



MAJOR TAX CHANGES AFFECTING PRIVATE CORPORATIONS

Hendry Warren Chronicle - Tax and Accounting Simplified

July 2017

Today, Finance Minister William Morneau released a discussion paper outlining the federal government's concerns about the current tax planning involving private corporations in Canada. In some instances, the discussion paper proposes definitive changes which were supported by draft legislation while, in other instances, it presents alternative approaches to address other concerns. The public has until October 2, 2017 to submit its comments on the proposals which are to be effective January 1, 2018.

The discussion paper makes it clear that the federal government believes the current tax rules have provided owners of private corporations opportunities to save income tax that are not available to non-business owners and business owners operating as sole-proprietors. The changes are proposed to eliminate these advantages.

Income Sprinkling

Under the current rules, private corporation owners are able to pay dividends to family members that are disproportionate to that family member's contribution to the business. As individual taxpayers in Canada are subject to graduated tax rates, these rules can provide for an absolute tax saving for the family. Common examples are the payment of dividends to: low income spouses, adult children to fund post-secondary education, and to elderly parents to fund elder care costs. The Income Tax Act (Canada) ("ITA") denies the deduction of

Our goal is to provide updates on topical accounting and tax issues. Information contained in this newsletter is not meant to be a comprehensive summary of the issues raised. Rather, we wish to bring what we believe to be important issues to the attention of our valued clients and readers. We would be pleased to discuss any questions that you, the reader, might have in greater detail.



salary paid to a family member if the salary is not "reasonable" based upon the duties and work performed by the family member. The ITA contains no such "reasonability" test for dividends.

To address these concerns, the following tax changes are proposed:

1. Dividends paid to family members in excess of a

“reasonable” amount will be subject to the top marginal rate of tax. The family member receiving the dividend would therefore pay the same income tax, or more, as the active business owner would have if he or she had received the dividend. This is accomplished by extending the current Tax on Split Income rules¹ to such dividends. The reasonableness test will be based upon the labour and capital contributions made by the recipient to the private corporation. The federal government is clearly extending the current rule for reasonableness of salaries to dividends.

2. Split Income will now include capital gains from the disposition of certain property, as well as the income from the property.

Lifetime Capital Gains Exemption

It has also become common practice for the shares of private corporations to be owned directly or indirectly by family members who are not active in the business. This allows the capital gain on the eventual sale of the corporate shares to be sprinkled amongst several family members resulting in significant income tax savings. These savings come in the form of utilization of multiple lifetime capital gains exemptions² (“LCGE”) and access to lower income tax brackets of family members. The LCGE is currently worth approximately \$223,000 of income tax savings for a qualifying gain that would otherwise have been taxed at the top marginal rate for a resident of Ontario. This underscores the incentive to engage in this form of planning.

The federal government has attacked this type of planning by proposing that, effective for dispositions after 2017, access to the LCGE of family members will be restricted as follows:

The LCGE is no longer available to shelter gains realized or accrued before the taxation year in which an individual attains 18 years of age. This presumably will create the requirement for a valuation of shares of private corporations owned by an individual shareholder on January 1st of the year in which they turn 18.

The LCGE would not apply to a taxable capital gain that



would be included in Split Income. This extends the reasonableness test for dividends to capital gains.

Gains that accrued while the shares were owned by a trust would no longer be eligible for the LCGE. Certain special purpose trusts such as: spousal, common law partner, alter ego and employee trusts would be exempted from this provision.

Special transitional rules are proposed to minimize the adverse impact of these rule changes for existing shareholders. A one-time election is being proposed whereby a taxpayer may elect in 2018 to be deemed to have disposed of qualified property at fair market value thereby realizing a capital gain. This deemed capital gain would be eligible for the LCGE under the old rules.³

Passive Investments Held By a Private Corporation

Many private corporations in Canada have accumulated passive investments. This is accomplished by paying income tax at lower rates on business income which is not

¹ The current Tax on Split Income rules subject certain dividends to the top marginal rate of tax. By doing so, the income tax benefit of paying dividends to low income minor children is eliminated. These rules apply to dividends paid from private corporations to children who are under 18 years of age in the year and whose parents control the private corporation, as well as other very specific types of income.

² The lifetime capital gains exemption provides a deduction, subject to certain restrictions, from income of up to \$835,714 of capital gains resulting from the sale of qualified small business corporation shares.

³ The current rules impose several eligibility requirements of the shares that must be met during the preceding 24 months prior to the disposition. These transitional rules reduce this period to 12 months for elective dispositions.

reinvested in the business but rather invested corporately to accumulate savings for the shareholders. The federal government does not support this planning and is committed to introducing tax rules that would eliminate this tax advantage.

A new methodology of taxing passive income earned by a private corporation has been introduced. The mechanics of the proposal are complex but the result is clear: the rate of tax that a private corporation pays on passive income will be increased to the top marginal rate of an individual.

There are some positive aspects of the new proposals:

The tax deferral that a corporation achieves on the original earning of the business income will be maintained. The business income that was taxed corporately at a rate of 15% or 26.5%, depending upon the availability of the small business deduction, can be invested into passive assets without further immediate taxation. However, the ultimate personal tax payable by the individual shareholder when the funds are paid as dividends will be higher, which offsets this deferral benefit in the future.

There has been speculation recently that the rate of income inclusion of capital gains may be increased from the current rate of 50%. The government has confirmed that the rate will remain unchanged.

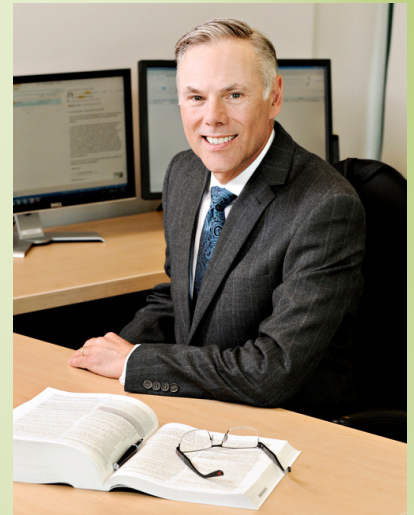
Existing passive investments held in private corporations would not be subject to these new rules. In this way, the government proposes to grandfather existing passive investments held in private corporations.

The Way Forward

The proposed rule changes are highly technical and, in some areas, not complete. Further study of the new proposals is required to gauge the full impact on private corporations and their shareholders. Every private corporation should revisit its dividend policies and corporate structure in light of these new proposals.

It would appear prudent for private corporations to plan to pay dividends to its shareholders in 2017 as the new income sprinkling rules will not apply until 2018. Further, where possible, shareholders should plan to use the 2018 one-time election to recognize a capital gain in respect of their private corporation shares to help facilitate access to the LCGE.

Hendry Warren LLP can assist you in understanding these rules and navigating a path for the future. Our partners will be contacting affected corporate clients in the coming days to assist in this regard.



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