Private Corporations: Proposed Changes to Tax Rules

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On July 18, 2017, the Department of Finance announced significant proposed changes to the taxation of private corporations. The March 2017 Federal Budget indicated that the government was reviewing certain tax planning strategies involving private corporations, with a plan to issue a paper outlining the perceived issues in more detail. This paper was part of the July 18th release, along with draft legislation covering two of the three areas of concern. The government has invited interested parties to comment on the proposals by October 2, 2017.

Individuals who either currently have a private corporation structure, or who are considering setting up a private corporation, should discuss these proposed measures with a tax advisor to determine the impact in their particular circumstances.

Income Splitting

Income Sprinkling

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 are taxed at a low tax rate (or pay no tax at all.) Currently there are anti-avoidance measures in place to limit this. One example of this is the current “kiddie tax”, which applies to what is called “split income”. For example, certain dividends paid to children under 18 years of age are taxed at the highest tax rate. Additionally, there are rules dictating that any salary paid to a family member must be reasonable in the circumstances for the corporation to claim a tax deduction.

Effective for 2018, the proposed changes would expand the kiddie tax rules, so that they would apply to more types of income, including certain interest income, and would also expand the rules to cover certain adults. The new rules would look at whether income received by an adult individual is reasonable, taking into account the person’s labour and capital contributions to the business, and previous returns and remuneration, in comparison to a situation where an arm’s length investment was made.

For example, assume that Pat invested $100,000 in a private corporation run by her mother. In return for that investment, she got preferred shares paying a 5% dividend rate. According to the government paper, this level of investment income should be considered reasonable, given that an arm’s length investor would expect to receive a 4-6% return. However, if Pat, in the course of an estate freeze,[1] paid only a nominal amount for common shares, but received the same amount of dividends, it would not likely be considered a reasonable return, given that her capital contribution to the business was nominal.

The government specifically expressed concern that the 18-24 age group appears "to present particular advantages for those seeking to sprinkle income", as they typically continue to be subject to a low tax rate. As such, the rules for those under age 25 are more expansive. For instance, compound income (investment income earned on reinvested split income) will be subject to the split income rules for those under age 25 regardless of the reasonableness test. Further, for the purposes of determining a reasonable return on a capital contribution, this age group will be limited to a rate of return equal to the prescribed rate of interest in the *Income Tax Regulations* (currently 1%). Even if the individual provided labour to the corporation, unless this labour was regular, continuous and substantial, any amounts paid in excess of the prescribed rate will be subject to the split income rules.

For those receiving income that may be subject to the expanded split income tax rules in 2018, a tax advisor should be consulted to consider whether amounts should be paid in 2017.

Lifetime Capital Gains Exemption ("LCGE")

The government is concerned that the LCGE is being multiplied within related groups, allowing more than one individual to claim the LCGE to reduce the taxable capital gain realized on the disposition of private company shares.[2] Most specifically, they are concerned about the use of family trusts to facilitate this arrangement.

Effective for dispositions of shares after 2017, three measures were proposed to prevent this from occurring. First, the LCGE would not be available for gains, either realized or accruing, before a person is 18 years old. Second, if a capital gain is subject to the new income splitting rules, then it is not eligible for the LCGE. And finally, except for certain exceptions, trusts would not be eligible to claim the LCGE.

Example

Assume that Bob undertook a reorganization of his private corporation in 2011. As part of that reorganization, a family trust subscribed for common shares, paying only a nominal value for them. Because the value of company assets has increased in value, these common shares have increased in value substantially since 2011. Bob's wife and two adult children are the beneficiaries of the trust. If the shares are sold prior to January 1, 2018, and the trust realizes a $2 million capital gain, this gain could be distributed out to the trust beneficiaries and each could claim the LCGE (assuming the shares otherwise qualify), eliminating all tax on the sale. This would no longer be permitted after January 1, 2018.

Transitional rules have been proposed to permit people to elect to crystalize a capital gain in 2018 so that they can claim the LCGE. **Individuals wishing to consider this opportunity should consult a tax advisor to make sure any requirements for this election are met before the end of 2017.**

Income Tested Benefits

It is proposed that split income be included for purposes of calculating income-tested benefits, such as personal tax credits that depend on income.

Passive Investment Income

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

	Corporate taxes on earnings
+	*Personal taxes on dividends*
=	*Personal taxes on income earned directly.*

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. This is commonly referred to a “tax deferral advantage”. Where income earned in the corporation is taxed at the lower small business rate, the tax deferral advantage is magnified. The government considers this unfair, and would like to neutralize this tax deferral.

For example, assume that Amira is an Ontario resident and pays tax at the top marginal tax rate. If she, a “sole proprietor”, earns $10,000 of business income personally from an unincorporated manufacturing business, after paying taxes she would have approximately $4,700 left for investment purposes. If, however, Amira earned that $10,000 through a corporation paying tax at the small business tax rate, the corporation would be left with $8,500 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 would end up with more after-tax income from the corporation at the end of the investment period because of the higher starting capital of $8,500 rather than $4,700.

The government paper provided a few potential approaches to end this deferral. The intent is that any new rules would apply on a go-forward basis. Draft legislation on this point was not included in the government release.

Converting Income into Capital Gains

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 is concerned that the current anti-avoidance rules do not specifically address certain transactions. The paper and draft legislation contain an expansion of the current rules. These are proposed to be effective July 18, 2017.

Conclusion

These proposals are very complex. The consultation process between the Department of Finance and interested parties may provide further clarity on these matters. **Those who may be impacted should consult a tax advisor to determine any actions that they may wish to take.**

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[1] An estate freeze is a corporate reorganization whereby shares that accumulate future growth are commonly issued to family members, or a trust that has family members as beneficiaries.

[2] In 2017, the LCGE can be claimed to offset up to $835,716 of capital gains on the sale of shares of a qualified small business corporation, or up to $1 million for shares of a farm or fishing corporation.