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Proposed Measures to End Certain Tax Planning Strategies Using Private Corporations

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Applies to: Shareholders in a private corporation and their families

In its 2017 budget, the federal government signaled its intention to address tax planning strategies involving private corporations that can result in high-income individuals obtaining tax benefits not available to other individuals. Accordingly, on July 18 the Minister of Finance of Canada tabled certain legislative proposals and a Consultation Document: Tax Planning Using Private Corporations.

The legislative proposals tabled by the Minister basically address income splitting and tax planning designed to convert income from a corporation (dividends, salary) into capital gains. The government also announced plans to change the rules with respect to corporations that hold passive investments. Consultations are then also being held on this subject. Here is a brief overview of the various proposed measures.

Legislative proposals to deal with income splitting

The legislative proposals tabled on July 18, 2017 aim to prevent taxpayers from using private corporations for income splitting by creating a structure that allows an individual (the entrepreneur-shareholder) to transfer income to family members who are taxed at a lower rate.

The proposals on this front affect both income splitting (of dividends, interest and other types of income) and the multiplication of lifetime capital gains exemption (LCGE).[1] They directly target structures involving family trusts.

In a nutshell, the proposals would:

- Extend the rules governing the tax on split income (the "kiddie tax") to some income earned by individuals aged over 18;
- Restrict eligibility for the LCGE by, among other things, eliminating the right to claim the LCGE on property held through a family trust.

[1] The LCGE ceiling is $835,716 in 2017 (it is indexed annually); for farm or fishing property it is $1 million.

Extension of the tax on split income[2]

CURRENT RULE

Under the tax on split income (TOSI) rules, the following types of income received by a minor child[3] are taxed at the higher marginal rate rather than the regular progressive rates:

- Dividends and other benefits[4] on unlisted shares held directly or through a trust or partnership;
- Income from a partnership or trust if it comes from:
  - a business operated by a parent of the child or a business of which the parent is a shareholder, or the rental of property to such a business;
  - a business activity or rental of property when a parent of the child plays an active role in the activity or is a partner in the partnership that is earning the income;
- A capital gain realized directly or through a trust, when corporate shares are transferred to a person with a non-arm's-length relationship with the minor, insofar as the taxable dividends paid on the shares are subject to the TOSI.

Therefore, the tax generally applies to dividends paid by private corporations as well as other income from a business owned by the minor's family members.

Income from property acquired upon the death of a parent is generally not subject to this measure and this tax does not apply to wages earned by a minor.

EXPANSION OF THE INCOME SUBJECT TO THE TAX

Under the proposed measures, the definition of "split income" would be extended to include:

- income from certain types of debt issued by a private corporation;[5]
- gains from dispositions of certain property (e.g. shares) when the income from the property is split income;
- in the case of minors and adults under 25, income from reinvested split income.[6]

Under the proposals, wages would still not be subject to the TOSI and the exemption for inherited property would be extended to adults aged 18 to 24.

EXTENSION TO INDIVIDUALS AGED 18 AND OVER AND NEW "REASONABLENESS" TEST

The government is proposing to extend the TOSI to adults who receive split income. However, to determine whether the tax applies to such income received by an adult, a "reasonableness" test is being proposed.

More specifically, the TOSI would generally apply to split income received by an adult if income received from a business of which a family member is an officer or shareholder exceeds what an arm's-length party would reasonably have agreed to pay. The reasonableness of the amount received would be assessed on the basis of the following factors:

- *Labour contributions*: the extent to which the individual is involved in the activities of the business (e.g., contributed labour that could otherwise have been remunerated by way of salary or wages);
- *Capital contributions:* the extent to which the individual has contributed assets, or assumed risk, in support of the business;
- *Previous returns/remuneration:* All previous amounts paid or payable to the individual in respect of the business. For example, this would include amounts paid by a corporation to the individual as dividends on shares held by the individual, as well as salary or wages paid by the corporation to the individual for services rendered by the individual in respect of the corporation.

To address the increase in tax planning strategies involving income splitting with young adults,[7] the "reasonableness" test will be more strictly applied to individuals aged 18 to 24.

In short, the split income received by an adult will have to be reasonable, based on the person's contribution to the family business from which the income is being received. If the amount is not reasonable, the higher personal tax rate will apply to the income.

Effective date

The proposed changes to the TOSI would generally apply as of 2018.

Limitations on lifetime capital gains exemption

Three measures are being proposed to address LCGE multiplication. Briefly, the proposed changes are as follows:[8]

1. An individual will no longer qualify for the LCGE in respect of capital gains realized or accrued before the taxation year in which the individual turns 18;
2. With some exceptions, gains that accrued during the time the property was held by a trust will no longer be eligible for the LCGE;
3. The LCGE will generally not be applicable in respect of a taxable capital gain that is included in an individual's split income, which will have the effect of introducing a "reasonableness" test for the realized gain.

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2 See Appendix 1 for a summary of the main proposed changes to the TOSI rules.

3 In this document, "minor" refers to a person aged under 18 and "adult" to a person aged 18 or over.

4 Including a taxable benefit included in income pursuant to section 15 of the *Income Tax Act* (ITA).

5 In short, interest income received from a corporation, partnership or trust will now be subject to the TOSI if other amounts (such as dividends) paid by the debtor to the individual were subject to the tax.

6 For example, interest income earned on an investment acquired with funds that were subject to the TOSI.

7 Having observed that a significant portion of dividends are being paid to individuals aged under 25, the Department of Finance wants to limit this type of income splitting in particular.

8 See Appendix 2 for a summary of the main proposed changes to the LCGE eligibility rules.

Minors

Under the proposed rules, no amount would be deductible under the LCGE if the individual has not reached the age of 18 during the year. In addition, an individual could not claim the LCGE in respect of a gain accrued before the beginning of the year in which he or she turned 18. This rule would apply whether the property was held during the said period by the individual, by another person or by a partnership.

Shares held by a trust

The proposed measures are intended to prevent an individual from claiming the LCGE in respect of gains that accrued on property held by a trust, other than one of the following:

- a spousal or common-law partner trust or *alter ego* trust (or a similar trust for the exclusive benefit of the settlor during the settlor's lifetime), where the individual claiming the LCGE is the trust's principal beneficiary;
- certain employee share ownership trusts, where the individual (i.e., as a beneficiary entitled to the capital gain) is, in general terms, an arm's length employee of the employer sponsor of the arrangement.

Therefore, shares and other property held by a family trust will no longer be eligible for the LCGE.

Effective date and election to crystallize accrued gain (transitional measure)

Under the legislative proposals, these new rules would apply as of 2018.

Transitional rules would allow individuals and trusts affected by the changes to crystallize the accrued gain on the eligible property they hold. Therefore, an individual or trust that makes such an election on a day in 2018 will be deemed to dispose of LCGE-eligible property for proceeds up to the fair market value of the property.

A capital gain realized under the election will generally be eligible for the LCGE using the current tax rules. However, the requirements that apply over a 24-month period[9] in order to claim the LCGE in respect of the disposition of a property will have to be met only during the 12-month period preceding the elective disposition.

The election will have to be made on the prescribed form and filed with the Minister by the tax filing deadline for the year in which the election is made, which generally means by April 30, 2019 for individuals.

SPECIAL RULES FOR MINORS

Minors will not be eligible to make an election pursuant to the transitional rules. However, a second transitional measure would make it possible to claim the LCGE if the shares are actually disposed of by the minor (or by a personal trust under which the minor is a beneficiary) in 2018, provided that the minor (or the trust) held the shares continuously from the end of 2017 until the disposition. Under those circumstances, the capital gain will not be subject to the TOSI rules, which would otherwise apply in respect of dispositions after 2017.

TAX IMPLICATIONS AND PLANNING

Family trusts and targeted individuals who hold shares or other property eligible for the LCGE will have to make an election to crystallize their accrued gains on that property. For that purpose, it may be necessary to perform a formal valuation of the property in question. The election (or any other form of crystallisation of a gain eligible for the LCGE) could make the gain subject to the alternative minimum tax. Under some circumstances, it may be advantageous to realize part of the gain in 2017 and part in 2018 in order to reduce the impact of this tax.

"Reasonableness" test

As noted above, the LCGE will generally not apply to a taxable capital gain that is included in an individual's split income. This rule will have the effect of introducing a "reasonableness" test for the LCGE when the property, including shares in a family business, is sold. It should be borne in mind that the capital gain is now subject to the TOSI. When the gain is realized by an adult individual on shares in a family business, it will now be necessary to apply the "reasonableness" test in order to determine whether it constitutes split income for that individual. If the "reasonableness" test is not met, the gain will be considered split income taxable at the maximum marginal rate and will not be eligible for the LCGE.

Converting income into capital gains

Individual shareholders with higher incomes can obtain a significant tax benefit if they successfully convert a corporate surplus that should be taxable as dividends, or salary, into (lower-taxed) capital gains. The tax authorities have been concerned about this type of planning, which they call "surplus stripping," for years.

The proposed measures aim to counter this type of planning, among other things by introducing a new anti-avoidance rule into the ITA.

New anti-avoidance rule

Under the legislative proposals published on July 18, 2017, an individual who receives an amount in a transaction that includes one of the following elements and is aimed at reducing his or her tax payable will be deemed to have received a taxable dividend:

- disposal of property;
- increase or reduction of paid-up capital in the capital stock of a private corporation.

Furthermore, under these circumstances the capital dividend account of the corporation involved in the transaction will be reduced accordingly.

Plans call for this measure to apply to amounts received or receivable, directly or indirectly, by an individual **after July 17, 2017**.

Proposed amendment to section 84.1

Section 84.1 of the ITA contains a rule preventing an individual from claiming the LCGE when transferring eligible shares to a corporation with which he or she has a non-arm's-length

[9] Such as those respecting ownership of the property and, in some cases, activities related to the business.

relationship. Under this provision, a gain on the sale of shares to such a corporation is treated as a deemed dividend rather than a capital gain. This anti-avoidance rule therefore limits access to the LCGE in respect of the transfer of a business to family members, including intergenerational transfers.[10]

While this rule is generally effective, it can be circumvented by some tax planning strategies under specific circumstances. The legislative proposals of July 18, 2017 contain amendments to this section to curb such strategies. Plans call for the changes to apply to dispositions made after July 17, 2017.

CONSULTATION ON INTERGENERATIONAL TRANSFERS

The government also recognizes that section 84.1 of the ITA makes it impossible to claim the LCGE in the case of some genuine intergenerational business transfers. The Minister of Finance is therefore seeking comments from stakeholders to find possible ways to accommodate intergenerational business transfers while still protecting against potential abuses of any such accommodation.

Upcoming proposals on corporations earning income from passive investments

The Consultation Document: Tax Planning Using Private Corporations published on July 18, 2017 also discusses the government's concerns about passive income earned in a corporation. The government believes that investment holding corporations are contributing to inequity in the tax system because holding passive investments in a private corporation gives shareholders a clear advantage compared with other investors.[11]

The consultation document sets out some possible approaches being considered by the government to put an end to what are deemed undue advantages related to the use of investment holding corporations, without indicating which options are likely to be chosen. However, the government has specified that the proposed reforms would generally affect corporate owners who are setting aside some of their corporate profits for passive investments. The proposed system would not impact taxes payable by corporations with no passive investment income. Moreover, the initial benefit from the lower corporate tax rates would also be preserved when the corporate owner reinvests its passively invested funds to expand the active business.

While it is impossible to predict at this stage what course the government will take, it seems clear that a major reform of the tax rules on income from passive investments is being readied.

The Government will continue to review this issue and will develop concrete legislative proposals after the current consultations. We will advise you of the changes in this area as soon as the legislative proposals are published.

Other proposed changes

The legislative proposals also include some additional compliance measures.

For example, trusts will now have a trust account number which they will have to declare in accordance with regulatory requirements, just as corporations and partnerships must use their business numbers.

As well, trusts and partnerships will now have to produce T5 slips for the interest paid during the year.

Your Raymond Chabot Grant Thornton advisor can help you determine which measures apply to your situation and assist you through the process of applying them. Feel free to consult him or her.

You can also visit our site at rcgt.com for additional information.

10 Raymond Chabot Grant Thornton has been calling for these rules to be relaxed for years. For more information, see the report entitled Business Transfers: Problems and Suggested Solutions.

11 An excerpt from the Consultation Document: Tax Planning Using Private Corporations published by the Department of Finance of Canada on July 18, 2017 is reproduced in Appendix 3 of this document to illustrate the problem identified by the government.

Appendix 1 – Summary of main proposed changes to TOSI rules[12]

The tax on split income (TOSI) applies to "specified individuals." The following table summarises the current and proposed meanings of "specified individual" for the purpose of determining whether one is subject to the TOSI.

Age	Current TOSI	Proposed TOSI Measures
Under age 18 ('minor specified individual')	Canadian resident throughout the year	Canadian resident at end of the year
	Parent resident in Canada at any time during year	At any time during the year either • parent resides in Canada, or • a related individual resides in Canada, and the minor receives income derived from a business of that related individual
Age 18 or older ('adult specified individual')	Not applicable	Canadian resident at end of the year
		At any time during the year a related individual resides in Canada, and the adult receives income derived from a business of that related individual

The next table summarizes the main proposed changes to the TOSI rules.

Element of TOSI Rules	Proposed Change
Specified individual	'Specified individual' would be expanded to include individuals resident in Canada at the end of the year, provided that an individual related to the first individual is resident in Canada at any time during the year and the first individual receives income derived from a business of that related individual.
Reasonableness test	For individuals over the age of 17, amounts would generally not be included in an individual's split income to the extent that the amounts satisfy the applicable reasonableness test.
Connected individual	An individual's income derived from the business of a related individual would include income derived from a corporation, if the related individual is connected to the corporation in a manner that indicates a level of influence over the amount.
Split income	Split income would be expanded to include: income from certain types of debt obligations; gains from the disposition of property the income from which is split income; and, for specified individuals under age 25, income (i.e., compound income) on property that is the proceeds from income previously subject to the TOSI rules or the attribution rules.
Inherited property	The current exclusion from a minor's split income in respect of certain inherited property (e.g., property inherited from a parent) would be extended to apply to adult specified individuals aged 18-24.

[12] Tables taken from pages 25 and 28 of the Consultation Document: Tax Planning Using Private Corporations, published by the Department of Finance of Canada on July 18, 2017.

Appendix 2 – Summary of proposed changes to LCGE rules[13]

The following table summarizes the LCGE eligibility rules provided in the legislative proposals published on July 18, 2017.

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.

[13] Table taken from page 30 of the Consultation Document: Tax Planning Using Private Corporations, published by the Department of Finance of Canada on July 18, 2017.

Appendix 3 - Issues related to passive investments inside a private corporation

The following excerpt from the Consultation Document: Tax Planning Using Private Corporations (page 14) published by the Department of Finance of Canada on July 18, 2017 summarizes the problem raised by the government with respect to holding passive investments in a private corporation. The government is reviewing this issue and plans to publish concrete legislative proposals after the current consultations.

Andrea's private corporation owns a manufacturing plant in Saskatchewan. Last year, the corporation generated $800,000 of taxable business income (after payment of employee salaries and other expenses). The corporation is large, and is not eligible for the small business rate. The applicable federal-provincial corporate income tax rate in Saskatchewan was 25 per cent in 2016, leaving the corporation with after-tax income of $600,000. Andrea would like to use $200,000 of that amount to modernize her plant next year, and keep the balance, or $400,000, for longer-term personal savings. As the controlling shareholder, she can either pay herself a dividend or invest the $400,000 in an account held within her corporation. Andrea has already made contributions to her Registered Retirement Savings Plan (RRSP) and her Tax-Free Savings Account (TFSA) up to the maximum limits.

Andrea will be better off if she keeps a diversified passive investment portfolio inside the corporation, rather than investing it as an individual.

- If she invests within the corporation, Andrea has an after-tax amount of $400,000 to add to her portfolio.
- If she were to invest in a personal account, she would have about $280,000 to invest (her marginal personal income tax rate is about 48 per cent in 2016, given that Andrea is a high-income earner, and dividend income is subject to the dividend tax credit).

When Andrea invests through her corporation, she benefits from a bigger initial portfolio, which compounds to larger investment income every year that can be reinvested. Although there is some reconciliation at the end — when Andrea winds down the portfolio and pays personal income taxes on it — she still ends up better off than if she had chosen to invest in a personal account. After 30 years, she would end up with about $570,000 more, after payment of corporate and personal income taxes, if she invests inside her corporation.*

Unlike Andrea, an individual earning salary income would have no alternative but to invest in a personal account. As a business owner, Andrea can realize a personal portfolio advantage that is the consequence of the low corporate income tax rate, which is intended to support the growth of active businesses — not to confer a personal savings advantage.

* Saskatchewan has announced reductions in their corporate and personal income tax rates. These announcements are reflected in the calculations.

- Holding a passive investment portfolio inside a private corporation is a strategy available to people who earn enough business income to hold savings in a corporate entity. The benefits are generally realized by high-income individuals, such as those whose annual savings exceed the ceilings for tax-assisted savings vehicles such as RRSPs and TFSAs.
- On the other hand, many smaller or less profitable private corporations are unable to make major passive investments after paying dividends to shareholders and salaries to owners and employees, paying down debt or reinvesting for future growth (e.g. by purchasing modern new equipment).