Potential changes to tax planning for private corporations

By Raymond Letendre

With the release of the 2017 federal budget earlier this year, the Liberal government hinted at changes to the way private corporations may be used for tax planning. The Department of Finance has now released a consultation paper that targets three specific tax-planning strategies using private corporations. These strategies are quite common and many business-owners could be impacted if the proposed changes become law. The discussion below is not intended to be an exhaustive explanation of tax strategies; rather the information is provided as a brief summary of the three issues identified in Budget 2017, as derived from the Department of Finance Consultation Paper.

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"Sprinkling Income" using private corporations

Currently
This strategy can reduce taxes by shifting income from high-income earners, typically at top marginal rates by paying dividends to family members in lower tax brackets. This is commonly known as "dividend sprinkling", or "income sprinkling".

Proposed
Rules to distinguish income sprinkling from reasonable compensation. Reasonable compensation would be determined based on the family member's contribution of value and financial resources to the corporation. These measures include:

1. Extension of the rules governing tax on split income (TOSI). This will apply to certain individuals who receive split income when the amount in question is unreasonable. An adult who receives split income would be liable for the tax on split income on the "unreasonable" portion of the income. This could include:
   - Expanding the meaning of "Specified Individual". Currently, only specified individuals are liable under TOSI rules, but the proposed changes include an extension of who is considered a specified individual, whether minor or adult, who receive split income.
   - Reasonableness test – individuals 18 and over. TOSI would generally apply to an adult specified individual's split income if the amount is

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unreasonable according to certain specified factors. An amount would not be considered reasonable in the context of the business to the extent that it exceeds what an arm's-length party would have agreed to pay to the adult specified individual, considering the following factors: Labour contribution, capital contribution, and/or previous returns/remuneration.

- **Introducing the meaning of "connected individual".** Generally, split income of an adult specified individual from a corporation over which the connected individual is presumed to exert influence would be subject to the TOSI if the amount is unreasonable according to those factors set out in the reasonableness test.
- **Additional changes to TOSI rules.** This would be an attempt to improve the existing rules, and to support the measures above. These could include a re-definition of split income; the current exclusion from a minor's split income in respect of certain inherited property; split income included in determining whether the individual qualifies for certain income-tested benefits; and TOSI rules extended to apply in the case of adult specified individuals aged 18-24. Where, a related individual who has sprinkled income with an adult specified individual aged 18-24 may be assessed joint liability with the adult specified individual for the adult specified individual's unpaid TOSI

2. Limiting multiplication of claims to the lifetime capital gains exemption (LCGE). Currently, family trusts may be used to facilitate arrangements whereby the LCGE limits of multiple family members are used to reduce capital gains tax. This arrangement permits multiple family members to claim the exemption even though the family member(s) may not have invested in, or otherwise contributed to, the business value reflected in the capital gains they realize. To address this, proposed changes include:
   - **Age limits** - individuals would no longer qualify for the LCGE in respect of capital gains that are realized, or that accrue, before the individual turns 18.
   - **Reasonableness test (again)** – Similar to the TOSI measures, to the extent that a taxable capital gain from the disposition of property is included in an individual's split income, the LCGE would not apply in respect of the capital gain from the disposition.
   - **Trusts** – Gains that accrue during the time the property is held in a trust will no longer be eligible for the LCGE, with certain exceptions.

3. Supporting measures to improve the integrity of the tax system in the context of income sprinkling:
   - **Introduction of tax reporting requirements** with respect to a trust's tax account number, similar to the requirements for corporations and partnerships in respect of their tax account numbers ("business numbers")
   - **Introduction of measures** so that the T5 slip requirements with respect to interest amounts apply to partnerships and trusts in the same circumstances in which they apply to corporations

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Holding a passive investment portfolio inside a private corporation

Currently

Corporate income is taxed at lower rates versus personal income. This provides incentive for business re-investment, and opportunity for business growth. However, when the owner of a private corporation uses earnings taxed at the lower corporate tax rates to fund passive investments held within the corporation, this can result in a tax deferral advantage due to after-tax income invested passively within the corporation being more than the after-tax income earned personally. It is felt that this creates an unfair benefit to owners of private corporations.

Proposed

Reforms are being considered intended to apply to corporate owners that set aside corporate profits for passive investments. The Government is considering 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. Approaches considered will have the objectives of: preserving the intent of the lower tax rates on active business income earned by corporations; eliminating the tax-assisted financial advantages of investing passively through a private corporation; and ensuring that no new avenues for avoidance are introduced. Other approaches are also being considered.

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Converting a private corporation's regular income into capital gains

Currently

Income earned by an individual indirectly through a corporation is subject to both corporate income tax (when the income is earned by the corporation) and personal income tax (when the income is distributed as a dividend from the corporation to the individual). The Canadian income tax system is designed so that the combined corporate and personal tax paid on income earned through a corporation and distributed as a dividend to an individual shareholder is roughly equivalent to the income tax that would have been paid if the income had been earned directly by the individual. This is commonly referred to as "tax integration".

A corporation distributes taxable dividends from its corporate surplus which, in general terms, is made up of its accumulated after-tax earnings and unrealized corporate value minus its liabilities. Through the operation of the dividend tax credit, an individual shareholder should in general retain on taxable dividends the same after-tax amount as the individual would have had if the corporate income had been earned directly by the individual. However, integration does not occur if corporate surplus is paid out in the form of tax-exempt, or lower-taxed, income. In effect, the income is not subject to the appropriate personal income tax and the income is subject to less tax than if the individual had earned the income directly.

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"). Effectively, this reduces income by taking advantage of lower tax rates that apply to capital gains.

Proposed

Section 84.1 of the Income Tax Act to be amended to prevent individual taxpayers from using non-arm's length transactions that 'step-up' the cost base of shares of a corporation in order to avoid the application of section 84.1 on a subsequent transaction. In general terms, this will be achieved by extending current rules that result in a so-called 'soft' cost base if the LCGE is claimed to cases where cost base is increased in a taxable non-arm's length transaction, and by ensuring that those rules apply in a manner that is consistent with this policy objective.

The Government also proposes that the Income Tax Act be amended to add a separate anti-stripping rule to counter tax planning that circumvents the specific provisions of the tax law meant to prevent the conversion of a private corporation's surplus into tax-exempt, or lower-taxed, capital gains. In general, the anti-stripping rule would apply to a non-arm's length transaction where it is reasonable to consider that 'one of the purposes' of a transaction or series of transactions is to pay an individual shareholder/vendor non-share consideration (e.g., cash) that is otherwise treated as a capital gain out of a private corporation's surplus in a manner that involves a significant disappearance of the corporation's assets. In such a case, the non-share consideration would be treated as a taxable dividend. It is proposed that the anti-stripping rule apply in respect of amounts that are received or become receivable on or after the date of the release of this consultation paper.

Next Steps

Stakeholders who choose to question the use of the mechanisms discussed can provide their views and ideas about the proposals. Comments may be submitted to fin.consultation.fin@canada.ca by October 2, 2017.

Sources

Government of Canada, Department of Finance Consultation Paper
http://www.fin.gc.ca/activty/consult_-eng.asp

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