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Tax Planning Using Private Corporations

On July 18th, 2017 the Department of Finance ("Finance") released its highly anticipated consultation paper: "Tax Planning using Private Corporations." The proposed amendments to the Income Tax Act (Canada) ("the Act") significantly change the tax rules applicable to private corporations. The proposals target three general areas:

1. Income sprinkling (i.e. income splitting, including the multiplication of the lifetime capital gains exemption);
2. Converting income into capital gains;
3. Holding passive investments inside a private corporation.

On Monday September 25th, 2017, the Canadian Tax Foundation hosted a policy conference. At this conference the Finance officials provided various insights with respect to the intended application of the proposed rules and potential revisions under consideration by Finance to the proposals set forth on July 18th, 2017. Below is a synopsis of some of the comments:

Income sprinkling

The proposed legislation has a set of reasonability tests to determine the reasonableness of the income paid to an individual. Practitioners are concerned that the reasonability tests will be difficult to apply in practice, however, Finance indicated that they do not consider these concerns to be justified. As based on their analysis the concept of a reasonability test is not new to the Act, and in their opinion these tests should not be overly burdensome or difficult to apply.

Furthermore, Finance indicated that they would be providing additional guidance in future technical notes on how to implement this reasonability test. Finance did mention that whether an amount was reasonable in a particular circumstance would be a highly factual determination.

Finally, in relation to the concept of income sprinkling, a particular question was posed as to how a reasonable amount of compensation is to be determined in a case where an individual provides early funding to a family member who is starting a new family business. Finance stated that in such a case, it would be reasonable to except the family member providing the early funding to be entitled to an **extraordinary** return if the business was successful due to the high level of risk associated with such a speculative investment.

Converting income into capital gains

A common post – mortem tax planning technique called a "pipeline" transaction is implemented in order to mitigate the double taxation on the death of an individual who owns private company shares. Through a series of transactions, an individual on death will pay capital gains rates which are lower as opposed to regular income or dividend tax rates when this technique is implemented. Finance indicated at the conference that it does expect the proposed rules to eliminate this type of planning.

Finance did indicate that they are considering a partial carve out from the rules to facilitate transactions that prevent double taxation at the death of a shareholder of a private corporation. This carve out may facilitate certain elements of the above mentioned pipeline transaction. Finally, Finance is also considering the introduction of grandfathering rules that will accommodate the implementation of pipeline transaction after July 17th, 2017 in respect of deaths that occurred before or close to the announcement of the proposals on July 18th, 2017.

Another point to note is that practitioners were concerned that as a result of the proposals they may not be able to declare a tax free capital dividend out of the corporation to the shareholder for the non-taxable portion of a capital gain. Finance did mention that the proposed rules are not intended to apply if a corporation triggers a capital gain upon a disposition of long-held marketable securities and then distributes a capital dividend.

Taxation of passive investment income

Draft legislation was not released with the July 18th, 2017 package with respect to the taxation of passive income earned by a private corporation. The consultation paper proposed to introduce rules that are intended to eliminate a perceived advantage available when excess funds arising from an active business carried on within a private corporation are retained in the corporation and used to fund passive investments. The consultation paper also discusses certain approaches that are under consideration.

At the conference, Finance emphasized that any amendments to the Act governing the taxation of passive investments held in a private corporation will not apply to existing passive investments or income earned thereon. (i.e. grandfathering relief will be available; the new rules will apply on a go-forward basis).

In addition to the above, Finance also suggested that the proposed rules may permit certain assets to be carved out from being subject to the high rate in particular shares of a controlled subsidiary.

Finally, Finance did mention that they are considering some sort of a test to be employed in determining whether a particular asset is an active business asset or not when applying the high rate tax to the income generated from that particular asset.

Conclusion

At present a high amount of uncertainty remains with respect to the final form the proposed rules will take. Until Finance reviews the consultation submissions, it is still uncertain whether the scope of the proposed rules will be meaningfully narrowed or not.