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Canadian Tax Alert

Department of Finance proposals on "Tax Planning Using Private Corporations"

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On July 18, 2017, the Department of Finance released a consultation document and draft legislation containing proposals that, if enacted, will affect private companies and their shareholders. Three tax planning strategies are being reviewed:

Income sprinkling – The tax implications of a shift of income that would otherwise be realized by a high-tax rate individual to family members subject to a lower rate of tax are being considered.

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- This typically occurs when dividends are paid from a private corporation or through a trust, but can also include other types of income. A proposed "reasonableness test", which would apply to certain payments made beginning in 2018, would consider (i) the labour contribution made to the business activities of the corporation by the individual receiving the dividend; (ii) the "capital" contributed by the individual receiving the dividend; and (iii) the previous returns and remuneration paid to the individual from the business. The Department of Finance also proposes to limit the multiplication of the lifetime capital gains exemption.

- **Holding a passive investment portfolio inside a private corporation** – The Department of Finance is seeking to address certain advantages created by the deferral of tax available through Canada's current integrated corporate and personal tax regimes, whereby incorporated taxpayers who have more money to invest inside their corporations have an advantage over average employees who pay full personal rates on their income. Options to curtail this advantage could include the elimination of refundable taxes on investment income from certain sources. The Department is also proposing that the non-taxable portion of capital gains from these sources would no longer increase the capital dividend account.

- **Capital gains** – Planning that includes realizing capital gains within a related group, which historically has allowed shareholders to extract cash at lower rates via the capital dividend account, is being addressed. Proposed legislation, which would be effective as of July 18, 2017, would eliminate the advantage of these related group transactions going forward and could have an impact on certain historical transactions. Certain transactions in a mergers and acquisitions context could also be affected by the current version of the draft legislation.

Below we highlight certain practical scenarios that may be affected by the proposed legislative changes. While the final rules will only be determined after the Department of Finance has had a chance to consult with stakeholders, it is important to be aware of the issues that may potentially be relevant to a particular business or investment arrangement. In some cases, action may be advisable before 2018.

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Income sprinkling

Under the proposals, the scenarios noted below could cause certain income to be taxed at the highest marginal tax rates, and/or the denial of the lifetime capital gains exemption on the disposition of qualifying shares.

Scenario	Issues and actions to consider
Your family has established a trust which makes allocations of income or capital gains to family members	• Review the nature of the assets owned by the trust and the history of acquisition • Review the sources of income or capital gains being allocated
Your family has established a trust which owns shares of a private corporation	• Review the beneficiaries of the trust and their current unused capital gains exemption • Determine the value of shares held by trust • Consider the status of the corporation in order to determine whether the disposition of its shares will qualify for the capital gains exemption
You have family members under the age of 25 years (including children, grandchildren, siblings, nieces or nephews) who earn passive investment income	• Review the original source of the funds invested and implications of the new rules
A loan is outstanding from a party who is related to your corporation (i.e., a family member)	• Consider the need to repay the loan before the application of the proposed legislation in 2018
Your private corporation currently declares and pays dividends (or a salary) to family members	• For dividends declared before December 31, 2017, consider increasing the amount of the dividend declared • For future years, consider the impact of the proposed rules and the limitations of the reasonableness test on payments: – involvement of family members in the business – capital investment of family members in the business – previous returns and remuneration
Your company or partnership engages the services of a related company to provide management services	• Consider the implications of the proposed legislation on income allocated from the company or partnership
You are planning a reorganization of the share structure of your private corporation, including the accrual of future growth of the corporation to family members directly or indirectly by way of a family trust (commonly referred to as an “estate freeze”)	• Some historical benefits of certain succession planning may be no longer apply as a result of the proposed legislative changes

Holding a passive investment portfolio inside a private corporation

Passive income and capital not distributed to the shareholders of the private corporation may be subject to a higher tax rate. No draft legislation for these changes has been released.

Scenario	Issues and actions to consider
Your private corporation is an investment company or holds passive assets not used in your active business	• Consider and model potential benefits still available under the proposed changes • Consider restructuring in advance of the effective date of the proposed changes
Your private Canadian corporation owns US assets to limit exposure to US estate tax	• Review annual distributions from the corporation to family members • Consider the impact of any proposed changes on the structure compared to the US estate tax savings

Capital gains

Realizing a capital gain in your private corporation could be subject to higher taxes under the proposed legislation.

Scenario	Issues and actions to consider
Your private corporation is currently in the process of disposing of an asset which will result in a capital gain	• Certain proposed changes could affect the tax consequences of this transaction, and make the planning less beneficial • Consider the impact of the proposed changes on your tax plan
Your private corporation was previously involved in a sale or transfer of assets or shares between related parties which resulted in a gain prior to July 18, 2017	• Consider whether there are any potential implications of the proposed legislation on tax balances arising from the transaction
A shareholder of a private corporation is disposing of shares to a related person after July 18, 2017	• Review the potential impact of the proposed legislation which will, if enacted as currently proposed, apply to dispositions occurring on or after July 18, 2017
You own shares that could be eligible for the capital gains exemption	• Consider whether the proposals will affect the tax implications on a future disposition
As part of an anticipated estate plan, a current shareholder is relying on a post-mortem tax planning to prevent double taxation	• Revisit the estate plan

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