

The updated CCPC tax proposals

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The federal government first announced proposed changes to the taxation of Canadian-controlled private corporations (CCPCs) on July 18, 2017. The originally-proposed measures focused on three areas: income sprinkling among family members, passive investment income earned within a corporation, and converting regular income from a corporation into capital gains. The government had invited interested parties to comment on the proposals by October 2, 2017 and they ultimately received over 21,000 submissions from various business groups, industry associations and other interested parties. In response to comments received, the Department of Finance made a series of announcements in October 2017 modifying and, in some cases, withdrawing some of the proposals. On December 13, 2017, more detailed revisions were announced to the rules targeting income sprinkling. Most recently, in the 2018 federal budget, detailed proposals were released regarding passive income earned in a corporation.

If you own a private corporation, you may be affected should the revised proposals become law.

This report will generally review the proposals, as well as the announced modifications, and set out steps that you may wish to consider. If you have a private corporation structure (including a professional corporation), or are thinking of setting up a private corporation, you should contact a tax advisor to discuss how these steps may apply in your particular circumstances.

Income sprinkling

Income splitting

By sprinkling income from a corporation among family members, rather than having one individual receive all of the income, the overall tax paid by the family may be reduced if some of the family members pay no tax or are taxed at a lower tax rate than the individual.

Currently there are anti-avoidance measures in place to limit this, such as the current “kiddie tax” that results in certain dividends paid to children under age 18 being taxed at the highest rate in the child’s hands. Effective for 2018, the proposed changes would expand the kiddie tax rules so that they would apply to more types of income and would also cover certain adults (the “split income” rules).

The submissions received by the government expressed concern over the complexity of this proposed change and its unintended consequences. As a result, on December 13, 2017, the government introduced revised rules.

The revised proposals for split income would generally apply where an adult receives dividend or interest income from a corporation, or realizes a capital gain, and a related individual is either actively engaged in the business of the corporation or holds a significant amount of equity (with at least 10% of the value) in the corporation.

The exceptions

The revised proposals include various exceptions, so that the split income rules would not apply in certain circumstances. The availability of these exceptions depends on one's age.

1. Excluded business

There is a broad exception that is available to anyone over age 17. The split income rules will not apply when the adult is "actively engaged on a regular, continuous and substantial basis in the business" in the year, or in any five previous years (which need not be consecutive). Adults will be treated as satisfying this condition if they worked in the business for an average of 20 hours per week during the year, or the part of the year during which the business operates if it is a seasonable business. For adults who work less than this amount, it will be a question of fact to determine if the exception is available.

Coincident with the release of the revised proposals in December 2017, the Canada Revenue Agency (CRA) issued guidance on how it would be applying the draft split income rules for adults. The CRA stated that "records such as timesheets, schedules or logbooks" and payroll records could be used to demonstrate the number of hours an individual has worked.

2. Excluded shares

For those over the age of 24, another wide-ranging exception is available where the individual holds a significant interest in the corporation. If an individual is at least 25 years old and owns shares with at least 10% of both votes *and* value of the corporation, then the split income rules will not apply. For 2018, you have until the end of the year to satisfy the 10% share ownership requirement.

Under the CRA's guidance, if shares are owned by a family trust, they will not be considered to be owned by beneficiaries for purposes of the 10% test.

This exception is not available for professional corporations (such as those for physicians, dentists, lawyers and others), or for corporations where at least 90% of the business income is from the provision of services. It is not yet clear how this 90% threshold is calculated where a corporation has business income flowing from both services and sales.

3. Reasonable rate of return

The split income rules will not apply if the income received is considered a "reasonable return" as compared to contributions made by certain other people to the business. For those over the age of 24, among the criteria considered are: the work performed, the property contributed and risks assumed.

The CRA also stated that it "does not intend to generally substitute its judgment of what would be considered a reasonable amount unless there has not been a good faith attempt to determine a reasonable amount based on" the criteria to determine a reasonable return.

This exception, however, is not as generous for those in the 18-24 year-old age range. The only factor that will be considered for these young adults is the "arm's length capital" that they have contributed. The value of work performed for a corporation is ignored for this age group.

To qualify as “arm’s length capital,” the funds cannot have been acquired from related parties. Salary received from a corporation that is reinvested in that or another corporation is acceptable, but not dividends or interest received from a private corporation.

Where capital invested does not satisfy the definition of “arm’s length capital,” the permitted rate of return before the split income rules come into play for this age group is calculated based on the CRA prescribed interest rate, which is currently 1% until April 1, 2018 when it rises to 2%.

4. Retirement

A further exception is available to accommodate certain retirees. If a shareholder who is involved in the business is at least 65 years of age, and if income received directly by that person would not be subject to the split income rules, income received by the shareholder’s spouse or common-law partner won’t be subject to the split income rules. This is consistent with the current rules for pension income splitting. Note that this exception will be available with respect to all corporations, including professional corporations.

5. Capital gains

Exemptions to the application of the proposed split income rules apply to certain capital gains realized on the disposition of private company shares.

When an individual dies, he or she is deemed to have disposed of all of their capital property, including private company shares, at their fair market value. If such a capital gain arises on a person’s death as a result of this deemed disposition, then the split income rules will not apply.

Also, if the capital gain is derived from the disposition of either qualified farm or fishing property, or qualified small business corporation shares, on which the lifetime capital gains exemption¹ (“LCGE”) could be claimed, then the

split income rules will not apply. If, however, the individual is under the age of 18, and the shares are transferred to a related party, then this exception will not apply and the capital gain will be subject to the split income rules.

Action items:

- Where dividend payments would be split income if paid to a shareholder under age 25, but would not be split income if they were at least 25 years of age, consider delaying the payments until the shareholder reaches 25 years of age.
- Where a shareholder under age 25 works in a business, but does not satisfy the average of 20 hours per week test, make sure the shareholder is paid a reasonable salary, and is not compensated for work performed through dividend payments.
- Consider the full effect of these proposed rules before finalizing any contemplated estate freeze transactions. Dividends and gains earned after 2017 on shares purchased for a nominal amount may be subject to tax at the highest rate.
- Review the share structure of any private corporations to determine if a reorganization should be considered.
 - You might consider changing the share structure to allow shareholders to qualify for the excluded share exception.
 - If more than one shareholder owns shares of the same class, corporate law might require you pay the same rate of dividends to all shareholders of the same class of shares. If you cannot pay dividends to one shareholder without causing another shareholder to receive dividends that would be taxed at the highest tax rate, you might consider a corporate reorganization so that the shareholders own different classes of shares.

Proposed limitations to access the Lifetime Capital Gains Exemption (WITHDRAWN)

The government expressed concern that the LCGE is being multiplied within related groups. This can happen where a family trust is a shareholder, and more than one individual (each individual trust beneficiary) claims the LCGE which reduced the taxable capital gain realized on the disposition of private corporation shares. In July 2017, various measures were proposed to prevent this from occurring.

Responding to numerous concerns of potential unintended consequences from the proposed measures, such as the possible impact on intergenerational transfers to family members, the government announced on October 16, 2017 that it will not be proceeding with the measures previously proposed to limit access to the LCGE. **The draft legislation released in December 2017 implements this retraction.**

As such, it remains possible to use a discretionary family trust to hold common shares in a private corporation and multiply the LCGE by distributing gains to individual trust beneficiaries; however, any dividends received by a trust beneficiary on those shares could be subject to the split income rules if the trust beneficiary does not qualify for any exceptions.

Passive investment income

The tax deferral advantage

One of the goals of the current system for taxing private corporations is that after-tax active business income earned through a corporation is approximately equal to after-tax active business income earned by an individual directly, after taking into account the personal tax liability on the dividend paid to move funds out of the corporation.

That is,

$$\begin{array}{r} \text{Corporate taxes on earnings} \\ + \text{Personal taxes on dividends} \\ \hline = \text{Personal taxes on income otherwise earned directly} \end{array}$$

The tax rate on income earned in a corporation is generally much lower than the top personal marginal tax rate for an individual income earner; consequently, until income is withdrawn from a corporation as a dividend, there is more after-tax income to invest within the corporation than there would be if the income was earned by the individual.²

If these corporate funds are not needed for a shareholder's living expenses and these funds are invested inside the corporation over long periods of time, a shareholder may end up with more after-tax income within the corporation at the end of the investment period because of the higher starting capital. This is commonly referred to as the "tax deferral advantage."

Figure 1: 2018 Tax Deferral Advantage by Province for SBD Income and ABI

	SBD Income (eligible for small business deduction)	ABI (not eligible for small business deduction)
BC	37.8%	22.8%
AB	36.0%	21.0%
SK	35.5%	20.5%
MB	40.4%	23.4%
ON	40.0%	27.0%
QU	35.3%	26.6%
NB	40.8%	24.3%
NS	41.0%	23.0%
PE	36.9%	20.4%
NL	38.3%	21.3%

The size of the deferral advantage depends on the difference between the applicable corporate tax rate and the shareholder's personal tax rate. Where income earned in the corporation is taxed at the lower small business deduction tax rate (SBD Rate), the tax deferral advantage, ranging

from 35.3% to 41% in 2018, is magnified as shown in Figure 1. Where the general corporate tax rate on active business income (ABI) applies, the deferral ranges from 20.4% to 27.0%.

Example

Amira is an Ontario resident and pays tax at the top marginal tax rate. If she, as a “sole proprietor,” earns \$10,000 of business income personally from an unincorporated manufacturing business, after paying taxes she would have approximately \$4,650 left for investment purposes. If, however, Amira earned that \$10,000 through a private corporation paying tax at the SBD Rate, the private corporation would be left with \$8,650 after-tax to invest. Even though the after-tax business income and the investment income would be taxable in Amira’s hands once paid out as a dividend, she is likely to end up with more after-tax income from the private corporation at the end of the investment period because of the higher starting capital of \$8,650 rather than \$4,650.

The government considers this unfair and would like to neutralize this tax deferral.

The approach that the government appeared to be considering in the paper released in July of 2017 would have made the currently refundable tax on investment income no longer refundable in most cases. It was estimated that this could have resulted in an effective tax rate of over 70% on certain passive income earned within a private corporation and approaching 60% on capital gains.³

During the period of consultation, the government heard that its proposals were very complex and the tracking of pre-and post-grandfathered assets would add significant administrative burdens on businesses. Submissions also indicated concern that the proposals would result in punitive effective tax rates.

As a result, in October of 2017 the government announced that this measure would be limited in scope: it announced a \$50,000 annual investment income threshold before this new tax regime would apply. Mention was made that this would be the return on \$1 million of investments, assuming a 5% rate of return. The government estimated that only 3% of private corporations earn more than this amount in a year. The purpose of the \$50,000 threshold was to permit savings within private corporations for such uses as funding a parental or sick leave, so as to alleviate some concerns raised during the consultation process.

The government also reinforced previous announcements that the new rules will apply on a go-forward basis only, referring to both investments and income earned on those investments.

But the government decided not to go this route.

Consistent with the government’s outlined principles and submissions received from Canadians in the consultation period, in the 2018 federal budget the government proposed an entirely new approach to limit the tax deferral advantage.

The “new” proposed rules (Budget 2018)

Two measures were proposed to address the tax deferral advantage. The first impacts eligibility for business income to be taxed at the lower SBD Rate. The second measure restricts payouts from the refundable dividend tax on hand account (RDTOH). Both of these measures are effective beginning January 1, 2019.

Restricting the SBD Rate

The SBD Rate currently applies federally on the first \$500,000 of qualifying active business income of a CCPC (the SBD Limit.) The first new measure proposes to reduce the SBD Limit for CCPCs with over \$50,000 of “adjusted aggregate investment income” (AAIL) in a year.

AAll will exclude capital gains / losses from the disposition of both property used principally in a Canadian active business, and shares of a connected CCPC where certain conditions are met. It will also exclude dividends that are received from connected corporations, and investment income that is incidental to an active business (such as interest from short-term deposits held for operational purposes.) It will include, however, dividends received from non-connected corporations, commonly referred to as portfolio dividends. In addition, net capital losses carried over from previous years will not be included in the calculation. Note that this measure does not exclude investment income earned on capital generated before the effective date, nor does it exclude investment income arising from capital invested by a shareholder.

Starting in 2019, the SBD Limit will be reduced by \$5 for each \$1 of AAll that exceeds \$50,000. It will reach zero once \$150,000 of AAll is earned in a year. Put another way, the SBD Limit of \$500,000 is reduced on a straight line basis once AAll is \$50,000 or more and is completely eliminated once AAll is \$150,000. Similar to the requirement that associated corporations share the SBD Limit, for purposes of calculating the AAll threshold, investment income of all associated corporations is combined.

Figure 2 illustrates the interaction between AAll and the impact on the SBD Limit.

Figure 2: Examples of Reduction in the Small Business Deduction Limit Based on Passive Investment Income⁴

If AAll is...	the SBD Limit will be...
\$50,000	$\$500,000 - (\$ 50,000 - \$50,000) \times 5 = \$500,000$
\$75,000	$\$500,000 - (\$ 75,000 - \$50,000) \times 5 = \$375,000$
\$100,000	$\$500,000 - (\$100,000 - \$50,000) \times 5 = \$250,000$
\$125,000	$\$500,000 - (\$125,000 - \$50,000) \times 5 = \$125,000$
\$150,000	$\$500,000 - (\$150,000 - \$50,000) \times 5 = \$ 0$

In 2019, ABI that exceeds the SBD Limit (and is not eligible for the SBD Rate of 9% federally) will be taxed at the general ABI rate of 15% (assuming no changes to the rate).

The provinces have their own SBD Limits and SBD Rates. There has been no word yet on whether any of the provinces will follow suit on the federal budget measure and reduce their own provincial SBD Limits when passive income exceeds certain levels, but based on previous tax measures, it seems likely the provinces will follow suit.

Where there is a certain level of AAll in a corporation, this proposed measure will limit the tax deferral advantage available on ABI earned after 2018 to the difference between the personal tax rate on ordinary income and the general corporate tax rate on ABI (income that is *not* eligible for the SBD Rate.) CCPCs that do not have any income that qualifies for the SBD Rate, such as pure investment holding corporations, will not be impacted by this measure.

Examples of new passive investment income / SBD limitation rules

The following examples are adapted from the 2018 Budget Plan and demonstrate how the new rules may affect a small business owner in 2019.

Example 1

Elise owns an incorporated catering business which earns \$100,000 (after tax) annually and pays out \$75,000 as non-eligible dividends each year. She retains the extra \$25,000 annually to build up a fund for a planned parental leave. Elise will not be affected by the new rules since the investment income on her savings will be well below the \$50,000 annual threshold. Thus, she will have no income taxed at the general corporate rate.

Example 2

Simon is an incorporated farmer who puts aside excess funds annually to manage weather and other risks affecting his livelihood. His goal is to

save \$500,000. He chooses to save through his corporation in the AgrilInvest program to take advantage of matching government contributions. Investment income from AgrilInvest is not considered AAll. As such, Simon will not be affected by the new rules.

Example 3

Claire owns a retail business and now uses the retained earnings in her corporation to invest in promising start-ups. She recently sold a 20-per-cent stake in a growing clean-tech firm, and realized a \$1 million capital gain, which she reinvested into two new start-ups. Claire also won't be affected by the new rules because her ownership stake in the active business she just sold is such that her capital gain will not count towards the \$50,000 threshold, and she is actively reinvesting.

Example 4

Amrita owns a hotel whose income depends on a number of factors outside her control, so she sets aside funds each year to ensure she can continue to pay salaries and expenses in case of a downturn. She has \$400,000 in savings in her corporation that she invests in low-risk bonds. Amrita will not be affected by the new rules because the investment income on her savings will be well below the \$50,000 threshold, and therefore she won't have business income taxed at the general corporate rate.

Example 5

Saanvi owns a retail store and keeps cash deposits to pay her suppliers and the salary of her employee. She earns interest income on these deposits, which in her circumstances is considered incidental to her business. As a result, Saanvi will not be affected by the new rules.

Example 6

Louis operates a successful medical practice, which is incorporated and earns more than \$500,000 annually. He has accumulated a portfolio with a value of \$5 million, which he intends to pass on to his children. Given his level of savings and

level of income, beginning in 2019, Louis will no longer receive the benefit of the small business rate to fund further passive investments. All of his business' income will be taxed at the general corporate rate.

Example 7

Jeff is an incorporated Ontario physician who earns \$500,000 of net income annually in his professional corporation. He has accumulated \$2,000,000 of retained earnings, which will be used to fund his retirement. Assume he earns a 5% annual rate of return which produces \$100,000 of annual investment income. For simplicity's sake, we'll also assume that this is ordinary investment income, although in reality it would likely be a mix of dividends and current and deferred capital gains, which would further complicate our math.

The new rule means that, starting in 2019, Jeff's corporation would only be entitled to the SBD Rate on \$250,000 of his professional income ($\$500,000 - (\$100,000 - \$50,000) \times 5$).

Limiting access to refundable taxes

The second proposed measure will limit tax advantages that CCPCs can obtain through the RDTOH system.

The tax system is designed to tax investment income earned by CCPCs at a higher rate, which is approximately equal to the top personal income tax rate. A portion of this high rate tax is then refunded when that investment income is paid out to shareholders as a dividend (and the shareholder is subject to tax.) This refund is made through the RDTOH account system.

In practice, however, any taxable dividends paid by a private corporation can trigger this refund, regardless of the source of that dividend. In other words, a dividend refund can be obtained irrespective of whether the dividend is coming from higher taxed investment income or lower-taxed ABI. This means that some CCPCs can pay

out dividends from their pool of ABI taxed at the general corporate rate, where the dividend is taxed in the shareholder's hands at a preferential tax rate, and still claim a refund of taxes paid on their investment income, which is intended to be taxed at higher tax rates when paid to a shareholder.

The government noted that this can provide a significant tax advantage and therefore it was proposed that CCPCs will generally no longer be able to obtain refunds of taxes paid on investment income while distributing dividends from income taxed at the general corporate rate.⁵ Refunds will continue to be available when “non-eligible dividends” are paid out. Shareholders pay a higher rate of tax on non-eligible dividends. This will be accomplished by establishing two new RDTOH accounts.

Alternative corporate investment strategies: corporate owned life insurance & individual pension plans

A corporation may choose to invest its after-tax income into a life insurance policy that insures the life of the owner-manager, or some other party. While income from savings in a life insurance policy that is not an exempt policy was specifically captured in the annual passive income test, it appears that an “exempt policy,” where no income is required to be included in the holder's income over the life of the policy, does not come under the ambit of these new proposals. This could be a strategy for business owners to consider in consultation with their advisors.⁶

An Individual Pension Plan (IPP) is a pension plan created for one person, rather than a large group of employees.⁷ Since the corporation contributes to the IPP and the income earned in the IPP does not belong to the corporation, it too should not be subject to the proposed rules. An IPP could be a strategy to consider once adjusted aggregate investment income exceeds the \$50,000 threshold.⁸

Action items:

- Consider a buy and hold strategy to defer capital gains if a corporation is approaching the \$50,000 threshold.
- Consider withdrawing sufficient salary from a private corporation to maximize contributions to RRSPs and TFSAs. For additional information, see our reports, [RRSPs: A Smart Choice for Business Owners](#)⁹ and [TFSAs for Business Owners... A Smart Choice](#).¹⁰
- Consider whether an Individual Pension Plan or corporately-owned life insurance may be appropriate.

Converting income into capital gains (WITHDRAWN)

There are currently anti-avoidance rules in place to prevent converting dividend income from private corporations to capital gains, which are taxed at a lower tax rate. The government was concerned that the current anti-avoidance rules do not specifically address certain transactions that they consider to be abusive.

The paper and draft legislation contained an expansion of the current rules proposed to be effective July 18, 2017. The proposed rules would have impacted certain post-mortem tax planning that provides relief from double taxation where private corporation shares are held at death. This is commonly referred to as a “pipeline transaction.”

The rules could also have treated capital gains realized on the disposition of private corporation shares to a family member as dividends. This was in addition to the gain being subject to the highest tax rate if it is considered split income.

In response to concerns expressed during the consultation period, the government announced on October 19, 2017 that it will not be moving forward with the original proposals regarding converting of income into capital gains.

Conclusion

The proposals affecting the taxation of CCPCs are extremely complex. The consultation process between the Department of Finance and interested parties resulted in a number of modifications to the proposals. Those who may be impacted should consult tax and legal advisors to determine any actions that they may wish to take.

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- ¹ The LCGE exempts the first \$848,252 (2018 amount) of lifetime capital gains on the sale of qualifying small business corporation shares from tax. For qualified farm or fishing property, the exemption is \$1 million.
- ² This assumes that the shareholder pays tax at the top marginal tax rate.
- ³ For more information, see “A 93% tax rate? Private corporation tax could make it possible”, Jamie Golombek, National Post, August 4, 2017, which is available online at <http://business.financialpost.com/personal-finance/taxes/a-93-per-cent-tax-rate-private-corporation-tax-could-make-it-possible>. This article discusses calculations performed by Mac Killoran of Fruitman Kates LLP and Jay Goodis of Tax Templates Inc.
- ⁴ The SBD Rate is to be 9.0%. This also assumes the SBD Limit remains at \$500K.
- ⁵ A limited exception will apply to portfolio dividends.
- ⁶ A tax advisor should be consulted before investing in corporate owned life insurance. It should also be considered whether this fits into your overall financial plan.
- ⁷ The main advantages of an IPP are that you can potentially contribute more money than you could with an RRSP and the plan is creditor-protected to the extent provided under the governing pension benefits legislation. There are setup and ongoing administrative costs associated with an IPP.
- ⁸ A tax advisor should be consulted before setting up an IPP.
- ⁹ The report *RRSPs: A Smart Choice for Business Owners* is available online at https://www.cibc.com/content/dam/small_business/advice_centre/business-reports/RRSPs-for-business-owners-en.pdf.
- ¹⁰ The report *TFSAs for Business Owners... A Smart Choice* is available online at https://www.cibc.com/content/dam/small_business/day_to_day_banking/advice_centre/pdfs/personal_finances/tfsas-for-business-owners-en.pdf.



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