Tax Planning Using Private Companies – Draft Proposals Released for Consultation

As noted in our **2017 Federal Budget summary**, the federal government indicated that it would review the use of certain tax planning strategies involving private corporations that it perceives unfairly reduce personal taxes of high-income earners through a variety of tax reduction strategies unavailable to other Canadians. Strategies involving private corporations specifically identified by the government at the time of the March 22, 2017 budget included:

- **Sprinkling income**, which can reduce income taxes by causing income (such as dividends and capital gains) that would otherwise be realized by an individual facing a high personal income tax rate to instead be realized by family members who are subject to lower personal tax rates (or who may not be taxable at all).
- **Holding passive investment portfolios**, which may be financially advantageous for owners of private corporations compared to otherwise similar investors. This is mainly due to the fact that corporate income tax rates, which are generally much lower than personal rates, facilitate accumulation of earnings that can be invested in a passive portfolio.
- **Converting regular income into capital gains**, which can reduce income taxes by taking advantage of the lower tax rates on capital gains relative to regular income.

On July 18, 2017, the government followed through on its intention to release a consultation paper which sets out the nature of these issues in more detail, as well as proposed policy responses which will be open for consultation until October 2, 2017.

Proposed Measures

The following proposed measures are very wide-ranging in their potential impact to private corporations. They affect many common tax planning strategies employed by family businesses and professional corporations, and seek to limit many of the current tax benefits of incorporation.

1. Income-splitting

The Government is concerned with the widespread use of income-splitting strategies involving private companies, particularly where individuals enriched are not actively involved in the business.

a) Extension of the "kiddie tax"

Prior to the introduction of the "kiddie tax" provisions in 2000, it was common for a minor child to hold shares in a private family business (typically through a family trust structure as part of an estate freeze) and receive dividends on these shares. Once allocated from the trust, these dividends from the private company could be taxed in the child's hands with little or no taxation assuming the child had limited, if any, other sources of income. However, the kiddie tax rules now cause affected dividends from a related private corporation to be automatically taxed to the child at top marginal rates, regardless of the child's level of income from other sources.

New proposals released as draft tax legislation in the consultation paper include an extension of this existing tax on split income for minors (i.e., kiddie tax) to also apply to adults (of any age) in certain circumstances after 2017, as follows:

- Dividends and other amounts received from a business by an adult family member of the principal of the business, may be subject to a reasonableness test which will be stricter for 18 to 24 year olds.
- The reasonableness test will be based on the contributions made (e.g., labour and capital) by the family member to the business, taking into account previous returns/remuneration, in light of the appropriate compensation that would be provided to an arm's-length person for similar contributions.
- To the extent the amount is not reasonable, the top tax rate will apply to the dividend income, regardless of the individual's actual marginal tax rate.

Other changes proposed are intended to improve the existing kiddie tax rules and support these additional measures, including expanding these rules to encompass reinvested "compound" income on affected distributions received by individuals under age 25, and gains from dispositions after 2017 of certain property, the income from which is "split income."

Continued

b) Restrictions on the multiplication of the lifetime Capital Gains Exemption (CGE)

In conjunction with the government's intent to limit the tax benefits of family members not actively involved in the business, another specific concern of the government is the use of family trusts to "multiply" access to the CGE limits (currently $835,716 for 2017) to other family members to reduce capital gains tax.

Three general measures are proposed to address CGE multiplication, as follows:

- First, individuals would no longer qualify for the CGE in respect of capital gains that are realized, or that accrue, before the taxation year in which the individual attains the age of 18 years.
- Second, the CGE would generally not apply to the extent that a taxable capital gain from the disposition of property is included in an individual's split income (as part of the expanded kiddie tax provisions previously discussed).
- 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 CGE.

These proposed measures would apply to dispositions after 2017. However, special transitional rules are also proposed.

2. Passive investment income

Active business income earned by a Canadian-controlled private corporation is generally taxed at the small business corporate income tax rate, which is significantly lower than the highest personal income tax rate. For example, in Alberta the small business corporate tax rate for 2017 is 12.5 per cent on the first $500,000 of earnings, whereas the top personal tax rate is 48.0 per cent, a difference of 35.5 per cent. As a result, to the extent a small business owner or incorporated professional retains a portion of their business earnings within the corporation, they are able to defer paying significant income tax until a later date when the funds are withdrawn, thereby providing additional funds that could be invested by the corporation to generate investment income.

Because of this deferral advantage available to many incorporated business owners that is not available to individuals, the government is concerned with the ability of high-income Canadians to invest more (after-tax) funds within their private corporation in 'passive' investments (versus reinvesting in the business) than what would be available after-tax if the business income was earned personally. The government is of the view that fairness and neutrality require that private corporations not be used as a personal savings vehicle for the purpose of gaining a tax advantage. As such, it is seeking to ensure that passive investments held within privately-controlled corporations be taxed at an equivalent rate to those held outside such corporations.

Accordingly, the government is proposing fundamental changes to the current tax system of "integration" which aims to ensure that an individual is indifferent between earning income through a corporation or directly. It has therefore introduced several approaches for review and consultation to establish what it perceives as greater fairness in the tax treatment of passive investment income of a private corporation, so that the benefits of the corporate income tax rates are directed towards investments focused on growing the business, rather than conferring a personal investment advantage to the corporate owner.

Specifically, it is the government's intention that the proposed approach would:

- eliminate the tax deferral advantage on passive income earned by private corporations
- preserve the intent of the lower corporate taxes to support growth and jobs
- ensure that private corporation owners do not have access to tax preferred savings options not available to others
- make the system neutral on a go-forward basis
- limit, to the extent possible, the complexity of these new rules

At this stage, no draft legislation has been introduced, instead the government announced that it will be seeking the feedback of stakeholders on the design considerations associated with each of the possible approaches introduced. The government intends to release a detailed proposal following these consultations, and indicated that it will provide time before any proposal becomes effective.

Continued

3. Converting income into capital gains

The government is also concerned with the use of certain complex tax strategies by higher-income individuals to reduce their income taxes by converting dividends (and salary) that would otherwise be received from private corporations into lower-taxed capital gains. Although there is an anti-avoidance rule that deals with transactions among related parties aimed at converting dividends and salary into lower-taxed capital gains, this rule is often being circumvented. Accordingly, the government has proposed amendments to this rule to address such tax planning. Specifically, effective as of July 18, 2017 – the date of this consultation paper – the government proposes that:

- This anti-avoidance section be amended to prevent individual taxpayers from using non-arm's length transactions that 'step-up' the cost base of shares of a corporation in order to avoid its application on a subsequent transaction.
- The *Income Tax Act* be amended to add a separate "anti-stripping" rule to counter tax planning that circumvents the specific provisions of the tax law meant to prevent the conversion of a private corporation's surplus into tax-exempt, or lower-taxed, capital gains.

On a related note, in light of the potential application of these anti-avoidance rules, the government has also requested the views and ideas of 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.

Summary

The income tax measures introduced in this consultation paper are only proposals at this stage, and may not ultimately be enacted into law. As these proposals are very complex and wide-ranging, and may have significant implications to your particular tax situation, you should consult with your tax advisors for specific advice and direction on how your particular situation may be affected by these potential changes in the tax law.

If you have any questions regarding these proposals, please consult with your tax advisor for further details.

This document is a summary of the Government of Canada's consultation paper and does not represent BMO Financial Group's view on the tax policies expressed in the consultation paper.

We're here to help.™

BMO Wealth Management provides this publication for informational purposes only and it is not and should not be construed as professional advice to any individual. The information contained in this publication is based on material believed to be reliable at the time of publication, but BMO Wealth Management cannot guarantee the information is accurate or complete. Individuals should contact their BMO representative for professional advice regarding their personal circumstances and/or financial position. The comments included in this publication are not intended to be a definitive analysis of tax applicability or trust and estates law. The comments are general in nature and professional advice regarding an individual's particular tax position should be obtained in respect of any person's specific circumstances.

BMO Wealth Management is a brand name that refers to Bank of Montreal and certain of its affiliates in providing wealth management products and services. Not all products and services are offered by all legal entities within BMO Wealth Management.

BMO Private Banking is part of BMO Wealth Management. Banking services are offered through Bank of Montreal. Investment management services are offered through BMO Private Investment Counsel Inc., an indirect subsidiary of Bank of Montreal. Estate, trust, planning and custodial services are offered through BMO Trust Company, a wholly owned subsidiary of Bank of Montreal.

BMO Nesbitt Burns Inc. provides comprehensive investment services and is a wholly owned subsidiary of Bank of Montreal. If you are already a client of BMO Nesbitt Burns Inc., please contact your Investment Advisor for more information. All insurance products and advice are offered through BMO Estate Insurance Advisory Services by licensed life insurance agents, and, in Quebec, by financial security advisors.

BMO Nesbitt Burns Inc. is a Member-Canadian Investor Protection Fund. Member of the Investment Industry Regulatory Organization of Canada.

® "BMO (M-bar Roundel symbol)" is a registered trademark of Bank of Montreal, used under licence. ® "Nesbitt Burns" is a registered trademark of BMO Nesbitt Burns Inc. All rights are reserved. No part of this publication may be reproduced in any form, or referred to in any other publication, without the express written permission of BMO Wealth Management.

07/17-1510