Proposed changes: Tax planning using private corporations

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On July 18, 2017 the Department of Finance released a consultation paper, *Tax Planning Using Private Corporations*, targeting the following three tax planning strategies involving the use of private corporations:

- Income sprinkling using private corporations,
- Holding a passive investment portfolio inside a private corporation, and
- Converting a private corporation's income into capital

The consultation paper sets out the nature of these issues in more detail, outlines some potential solutions to address them and invites input from Canadians. Proposed legislation targeting income sprinkling (including the multiplication of the lifetime capital gains exemption) and converting income into capital gains was also released along with the consultation paper.

The proposed measures, if implemented, will have a significant impact on private companies.

Income sprinkling using private corporations

Income sprinkling can reduce income taxes by causing income that would otherwise be realized by an individual subject to the top marginal tax rates to, instead, be realized by family members who are either subject to lower personal tax rates or not taxable at all. The proposed rules will distinguish income sprinkling from reasonable compensation for family members through the following measures:

- Extending the tax rules regarding split income;
- Limiting the multiplication of the lifetime capital gains exemption (LCGE); and
- Supporting measures to improve the administration of the income tax rules to address income sprinkling.

Extending the tax rules regarding split income

The measures being proposed will extend the tax on split income rules (TOSI) to apply to certain adult individuals who receives split income (i.e., income from the business of a related individual, including a corporation in which a related individual has influence) when the amount in question is unreasonable under the circumstances. An adult individual in receipt of split income would be liable for the TOSI on the unreasonable portion of the income. Specifically, the proposals include:

- **Expanding the meaning of "specified individual"**. Only "specified individuals" are liable under the TOSI. The proposals extend the meaning of "specified individual" to include Canadian resident individuals, whether minor or adult, who receive split income. A Canadian resident minor would also continue to be a specified individual if a parent of the individual resides in Canada at any time in the year.

- **Introducing a reasonableness test**. A reasonableness test is introduced for the purpose of determining whether TOSI applies to a specified individual who is an adult. If a split income amount received by an adult specified individual is reasonable within the meaning of this test, then the amount that would otherwise be split income of the individual would be excluded from split income and not be subject to the TOSI. 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. Factors that will be considered to determine reasonableness include labour and capital contributions to the business, risk assumed and previous returns or remuneration. The test will apply differently depending on whether the individual is between the ages of 18 and 24 years old or is 25 years old or older. If an amount is determined not to be reasonable, the top marginal tax rate will apply.

  The proposals also provide that TOSI would apply to the split income of adult specified individuals regardless of the reasonableness test, to compound income that is derived from the investment of split income and certain other amounts of an individual under age 25, as well as amounts brought into split income under a proposed anti-avoidance rule that applies in respect of certain property held or acquired to circumvent the TOSI rules.

- **Introducing the definition of "connected individual".** A connected individual test is introduced to determine whether an adult specified individual's income from a corporation would be treated as being split income. A Canadian resident individual with influence over a corporation would be treated as connected with the corporation; thus, adult family members of the "connected individual" who receive dividends would be required to determine whether a portion of the amount received is unreasonable.

- **Include additional changes to TOSI rules.** To improve the existing rules and support the measures set out, additional changes to the TOSI rules are proposed, the most significant of these are:
  a) The definition of "split income" would be extended to include:
     - income from certain types of debt obligations (e.g., debt that is issued by a private corporation and that is not publicly traded);
     - gains from dispositions after 2017 of certain property the income from which is split income; and
     - in the case of specified individuals (minor and adult 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.

  b) 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.
  c) An individual's split income would be included in determining whether the individual qualifies for certain income-tested benefits (e.g., personal tax credits that depend on income).
  d) Certain income arising as part of a tax-avoidance arrangement, or compound income), would be subject to the TOSI without regard to the reasonableness test.
  e) The current joint and several tax liability rule with respect to the TOSI rules would be extended to apply in the case of adult specified individuals aged 18-24 years old. A related individual who has sprinkled income with an adult specified individual aged 18-24 years old may be assessed joint liability with the adult specified individual for the adult specified individual's unpaid TOSI that arises in respect of that sprinkled (i.e., that part of the split) income.

These measures will ensure that the TOSI applies as an effective mechanism for limiting income sprinkling while recognizing the legitimate contributions of different family members to the success of some private businesses.

The measures would generally apply for the 2018 and later taxation years.

Limiting the multiplication of the lifetime capital gains exemption (LCGE)
One concern is the use of family trusts to facilitate arrangements whereby the LCGE of multiple members of a family is used to reduce capital gains tax. These arrangements are used in such a way that enables other family members to claim the LCGE even though they may not have invested in, or otherwise contributed to, the value of the business as reflected in the capital gains realized on the disposition of the shares of the business that is eligible for the LCGE.

To address the multiplication of the LCGE, the following measures are proposed:

- Individuals will no longer qualify for the LCGE in respect of capital gains that are realized, or that accrue, before the taxation year in which the individual attains the age of 18 years old.
- The LCGE generally won't apply to the extent that a taxable capital gain from the disposition of property is included in an individual's split income.
- Gains that accrue during the time that property is held by a trust will no longer be eligible for the LCGE, subject to certain exceptions.

The proposed measures would apply to dispositions after 2017. However, special transitional rules would permit affected individuals to elect to realize, on a day in 2018, a capital gain in respect of eligible property by way of a deemed disposition for proceeds up to the fair market value of the property. The election would be available for property owned by the individual continuously from the end of 2017 until the day of the deemed disposition. Capital gains realized under the election would generally be eligible for the LCGE using the current tax rules (i.e., the rules as they apply to dispositions before 2018).

Note: Certain conditions which are required (i.e., relating to the ownership of, value of and, in some cases, activities in respect of, the property) to claim the LCGE in respect of the disposition of a property which must be met over a 24 month period before the disposition would be treated as satisfied if they are met during the 12 month period preceding the elective disposition

Supporting measures to improve the administration of the income tax rules to address income sprinkling
To improve the administration of the income tax rules to address income sprinkling, the following measures have been proposed:

- Introduction of tax reporting requirements with respect to a trust's tax account number which are similar to the requirements for corporations and partnerships in respect of their tax account numbers (i.e., "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.

These measures ensure that trusts are subject to information reporting rules that parallel existing rules for corporations and partnerships, and would apply for the 2018 and subsequent taxation years.

Holding a passive investment portfolio inside a private corporation

Corporate income is taxed at lower rates compared to personal income to provide more money for businesses to invest and grow. However, when a corporate owner uses earnings taxed at the lower corporate income tax rates to fund passive investments held within the corporation, this can result in a tax deferral advantage because the amount of after-tax income that can be invested passively within the corporation is larger than the after-tax income earned personally. Thus, individuals can benefit from retaining passive assets in a corporation.

The government will be designing new rules over the coming months. The proposed reforms are intended to apply to corporate owners that are setting aside some of their corporate profits for passive investments. The proposed system is not intended to impact taxes payable by corporations with no passive investment income. 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.

Converting a private corporation's income into capital gains

The measures being proposed include tightening surplus stripping to prevent individual taxpayers from using non-arm's length transactions to "step up" the cost base of shares of a corporation to avoid the application of section 84.1.

Section 84.1 ensures that a corporate distribution is taxed as a taxable dividend when an individual sells shares of a corporation to a non-arm's length corporation. This rule effectively prevents surplus stripping to the extent that the cost to an individual of his or her share represents capital gains that were effectively tax-free to the non-arm's length seller. The rule provides that the individual's adjusted cost base of the shares excludes the portion of the purchase price representing those tax-free proceeds (often referred to as "soft" cost base).

The proposed measures will extend the current rules in subsection 84.1(2) that result in a so-called "soft" cost base if the LCGE (or pre-1972 surplus) is claimed to cases where cost base is increased in a taxable non-arm's length transaction. In some instances, this change might give rise to both a capital gain on a "step-up" transaction and a taxable dividend on a subsequent non-arm's length disposition. The paper states that this is to discourage taxpayers from entering into schemes that seek to avoid section 84.1.

It is proposed that this amendment apply to shares disposed of on, or after the date of the release of this consultation paper.

New anti-stripping rule – Section 246.1

The government is also proposing that a separate anti-stripping rule be added to target tax planning which circumvents the current tax rules which were designed 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.

Intergenerational business transfer

The application of section 84.1 can be an impediment to the transfer of a business from one generation to another within a family because the LCGE would not be available when shareholders sell their shares to a corporation owned by their adult children. In contrast, if these shareholders were to instead sell their shares to an arm's length corporation, the transaction would not be subject to section 84.1 and the LCGE could be used.

A genuine intergenerational transfer of shares of a small business corporation to an adult child's corporation should presumably be treated the same as a sale to an arm's length corporation. However, a major policy concern is distinguishing a genuine intergenerational transfer from a tax avoidance transaction, undertaken among family members.

The government is interested in the views and ideas on whether, and how, it would be possible to better accommodate genuine intergenerational business transfers while still protecting against potential abuses.

Next steps

Stakeholders can provide their views and ideas about the proposals to address the tax planning strategies as outlined in the consultation paper by submitting their comments to fin.consultation.fin@canada.ca by October 2, 2017.

As noted above, the proposed measures, as outlined in the consultation paper and the draft legislation, will have a significant impact on private companies. Please contact your Grant Thornton advisor if you would like to discuss these proposals further, or learn how they may affect you and your business. We can help you prepare for these changes.

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