Department of Finance Canada | Ministère des Finances Canada

Tax Planning Using Private Corporations

Ted Cook, Director – Tax Legislation Division

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Canada

INCOME SPRINKLING

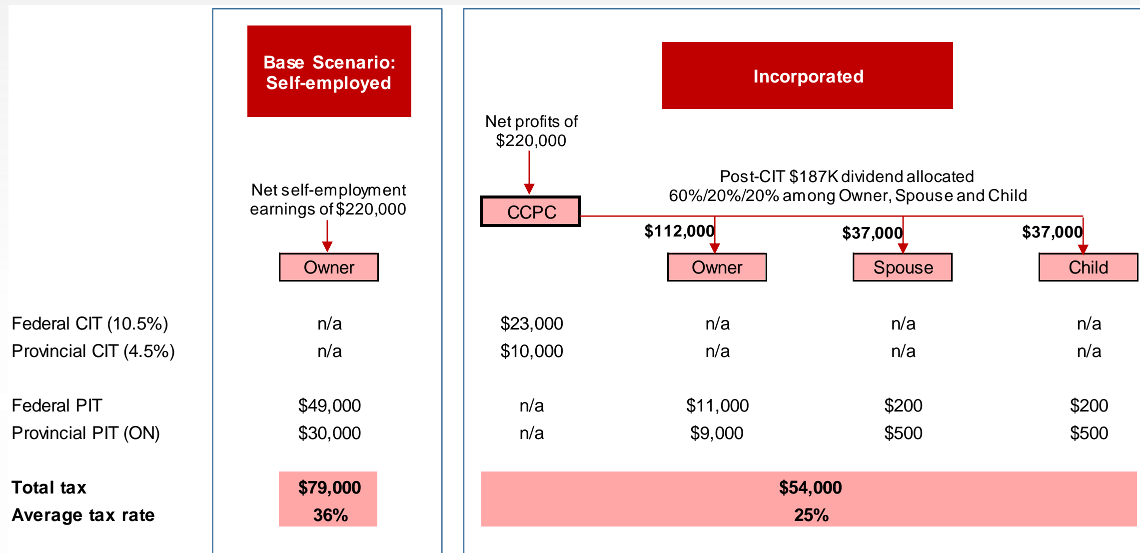
Overview

- Tax-planning arrangements under which income that would otherwise have been taxed as income of a high-income individual in the absence of the "income sprinkling" arrangement is instead taxed as income of a lower-income individual, typically a family member of the high-income individual

- The intended effect of the arrangement is to have the income subject to a lower or nil effective rate of income tax by accessing otherwise unused tax attributes of the lower-income individual

- Tax benefits from income sprinkling increase with:
  - The difference in tax rates between the sprinklor and the sprinklee
  - The amount of income that can be sprinkled
  - The number of individuals who can receive the sprinkled income

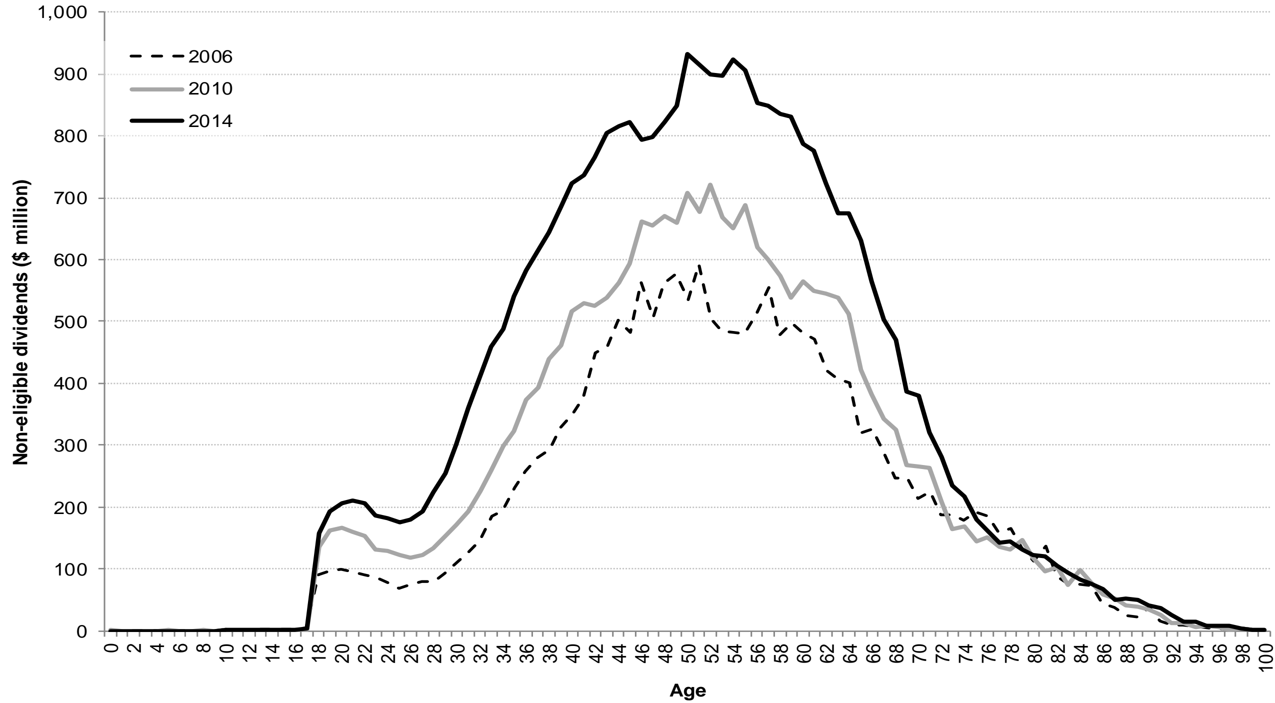
Example



	Base Scenario: Self-employed – Owner	Incorporated – CCPC	Incorporated – Owner	Incorporated – Spouse	Incorporated – Child
Federal CIT (10.5%)	n/a	$23,000	n/a	n/a	n/a
Provincial CIT (4.5%)	n/a	$10,000	n/a	n/a	n/a
Federal PIT	$49,000	n/a	$11,000	$200	$200
Provincial PIT (ON)	$30,000	n/a	$9,000	$500	$500
Total tax	**$79,000**	**$54,000**			
Average tax rate	**36%**	**25%**			

- In base scenario, net earnings are taxable at full PIT rates in the hands of the self-employed individual
- In the scenario where the individual incorporates, the after-CIT profits are paid out as dividends to the owners of the CCPC, including the individual's spouse and adult child
- Taxes are reduced because the spouse and adult child do not pay federal tax on the dividend income

Dividends by Age



Issue

- The use of a private corporation in particular facilitates income sprinkling arrangements

- Income sprinkling raises a number of tax policy concerns
  - High income individuals able to control income and to whom it is paid can obtain tax benefits not available to those who do not control income
  - Erodes tax base

Existing Rules

- Existing rules that constrain income sprinkling
  - ➢ Longstanding rule restricts the deduction of expenses (including salary) if amount not reasonable
  - ➢ Attribution rules apply to gift arrangements to redirect income back to the high-income individual
  - ➢ Tax on split income (TOSI) introduced in 1999

- Existing rules not fully effective in constraining sprinkling with adults
  - ➢ Attribution rules apply to spouses, but tax planning can circumvent the rules
  - ➢ Limited rules to address arrangements involving other adults (such as children)
  - ➢ Jurisprudence has limited the effective scope of some of the rules: 1998 *Neuman* decision (Supreme Court of Canada)

- Some structures have been identified that seek to circumvent the TOSI rules applicable to minors

LCGE Multiplication

- The Lifetime Capital Gains Exemption (LCGE) provides an exemption in computing taxable income in respect of capital gains realized by individuals on the disposition of qualified farm or fishing property (QFFP) and qualified small business corporation shares (QSBCs)
- By having family members (or a family trust) as shareholders of the QSBCs, the LCGE limit of each family member can be accessed on a disposition of the QSBCs
- This raises a concern the individuals may be able to claim the LCGE even though they may not have invested in, or otherwise contributed to, the business value reflected in the capital gains from the disposition of the QSBCs

Policy Response

Proposals to address income sprinkling

- Expand TOSI rules to Canadian resident individuals, whether minor or adult, who receive 'split income'
- Refine 'split income' definition
  - Include new categories of amounts, such as corporate debt
  - Income received by an individual over 17 from a corporation will only be split income if a related individual (a 'connected individual') has a certain measure of influence over the corporation
- Introduce a reasonableness test to determine whether split income received by an individual over 17 will be subject to the TOSI
  - The test is more stringent for individuals between 18 and 24

Policy Response – LCGE Multiplication

Proposals to address LCGE multiplication

- Individuals will 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
- The LCGE will generally not apply to the extent that a taxable capital gain from the disposition of property is included in an individual's split income
- Subject to certain exceptions, gains that accrued during the time that property was held by a trust will no longer be eligible for the LCGE
    - Transitional rules would 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

CONVERSION OF DIVIDENDS INTO CAPITAL GAINS

Overview

- Dividends are taxed at a higher rate than capital gains, which are only one-half taxable
- Individual shareholders can reduce their income taxes by converting corporate income (e.g., amounts that would otherwise be paid out as dividends) into capital gains
- The federal and provincial tax savings in 2016 associated with converting dividends into lower-taxed capital gains is approximately
  - $17,500 per $100,000 of conversions of ineligible dividends (at the average/highest provincial tax rate for ineligible dividends paid from corporate earnings taxed at the small business rate)
  - $11,100 per $100,000 of eligible dividends (at the average/highest provincial tax rate for eligible dividends paid from corporate earnings taxed at the 15% general rate)

Section 84.1 – Dividend Treatment (applicable)

- Section 84.1 addresses individual tax avoidance that can arise when an individual sells shares of a Canadian corporation to another corporation related to the individual (e.g., owned by individual, spouse, siblings, children/grandchildren)
- Such share sales could, absent section 84.1, be used to convert dividends in the hands of the individual into lower-taxed capital gains, including gains eligible for the Lifetime Capital Gains Exemption (LCGE)
  - This is because the related corporation could pay the individual with the proceeds of a dividend from the Canadian corporation, which the related corporation can receive tax-free because the inter-corporate dividend deduction is available
- To prevent this result, the proceeds from the share sale are treated as a taxable dividend and not as a capital gain if section 84.1 applies

Section 84.1 – Capital Gains (inapplicable)

- Section 84.1 does not apply on a sale of shares by individuals to their children, to any other related individual, or any arm's length person
  - Individuals can claim capital gains treatment – including the LCGE, where available – on a direct sale of shares to their children
  - It is not necessary for section 84.1 to apply in this case because the individual purchaser would face dividend taxation if they attempt to withdraw earnings of the corporation

Avoidance of Section 84.1 (cont'd)

- The conversion of dividends into lower-taxed capital gains ineligible for the LCGE benefits owners of both large and small private corporations
- Section 84.1 applies only to sales by individuals to corporations and can be avoided

Intergenerational Business Transfers

- It is argued by some that existing section 84.1 should be loosened with respect to the LCGE to facilitate intergenerational business transfers
- The tax policy concern regarding intergenerational business transfers is distinguishing a genuine sale, where the children carry on the business, from a sale that facilitates the conversion of dividends into capital gains

Policy Response

- Proposed amendment to section 84.1 to address “multi-step” planning
- Proposed introduction of a supporting anti-avoidance rule to address other transactions that could be used to convert dividends into capital gains
- Comments sought regarding whether, and how, it would be possible to better accommodate genuine intergenerational business transfers while still protecting against potential abuses

Passive Investment Income

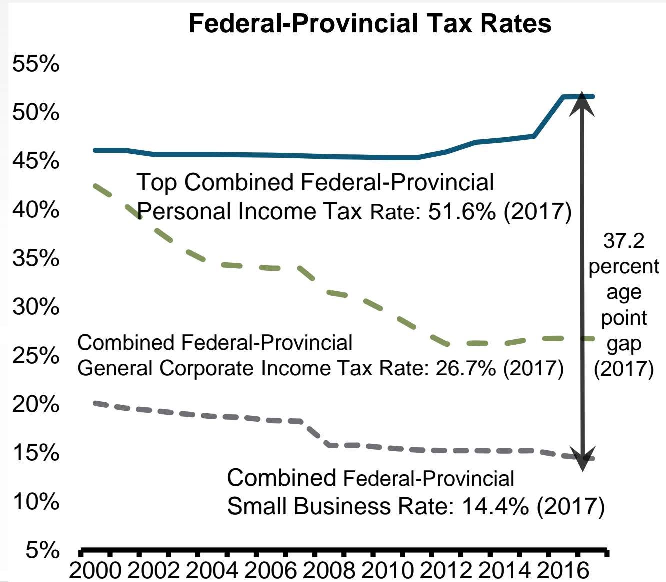
Outline

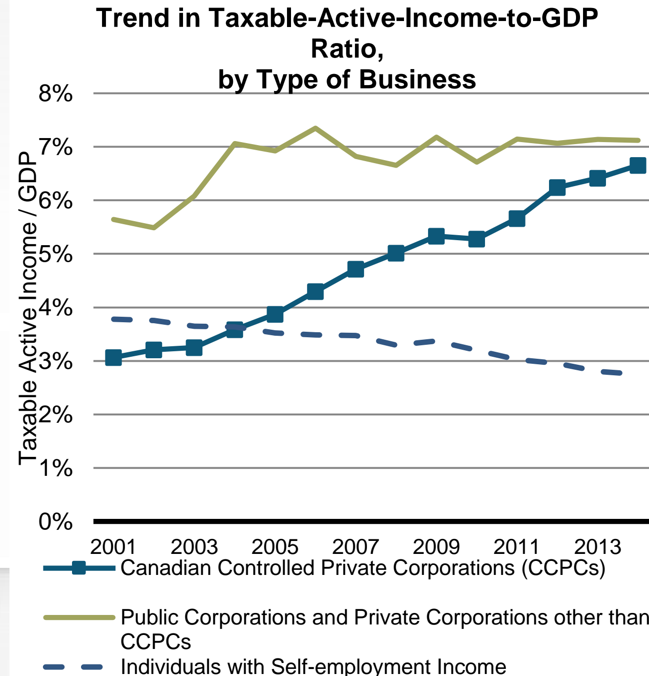
- Policy context
- Historical context: current rules
- Consultations: approaches put forward for discussion
- Key questions for discussion

Increasing Incentives for Tax Planning Using a Private Corporation

*The **growing gap** between corporate and personal income tax rates since 2000 has increased rewards associated with tax planning in a private corporation…*

… Over this period, a growing share of high-income self-employed individuals have chosen to incorporate





Integration

- Low corporate tax rates on business income are intended to provide a tax advantage as long as income is retained for active business reinvestments
- Income that is paid out of a corporation as a dividend is generally meant to be subject to the same amount of tax as income received directly by the individual

$$\textit{Corporate taxes on earnings} + \textit{Personal taxes on dividends} = \textit{Personal taxes on income earned directly}$$

- Integration issue: incentive to hold savings financed by retained earnings within corporations to save taxes
  - ➢ This issue was recognized in 1972

Historical context: Current rules

- Current system introduced in 1972
- Refundable taxes on investment income ensure integration when business owner uses after-tax income to finance a passive portfolio within a corporation
- In 1972, the introduction of Part V tax ensured integration when using retained earnings to finance a passive portfolio
- Part V tax repealed on the basis that:
  - ➢ It was seen as complex
  - ➢ This added complexity was believed not necessary

    I believe that these small corporations which enjoy the benefit of the lower rate of tax will, in fact, use these savings to expand their businesses, to improve their technology and to create more jobs for Canadians

Consultations

- Government is seeking input on best manner to eliminate deferral advantages going forward

- Paper lays out two broad approaches:
  - ➢ Reintroduction of Part V tax, with adjustments
  - ➢ Introduction of a deferred taxation model
    - A deferred taxation model could take various forms, two of which are described in the paper:
      - Apportionment approach
      - Elective approach

Reintroduction of Part V Tax

- Imposition of an upfront tax when retained earnings are used to acquire passive investments
  - ➢ This additional tax would bridge the gap with top PIT rate
    - For example, a business eligible for the small business deduction would pay a 35% additional tax at the time of acquisition of portfolio assets
  - ➢ Tax refundable if later on assets are used to reinvest in the business
  - ➢ Need to keep track of income streams in order to apply the appropriate amount of tax when investment assets are purchased

- Passive investment income would continue to be taxed as per current rules

Deferred Taxation Model: Apportionment Approach

- Need to track source of financing for passive investments in order to estimate deferral

- Affects businesses at the moment of dividend payout:
  - ➢ Affects tax outcomes at the moment a dividend is paid out, rather than when an investment asset is acquired
    - But in effect, same overall outcome as Part V tax
  - ➢ Those saving to reinvest in their business not materially affected
  - ➢ Precision in tax outcomes, tailored to various business situations

Deferred Taxation Model: Elective Approach

- Minimizes needs for tracking, in favour of proxy methods
- Default tax treatment tailored to the case of a business using retained earnings to finance portfolio investments
- Elections available for businesses with general rate income
- Under both approaches, options to keep current tax regime available when investments finance with savings taxed at the personal level

Key Questions for Discussion

- Government is seeking feedback, in particular:
  - ➢ What is the best approach to tackle the issue?
  - ➢ How to minimize complexity, while achieving policy objectives?
  - ➢ Capital dividend account: what is the appropriate scope of the new tax regime with respect to capital gains?
  - ➢ Transition issues