Update on the CCPC tax proposals December 2017

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The federal government first announced proposed changes to the taxation of Canadian-controlled private corporations (CCPCs) on July 18, 2017. The originally-proposed measures focused on three areas: income sprinkling among family members, passive investment income earned within a corporation, and converting regular income from a corporation into capital gains. The government had invited interested parties to comment on the proposals by October 2, 2017 and they ultimately received over 21,000 submissions from various business groups, industry associations and other interested parties. In response to comments received, the Department of Finance made a series of announcements in October 2017 modifying and, in some cases, withdrawing some of the proposals. On December 13, 2017, more detailed revisions were announced to the rules targeting income sprinkling.

If you own a private corporation, it may be affected should the revised proposals become law.

This report will generally review the proposals, as well as the announced modifications, and set out steps that you may wish to consider. If you have a private corporation structure (including a professional corporation), or are thinking of setting up a private corporation, you should contact a tax advisor to discuss how these steps may apply in your particular circumstances.

Income Sprinkling

Income Splitting

By sprinkling income from a corporation among family members, rather than having one individual receive all of the income, the overall tax paid by the family may be reduced if some of the family members pay no tax or are taxed at a lower tax rate than the individual.

Currently there are anti-avoidance measures in place to limit this, such as the current "kiddie tax" that results in certain dividends paid to children under age 18 being taxed at the highest rate in the child's hands. Effective for 2018, the proposed changes would expand the kiddie tax rules so that they would apply to more types of income and would also cover certain adults (the "split income" rules).

The submissions received by the government expressed concern over the complexity of this proposed change and its unintended consequences. As a result, on December 13, 2017, the government introduced revised rules.

The revised proposals for split income would generally apply where an adult receives dividend or interest income from a corporation, or realizes a capital gain, and a related individual is either actively engaged in the business of the corporation or holds a significant amount of equity (with at least 10% of the value) in the corporation.

The Exceptions

The revised proposals include various exceptions, so that the split income rules would not apply in certain circumstances. The availability of these exceptions depends on one's age.

1. Excluded business

There is a broad exception that is available to anyone over age 17. The split income rules will not apply when the adult is "actively engaged on a regular, continuous and substantial basis in the business" in the year, or in any five previous years (which need not be consecutive). Adults will be treated as satisfying this condition if they worked in the business for an average of 20 hours per week during the year, or the part of the year during which the business operates if it is a seasonable business. For adults who work less than this amount, it will be a question of fact to determine if the exception is available.

Coincident with the release of the revised proposals on December 13, the Canada Revenue Agency (CRA) issued guidance on how it would be applying the draft split income rules for adults. The CRA stated that "records such as timesheets, schedules or logbooks" and payroll records could be used to demonstrate the number of hours an individual has worked.

2. Excluded shares

For those over the age of 24, another wide-ranging exception is available where the individual holds a significant interest in the corporation. If an individual is at least 25 years old and owns shares with at least 10% of both votes *and* value of the corporation, then the split income rules will not apply. For 2018, you have until the end of the year to satisfy the 10% share ownership requirement.

Under the CRA's guidance, if shares are owned by a family trust, they will not be considered to be owned by beneficiaries for purposes of the 10% test.

This exception is not available for professional corporations (such as those for physicians, dentists, lawyers and others), or for corporations where at least 90% of the business income is from the provision of services.

3. Reasonable rate of return

The split income rules will not apply if the income received is considered a "reasonable return," as compared to contributions made by other people to the business. For those over the age of 24, among the criteria considered are: the work performed, the property contributed and risks assumed.

The CRA also stated that it "does not intend to generally substitute its judgment of what would be considered a reasonable amount unless there has not been a good faith attempt to determine a reasonable amount based on …" the criteria to determine a reasonable return.

This exception, however, is not as generous for those in the 18-24 year-old age range. The only factor that will be considered for these young adults is the "arm's length capital" that they have contributed. The value of work performed for a corporation is ignored for this age group. To qualify as "arm's length capital", the funds cannot have been acquired from related parties. Salary

received from a corporation that is reinvested in that or another corporation is acceptable, but not dividends or interest received from a private corporation.

Where capital invested does not satisfy the definition of "arm's length capital," the permitted rate of return before the split income rules come into play for this age group is calculated based on the CRA prescribed interest rate, which is currently 1% (until at least March 31, 2018).

4. Retirement

A further exception is available to accommodate certain retirees. If a shareholder is at least 65 years of age, and if income received directly by that person would not be subject to the split income rules, income received by the shareholder's spouse or common-law partner won't be subject to the split income rules. This is consistent with the current rules for pension income splitting.

5. Capital Gains

Exemptions to the application of the proposed TOSI rules apply to certain capital gains realized on the disposition of private company shares.

When an individual dies, he or she is deemed to have disposed of all of their capital property, including private company shares, at their fair market value. If such a capital gain arises on a person's death as a result of this deemed disposition, then the split income rules will not apply.

Also, if the capital gain is derived from the disposition of either qualified farm or fishing property, or qualified small business corporation shares, on which the lifetime capital gains exemption[1] ("LCGE") could be claimed, then the split income rules will not apply. If, however, the individual is under the age of 18, and the shares are transferred to a related party, then this exception will not apply and the capital gain will be subject to the split income rules.

Action Items:

- Where dividend payments would be split income if paid to a shareholder under age 25, but would not be split income if they were at least 25 years of age, consider delaying the payments until the shareholder reaches 25 years of age.
- Where a shareholder under age 25 works in a business, but does not satisfy the average of 20 hours per week test, make sure the shareholder is paid a reasonable salary, and is not compensated for work performed through dividend payments.
- Consider the full effect of these proposed rules before finalizing any contemplated estate freeze transactions. Dividends and gains earned after 2017 on shares purchased for a nominal amount may be subject to tax at the highest rate.
- Review the share structure of any private corporations to determine if a reorganization should be considered.
  - You might consider changing the share structure to allow shareholders to qualify for the excluded share exception.
  - If more than one shareholder owns shares of the same class, corporate law might require you pay the same rate of dividends to all shareholders of the same class of shares. If you cannot pay dividends to one shareholder without causing another shareholder to receive dividends that would be taxed at the highest tax rate, you might consider a corporate reorganization so that the shareholders own different classes of shares.

Proposed limitations to access the Lifetime Capital Gains Exemption (LCGE) — WITHDRAWN

July 18, 2017 Proposals

The government expressed concern that the LCGE is being multiplied within related groups. This can happen where a family trust is a shareholder, and more than one individual (each individual trust beneficiary) claims the LCGE which reduced the taxable capital gain realized on the disposition of private corporation shares. In July 2017, various measures were proposed to prevent this from occurring.

Responding to numerous concerns of potential unintended consequences from the proposed measures, such as the possible impact on intergenerational transfers to family members, the government announced on October 16, 2017 that it will not be proceeding with the measures previously proposed to limit access to the LCGE. **The draft legislation released on December 13, 2017 implements this retraction.**

As such, it remains possible to use a discretionary family trust to hold common shares in a private corporation and multiply the LCGE by distributing gains to individual trust beneficiaries; however, any dividends received by a trust beneficiary on those shares could be subject to the split income rules if the trust beneficiary does not qualify for any exceptions.

Passive Investment Income

One of the goals of the current system for taxing private corporations is that after-tax income earned through a corporation is approximately equal to after-tax income earned by an individual directly, after taking into account the personal tax liability on the dividend paid to move funds out of the corporation.

That is,

	Corporate taxes on earnings
+	Personal taxes on dividends
=	Personal taxes on income otherwise earned directly

The tax rate on income earned in a corporation is generally much lower than the top personal marginal tax rate for an individual income earner; consequently, until income is withdrawn from a corporation as a dividend, there is more after-tax income to invest within the corporation than there would be if the income was earned by the individual.[2]

If these funds are invested inside the corporation over long periods of time, a shareholder may end up with more after-tax income within the corporation at the end of the investment period because of the higher starting capital. This is commonly referred to as the "tax deferral advantage." Where income earned in the corporation is taxed at the lower small business rate, the tax deferral advantage, ranging from 35% to 40% in 2017,[3] is magnified. The government considers this unfair and would like to neutralize this tax deferral.

Example

Amira is an Ontario resident and pays tax at the top marginal tax rate. If she, as a "sole proprietor," earns $10,000 of business income personally from an unincorporated manufacturing business, after paying taxes she would have approximately $4,700 left for investment purposes. If, however, Amira earned that $10,000 through a private corporation paying tax at the small business tax rate, the private corporation would be left with $8,500 after-tax to invest. Even though the after-tax business income and the investment income would be taxable in Amira's hands once paid out as a dividend, she is likely to end up with more after-tax income from the private corporation at the end of the investment period because of the higher starting capital of $8,500 rather than $4,700.

The government paper provided two potential approaches to end this deferral but draft legislation was not included. The approach that the government appeared to be considering would make the currently refundable tax on investment income no longer refundable, unless the investments arose from capital contributions from shareholders. It has been estimated that this would result in a tax rate of over 70% on certain passive income earned within a private corporation and approaching 60% on capital gains.

It was expressed that any new rules would apply on a go-forward basis.

On October 18, 2017 the government announced that this measure will now be limited in scope: there will be a $50,000 annual investment income threshold before this new tax regime will apply. Mention was made that this would be the return on $1 million of investments, assuming a 5% rate of return. The government estimates that only 3% of private corporations earn more than this amount in a year. The purpose of the $50,000 threshold is to permit savings within private corporations for such uses as funding a parental or sick leave, so as to alleviate concerns raised during the consultation process.

The government also reinforced previous announcements that the new rules will apply on a go-forward basis only. This refers to both investments and income earned on those investments.

Further, on October 20, 2017 the government acknowledged concerns raised by the venture capital community, which pointed out that private corporations are an important source of funding for this sector. Although no assurance was provided, the government indicated that in developing the new rules, they will consider whether capital gains from the sale of shares of a corporation that carries on an active business should be excluded.

Draft legislation to implement this proposal will be released as part of the 2018 federal budget.

Action Items:

- Consider withdrawing sufficient salary from a private corporation to maximize contributions to RRSPs and TFSAs.
- Since the passive investment rules should only be applied prospectively, there should not be a need to withdraw already-taxed retained earnings from your corporation. The new rules are expected to tax only future investment income on future earnings at the higher, non-refundable, rate of tax.
- If these rules come into play in the future, consider whether an Individual Pension Plan or corporately-owned life insurance may be appropriate.

Converting Income into Capital Gains (WITHDRAWN)

There are currently anti-avoidance rules in place to prevent converting dividend income from private corporations to capital gains, which are taxed at a lower tax rate. The government was concerned that the current anti-avoidance rules do not specifically address certain transactions that they consider to be abusive.

The paper and draft legislation contained an expansion of the current rules which were proposed to be effective July 18, 2017. The proposed rules would have impacted certain post-mortem tax planning that provides relief from double taxation where private corporation shares are held at death. This is commonly referred to as a “pipeline transaction.”

The rules could also have treated capital gains realized on the disposition of private corporation

shares to a family member as dividends. This was in addition to the gain being subject to the highest tax rate if it is considered split income.

In response to concerns expressed during the consultation period, the government announced on October 19, 2017 that it will not be moving forward with the proposals regarding converting of income into capital gains.

Conclusion

The proposals affecting the taxation of CCPCs are extremely complex. The consultation process between the Department of Finance and interested parties resulted in a number of modifications to the proposals. Those who may be impacted should consult tax and legal advisors to determine any actions that they may wish to take.

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[1] The LCGE exempts the first $835,716 (2017 amount) of lifetime capital gains on the sale of qualifying small business corporation shares from tax. For qualified farm or fishing property, the exemption is $1 million.

[2] Assuming the shareholder pays tax at the top marginal tax rate.

[3] On October 16, 2017, the government announced that it will be decreasing the federal income tax rate on small business income, which would also increase the tax deferral advantage, by 0.5% in 2018 and by a further 1% in 2019.

Disclaimer:

As with all planning strategies, you should seek the advice of a qualified tax advisor.

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