Mackenzie Tax and Estate Planning

Tax Planning by Private Corporations

On July 18, 2017, the Department of Finance Canada issued its highly anticipated consultation paper, which addressed some of the tax strategies that incorporated business owners and professionals use in their tax planning. The government's view is that private corporations provide high income individuals with an unfair tax advantage that is not generally available to other Canadians. The government is focused on the following three tax planning issues, as identified in the 2017 Federal Budget:

Income Sprinkling

Income sprinkling describes an arrangement that results in income that would otherwise be realized by a high-income individual facing a higher personal income tax rate to instead be realized (e.g., via dividends or capital gains) by family members who are subject to lower personal tax rates (or who may not be taxable at all). This strategy could be applied, for example, by a business owner who earns income through a private corporation and without an income sprinkling arrangement, would pay tax on the income at his or her high personal tax rate. He or she may issue dividends to family members who may be taxed at lower rates in order for them to realize the income instead. The result is an overall tax reduction that is not otherwise available to other Canadians who do not earn income through a corporation.

The tax rules currently deal with income sprinkling used by private corporations by way of a reasonableness test whenever salary or wages are paid to family members. A reasonableness test generally does not apply to dividends. Also, a "Tax on Split Income" (TOSI) applies to dividends on unlisted shares (as well as other types of income) paid to minor children (under the age of 18) of a related individual. Under the TOSI rules, dividends paid to minor children are taxed at the top personal marginal tax rate.

Proposal

In response, the government proposes to extend the existing TOSI rules that currently apply only to minors to adult family members in certain circumstances. Specifically, dividends and other amounts received from a private business, by an adult family member of the principal of the business, may be subject to a reasonableness test. The reasonableness test will be applied to all adult family members and will be based on contributions (labour, capital, and previous returns/remuneration) made by the adult family member to the business. The reasonableness test will be applied differently for adult family members between the ages of 18-24 and ages 25 and above. To the extent that dividends paid to adult family members do not meet the new reasonableness tests, the TOSI rules will apply and tax such dividends at the top personal marginal tax rate of the adult family member.

There are also proposed measures that address other income sprinkling issues, including the multiplication of the Lifetime Capital Gains Exemption (LCGE). In 2017, every Canadian taxpayer is entitled to claim an exemption of up to $835,716 on the sale of Qualified Small Business Corporation shares ($1M in the case of Qualified Farming/Fishing Property). A business owner can multiply this exemption with family members, for example, by incorporating a family trust as owner of the shares of the private corporation, and having family members as beneficiaries of the family trust. Under current tax rules, each family member would be entitled to claim their own LCGE, thereby multiplying the number of exemptions available and reducing income taxes on the sale of the business.

Three general measures are proposed to address LCGE multiplication. First, 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 turns 18 years old. Second, the LCGE would generally not apply to the extent that a taxable capital gain from the sale of the business is included in an individual's split income. Third, subject to certain exceptions, gains that accrued during the time that property was held by a trust would no longer be eligible for the LCGE.

These proposed measures would apply to dispositions after 2017. Also, a special set of transitional rules are proposed.

Holding Passive Investments inside a Private Corporation

One of the main income tax benefits available to incorporated business owners and professionals is access to the small business deduction limit, which allows for a reduced tax rate on the first $500,000 (Federal) of income earned in the corporation. To the extent that a business owner/professional retains their profits in their corporation, a significant tax deferral is available. The tax deferral results in much more capital available to the business owner or professional that can either be used to reinvest in the business, or to set aside as personal savings in their corporation. There are no proposed changes to business owners or professionals who choose to reinvest their profits back into the business (by purchasing additional equipment, or hire more employees); however, the government is concerned about business owners and professionals setting aside the capital for personal savings, as this generally results in a much higher level of savings when accumulated in a private corporation – a strategy that is not available to the average Canadian.

The government will consider approaches that can meet the following objectives:

- Preserve the intent of the lower tax rates on active business income earned by corporations, which is to encourage growth and job creation. That is, there will be no impact on business owners or professionals who use their profits to reinvest in their business.
- Eliminate the tax-assisted financial advantages of investing passively through a private corporation, and ensure that no new avenues for avoidance are introduced.

The government has highlighted a few possible remedies to eliminate the incentives to invest passively within a corporation and is looking for stakeholders to provide feedback on each possible approach.

Converting Income into Capital Gains

Incorporated business owners and professionals can reduce income taxes by taking income that would either be taxed as salary or dividends, and instead having it taxed as a capital gain. For high income individuals, capital gains are taxed more favourably than dividends. As a result, there are transactions taking place among related parties aimed at converting dividends and salary into lower-taxed capital gains. Although there are some anti-avoidance provisions in our tax law designed to thwart these transactions, the rules are being circumvented.

Proposal

The government has proposed to expand existing anti-avoidance rules found in subsection 84.1 of the Income Tax Act and introduce new rules designed to prevent the surplus income of a private corporation from being converted to a lower taxed capital gain, and stripped from the corporation in a non-arm's length transaction.

The consultation paper also noted that a genuine intergenerational transfer of shares of a small business corporation to an adult child's corporation should be treated the same as a sale to an arm's length corporation; however, a major policy concern is distinguishing between a genuine intergenerational transfer and a tax avoidance transaction undertaken among family members. The government is seeking comments from stakeholders regarding whether, and how, it would be possible to better accommodate genuine intergenerational business transfers while still protecting against potential abuses of any such accommodation.

The Department of Finance is accepting submissions to these proposals until October 2, 2017. The Mackenzie Tax & Estate Planning Group is engaged in a full review of the proposals and will continue to update financial advisors on the continuing developments to determine the impact to their clients with private corporations.

If you have any questions or comments, please contact the Mackenzie Tax & Estate Planning Group.

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