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Canadian Government Proposes Major Changes to the Taxation of Private Corporations

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The Canadian Department of Finance released a discussion paper earlier today on tax planning using private corporations. Included with the paper is draft legislation for a couple of the matters discussed in the paper. Finance has requested comments on the discussion paper by October 2, 2017.

Finance announced in the 2017 Budget that this summer it would be releasing a paper for consultation on the taxation of private corporations. Although some of the items discussed in the paper had been expected by the tax community, the breadth of the proposals was unanticipated. These proposals, if enacted, potentially affect most Canadian business owners who carry on their businesses through private corporations. The proposals significantly increase the complexity of the tax rules applicable to private corporations and reverse many long-standing tax policies that have encouraged business growth. We summarize the proposals below.

Passive Investment Income

The government is concerned that individuals who carry on business through a corporation can leave their business income in the corporation to make passive investments, thereby providing a tax deferral advantage to these individuals. This possibility arises because business income in a corporation is taxed at a much lower rate (the small business rate or the general corporate rate) than the rate applicable to income earned personally. As a result, if the after-tax business income is retained in the corporation, a larger sum is available to invest. Although rules are in place to tax passive income earned by a private corporation at a rate approximating personal rates by way of a refundable tax, as well as to tax dividends from private corporations at an integrated rate, the government states that these rules do not look to the source of the income used to make the investment.

The government is seeking input on potential approaches to neutralize the tax deferral advantage associated with making passive investments through a private corporation. A proposal being considered by the government involves making the current refundable tax on passive investment income non-refundable where earnings used to fund such investments were taxed at low corporate rates. In addition, access to the lower "eligible dividend" rate would not be available for passive investments funded with active business income, such as dividends from publicly traded stocks. As well, the non-taxable portion of capital gains funded from active business income would not be added to the capital dividend account of the corporation. An exception would be made where the investments are funded by income contributed to the corporation by a shareholder from income taxed at the personal rate. To ensure neutrality, it would be necessary to track whether the funds used to make a passive investment were taxed at the small business rate or the active business rate, or were contributed by the shareholder from after-tax personal income. The proposals consider both an apportionment method and an elective method to determine the source of the income. A further election is envisioned for corporations focused on passive investments to maintain the current system.

The government is seeking input on these proposals. It is intended that any new rules would apply only on a go-forward basis.

Anti-Income-Splitting Rules

The proposed legislation significantly expands the scope of the tax on split income (the "kiddie tax"). The *Income Tax Act* (Canada) (Tax Act) currently includes a tax on split income that taxes minor children at the top-marginal rates on certain types of income (such as certain dividends on private company shares, trust allocations or partnership income) and capital gains realized on dispositions to non-arm's-length persons. Minor children also cannot claim the lifetime capital gains exemption on such capital gains. The proposals extend the tax on split income to any Canadian resident who receives income from a related business if the income received is unreasonable in the circumstances having regard to the labour and capital contributed by the individual to the business. The paper notes that income splitting is more likely to occur with adult children aged 18 to 24. Accordingly, income earned by persons aged 18 to 24 will be subject to a higher degree of scrutiny to establish that the income is reasonable. The reliance on a reasonableness test introduces a significant degree of uncertainty to the tax treatment of dividends or other amounts potentially subject to the tax on split income.

The proposals extend the tax on split income to income from certain indebtedness, to capital gains, if the income on the disposed property would have been subject to the tax on split income, and to any income realized by minors and certain adults under the age of 25 that is derived from after-tax earnings that were subject to the tax on split income or the attribution rules in the Tax Act. The rules also impose joint and several liability for the tax on split income imposed on a person under 25 years of age to parents and certain related persons. The proposed changes to the tax on split income apply to the 2018 and following taxation years.

Lifetime Capital Gains Exemption Restrictions

The Tax Act currently provides an exemption for all Canadian resident individuals on the first $835,716 (for 2017) of capital gains realized on the disposition of qualified small business corporation shares and the first $1 million of capital gains realized on the disposition of qualified farm and fishing property. The proposals eliminate the lifetime capital gains exemption on gains on the disposition of property (i) that accrued before the taxation year in which the individual turns 18 years of age; (ii) if income on the property was subject to the tax on split income; or (iii) that accrued while the property was held by a trust (other than a spousal trust or common law partner trust or certain trusts established to hold shares for employees). These proposals would restrict the ability to claim the lifetime capital gains exemption to many family business owners who have undertaken typical estate planning transactions and introduce substantial uncertainty relating to the valuation of property where only part of the ownership period is during the denial period. The proposed changes apply to dispositions occurring after 2017.

Converting Income into Capital Gains

Where an individual holds shares of a corporation that has excess cash, the individual could undertake a series of transactions to extract the cash in a manner that would result in the individual being taxed at a capital gains rate that is lower than what would be imposed on a taxable dividend received by the individual from the corporation. The planning to achieve this result is generally structured to avoid the existing rule in section 84.1 of the Tax Act that deems capital gains realized on transfers of shares to a related corporation in consideration for cash or other non-share consideration to be taxed as a dividend. The draft legislation includes an amendment to extend section 84.1 of the Tax Act and a new anti-avoidance rule to be included in section 246.1 of the Tax Act, which are intended to deter such planning. The proposed changes apply immediately.

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