TAXBULLETIN
WILKINSON TAX GROUP

When Finance Minister Bill Morneau delivered the Liberal Government's second budget on March 22, 2017 it included an announcement that the Department of Finance intended to review various tax planning strategies commonly utilized by private corporations. The stated purpose of this was to review "the use of tax planning strategies involving private corporations that inappropriately reduce personal taxes of high-income earners".

The draft legislation announced on July 17, 2017 targets three perceived abuses:

- Splitting income using private corporations in two main areas
    - Dividend sprinkling or other income splitting
    - Multiplication of the Lifetime Capital Gains Exemption (LCGE)
- Corporations investing in passive assets (holding companies)
- Converting income into capital gains

An in-depth analysis of the proposed legislation follows:

SPLITTING INCOME USING PRIVATE CORPORATIONS

A relatively common strategy for owner-managers of private companies is to have family members subscribe for shares directly or through a trust so that they can be paid dividends and benefit from the LCGE (currently approximately $836,000). These income splitting strategies can substantially reduce a family's annual taxes by taxing income at the family member's lower marginal tax rates that could otherwise be taxed at the principal's higher personal tax rates.

For example, a married couple in Ontario have a private corporation earning income of $235,000. The corporation will pay approximately $35,000 in corporate tax leaving $200,000 to be distributed to its shareholders as dividends. If this was distributed to a single shareholder earning no other income the personal taxes would be approximately $55,000. If the income were instead distributed equally to the couple, each shareholder would pay approximately $15,700 or a total of $31,400 for a savings of $23,600. This savings can be increased if other family members are also shareholders.

Share ownership by family members may also mean that the shareholder is entitled to a share of the sale proceeds if a business is sold. A further concern for Finance involves multiplication of access to the LCGE. The LCGE provides an exemption in respect of capital gains realized on the sale of qualified small business corporation shares and qualified farm or fishing property. An individual may shelter capital gains realized on the disposition of qualified small business shares up to a lifetime limit of $835,716 in 2017. This limit increases over time as it is indexed to inflation. The lifetime limit in respect of capital gains from the disposition of qualified farm or fishing property is $1 million.

Dividend Sprinkling or Other Income Splitting

The government will address these concerns in part by expanding the range of the Tax on Split Income (TOSI) which previously only applied to certain income received by minor children and was appropriately referred to as the “Kiddie Tax”. This tax effectively means the shareholder will pay tax at the highest marginal rate, eliminating any benefit from income splitting

Generally, these proposed measures would apply the TOSI to a Canadian resident adult individual who receives split income (i.e., income from the business of a related individual, including a corporation over which a related individual has influence), when the amount in question is unreasonable under the circumstances.

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 individual, considering the labour and capital contributions of the individual. The tests will be more restrictive for those aged 18 to 25.

Specifically the reasonableness tests are proposed to be as follows:

1) Labour contributions, the extent to which:
   a) For an adult specified individual age 18-24, the individual is actively engaged on a regular, continuous and substantial basis in the activities of the business; and
   b) For an adult specified individual age 25 or older, the individual is involved in the activities of the business (e.g., contributed labour that could have otherwise been remunerated by way of salary or wages).

2) Capital contributions, the extent to which:
   a) For an adult specified individual age 18-24, the amount exceeds a legislatively-prescribed maximum (using the same rate used for purposes of the tax attribution rules) allowable return on the assets contributed by the individual in support of the business; and
   b) For an adult specified individual age 25 or older, the individual has contributed assets, or assumed risk, in support of the business.

Given the vagueness of several of the terms, clear guidance will have to come from the Canada Revenue Agency and eventually case law to determine the acceptable payments with respect to these rules.

The following is a list of the other material proposed changes.

1) The definition ‘split income’ would be extended to include:
   a) Income from debt that is issued by a private corporation and that is not publicly traded;
   b) Gains from dispositions after 2017 of certain property the income from which is split income (which effectively means no LCGE on that property); and
   c) For individuals under age 25, reinvested income that was previously subject to the TOSI rules or the attribution rules;

2) The current exclusion from TOSI for inherited property would be extended to apply to individuals aged 18-24;
3) TOSI will be included in determining whether the individual qualifies for certain income-tested benefits (e.g., personal tax credits that depend on income);
4) There will be a joint and several tax liability rule with respect to the TOSI in the case of adult specified individuals aged 18-24.

These provisions will be effective for the 2018 taxation year. This should be a significant factor in determining dividends to be paid in 2017.

If these changes are implemented, it is likely that we will see more usage of alternative methods of income splitting that were more common prior to the prevalence of dividend sprinkling. Examples of these methods include loans from high income family members to low income earners to invest or reasonable salaries paid to family members.

Multiplication of the Lifetime Capital Gains Exemption

Three general measures are proposed to address LCGE multiplication.

1) Individuals would 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;
2) LCGE would generally not apply to the extent that a taxable capital gain from the disposition of property is included in an individual's split income; and
3) Gains that accrued during the time that property was held by a trust (other than certain excluded trusts) would no longer be eligible for the LCGE;
   a) This would apply whether the trust disposes of the property or a former beneficiary disposes of property "rolled out" from the trust.

The second measure effectively applies the reasonableness test for TOSI to the eligibility for the LCGE.

An exception for the third rule for trusts would be provided for:

1) A spousal or common-law partner trust or alter ego trust (or a similar trust for the exclusive benefit of the settlor during the settlor's lifetime), where the individual claiming the LCGE is the trust's principal beneficiary;
2) Certain employee share ownership trusts, where the individual (i.e., as a beneficiary entitled to the capital gain) is, in general terms, an arm's length employee of the employer sponsor of the arrangement.

The proposed measures would apply to dispositions after 2017. Special transitional rules would allow affected individuals to elect to realize, on a day of their choosing 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 modified so that various 24 month tests will be 12 month tests.

Planning point: To claim the LCGE, the shares of the corporation being sold must meet certain criteria including tests that measure the proportion of a corporation's assets that are used in a Canadian active business. Very generally, the shares must be held by a related person for at least 24 months, more than 50% of the value of a corporation's assets must be used in Canadian active business for a period of 24 months and 90% of the value of a corporation's assets must be used in Canadian active business at the time of the disposition.

As noted above, the 24 month test will be 12 months for purposes of the election. As such, certain corporations may have to be restructured or purified **in 2017** to meet the 12 month value and ownership tests.

INVESTING IN PASSIVE ASSETS (HOLDING COMPANIES)

Canada's current system of taxation of private corporations generally tries to integrate the overall taxation such that an individual earning income directly will pay the same amount of tax as a person that earns the same income through a corporation. To put it another way, the combined corporate tax and personal tax on a dividend should be equal to the personal tax that a person would pay on the same income. While this is largely true with the current system of taxation, the flexibility offered by corporate ownership can provide opportunities to defer or reduce the ultimate personal tax such that there may be a tax advantage to an incorporated business.

Corporations earning active business income in Ontario pay corporate income taxes at a rate of 15% on the first $500,000 of active business income and up to 26.5% on business income in excess of that. The tax on the dividends received by the shareholder will bring that total tax to about 54% at the highest rates which is essentially the same as if business income had been earned personally. However, that additional personal tax is only paid when the corporation pays a dividend to its shareholders. The purpose of this deferral of personal tax is to allow the corporation to re-invest more of the profits towards income earning purposes.

In some cases, the profits are not reinvested into the active business but are instead invested into passive investments. The proposals indicate that Finance believes that using the deferral of corporate tax for investing in passive assets is an inappropriate use of that benefit. Passive income earned by a corporation is currently taxed at a high rate in Ontario (50%) but is still integrated with personal tax rates as a portion of that corporate tax is refunded when a dividend is paid by the corporation to its shareholders.

Finance has put forward alternative proposals addressing this perceived issue. The first proposal discussed would impose a tax on corporate profits that are not re-invested back in to active business operations of the company. However, the discussion also indicates that this method is unlikely to be chosen based on the complexities and cash flow issues it could create.

The proposal being considered by Finance essentially increases the overall tax paid by the corporation and shareholders on passive income funded by corporate business profits.

The main mechanisms for accomplishing this would be:

- Making the corporate tax on passive investment income entirely non-refundable where the source of the funds for the investment was taxed at corporate business income rates;
- Dividend income from publicly-traded stocks would no longer be treated as eligible dividends, but would be treated as non-eligible dividends taxed at a higher rate personally; and
- The 50% non-taxable portion of capital gains would not be added to the capital dividend account that can be paid tax free to the shareholders;
    - An exception may be provided where the gain is from an active business asset or a share investment in an active business.

These potential changes effectively impose a higher overall tax burden that would be applied if an individual earned the income directly. The application of these measures may differ depending on whether the passive investments are funded by corporate income taxed at the small business rate or the general rate. An exception would be made where the capital is contributed to the corporation by an individual shareholder.

The change in overall taxation is significant. The following chart assumes the highest marginal tax rate for the recipient shareholder:

Dividend			2017	2018
			$	$
	Income earned		1,000	1,000
	Corporation tax		(502)	(502)
			498	498
	Dividend refund		307	-
	Available for dividend		805	498
	Personal Tax		(365)	(226)
	After tax cash		**440**	**273**
	Effective Tax Rate		**55.97%**	**72.74%**
Earned Personally				
	Income earned		1,000	1,000
	Personal Tax		(535)	(535)
	After tax cash		**465**	**465**
	Effective Tax Rate		**53.53%**	**53.53%**
Tax Savings (Cost) of Dividends			(24)	(192)
Deferral Available			34	34

Finance has assumed that the effective tax rate of up to 72.74% will dissuade shareholders from investing after business tax profits in a corporation. It is worthwhile to note that the election available for passive corporations discussed below should alleviate this issue for corporations whose only activity is investing. However, it will not be possible to transfer investments from one corporation to a passive investment corporation tax-free such that the deferral will be eliminated in that scenario.

As discussed, the source of the funds the corporation invests will determine the tax treatment of the income earned and dividends paid by the corporation. Two alternatives are considered in the discussion with a third option available in either scenario. Both alternatives will add complexity to the tax system.

Apportionment Method

The apportionment method would be based, going forward, on the corporation's cumulative share of earnings taxed at the small business rate and the general rate, as well as amounts contributed by shareholders from their after-tax income. This would translate into three possible tax treatments for these amounts when distributed as dividends—eligible dividends, non-eligible dividends, or dividends that would be received tax-free at the shareholder level.

One significant question with this method is how these "pools" will be treated when intercompany dividends are paid or corporate reorganizations occur. Tracking these pools across several layers of corporate groups or through a complicated reorganization will be exceptionally complicated.

Elective Method

The elective method would be an all or nothing choice. Essentially, under the default tax treatment (no election), passive income earned would be subject to non-refundable corporate taxes at a high rate, and dividends distributed from such income would be treated as "non-eligible" dividends as shown in the chart above.

The elected option means that passive income earned by corporations subject to tax at the general corporate rate would be subject to an exceptionally high tax rate on passive income. In that situation they would be able to elect a tax treatment that would apply additional non-refundable taxes on passive income, and would treat dividends paid out from passive income as eligible dividends subject to lower personal taxes. However, this election would remove the corporation's access to the small business rate of 15% on all business income.

Corporations Focused on Passive Investments

No matter which of the aforementioned alternatives is selected, an option will be available for companies that are primarily investment companies. This method would allow companies to elect to have all income generated by the entity being taxed as passive investment income (and therefore taxed at a level that approximates the top personal income tax rate).

All inter-corporate dividends would be subject to a refundable tax that would ensure that the corporate passive investment is funded with an after-tax amount that is comparable to what would be available to an individual investor at a top personal income tax rate.

Under this election, and consistent with how the system is currently structured, all income earned within the entity would be subject to refundable taxes that would be refunded upon distribution of income via dividends. There would be no deferral of tax in this option but there would also not be a punitive tax on the income earned.

Transition

Existing stocks of passive assets held in Canadian private corporations are significant. It is the intent that the new rules would apply on a go-forward basis. Once a new approach is determined for the tax treatment of passive investment income, Finance will consider how to ensure that the new rules have limited impacts on existing passive investments. Finance will bring forward a detailed proposal following these consultations, and time will be provided before any such proposal becomes effective.

CONVERTING INCOME INTO CAPITAL GAINS

Previously in the bulletin we discussed the concept of integration which attempts to ensure that the overall tax on corporate income is the same as if that income were earned personally. However, significant tax savings can arise where corporate income is extracted as a capital gain rather than a dividend. In Ontario, the difference between capital gains rates and dividends can be up to 19%.

Several tax planning strategies seek to take advantage of this difference and they range from necessary post mortem and business reorganization tax planning to tax planning that manufactures artificial capital gains.

The Government proposes that an existing anti-avoidance provision will be amended to apply in more situations. This provision will now ignore the tax cost of shares that arose from taxable capital gains realized by non-arm's length parties. As a result, double taxation could arise where shares are sold or otherwise transferred (say on death) from one party to another and the shares are subsequently redeemed by the company when it winds up. In that scenario, tax will have been paid on the capital gain and on the dividend resulting from the wind-up.

A relatively common post-mortem strategy referred to as "the pipeline" may be eliminated with these changes. This strategy ensures that when someone passes away, the accrued gain on a corporation is actually taxed as a capital gain and not as a dividend. It also eliminates the aforementioned double tax.

One positive change being considered is allowing family members to use corporations to acquire the shares of a family business as part of an ownership transition. This would allow lower corporate tax rates to fund the buyout of a family member rather than income taxed at higher personal rates. Currently, only unrelated parties can obtain this advantage.

A separate anti-stripping rule is also proposed to counter tax planning strategies that convert regular income of a corporation into tax-exempt withdrawals of capital or into lower-taxed capital gains.

If you have any questions or concerns about the topics in the Bulletin, please contact your tax advisor at Wilkinson & Company LLP