, the Government has indicated they are interested in hearing from the public on this issue.

The measures introduced on July 18, 2017, will have a significant impact on tax planning for private corporations. For more information of how they will affect you and your business, please contact your local MNP Advisor.

Everything Counts

When it comes to tax, it's all about the details. Knowing the rules and regulations, what qualifies, what doesn't and how to structure your business and claims most effectively. Our specialized teams are focussed on every facet of tax. We have the in-depth knowledge and experience that will allow you to capitalize on all the opportunities available. We know what to look for, right down to the smallest details. And it's the small details that can add up to make a big difference.

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