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Special Tax Alert – July 31, 2017

On July 18, 2017 Minister of Finance William Morneau released information indicating that there would be a 75 day consultation period on changes to the Income Tax Act in regard to the following 3 areas:

1. Sprinkling income using private corporations,
2. Holding a passive investment portfolio inside a private corporation, and
3. Converting a private corporation's regular income into capital gains.

Included with this release and not well publicised was draft legislation effective 2018 for item 1 and draft legislation effective July 18, 2017 for item 3, as well as major restrictions to the availability of the lifetime capital gains exemption (LCGE). In addition, a large volume of information on item 2 was released but without proposed legislation.

These changes come shortly on the heels of the previous increase in the personal tax rates of:

- Federally, for persons earning more than $200,000 an increase to 33% from 29% effective in 2016,
- The previous 1% additional Ontario personal tax on income greater than $220,000,
- Elimination of the Family Tax Cut, and
- The impact on the Ontario Surtax from the other changes.

In addition, beginning in 2017 severe restrictions on the ability to access the corporate small business deduction were added to the legislation.

Also beginning in 2017 many tax credits for students were eliminated both Provincially and Federally.

These changes represent a continuous and ongoing change to the nature of taxation in Canada and more particularly on individuals operating business within a corporate structure and/or high-income earners. The full impact of the changes remains to be seen. The following is a summary of the legislative changes related to sprinkling income, converting regular income into capital gains and the capital gains exemption.

We believe the previous and these proposed changes will impact virtually all of our clients.

<u>Sprinkling Income Using Private Corporations</u>

The current rules include the following:

1. A long-standing rule that provides that only "reasonable amounts" can be deducted by a corporation for payments such as wages, management fees to another person including a family member.
2. There are "attribution rules" that apply in certain circumstances to property income.
3. There is a "tax on split income" (TOSI) that applies to income sprinkling to individuals under the age of 18.

The proposed rules:

1. Extend the TOSI rules.
2. Constrain the ability to access the LCGE.
3. Supporting measures to improve the integrity of the tax system

<u>1. Extension of TOSI Rules</u>

The expansion of the TOSI rules include major expansion of the term "specified individuals" to whom the rules apply. Essentially a specified individual will now be any Canadian resident individual regardless of age who receives split income derived from a business of a related individual who resides in Canada. Previously these rules only applied to individuals under the age of 18.

Also added to the TOSI rules is a reasonableness test for both labour and capital contributions for individuals age 18 and over. There are also special rules for those aged 18 to 24.

There is also an addition of a definition of a "connected individual" in the proposed TOSI rules. A connected individual will be defined as an individual who is resident in Canada with "strategic influence", equity influence", "earnings influence" and "investment influence". The equity and investment influence criteria are further defined to include a 10% test such that there may be more than one connected individual in respect of a corporation.

The overall result of the extension of the TOSI rules will be that an individual receiving split income will be taxed at the highest individual tax percentage for the year multiplied by the amount of the split income.

<u>2. Constrain the Ability to Access the LCGE</u>

The proposed constraints are as follows:

1. 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 turns 18.

2. The LCGE would generally not apply to the extent the taxable capital gain from the disposition of property is included in the individual's split income.

3. Individuals will no longer be permitted to claim the LCGE in respect of capital gains that accrue during a period in which a trust holds the property (except for a spousal, common-law partner or alter ego trust as well as certain employee share ownership trusts).

The proposed measures would apply to disposition occurring after 2017.

3. Support measures to improve the integrity of the tax system

In conjunction with the legislative changes certain reporting changes will be made. Regarding trusts and partnership T5 reporting.

Holding a Passive Investment Portfolio Inside a Private Corporation

Holding funds in this manner has been a long-standing practice of private corporations the normal purpose of which tends to be saving for retirement, future business and property investment, savings for children and grandchildren's education, holding funds separate and distinct from an estate, and for other varied reasons.

An extensive release on this topic has been made with proposed approaches. It is our expectation that further legislative changes will be introduced after the consultation period. **The proposed changes would most likely introduce further taxes on these structures.**

Converting a Private Corporation's Regular Income into Capital Gains

Section 84.1 of the Income Tax Act is a long-standing provision and generally applies when an individual sells shares of a Canadian corporation to another Canadian corporation on a non-arms length basis and the individual receives back non-share consideration such as cash or debt in excess of the greater of two amounts, being:

1. The adjusted cost base of the shares to the individual, and
2. The paid-up capital in respect of the shares.

To the extent the amount received is greater that the larger of the two amounts the amount is treated as a taxable dividend. In summary, this section says you cannot create and remove equity from a company by selling it to another company that you own and treat this as a capital gain, which makes logical sense.

The Government proposes that Section 84.1 be amended effective July 18, 2017 to prevent taxpayers from using non-arm's length transactions that "step-up" the cost base of shares of a corporation to avoid the application of section 84.1 on a subsequent transaction.

As well, new "anti-stripping" rules are proposed as follows:

1) A rule that will apply to non-arm's length transactions where it is reasonable to conclude that one of the purposes of the transaction (or series of transactions) is to pay an individual shareholder non-share consideration such as cash or debt where tax is avoided. The individual will be taxable on the amount as if it were a dividend.
2) Where a capital dividend has been paid to an individual and the anti-stripping rule applies, the capital dividend will be recharacterized as a taxable dividend and the balance of the capital dividend account will be adjusted accordingly.

These provisions would seem to have the impact of severely restricting the distribution of corporate income in that distributions may only be made by way of taxable dividend except in restrictive circumstances.

Example of How the New TOSI Rules Might Apply

A young couple, spouse A and spouse B start a small business from zero and incorporate. As a young family, they also chose to have children and so A decides to devote their time and attention to raising children whereas B runs the family business. If A and B incorporate and own shares of the company equally the following tax rules would seem to apply if the company earns $100,000 in net profit before tax:

1. Corporate tax of $15,000 (assuming the Small Business Deduction is still applicable) will be payable leaving $85,000 of net profit to distribute.
2. If the company distributes the $85,000 to its two shareholders 50% each, then technically speaking the personal tax will be as follows:
    a. As B operates the business and meets the requirements their dividend of $42,500 will attract personal tax (assuming no other income) of $1,350 in Ontario (at 2016 tax rates).
    b. Under the old rules A would have the same personal tax burden. However, the new TOSI rules likely apply and therefore the tax would be $19,255. **Therefore, the overall tax on the $100,000 of income will be $35,605 or 35.6% annually**.
3. In addition, sometime down the road if the family decided to sell the business for say $200,000, having built that value over the years, the following would be the tax result:
    a. B would potentially be eligible for the LCGE assuming qualifying criteria were met and hence their $100,000 gain would be offset by a deduction for the LCGE and the tax would be zero.
    b. A, however, would not be eligible if the TOSI rules apply, and therefore would be taxable on their $100,000 capital gain.

Based on these rules, the most likely recommended structure would be for B to own 100% of the company such that their personal tax on $85,000 of dividends would be $10,988, compared to $2,700 under the existing system (for an overall tax cost of $25,988 or roughly 26%). The second alternative would be to pay out a salary resulting in no corporate tax, personal tax of $24,093 and a Canada Pension Plan contribution of $5,088 (at 2016 rates) for an overall cost of $29,181.

As well, the entire $200,000 capital gain would be eligible for the LCGE assuming qualification criteria are met.

Conclusion

These proposed changes represent an unprecedented change to the way private corporations have been taxed since the 1970's. Please contact us to discuss these proposals. We expect to continue to study and monitor the proposals in greater detail over the coming weeks and months. We anticipate further announcements will be made after the 75-day consultation period. We also expect to be contacting you, our valued clients to review the impact of these and expected future changes over the coming months. These changes impact all private corporation including professionals, agriculture, manufacturing, wholesale, passive investment and many other industries and not just a select few.

Should you have concerns with these fundamental changes in the way private corporations are taxed we would encourage you to contact your MP during the consultation period.