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Canadian Tax Alert

Finance proposals on “Tax Planning Using Private Corporations”: Holding passive investments inside a private corporation

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On July 18, 2017, the Department of Finance issued broad sweeping proposals impacting private corporations and their owners. Our July 26, 2017 Canadian Tax Alert provided an overview of all the changes, and outlined typical scenarios that could be affected by the proposals.

This Canadian Tax Alert looks specifically at the proposed changes to holding passive investments inside a private corporation, and is aimed at providing a more thorough analysis of those proposals, with examples of how the proposals could affect various transactions and structures.

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Framework

Under the general description of “holding passive investments inside a private corporation”, the Minister of Finance is seeking to eliminate the perceived tax advantage of entrepreneurs earning passive income through a private corporation that was taxed at lower corporate tax rates. Under the current rules, corporate tax deferral can allow for a larger accumulation of capital within the corporation and a higher amount of net after-tax cash once the funds are distributed to an individual shareholder in comparison to an individual earning the same funds personally and investing the net after-tax cash once the highest amount of personal tax is paid.

The July 18th, 2017 government proposals outlined potential approaches to deal with the taxation of passive investments within a Canadian-controlled private corporation (CCPC) and the ultimate dividend distribution to individual shareholders. The proposals put forward are under public consultations and no draft legislation has been released. There is also no certainty with reference to the timeframe in which such draft legislation may be released and subsequently, enacted.

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Current rules

Currently, aggregate investment income (i.e., interest, rent, capital gains and dividends), earned by a CCPC is subject to the following rules:

- Interest and rental income is subject to provincial corporate income tax rates that vary between 11% and 16%. At the federal level, the corporation is liable to pay tax on this income at 38⅔ %, bringing the combined federal-provincial tax rate between 49.67% and 54.67%. A portion of the federal taxes paid is refundable upon the payment of taxable dividends.[1]
- The taxable portion of the capital gains is taxed following the same rules as interest and rental income (including the refundable tax regime where $30^{2}/_{3}$% of the tax is refundable upon payment of taxable dividends). The non-taxable portion of the capital gain is added to the "capital dividend account” (CDA). The capital dividend account is a tax pool that entitles a corporation to file an election to distribute amounts on a tax-free basis to shareholders (by paying a "capital dividend").
- As a general rule, dividends received from a connected corporation can be received on a tax-free basis by a CCPC. A corporation is connected to another where it controls or owns more than 10% of the votes and more than 10% of the value of all shares. Other dividends received from non-connected corporations are subject to a refundable federal tax representing 38⅓% of the dividend received. This refundable tax can also apply where a dividend is paid by a connected corporation that is entitled to a refund of refundable tax. The refundable tax is added to the refundable dividend tax on hand (RDTOH) account of the corporation and is refundable upon payment of taxable dividends to shareholders.

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[1] A portion of the tax representing 30⅔% of the taxable investment income is refundable upon payment of taxable dividends.

The objective of the current rules is to ensure that a dollar of passive investment income earned via a corporation and distributed to shareholders as dividends bears a tax burden, when corporate and personal taxes are combined, that is roughly similar to that of a dollar of passive investment income earned directly by an individual. The tables below illustrate the taxation of active business income[2] and passive income earned through a corporation under the current rules in comparison to salary or passive income earned directly by an individual[3] (based on tax rates applicable in Ontario).

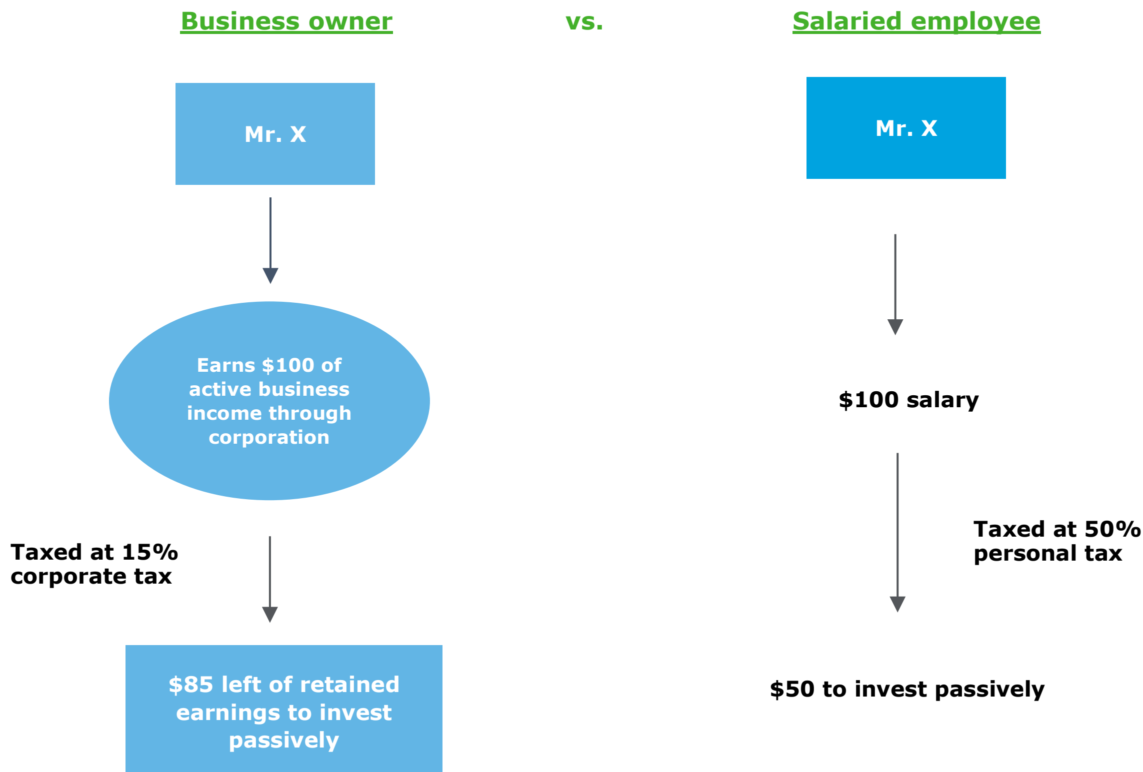
Example of taxation of active business income vs. salary		
	Individual	Corporation
Income earned	500,000	500,000
Corporate tax		(75,000)
Amount available for distribution		425,000
Individual Tax	(267,650)	(192,525)
Net after tax earnings for individual/shareholder	232,350	232,475

Example of taxation of passive income		
	Individual	Corporation
Passive income earned (interest)	500,000	500,000
Corporate tax		(250,850)
		249,150
Refundable tax portion		153,350
Amount available for distribution		402,500
Individual tax	(267,650)	(182,333)
Net after tax earnings for individual/shareholder	232,350	220,167

Basis for the Government's proposals

Under the current rules, Canadian individuals earning business income through a private corporation are able to defer personal taxation on this business income until the payment of dividends by the corporation. As such, contrary to individuals earning salary or self-employed income which is generally taxed at higher rates, the individual reinvesting net profits earned through a corporation can benefit from having a larger amount of capital to invest as shown in the following diagram.

[2] Assuming the income is eligible to the small business deduction.
[3] The individual tax presented in the table is assumed to be at the highest applicable marginal tax rates.



Approaches under consideration

In its proposals, the Government is presenting two broad approaches that would be applicable on a prospective basis, implying that a number of transitional rules could be put in place. The two approaches can be summarized as follows:

- The "1972 approach", where a refundable tax is applied on any net earnings of a corporation that are not re-invested to acquire business assets; and
- The deferred taxation approach, where the current refundable tax regime will be replaced with a non-refundable tax and the non-taxable portion of capital gains on investment assets would no longer be added to the corporation's CDA.

<u>The 1972 approach</u>

Under the 1972 approach, any net active business profits earned through a private corporation that is not reinvested in assets used in an active business would be subject to an immediate additional refundable tax (similar to the current RDTOH). As a result, these earnings would be subject to a tax rate equivalent to the highest marginal tax rate of an individual.

Considering the potential adverse cash flow implications of this approach and the difficulties that can be associated to the tracking of the funds reinvested in business operations/assets, the Department of Finance indicated that this approach was not being considered at this stage.

<u>The deferred taxation approaches</u>

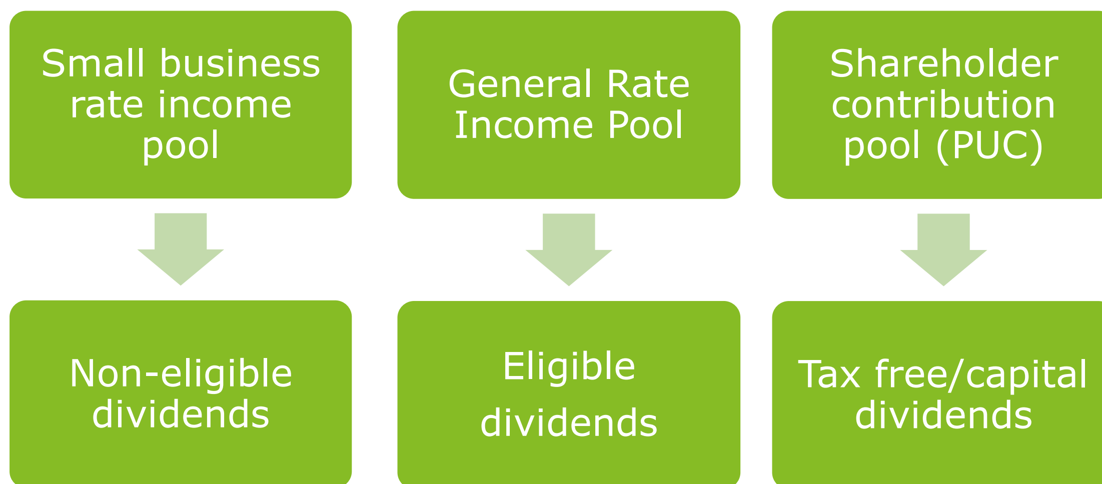
Under the deferred taxation approaches, passive investment income would be taxed at a rate equivalent to the top personal tax rates (i.e. theoretically assumed to be 50%) and no portion of such tax would be refundable. Furthermore, the Department of Finance is questioning whether there should still be additions to the CDA in relation to the non-taxable portion of capital gains realized by corporations. The deferred taxation approaches

proposed by the Department of Finance should not otherwise impact the immediate taxation of active and passive income earned at the corporate level, but would impact the taxation of corporate distributions to individual shareholders.

Two methods are currently being contemplated to determine the tax treatment of distributions paid from passive income: the apportionment method and the elective method. Under both methods, certain corporations focused on passive investments could be entitled to file an election to maintain the current regime applicable to passive earnings earned through a private corporation.

The apportionment method

The apportionment method requires a tracing of the sources of the funds used to acquire investment assets owned by a corporation. Under the apportionment method, it is assumed that the passive income earned by a corporation is financed proportionally from three pools: the small business rate income pool (business income subject to small business deduction), the general rate income pool (business income taxed at the general rate) and the shareholder contributions pool. The after-tax proceeds of investment income is then allocated to each of these pools in proportion of the balance of each pool at the beginning of each year. When the corporation pays dividends, the corporation will be entitled to elect from which pool each dividend is paid, which will determine the tax rate applicable to the individuals receiving the dividends.



Non-eligible dividends (or "ordinary dividends") are taxed at higher personal tax rates[4] than eligible dividends.[5] Capital dividends can be paid on a tax-free basis.

Although the Department of Finance has indicated that a corporate taxpayer should have most of the information required to track the earnings as contemplated in relation to each pool, the complexities associated with the proposals put forward are numerous. Each corporate taxpayer would need to track three separate pools of earnings. Furthermore, shareholder contributions would presumably need to be tracked by shareholder and class of shares and elections may be required for passive investment corporations. Finally, both the current refundable regime and the proposed amendments may co-exist for the same corporate group and various transitional provisions would need to consider the impact of current CDA, RDTOH and general rate income pools. The result would likely be a significant increase in the compliance burden for taxpayers.

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[4] Highest marginal tax rates on non-eligible dividends range from 39.62% to 46.97% depending on the province of the individual.

[5] Highest marginal tax rates on eligible dividends range from 31.30% to 42.62% depending on the province of residence of the individual.

The elective method

Alternatively, the elective method provides that private corporations would be subject to a default tax treatment, unless they elect otherwise. Under the default treatment, all dividends paid from investment income would be treated as non-eligible dividends while, under the elective treatment, all dividends paid from investment income would be treated as eligible dividends. However, under the elective treatment, the corporation would no longer be entitled to claim the small business deduction on its first $500,000 of active business income. The tables below provide a comparative summary of the default and the elective treatments under the elective method.

Comparative summary of default and elective method

	Default method	Elective method
Access to small business deduction	Yes	No
Non-refundable tax on investment earnings	Yes	Yes
Dividend distributions on passive income	All non-eligible	All eligible
CDA on capital gains from investment assets	No	No
Recognition of shareholder contributions on eventual distributions	No	No

It should be noted that the default treatment is based on the assumption that all investments of a private corporation are financed with low taxed business earnings of the corporation. In contrast, the elective treatment assumes that all income earned by the corporation is subject to general tax rates. It should be noted that under both approaches, the elective method does not recognize that shareholder contributions could have been used to acquire passive investments. Therefore, shareholders that financed their private corporations with equity in greater proportion would be disadvantaged under the elective method in comparison to the apportionment method.

In summary, under the deferred taxation approaches, a tax deferral would still be maintained at the corporate level, leaving more funds available for re-investment by the corporation. However, the portion of tax on investment income representing 30 $^{2}/_{3}$% of the investment income would no longer be refundable upon distributions to shareholders. As a result, the effective tax rate on investment income earned through a corporation will increase to 70%-75% when the income is distributed to individuals (unless attributable to shareholder contributions under the apportionment method) (see the table below). These high effective tax rates could also be applicable to certain businesses considered to be specified investment businesses. For instance, an individual operating, through a private corporation, a car rental business with 5 or less employees could be subject to these high effective tax rates. Finally, the concepts elaborated by the Government would require the tracking of a number of tax pools and elections and thus would most likely result in an increase in tax compliance costs.

Passive income earned by a corporation under the deferred taxation approaches	
Passive income / income from specified investment business	100,000
Corporate tax (theoretical 50% tax rate)	(50,000)
Amount available for distribution (non-eligible dividend)	50,000
Personal tax on distribution (Ontario)	(22,650)
Amount available to shareholder	27,350
Effective tax rate	72.65%

Election for corporations focused on passive investments

Under both the apportionment and the elective methods, an election to maintain the current regime will be available to a corporation who meets the following conditions:

- Uses earnings that were taxed at the personal level to fund passive investments (i.e. equity from share capital);
- Is not engaged in an active business; and
- Only earns passive income.

The eligibility for the election is very restrictive, entitling only a limited number of corporations to file the election. Furthermore, until further information is released with regard to the scope and details of the propositions, given the condition that the funds must originate from taxed earnings of an individual and the proposition of certain anti-avoidance rules, the benefits of creating a structure in view of filing this election may be limited.

Application to private corporations that are not Canadian-controlled?

The proposals appear to target CCPCs only. However, the Department of Finance document raises the question on whether other private corporations, such as corporations controlled by non-residents, should be subject to these new rules. The inclusion of other private corporations in the scope of the proposed rules would greatly impact these corporations that hold investment portfolios in Canada. As illustrated in the tables below, the tax burden of these non-resident companies would increase by approximately 24% (before the application of Canadian withholding taxes on repatriation of profits outside of Canada).

Effect of including other private corporations to the scope of the proposals

	Current rules	Proposals
Investment income	100,000	100,000
Tax (non-refundable)	(26,000)	(50,000)
After-tax (before Canadian withholding tax)	74,000	50,000

These are concepts subject to consultation, not law…

The changes described herein are concepts currently subject to consultation. Draft legislation has not yet been issued and therefore these concepts do not represent law. The consultation period associated with the proposals closes on October 2, 2017 and there may be changes to the proposals as originally presented. Deloitte will be providing a submission to the Minister of Finance as part of the consultation process.

Since there remains a large number of open questions and because the proposals are highly contentious and subject to change, we caution our readers against taking premature actions that may ultimately be unnecessary or counter-productive. We believe that a thoughtful approach would dictate to wait until more specific information is released by the Government. The structuring of the holding of passive investments through corporate vehicles and the payment of dividends to recover accrued refundable tax, among other actions, should be discussed with your tax advisors. Your Deloitte tax team remains available to support you through these uncertain times.

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