# Taking Action: CCPC tax proposals What you need to know (and do)

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*On July 18, 2017, the Department of Finance announced significant proposed changes to the taxation of private corporations. These proposed measures focused on three areas: income sprinkling among family members, passive investment income earned within corporations and converting regular income from a corporation into capital gains. If these proposals become law, they will significantly impact the tax treatment of many Canadian small businesses that are operated through a private corporation. The government has invited interested parties to comment on the proposals by October 2, 2017. Various business groups and industry associations have either made submissions to the government, or are in the course of finalizing submissions.*

***If you own a private corporation, it may be affected should the proposals become law.***

***This report will generally review the proposals and set out steps that you may wish to consider. If you have a private corporation structure (including a professional corporation), or are thinking of setting up a private corporation, you should contact a tax advisor to discuss how these steps may apply in your particular circumstances.***

## Income Sprinkling

### Income Splitting

By sprinkling income from a corporation among family members, rather than having one individual receive all of the income, the overall tax paid by the family may be reduced if some of the family members are taxed at a lower tax rate than the individual or pay no tax at all. Currently there are anti-avoidance measures in place to limit this, such as the current "kiddie tax" that results in certain dividends paid to children under age 18 being taxed at the highest rate.

Effective for 2018, the proposed changes would expand the kiddie tax rules so that they would apply to more types of income and would also cover certain adults (the "split income" rules). The new "split income" rules would look at whether income received by an adult individual is "reasonable," taking into account the person's labour and capital contributions to the business along with any previous returns and remuneration, in comparison to a situation where an arm's length investment was made.

These new rules will likely affect anyone who has done an estate freeze. An estate freeze is a corporate reorganization whereby the fair market value of a business is "frozen" by exchanging common shares for preferred shares, with a redemption value equal to the fair market value of the company. New common shares that accumulate future growth are then commonly issued to family members or, more commonly, to a trust that has family members as beneficiaries. The new rules will subject dividends paid on most shares received on an estate freeze to tax at the highest rate. If those shares are sold at a gain, this gain would also be considered split income and taxed at the highest rate.

### Example

*Assume Pat invested $100,000 in a private corporation run by her mother. In return for that investment, she got preferred shares paying a 5% dividend rate. According to the government paper, this level of investment income should be considered reasonable, given that an arm's length investor would expect to receive a 4 — 6% return.*

*Suppose, on the other hand, that Pat had received her common shares in the course of an estate freeze and had paid only a nominal amount. If she received the same amount of dividends, they would not likely be considered "reasonable," given that her capital contribution to the business was nominal, so she would pay tax on the dividends at the highest marginal rate.*

The rules for individuals under age 25 are even more expansive. For the purposes of determining a "reasonable" return on a capital contribution, this age group will be limited to receiving a rate of return equal to the government's prescribed rate of interest (currently 1% until December 31, 2017). Even if the individual provided labour to the corporation, unless this labour was "regular, continuous and substantial," any dividends paid in excess of the prescribed rate will be subject to the split income rules.

**Action Items:**

- If your private corporation has other shareholders, such as your spouse, partner, or other adult relatives[1] as shareholders, consider whether it makes sense to pay additional dividends to family members who are in lower tax brackets in 2017 to maximize any income sprinkling opportunities before any proposed rules could increase the tax rate on such income commencing in 2018.
- Starting in 2018, consider delaying dividend payments to related adults who have made capital contributions to a private corporation until they have reached 25 years of age.
- For 2018, review your dividend compensation strategy for any related adults over age 25 for services provided to your private corporation as they could potentially be considered split income and subject to tax at the top rate.
- Consider the full effect of these proposed rules before finalizing any contemplated estate freeze transactions. Dividends and gains earned after 2017 on shares purchased for a nominal amount may be subject to tax at the highest rate.
- Consider these proposed rules before setting up a new business with funding or a guarantee from a family member. Dividends, interest and gains earned after 2017 on shares / debt held by the family member could be caught by the new rules and taxed at the highest tax rate if

they are not considered "reasonable." If you borrow to put capital into a private corporation, and the debt is guaranteed by a relative, the capital contributed by you may be disregarded for purposes of determining a reasonable rate of return.

- Review the share structure of any private corporations to determine if more than one shareholder own shares of the same class. Corporate law might require you pay the same amount of dividends to all shareholders of the same class of shares. If you cannot pay dividends to one shareholder without causing another shareholder to be taxed at the highest tax rate on dividends received by them, you may consider a corporate reorganization so that the shareholders own shares of different classes.

### Lifetime Capital Gains Exemption ("LCGE")

The government is concerned that the LCGE[2] is being multiplied within related groups, often by having a family trust be a shareholder, allowing more than one individual to claim the LCGE to reduce the taxable capital gain realized on the disposition of private corporation shares. Effective for dispositions of shares after 2017, three measures were proposed to prevent this from occurring. First, the LCGE would not be available for gains, either realized or accruing, before an individual is 18 years old. Second, if a capital gain is subject to the new tax on split income rules discussed above, then it is not eligible for the LCGE. And finally, except for certain exceptions, beneficiaries of trusts would no longer be able to claim the LCGE.

#### Example

*Assume that Bob undertook an estate freeze in 2011. As part of that estate freeze, a family trust subscribed for common shares, paying only a nominal amount for them. These common shares have increased in value substantially since 2011. Bob's wife and two adult children are the beneficiaries of the trust. If the shares are sold prior to January 1, 2018, and the trust realizes a $2 million capital gain, this gain could be distributed to the trust beneficiaries and each could claim his or her LCGE (assuming the shares otherwise qualify), eliminating all tax on the sale. This would no longer be permitted after January 1, 2018.*

Transitional rules have been proposed to permit some shareholders to elect to "crystalize"[3] a capital gain in 2018 so that they can still claim the LCGE.

**Action Items:**

- In order to file the election to crystalize the LCGE, more than 50% of the assets within the corporation must be used in an active business for at least one year prior to the election. As a result, consider whether any steps need to be taken before December 31, 2017 to reduce the non-active assets so that this test is met at some point in 2018 if you plan to make the election. For instance, non-active assets can be used to pay down debts or a bonus could be paid to the active shareholder(s) out of non-active assets.[4]
- If you are planning to make the election to claim the LCGE, consider whether a valuation of the corporation will be necessary so that the LCGE can be claimed on the deemed capital gain arising on all or a part of the increase in value of the shares. Harsh penalties could apply if an inaccurate fair market value is used for the election.
- Consider whether valuations should be obtained when shareholders turn 18 years old if the LCGE is available for gains accruing after that date.

## Passive Investment Income

One of the goals of the current system for taxing private corporations is that after-tax income earned through a corporation is approximately equal to after-tax income earned by an individual directly, after taking into account the tax liability on the dividend paid to remove the funds from the corporation. That is,

| | |
|---|---|
| | Corporate taxes on earnings |
| + | Personal taxes on dividends |
| = | Personal taxes on income otherwise earned directly |

The tax rate on income earned in a corporation is generally much lower than the top personal marginal tax rate for an individual income earner; consequently, until income is withdrawn from a corporation as a dividend, there is more after-tax income to invest within the corporation than there would be if the income was earned by the individual.[5] As these funds are invested inside the corporation over long periods of time, a shareholder can end up with more after-tax income from the corporation at the end of the investment period because of the higher starting capital. This is commonly referred to as the "tax deferral advantage." Where income earned in the corporation is taxed at the lower small business rate, the tax deferral advantage, ranging from 35% to 40%, is magnified. The government considers this unfair and would like to neutralize this tax deferral.

### Example

*Amira is an Ontario resident and pays tax at the top marginal tax rate. If she, as a "sole proprietor," earns $10,000 of business income personally from an unincorporated manufacturing business, after paying taxes she would have approximately $4,700 left for investment purposes. If, however, Amira earned that $10,000 through a private corporation paying tax at the small business tax rate, the private corporation would be left with $8,500 after-tax to invest. Even though the after-tax business income and the investment income would be taxable in Amira's hands once paid out as a dividend, she is likely to end up with more after-tax income from the private corporation at the end of the investment period because of the higher starting capital of $8,500 rather than $4,700.*

The government paper provided two potential approaches to end this deferral, but draft legislation was not included. The approach that the government appears to be considering would make the currently refundable tax on investment income no longer refundable, unless the investments arose from capital contributions from shareholders. It has been estimated that this would result in a tax rate of over 70% on certain passive income earned within a private corporation and approaching 60% on capital gains. It was expressed that any new rules would apply on a go-forward basis.

**Action Items:**

- Consider withdrawing sufficient salary from a private corporation to maximize contributions to RRSPs and TFSAs. Since the rules should only be applied prospectively, there should not be a need to withdraw already-taxed retained earnings from your corporation. The new rules, when enacted, would only tax future investment income on future earnings at the higher, non-refundable, rate of tax.
- If these rules come into play in the future, consider if an Individual Pension Plan or corporate-owned life insurance may be appropriate.

## Converting Income into Capital Gains

There are currently anti-avoidance rules in place to prevent converting dividend income from private corporations to capital gains, which are taxed at a lower tax rate. The government is concerned that the current anti-avoidance rules do not specifically address certain transactions that they consider to be abusive. The paper and draft legislation contain an expansion of the current rules. These are proposed to be effective July 18, 2017.

The proposed rules will impact certain post-mortem tax planning that provides relief from double taxation where private corporation shares are held at death. This is commonly referred to as a “pipeline transaction.”

The rules may also treat capital gains realized on the disposition of private corporation shares to a family member as dividends. This is in addition to the gain being subject to the highest tax rate if it is considered split income.

**Action Items:**

- Consider the proposed rules prior to sale of private corporation shares to a family member to determine whether the gain may be treated as a dividend for tax purposes.
- Consider the full effect of the proposed rules prior to implementing a pipeline transaction following the death of a shareholder of private corporation shares. Other strategies for post-mortem planning to reduce double taxation on death should be considered. One common strategy is to redeem private corporation shares after death, which often results in both a deemed dividend and a capital loss. It may be possible to carry back any such capital loss to the terminal tax return of the deceased to offset the deemed gain on the shares realized on death. The caveat here is that this must, however, be carried out within one year after death.

## Conclusion

The proposals released on July 18, 2017 are extremely complex. The results of the consultation process between the Department of Finance and interested parties may provide further clarity on these matters. Those who may be impacted should consult a tax advisor to determine any actions that they may wish to take.

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[1] Relatives (and related) for this purpose includes not only children, parents and spouses / common-law partners, but also grandparents, siblings, in-laws, aunts and uncles, and nieces and nephews.

[2] The LCGE exempts the first $835,716 (2017 amount) of lifetime capital gains on the sale of qualifying small business corporation shares from tax. For qualified farm or fishing property, the exemption is $1 million.

[3] Crystallization is the act of recognizing a capital gain (or loss) for tax purposes which doesn’t necessarily involve an actual sale to a third-party. In this context, it is a “deemed sale” for tax purposes.

[4] Those under age 18 may not make this election, and there must be an actual disposition in 2018 to claim the LCGE.

[5] Assuming the shareholder pays tax at the top marginal tax rate.