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TAX — SPECIAL ALERT

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Kay's practice focuses on tax matters, including corporate reorganizations, cross-border transactions, purchase and sale of businesses, personal tax and estate planning.

Sweeping Proposed Tax Changes to Private Corporations

On July 18, 2017, the Department of Finance released legislative proposals ("Proposals") and a consultation paper dealing with tax planning using private corporations. The 2017 Federal Budget alluded to certain changes to tax planning for private corporations, but the impact of the Proposals is far-reaching. In fact, these Proposals affect many of our owner-manager clients.

Income Splitting

Very generally, the Proposals will eliminate most common income splitting strategies used by small businesses. Under the current rules, adults (spouse and children over the age of 18) may be shareholders of a private corporation and receive dividends from the corporation. Such dividends are then taxed in the hands of the shareholder at his or her personal graduated income tax rates.

The Proposals extend the concept of "tax on split income" ("TOSI"), which is currently known as "kiddie tax", to dividends and other amounts received from a corporation by adult shareholders. TOSI is taxed at the highest personal income tax rate. Under the Proposals, dividends and other amounts received by a family member of the principal of the business, may be subject to a reasonableness test. This test is stricter if the family member is between the age of 18 and 24 years old.

The reasonableness test will require the family member to show that the amount of the dividend is reasonable given his/her labour contributions to the activities of the business, his/her assets contributed or risks assumed in respect of the business and his/her previous returns and remuneration paid to him or her. If the reasonableness test is not met, the dividend or amounts received by the family member from the business will be taxed at the highest personal income tax rate.

If the Proposals are enacted, the TOSI will apply to dividends and other amounts received in 2018.

Lifetime Capital Gain Exemption Multiplication

A common tax planning strategy, under the current rules, is to have a family trust (with family members, including minors, as beneficiaries) hold the common shares of an active business in Canada. On a future sale of the shares of the corporation to a third party purchaser, the capital gains would be realized by the family trust and the gains would be allocated to one or more beneficiaries of the trust. If the beneficiary has not claimed his or her lifetime capital gains exemption (in 2017, the exemption is $835,714), he or she may claim such exemption to shelter all or a part of the gains allocated to him or her.

Under the Proposals, individuals under the age of 18 will be not entitled to the lifetime capital gains exemption. Furthermore, if the gain was accrued while a trust held the shares, an adult beneficiary will not be entitled to claim the lifetime capital gains exemption. He or she must have held the shares personally in order to claim the exemption. Finally, the availability of the exemption will be subject to a reasonableness test similar to the ones described above.

The Proposals refer to a special election in the 2018 taxation year to allow individuals to crystallize their unutilized capital gains exemption.

If the Proposals are enacted, the rules will apply for dispositions after 2017.

Other measures

The Proposals contain draft legislation dealing with strategies converting a corporation's surplus into capital gains. In addition, while there is no draft legislation in the Proposals in respect of the tax treatment of passive income held by private corporations, the Department of Finance is concerned that there is unfairness in allowing private corporations to use low after-corporate tax income to invest in passive investments. The Department of Finance is interested in comments and alternatives in dealing with this perceived unfairness.

The deadline to submit for the public to submit comments in respect of the Proposals is October 2, 2017.

Conclusion

While the Proposals (if enacted) will eliminate the common tax planning strategies discussed above, in certain circumstances, if the objective is not income splitting or the multiplication of the lifetime capital gains exemption but for other reasons, such as an estate freeze to pass on the wealth to the next generation, tax planning for the private corporation is still possible.

We encourage you to discuss the impact of these Proposals with one of the members of our Tax and Estate Planning Groups. We will be hosting a webinar on this topic on Tuesday, August 15th. Click here for more information and to register.

For more information, please contact a member of our Tax Group or our Wills, Trusts & Estates Group:

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