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TAX PLANNING USING PRIVATE CORPORATIONS

The Department of Finance released a consultation paper on July 18th, 2017 proposing changes to how private corporations are used to gain certain tax advantages.

As a result, small business owners, incorporated professionals and others, will likely face a higher tax bill in the years ahead.

The paper addresses the changes to three main types of planning:

1) The sprinkling of income using private corporations, this generally entails:

    - Using a private corporation to allocate income to a family member who is subject to a lower personal tax rate or who may not be taxable at all;

    - Providing the ability to multiply the lifetime capital gains exemption.

2) Obtaining a tax deferral by earning passive investment income in a corporation.

3) The conversion of dividend and salaries to capital gains to achieve a lower tax rate.

<u>INCOME SPRINKLING</u>

The new proposed income sprinkling rules are designed to address structures put into place that would reduce the overall tax burden of a family unit.

In a typical example, dividends that would have been received by the primary owner/manager of the private corporation, say, mom or dad, would instead be paid to the adult kids of the primary shareholder, who are often in lower tax brackets than the primary owner/manager and thus reducing the overall family tax bill.

The Government argues that in a lot cases this sprinkling is unfair as “the income distributed to the family member may exceed what would have been expected, having regard to the family member’s labour and capital contributions to that particular business” or what another arms length individual would pay for the same service received by that person who received the income.

The government is proposing to extend the current Tax on Split Income rules (also known as the “kiddie tax rules”) to any Canadian resident individual, who receives such split income (as mentioned in the example above) to the extent that the allocated income is determined to be unreasonable. The reasonability test will generally encompass:

- An amount that would be considered unreasonable if that amount exceeds what an arms length individual would have been paid for the same or similar amount of work performed by the individual;

- An amount would also be considered unreasonable if a person who has contributed little or no capital or assumed little or no risks in the business was compensated above and beyond what an arms length individual in such a situation were to be compensated.

These proposals if enacted would be effective for 2018 and later tax years and may severely limit the ability of business owners to split income with family members.

EARNING PASSIVE INVESTMENT INCOME IN A CORPORATION

When a corporation generates what is considered Active Business Income, it is eligible for a tax rate that is generally lower than an individual's tax rate (15 per cent in Ontario, but it varies by province) on the first $500,000 of active business income.

If a business owner doesn't need all his earnings to support his lifestyle, it's common to leave the rest in the corporation to invest – perhaps in a portfolio earning passive income. This creates a sizable deferral of tax.

For example, if an individual resident in Ontario earned $100,000 in taxable income without a corporation at the highest tax rate in Ontario, they would have paid $53,530 in taxes and have funds of $46,470 in after tax funds available to invest.

If that same individual earned $100,000 in active business income in a corporation, they would pay tax of $15,000 or 15% on that income and have $85,000 available to invest.

If that $85,000 was left in the corporation there would be a constant deferral of tax until the funds were withdrawn out of the corporation.

The government is exploring how to limit the perceived benefit of leaving excess earnings inside a corporation to grow in passive investments and is seeking feedback with respect to suggested solutions outlined in the paper to deal with the taxation of investment income in a private corporation to eliminate this perceived advantage.

The paper is clear that the changes the government is considering should not apply to companies that reinvest the after-tax profits in the active business operations.

CONVERTING INCOME TO CAPITAL GAINS

A significant tax benefit can be obtained by individual shareholders with higher incomes when planning is undertaken to convert corporate surplus that would normally be taxable as dividends or salary into lower-taxed capital gains.

This is usually done using a complex set of steps involving selling of some shares to another company related to the shareholder. The government proposes to close these opportunities by amending section 84.1 of the Income Tax Act (Canada) ("the Act").

It is proposed that these measures will be effective as of the release date of July 18, 2017. This type of planning can no longer be implemented if these measures are enacted.

The government is also considering allowing intergenerational transfers in qualified small business corporations (QSBC) to not attract dividend taxation but rather capital gains exemption treatment when the shares of their company are purchased by a corporation that is owned by their adult children.

The government has requested feedback from stakeholders on how the tax rules could better accommodate genuine intergenerational business transfers while protecting against potential abuses that could arise with certain planning.

SUMMARY

In summary, the next steps in all three of these areas are as follows:

Income sprinkling: The government has released detailed legislative proposals to address income sprinkling, and the government is seeking input on the legislation as well as whether the reasonability test provides an appropriate mechanism for responding to income sprinkling.

Earning passive income in a corporation: The government will be designing new rules over the coming months to tax corporate passive income. Furthermore, the government has posed seven questions to the taxpayer in respect of these rules.

Converting income to capital gains: The government has proposed draft legislation which has been released for comment and the government has invited the taxpayer for views and ideas on whether, and how, it would be possible to better accommodate genuine intergenerational business transfers in the act.

The deadline, and hence the consultation period ends, on October 2nd, 2017 subsequent to which the government will further address the matters mentioned above.

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The full proposals are available at:

http://www.fin.gc.ca/n17/17-066-eng.asp