# Planning**Matters**

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# 75 Day Consultation Ends: Review of the Government's Proposed Tax Changes

The tax and business communities were in a frenzy over the summer months after the Department of Finance released proposed legislation and a consultation paper ("Finance Paper") on July 18th, 2017. The Finance Paper presents the most significant tax changes to private corporations, and thereby to a substantial number of families, in Canada's recent history. The proposed changes address three key areas where the government perceives there to be an "unfair" tax advantage to shareholders of private corporations:

- **Earning passive investment income in a corporation**
- **Income sprinkling**
- **Converting income to capital gains**

## This article does not debate whether these proposed changes are fair or unfair; how it will impact the labour force; or speculate on the impact to domestic entrepreneurs and family owned businesses. This article, rather, summarizes the three strategies that are being targeted and the Government's proposals.

### Passive Investment Income in a Corporation

Passive investment income refers to income derived from an investment portfolio, as opposed to income earned from actively running a business. Corporate tax rates on active business income in Canada are significantly lower than personal tax rates. For example, in British Columbia, the tax rate on small business income earned by a Canadian controlled private corporation is 12.62% (2017) as compared to the top personal marginal tax rate of 47.7% (2017). As a result, private corporations earning business income can accumulate more after-tax funds to invest. This difference in tax is a deferral since the incremental amount invested will eventually be taxed when the corporate retained earnings are distributed to shareholders as dividends.

Critically, for those investors who have an investment portfolio managed through an operating company, the government perceives these as passive investments given that the underlying investments are unrelated to business operations. The proposed changes seek to essentially eliminate the benefit of the deferral so the result is more closely aligned with the passive investments that can be accumulated by individuals who generate income in their personal capacity.

One of the approaches would leave the corporate taxation of income as is, except that when the passive investment earnings that were earned on after-tax business income are distributed from the corporation as dividends to the shareholders, the corporation would no longer be entitled to a refund of refundable tax paid on the investment income. Moreover, private corporations would not be able to distribute 50% of capital gains realized on passive investments to shareholders as a tax free capital dividend. To put this into context, in Ontario, these proposals could increase the combined corporate and personal tax rate on investment income and capital gains funded with after tax business income to about 73% and 59% respectively.

Please note that, at this time, the government has not determined a final approach to these proposals and there is no draft legislation. The government intends that the proposed new measures would only apply on a go-forward basis and is considering how to ensure that the new rules have a limited impact on existing passive investments.

### Income Sprinkling

According to the government, income sprinkling occurs when income that would have been earned by an individual in a high personal tax bracket is shifted to an individual in a low or nil personal tax bracket. In the case of private corporations that carry on an active business, this can be effected by structuring the ownership of the private corporation so that other family members can receive dividends or realize capital gains, whether directly or through the use of a family trust.

For example, it was common practice for a shareholder to implement an estate freeze of their business by exchanging his or her common shares of the private corporation for fixed-value preference shares. A trust for the benefit of the business owner's children, and often the spouse, would subscribe for new common shares of the corporation for a nominal amount after the freeze. This structure allowed the corporation to pay dividends to the trust and the trustees to allocate the dividends to the adult beneficiaries to be taxed at their marginal tax rates. In addition, this structure provides the opportunity to multiply the use of the lifetime capital gains exemption ("LCGE"), which is $835,714 in 2017 for each individual, among the beneficiaries if the trust sold the common shares to a purchaser. The proposed changes have been introduced to limit the access to the LCGE which would apply to dispositions after 2017, subject to special transitional rules where an adult individual and certain "trusts" can elect to "dispose" of certain property in 2018 to maintain the benefit of the current enacted provisions in the Income Tax Act.

The proposals also extend the tax on split-income ("TOSI") provisions - also referred to as "kiddie tax" - to adult children, spouses and other family members who derive income (e.g., dividends or capital gains) from a business of a related individual after 2017. Furthermore, the proposals introduce a "reasonableness test" in that TOSI would apply only where an amount received was not considered reasonable (i.e., it is greater than an amount that would be paid to the individual by an arm's length party) taking into account the labour and capital contributions of the individual. The test is stricter for individuals between the ages of 18 and 24. In short, income sprinkling reduces the family's overall tax burden. According to the Department of Finance "This is fundamentally unfair, and erodes the tax base and the integrity of the tax system". Although the changes are yet to be finalized and approved, some families may wish to consult their tax advisors before the end of 2017 to determine whether any planning should be undertaken.

## Converting Income to Capital Gains

Income earned in a corporation is subject to corporate income tax and personal income tax in the hands of the shareholder when amounts are paid as dividends. The total tax paid at both the corporate and personal level is intended to be approximately equal to the taxes that would be payable if the individual earned the income directly (although this is not actually achieved with the result in many provinces being an overpayment of tax for general business income earned in a corporation). This is not the case, however, when income that would be paid as a dividend to a shareholder is converted into a capital gain as capital gains are currently taxed at a rate significantly less than dividends.

Currently business owners can employ transactions that create a means to strip surplus retained earnings from the corporation at an effective capital gains tax rate. In response, the proposals prevent individuals from using non-arm's length transactions to increase the cost base of their shares and from implementing other transactions to effect a distribution at capital gains rates.

For example, Angela sells her shares of Opco to her brother Frederic for $1 million and she realizes a capital gain of $1 million that is subject to income tax of $270,000 (assuming a 27% tax rate on capital gains). Frederic sells the shares of Opco to his Holdco for $1 million of cash. The application of the proposed rules would result in Frederic realizing a deemed dividend of $1 million which would be subject to income tax of $450,000 (assuming a 45% tax rate on dividends) for total taxes of $720,000 (which is 72% of the proceeds) for the family.

Moreover, the proposals will have a significant impact on individuals who die owning private company shares where post-mortem planning must be completed after the shareholder's death to avoid double taxation. Double tax can arise without post-mortem planning if corporate assets are sold and distributions are made to the estate or its beneficiaries after the individual's death. Under the proposals, it will no longer be possible for an estate or its beneficiaries to implement "pipeline" planning to avoid the double taxation. Pipeline planning preserves capital gains treatment upon the death of a shareholder. Rather, the executors of the estate will be required to implement subsection 164(6) planning to avoid double tax, which generally results in dividend treatment, which may greatly increase the tax payable by the estate.

The proposals also include a new anti-avoidance rule that could re-characterize a distribution from a corporation after July 18, 2017 into a taxable dividend under the following simplified circumstances:

- **An individual receives an amount as part of a transaction or event or a series of transactions or events from a non-arm's length person;**
- **There has been a disposition of property, or an increase or reduction of capital of a corporation's shares; and**
- **It is reasonable to consider that one of the purposes of the transaction, event or series was to effect a significant reduction or disappearance of assets of a private corporation at any time in a manner such that any part of the tax otherwise payable by the individual is avoided (i.e., is less than what would have been paid on a taxable dividend).**

This anti-avoidance rule is worded very broadly and will leave many private corporation shareholders with uncertainty about when it could apply to some typical transactions.

## SUMMARY


**Overall the proposed measures add further tax complexity for shareholders of private corporations.**

Backlash has been widespread from individuals, professionals, industry bodies and lobbyists whom would have submitted feedback to the Liberals by the time the consultation window closed, October 2nd 2017. To date the federal government seems committed to defending its plans to close "loopholes", which it says have allowed high earning-business owners to avoid higher taxes. We will all know more once the government has responded to the public submissions in the fall.


### About the Author:

**Chantal Copithorn** is a partner in the Private Company Services Group at PwC. She works exclusively in the area of tax planning and compliance for shareholders of private companies and other high net worth individuals. She advises on tax planning for estates, use of trusts, will planning, distribution planning for corporations and trusts and charitable giving strategies.

### About the Editor:

With over 15 years of experience spanning three continents, **Trevor Hunt** joined Leith Wheeler in 2016. Based in Toronto, Trevor is responsible for managing Private Client and Foundation portfolios on a discretionary basis. Previously, Trevor was Vice President for a multinational investment advisory firm responsible for high net worth families, foundations and institutions across Canada. He has extensive expertise in manager research and selection, tactical asset allocation, portfolio implementation and portfolio management.




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