Proposed Changes to Tax Planning for Private Corporations

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AGENDA

- Overview of proposed changes
- Income sprinkling using private corporations
- Holding passive investments in private corporations
- Converting income into capital gains
- BC Budget highlights

OVERVIEW

- Growing trend by Finance to alter the taxation of private corporations and eliminate tax planning strategies. Last year, Finance introduced anti-avoidance rules relating to multiplication of the small business deduction.

- On July 18, 2017, Finance released its 63-page consultation paper regarding significant proposed rule changes to address tax planning for private corporations.

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INCOME SPRINKLING CHANGES

- Income sprinkling refers to the concept of reducing income taxes that would otherwise be realized by high income earners to be realized instead by low income family members (e.g. spouse). Overall family taxes will be lower compared with one person receiving the income.

- Two main proposed changes:
  - Extension of Tax on Split Income ("TOSI") rules
  - Constraining multiplying lifetime capital gains exemption ("LCGE")

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Current TOSI Rules

- The current TOSI rules only apply to individuals under 18. Effectively taxes split income to minors at the highest marginal tax rate – commonly referred to as “kiddie tax”.
  - Most common application: minors that receive dividends from their parents’ private corporations will be subject to kiddie tax.

- Spouses and adult children that hold shares in the company can receive discretionary amount of dividends to utilize their respective low marginal tax rates (e.g. dividend sprinkling).

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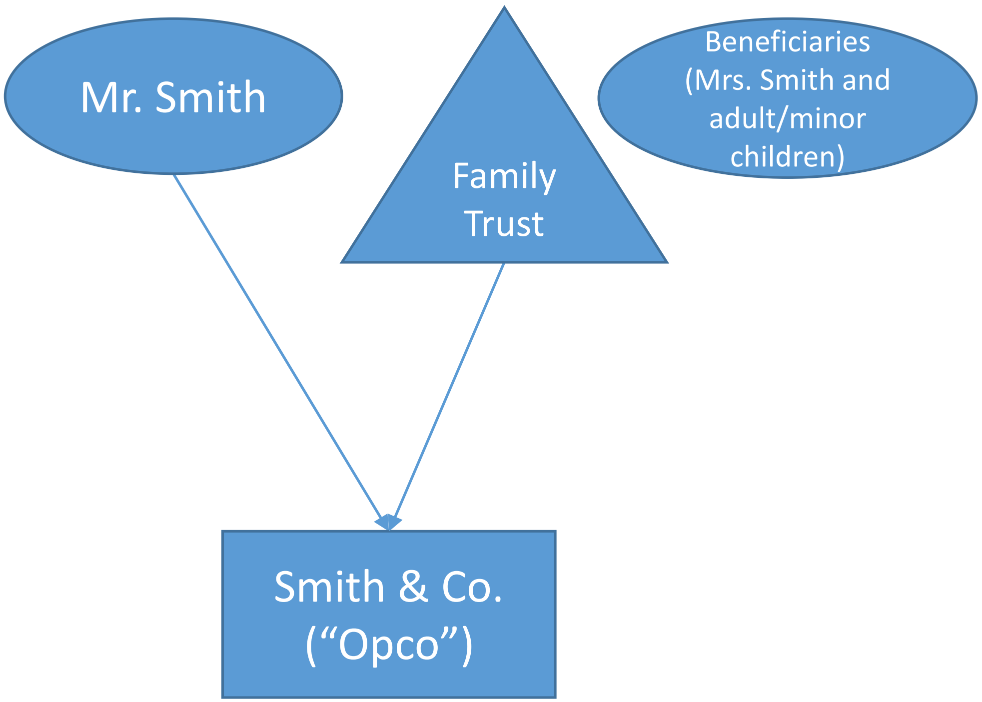
Current TOSI Rules
Example of Application



- *Opco can distribute dividends to the Family Trust which can then allocate the income to the adult beneficiaries to take advantage of lower tax brackets.*

- *Lifetime capital gains exemption may be available to Mr. Smith and beneficiaries (including minors) on the sale of Opco shares to a third party.*

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Proposed TOSI Rules

- Proposed changes to the TOSI rules would result in:
  - Expanding the individuals subject to the TOSI rules to include *any* Canadian resident individual that receives income from a business of a *related individual*.
  - Including a new "reasonableness test" for adult individuals to determine if the TOSI rules would apply.
  - Introducing meaning of "connected individual" to determine if the TOSI rules would apply.

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Proposed TOSI Rules

- The concept of a “reasonableness test” would consider labor and capital contributions to the company by the individual.

- The test would apply differently based on the age of the adult individual. Example:
  - 18-24: “actively engaged” in business for labor test
  - 25+: “involved” in business for labor test

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Proposed TOSI Rules

- Finance has indicated the proposed TOSI rules would apply to the 2018 and later taxation years.

- This would allow income splitting strategies under the current rules for the 2017 year.

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Current LCGE Rules

- Lifetime capital gains exemption rules permit individuals to shelter up to $836k of capital gains from taxation on the sale of certain private corporation shares. The current rules may allow multiplication of the LCGE for a family business.

- Minors are able to utilize LCGE on sale of private corporation shares.

- Trusts can also distribute the capital gains to the beneficiaries to allow the beneficiaries to claim their respective LCGE.

Proposed LCGE Rules

- Proposed changes to the LCGE rules would result in:
  - Eliminating the LCGE for minors, regardless of their involvement with the company.
  - Including a new “reasonableness test” for adult individuals to determine if LCGE would still be available.
  - Eliminating the LCGE for gains that accrued during the period in which a family trust holds the shares.

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Proposed LCGE Rules

- Finance has indicated that these proposed measures would generally apply for the 2018 and later taxation years.

- Transitional rules would be available to allow 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 capital gain triggered from the election would be eligible for the LCGE.

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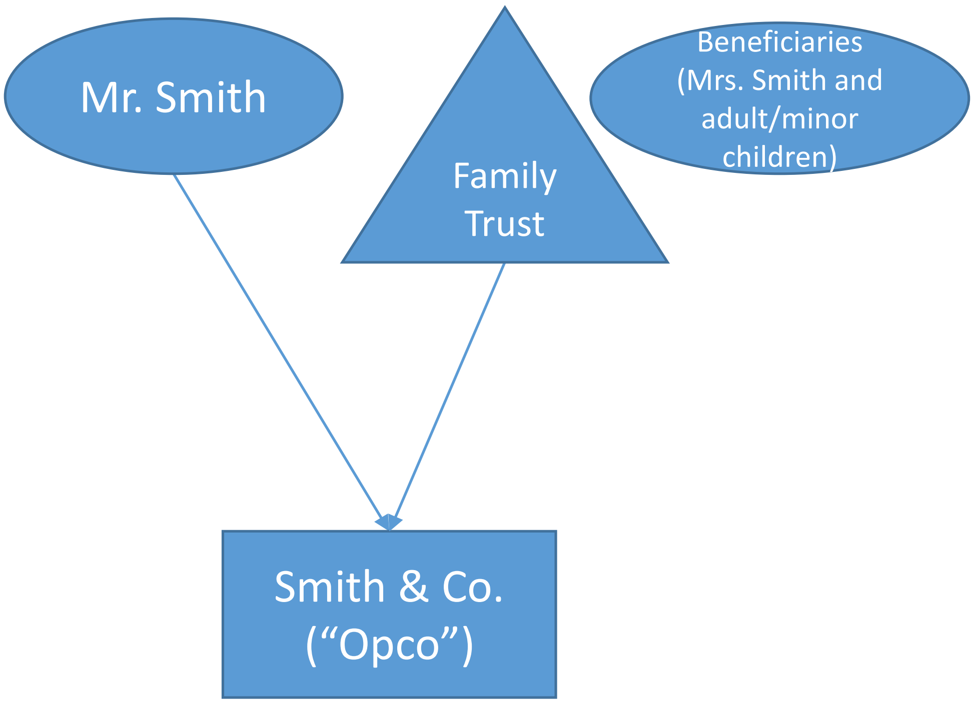
Proposed TOSI/LCGE Rules Example of Application



- *If Opco distributes dividends to the Family Trust which then allocates the income to the adult beneficiaries, are the amounts considered “unreasonable”? If so, new TOSI rules would apply (i.e. top tax rate)*

- *Lifetime capital gains exemption is no longer available in respect of capital gains that accrued during period the Trust holds Opco shares.*

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PASSIVE INVESTMENT CHANGES

- Due to low corporate income tax rates, private corporations can invest after-tax funds in passive investments (e.g. GICs, stocks, real estate).

- Companies start with a higher initial capital base compared with individuals who earn their income directly, resulting in a higher retirement portfolio for business owners.

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PASSIVE INVESTMENT CHANGES

- Finance is concerned with the fairness and neutrality of the current system and the tax-deferral opportunities for private corporations, and it has proposed various measures to address these concerns.
  - Corporate tax rate: 13% and 26%
  - Highest marginal tax rate: 48%

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Current Passive Investment Rules

- Income integration ultimately ensures income is taxed at the same level of tax whether earned through a company or by an individual.

- However, private companies can reinvest after-tax funds in passive investments with a higher initial capital base:
  - For $100 of active business income, an employee would have $52 available to invest compared with a company that would have $74 - $87 to invest.

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Proposed Passive Investment Rules

- Policy paper does not contain draft legislation yet. However, the paper discusses new concepts being considered to alter the passive investment tax system.

- Proposed concepts to the current tax system are complex. Finance has identified possible approaches to ensure personal savings are equalized regardless of investing personally or through a corporation.

- One suggested approach by Finance is eliminating the refundable tax system on passive investments or eliminating inclusion of non-taxable portion of capital gains to capital dividend account in certain situations.

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Proposed Passive Investment Rules

- Finance has indicated that these proposed measures would apply on a go-forward basis and would have a limited impact on existing passive investments.

INCOME/CAPITAL GAIN CONVERSION CHANGES

- Capital gains are generally subject to a lower personal income tax rate compared with dividend income.

- The *Income Tax Act* contains anti-surplus stripping rules to prevent corporate surplus from being extracted at the lower capital gains tax rates instead of the higher dividend tax rates.

Proposed Anti-Avoidance Rules

- Finance has proposed to expand these anti-avoidance rules on certain types of non-arm's length transactions.

- One of the proposed changes would effectively reduce the cost base of an individual's shares by the amount of capital gains realized on prior dispositions of the shares by non-arm's length individuals (regardless if the gains were previously sheltered by the LCGE).

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Proposed Anti-Avoidance Rules

- Most common application of anti-avoidance rules will be to post-mortem pipeline strategy.

- Under current rules, pipeline strategy allows the estate to avoid double taxation – e.g. capital gain on terminal return, and subsequent dividend to estate on windup of company.

- Pipeline results in only capital gain on terminal return. Under proposed rules, pipeline strategy will also result in a deemed dividend to the estate.

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Proposed Anti-Avoidance Rules

- Finance has indicated that these proposed anti-avoidance measures would generally apply to shares disposed of, and amounts received or that became receivable, on or after July 18, 2017.

BC BUDGET TAX HIGHLIGHTS

- **Increase in BC top personal income tax rate by 2.1%:**
  - Effective for 2018, combined federal and BC top personal income tax rate (income over $202,800 in 2017, to be indexed for 2018) will be 49.80% (2017: 47.7%). Dividend tax credits will be adjusted to avoid double taxation.

- **Increase in BC general corporate income tax rate by 1%:**
  - Effective for 2018, combined federal and BC general corporate income tax rate will be 27% (2017: 26%).

- **Decrease in BC small business corporate income tax rate by 0.5%:**
  - Effective April 1, 2017, combined federal and BC small business corporate income tax rate will be 12.5% (2017: 13%).

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SBD CHANGES

- *Reminder*: New rules were enacted that restrict multiple access to the small business deduction – e.g. designated members of partnerships; and specified corporate income of a CCPC.

- New rules apply to tax years beginning after March 21, 2016. Accordingly, some 2017 tax filings may already be affected by these new rules.

CONCLUSION

- Several proposed and newly enacted rules that will impact taxation of private corporations moving forward. Entire tax landscape will change.

- Review your corporate structures to determine overall impact.

- Do consider taking advantage of income splitting opportunities still available for 2017 year.

- Do consider transitional rules for LCGE in 2018 and purification requirements in 2017. Consider AMT application.

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