Department of Finance targets tax planning using private corporations

Wealth Management Taxation, The Bank of Nova Scotia

On July 18, 2017, Finance Minister Bill Morneau released a consultation paper and draft legislation aimed at addressing specific tax planning opportunities involving private corporations. The release of these measures follows the Federal Government's promise to review certain tax planning using private corporations, as outlined in the Federal Budget tabled on March 22, 2017. The proposed measures may impact a significant number of business owners and shareholders of private corporations.

Proposals

Preventing "income sprinkling"

Currently, any dividends paid from private corporations to minor individuals (under the age of 18) are subject to tax at the highest marginal tax rate (often referred to as "Kiddie Tax"). Under the proposed changes, these rules would also be extended to certain adult shareholders in situations where those individuals do not actively participate in or contribute to the business in terms of labour or capital, or where amounts paid to those individuals are not considered "reasonable". The changes are aimed at reducing such income splitting opportunities by taxing individuals at the highest marginal tax rates, beginning in 2018.

Furthermore, a common planning technique currently in use involves holding Qualified Small Business Corporation shares through a family trust, in order to allow multiple family members to utilize their Lifetime Capital Gains Exemption ($835,716 in 2017) upon the eventual sale of the company. Additional measures are aimed at limiting such multiplication of claims to the Lifetime Capital Gains Exemption, beginning in 2018.

Passive investments held in a private corporation

Under current rules, many small business owners benefit from a deferral of personal tax where business income earned inside a corporation is not ultimately distributed to shareholders. These funds are typically kept inside the corporation and invested in investment portfolios which generate passive income and gains. The Department of Finance aims to eliminate the benefit of such arrangements through a number of proposed reforms. The following possible approaches are under consideration for situations involving retained earnings invested within a private corporation in order to generate passive investment income, dividends, and capital gains:

1. Changes to the refundable tax regime currently applicable to investment income earned by private corporations.
2. Elimination of the addition to the Capital Dividend Account relating to the untaxed portion of capital gains, and the ability to pay these funds to individual shareholders in the form of tax-free capital dividends.
3. Modification to the rules relating to the payment of tax preferential "eligible" dividends.

The government is currently requesting feedback on the above approaches by October 2, 2017.

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Preventing the conversion of a private corporation's regular income into capital gains

Current legislation ensures that most corporate distributions are taxed as dividends in the hands of shareholders. However, there are some situations which may allow these corporate surpluses to be converted into taxable capital gains instead of regular dividends, and effectively result in distributions to shareholders being taxed at a lower rate. While the proposed changes aim to eliminate this type of planning, they may also inadvertently eliminate certain types of post-mortem tax planning which can currently prevent double or triple taxation of the same corporate value. These proposed changes are effective immediately.

Summary

While some of the proposals discussed in the consultation paper are accompanied by draft legislation, other proposals, particularly the proposal covering passive investments held inside a private corporation, are not. It is not yet clear what the rules will actually look like once final legislation is introduced and enacted, and whether any action is appropriate at this time or should be delayed until more clarity is available. For example, business owners or professionals who have not yet incorporated but were, prior to the release of the proposals, contemplating incorporation, may wish to discuss the purpose and timing of that decision with their advisors.

Clients should speak with their tax advisors to determine the potential impact of the proposed measures and discuss options they might consider in the event that the proposals are implemented.

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