NATIONAL BANK FINANCIAL
WEALTH MANAGEMENT

Tax Planning Using Private Corporations

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Introduction

In Budget 2017, the Minister of Finance, Mr. Bill Morneau, announced the Government of Canada's intention to address, in the upcoming months, tax planning strategies involving the use of private corporations by way of a paper detailing the nature of the issues of interest. With the July 18, 2017 release of the Department of Finance Canada consultation paper entitled "**Tax Planning Using Private Corporations**" (hereinafter the "**Consultation Paper**"), the Government is asking Canadians what actions should be taken to ensure that high-income individuals are prevented from using strategies involving private corporations to gain unfair tax advantages. The Government is consulting Canadians on three tax practices that are being used to gain unfair tax advantages:

1. **Sprinkling income using private corporations**
   Shifts income from an individual facing a higher personal income tax rate to a family member who is subject to lower personal tax rates or who may not be taxable at all. *Detailed legislative proposals have been released. If they are adopted, the proposed measures would apply to dispositions after 2017. However, special transitional rules are proposed.*

2. **Holding a passive investment portfolio inside a private corporation**
   May lead to higher wealth accumulation than if the passive investment portfolio were held in a personal savings account. *There are no legislative proposals released in conjunction with the Consultation Paper. However, the Consultation Paper describes possible general approaches to eliminate passive investment incentives for private corporations.*

3. **Converting a private corporation's regular income into capital gains**
   Reduces income taxes by taking advantage of lower effective tax rates on capital gains. *Detailed legislative proposals have been released. If they are adopted, they will be effective as of July 18, 2017.*

Canadians' views will be taken into full consideration as the Government moves forward to address the issues related to tax planning using private corporations.

The deadline for submissions is October 2, 2017.

1. Income Sprinkling using Private Corporations

Income sprinkling involves diverting income from a high-income individual to family members with lower personal tax rates, or who may not be taxable at all. Income sprinkling is providing unintended benefits to higher-income individuals, principally through the use of private corporations. The Government of Canada states that this is unfair and inconsistent with a tax system that works for all and therefore, Finance proposes a number of measures that fall into **three general categories**:

I. Extension of the tax on split income (hereinafter "**TOSI**") rules

II. Constraining multiplication of claims to the lifetime capital gains exemption ("**LCGE**")

III. Supporting measures to improve the integrity of the tax system in the context of income sprinkling

Note that detailed legislative proposals were released for comment in conjunction with the Consultation Paper.

I. Extension of the tax on split income (TOSI) rules (commonly known as "Kiddie Tax")

Current Rules: The TOSI (i.e. "kiddie tax") currently applies to a "*specified individual*'s" "*split income*" for a taxation year.

- *Specified individual*: a minor; more specifically, an individual under the age of 18 years at the end of the year;

- *Split income*: generally includes dividends on unlisted shares of a corporation (i.e. private corporation), and income from a trust (or partnership) that is derived from a business, profession or rental activity of a related person. The TOSI does not apply to employment income.

Ultimately, the current tax rules surrounding "kiddie tax" (TOSI) subject minors (individuals under the age of 18 years at the end of the year) to the **top tax rate** on dividends received from private corporations, as well as certain other income from businesses of family members.

Proposed measures: Measures are proposed to extend the TOSI to apply to certain **adult** individuals who have amounts included in "*split income*", BUT generally only to cases where the amount is ***unreasonable*** under the circumstances (i.e. "*reasonableness test*"). Hence, the definition of "*specified individual*" would be expanded to apply to any Canadian resident individual, regardless of their age (minor or adult), where the individual receives *split income.*

Generally, an amount would not be considered reasonable to the extent that it exceeds what an arm's-length party would have agreed to pay to the ***adult** specified individual*, considering certain factors such as, for example, the **extent of the labour and capital contributions** provided by the *adult* specified individual. Note that the proposed factors are different depending on the age of the ***adult** specified individual*. Hence, different factors would apply for individuals aged from 18 to 24 years than for those who are 25 years of age or older.

If these legislative proposals are adopted, they would apply to dispositions after 2017.

II. Constraining multiplication of claims to the lifetime capital gains exemption

The Government of Canada is concerned with the tax planning of the so-called "multiplication" arrangements with respect to the LCGE. One particular concern is the use of family trusts to facilitate arrangements under which the LCGE limits of multiple members of a family may be used to reduce capital gains tax. Individuals (e.g. children, grand-parents, nieces and nephews, etc.) have used these arrangements in a way that permits them to claim the exemption even though they may not have invested in, or otherwise contributed to, the business value reflected in the capital gains they realize on the disposition of property that is eligible for the exemption.

Three general measures are proposed in the Consultation Paper to address LCGE multiplication:

- First, 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;

- Second, 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"*. Hence, the *reasonableness test* would be the same as that which applies in respect of the TOSI measures described above in respect of *adult specified individuals*

- Third, subject to certain exceptions (e.g., when several conditions are met, a spousal or common-law trust, an *alter ego* trust, etc.), gains that accrued during the time that property was held by a trust would no longer be eligible for the LCGE.

If they are adopted, the proposed measures would apply to dispositions after 2017. ***However, special transitional rules are proposed.***

Table 4 of the Consultation Paper reproduced below summarizes the LCGE rules as they would apply in the context of the proposed measures:

Age	Proposed LCGE Measures
Minor	Not eligible to claim the LCGE in respect of dispositions after 2017, subject to the transitional rule for dispositions in 2018.
Adult	No LCGE in respect of capital gains from a disposition after 2017, subject to the transitional rule for elective dispositions in 2018: • to the extent the capital gain accrued before the year in which the individual attained age 18; • to the extent the capital gain accrued during a period in which a trust held the property (with an exception for certain capital gains that accrue on property held by an eligible LCGE trust); and • to the extent the taxable portion of the capital gain from the disposition of property is included in an individual's split income under the TOSI.

III. Supporting measures to improve the integrity of the tax system in the context of income sprinkling

Measures are also being considered to improve the administration of the income tax rules to address income sprinkling:

- The introduction of tax reporting requirements with respect to a trust's tax account number (rules similar to the requirements for corporations and partnerships in respect of their tax account numbers, i.e. their "business numbers");

- The introduction of measures so that the T5 slip requirements with respect to interest amounts would apply to partnerships and trusts in the same circumstances in which they apply to corporations.

These measures would better ensure that trusts are subject to information reporting rules that parallel existing rules for corporations and partnerships, *and would apply for the 2018 and subsequent taxation years.*

2. Holding a Passive Investment Portfolio inside a Private Corporation

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The Government of Canada is seeking input on possible approaches in order to establish fairness in the tax treatment of passive investment income of a private corporation. There are no legislative proposals released in conjunction with the Consultation Paper. However, the Consultation Paper describes possible general approaches to eliminate passive investment incentives for a private corporation.

Active corporate income is taxed at lower rates than personal income, giving businesses more money to invest in order to grow their business, find more customers and hire more people. But there are times when private corporations earn income beyond what is needed to re-invest and grow the business. In these cases, those who own and control a private corporation have the opportunity to hold passive investments inside the corporation. The Government is of the view that fairness and neutrality require that private corporations not be used as a personal savings vehicle for the purpose of gaining a tax advantage. Passive investments held within privately-controlled corporations should be taxed at an equivalent rate to those held outside such corporations.

The Government is therefore aiming to eliminate the benefit of potential **additional passive savings** when retained earnings are kept in the company. Currently, integration is almost perfect when business income is earned personally versus when it is earned through a corporation and subsequently paid as a dividend to the shareholder. However, where the amount remains in the company, **additional savings** are available to the shareholder. In the Consultation Paper, the Government gives the following example: an individual subject to a marginal rate of 50%, who personally earns $100,000 in business income will have about $50,000 to invest passively. If this income is earned through a corporation taxed at a rate of 15% and remains invested in the corporation, the individual will have an amount of approximately $85,000 available for passive investment. It is this advantage, associated with the additional "***passive savings***" of $35,000 in the corporation that the government is aiming to eliminate.

The Government is studying the changes required to establish fairness in the tax treatment of passive investment income of a private corporation, so that the benefits of the corporate income tax rates are directed towards investments focused on growing the business, rather than conferring a personal investment advantage to the

corporate owner. That being said, the Government will consider approaches that can meet the following objectives:

- preserving the intent of the lower tax rates on active business income earned by corporations, which is to encourage growth and job creation; and

- eliminating the tax-assisted financial advantages of investing passively through a private corporation, and ensuring that no new avenues for avoidance are introduced.

Enhancing the fairness of the tax system in this area will necessitate the introduction of new tax rules. Limiting to the extent possible the complexity of these new rules will also be an important objective of the Government.

The Consultation Paper describes broad possible approaches to eliminate incentives to invest passively within a corporation. The Government is seeking the feedback of stakeholders on the design considerations associated with each possible approach.

3. Converting a Private Corporation's Regular Income into Capital Gains

Note that detailed legislative proposals were released for comment in conjunction with the Consultation Paper.

I. Tax planning under the current provision of paragraph 84.1 of the Income Tax Act ("ITA")

Individual shareholders with higher incomes can obtain a significant tax benefit if they successfully convert corporate surplus that should be taxable as dividends, or salary, into lower-taxed capital gains (such conversions are commonly referred to as "*surplus stripping*"). Note that for higher-income individuals, dividends are taxed at a higher tax rate than capital gains, which are only one-half taxable. As a result, income taxes can be reduced by converting dividends (and salary) that would otherwise be received from private corporations into lower-taxed capital gains.

Section 84.1 of the ITA is an important anti-avoidance rule in the private corporation context. It seeks to ensure that a corporate distribution is properly taxed as a taxable dividend (and not as a capital gain) when an individual sells shares of a corporation to a non-arm's length corporation (for example, to another corporation owned by the individual).

The present wording of section 84.1 is problematic in that the provision describes a specific type of avoidance transaction. As a result, the section does not apply to transactions that avoid its specific terms and therefore, the government proposed to amend the income tax rules to address such tax planning. In general terms, this will be achieved by:

- extending the current rules of section 84.1; and
- adding a new and separate anti-stripping rule to the ITA.

If they are adopted, these amendments would be applicable effective July 18, 2017.

II. Intergenerational business transfer

The Government indicated in Budget 2017 that, while reviewing the use of tax planning strategies involving private corporations that inappropriately reduce personal taxes, it would consider whether there are features of the current income tax system that have an inappropriate, adverse impact on genuine business transactions involving family members.

Although it has been suggested that a genuine intergenerational transfer of shares of a small business corporation to an adult child's corporation should be treated the same as a sale to an arm's length corporation, a major policy concern is the ability to distinguish a genuine intergenerational transfer from a tax avoidance transaction. The hallmarks that ensure a genuine transfer of a business to a new owner would generally include:

- the vendor ceasing on the transfer to have factual and legal control of the transferred business;
- the intent of the new owner to continue the business as a going concern long after its purchase;
- the vendor not having any financial interest in the transferred business; and
- the vendor not participating in the management and operations of the business.

Consequently, the Government is interested in the views and ideas of stakeholders regarding whether, and how, it would be possible to better accommodate genuine intergenerational business transfers while still protecting against potential abuses of any such accommodation.

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