



TaxNewsFlash Canada

Finance Targets Private Company Tax Planning

July 18, 2017
No. 2017-38

Owners of private companies in Canada may want to review and comment on a consultation paper released by Finance. This paper includes significant measures and complex proposed rules and approaches to address certain tax planning strategies involving private corporations that Finance believes “inappropriately reduce personal taxes”. Finance is seeking input on its proposals by October 2, 2017.

The 63-page paper, “Tax Planning Using Private Corporations”, outlines the proposals to address tax planning involving income sprinkling using private corporations and converting a private corporation’s income into lower-taxed capital gains. In addition, Finance is seeking comments on possible approaches to address planning where passive investments are held inside a private corporation. Most of the proposed measures generally apply to the 2018 and subsequent tax years, except for certain measures dealing with the proposed anti-surplus stripping rule which would apply to shares disposed of, and amounts received or become receivable, on or after July 18, 2017 (i.e., the consultation paper’s release date).

In addition to the consultation paper, Finance also released 26 pages of proposed legislation and 47 pages of accompanying explanatory notes to implement certain proposals. This edition of *TaxNewsFlash-Canada* provides highlights of Finance’s proposed changes and approaches to address these strategies.

Background

Finance announced that it would conduct a review of tax planning strategies involving private corporations in the 2017 federal budget and that it would introduce a consultation

paper on this issue (see [TaxNewsFlash-Canada 2017-10, “Federal Budget Highlights”](#)). Finance said it would review specific tax planning strategies including:

- Income sprinkling using private corporations
- Converting a private corporation’s income into capital gains
- Holding a passive investment portfolio inside a private corporation.

In 2015, the government stated in its election platform that it would ensure that Canadian-controlled private corporation (CCPC) status would not be used to reduce the income tax obligations of high-income earners (see [TaxNewsFlash-Canada 2016-07, “2016 Federal Budget—What Tax Changes are in Play?”](#)).

Ontario also announced in its 2017 budget that it intends to review the taxation of private companies (see [TaxNewsFlash-Canada 2017-25, “Highlights of the 2017 Ontario Budget”](#)).

Income sprinkling using private corporations

“Income sprinkling” involves reducing income taxes by causing income that would otherwise be realized by an individual at a high personal income tax rate to instead be realized by family members who are subject to lower personal tax rates.

Tax on split income rules

To address income sprinkling, Finance proposes to extend the tax on split income rules (i.e., “kiddie tax”) to apply to certain adult individuals, but generally only where the amount is “unreasonable” under the circumstances. The reasonableness test would apply to split income, which includes income from the business of a related individual and a corporation over which a related individual has influence. Factors that will be considered to determine reasonableness include labour and capital contributions to the business, risk assumed and previous returns or remuneration. If an amount is determined not to be reasonable, the top marginal tax rate will apply. These rules will be more restrictive for family members aged 18-24.

Currently, the tax on split income does not apply to “compound” income (i.e., income earned from an investment that is subject to the tax on split income). This income is taxed at the lower rate applicable to the family member who earned the compound income. Under the proposals, compound income will be subject to the tax on split income. Further, compound income and certain other amounts, of an individual under the age of 25 will also be subject to the tax on split income.

The proposed measures expand the types of income that are considered to be split income (however these rules would still not generally apply to income received by an individual as salary, wages or certain inherited property). These proposed measures would apply to the 2018 and subsequent tax years.

An individual's split income would be included in determining whether the individual qualifies for certain income-tested benefits (e.g., personal tax credits that depend on income).

Lifetime capital gains exemption

To address income sprinkling by multiplying the lifetime capital gains exemption across multiple family members, Finance proposes to no longer allow individuals to qualify for the exemption for capital gains that are realized, or that accrue, before the taxation year in which the individual turns 18. Further, gains that accrued during the time that property was held by a trust would generally no longer be eligible for the exemption, subject to certain exceptions (including for spousal or common-law partner trusts, alter ego trusts and certain employee share ownership trusts). In addition, the capital gains exemption 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.

These proposed measures would generally apply to dispositions after 2017. However, special transitional rules would allow affected individuals to elect to realize, on a day in 2018, a capital gain on eligible property by way of a deemed disposition for proceeds up to the fair market value of the property. The election would be available for property owned by the individual continuously from the end of 2017 until the day of the deemed disposition. Capital gains realized under the election would generally be eligible for the lifetime capital gains exemption using the current tax rules.

Tax reporting requirements

Finance proposes to introduce tax reporting requirements related to a trust's tax account number, similar to the requirements for corporations and partnerships (known as "business numbers"). In addition, Finance is considering measures to ensure that the T5 slip's interest amount requirements apply to partnerships and trusts in the same circumstances in which they apply to corporations. The proposed measures would apply to the 2018 and subsequent tax years.

Converting a private corporation's income into capital gains

Anti-surplus stripping rule

Finance proposes changes to prevent individual taxpayers from using non-arm's-length transactions that "step-up" the cost base of shares of a corporation and avoid the application of section 84.1. The anti-surplus stripping rule in section 84.1 is generally intended to prevent corporate surplus from being extracted at the lower capital gains tax

rates instead of the higher dividend tax rates where an individual sells shares of the corporation to a non-arm's-length corporation. If certain conditions are met, then the purchaser corporation is deemed to have paid, and the individual taxpayer is deemed to have received, a dividend. This effectively prevents capital gain treatment if the taxpayer receives non-share consideration that exceeds the shares' tax attributes.

Specifically, Finance proposes to reduce the cost base of the taxpayer's share by the total of all capital gains realized on previous dispositions of the share by the taxpayer and any non-arm's length individual. This cost base reduction will apply regardless of whether a capital gains exemption was claimed on the previous disposition. Currently, this cost base reduction rule only applies to reduce an individual's cost base where the capital gains exemption was previously claimed (or where the gain is a tax-free pre-1972 gain). Finance says that although this change could give rise to both a capital gain on a "step-up" transaction and a taxable dividend on a subsequent non-arm's-length disposition, it is ultimately intended to discourage taxpayers from trying to avoid section 84.1.

Intergenerational transfers of shares

Finances states that, although it has been suggested that a genuine intergenerational transfer of shares of a small business corporation to an adult child's corporation should be treated in the same manner as a sale to an arm's-length corporation, a major policy concern is distinguishing a genuine intergenerational business transfer from a section 84.1 avoidance transaction undertaken among family members. As a result, Finance is interested in feedback on whether, and how, it would be possible to better accommodate genuine intergenerational business transfers.

New anti-surplus stripping rule

Further, Finance proposes to introduce a separate anti-surplus stripping rule to address tax planning that it believes circumvents the rules on the conversion of a private corporation's surplus into tax-exempt, or lower-taxed, capital gains. This anti-surplus stripping rule would generally apply to non-arm's-length transactions where it is reasonable to consider that "one of the purposes" of a transaction or series of transactions is to pay an individual shareholder/vendor non-share consideration (e.g., cash) in a manner that involves a "significant disappearance" of the corporation's assets. In such a case, the non-share consideration would be treated as a taxable dividend, instead of a capital gain.

According to Finance, these changes would apply to shares disposed of, and amounts received or that become receivable, on or after July 18, 2017.

KPMG observations

Capital gains are taxed at a lower rate than regular income, eligible and non-eligible dividends. In the case of regular income, capital gains are taxed at only half the rate of regular income. This potential tax savings is in the 25% range. Compared to eligible dividends, tax on capital gains can be about 6.5% to almost 17% lower. In the case of

non-eligible dividends, the tax on capital gains can be about 16% to 20% lower, depending on your province of residence. The following table illustrates the difference in the tax rates between capital gains and other types of income:

Combined Top Marginal Tax Rates for Individuals - 2017							
	Tax on Capital Gains	Regular Income		Eligible Dividends		Non-Eligible Dividends	
		Rate	Difference	Rate	Difference	Rate	Difference
British Columbia	23.85%	47.70%	23.85%	31.30%	7.45%	40.95%	17.10%
Alberta	24.00%	48.00%	24.00%	31.71%	7.71%	41.29%	17.29%
Saskatchewan	23.88%	47.75%	23.87%	30.33%	6.45%	39.62%	15.74%
Manitoba	25.20%	50.40%	25.20%	37.79%	12.59%	45.74%	20.54%
Ontario	26.76%	53.53%	26.77%	39.34%	12.58%	45.30%	18.54%
Quebec	26.65%	53.31%	26.66%	39.83%	13.18%	43.84%	17.19%
New Brunswick	26.65%	53.30%	26.65%	33.51%	6.86%	46.25%	19.60%
Nova Scotia	27.00%	54.00%	27.00%	41.58%	14.58%	46.97%	19.97%
Prince Edward Island	25.69%	51.37%	25.68%	34.23%	8.54%	43.87%	18.18%
Newfoundland and Labrador	25.65%	51.30%	25.65%	42.62%	16.97%	43.62%	17.97%

Holding a passive investment portfolio inside a private corporation

Owners of private corporations may accumulate earnings where they hold a passive investment portfolio inside a private corporation, since corporate income tax rates are generally lower than personal tax rates. Although Finance has not yet released proposed legislation to address the tax treatment of passive investment income inside a private corporation, the consultation paper asks for feedback on possible approaches and design considerations to ensure neutrality.

Background

As corporate tax rates are generally lower than personal tax rates, there is an incentive to earn income in a corporation and then retain the after tax earnings in the corporation to earn passive income. While the current tax system applies additional refundable taxes on passive income to ensure that the tax paid on the passive income approximates that which an individual in the top tax bracket would pay, Finance states that there is no tax provision to align the earnings available to fund the passive investment within the corporation with the after tax amount that would be available to the individual if such income was earned individually. As a result, the use of a corporation results in a greater amount of funds being available for passive investment or savings.

Finance is seeking to introduce rules to eliminate the financial advantages of investing passively through a private corporation by introducing an alternative approach of taxation.

The new regime would essentially replace the current regime of refundable taxes on passive investment income so that the passive investment of an individual investing in their

private company would be taxed at the same rate as a salaried individual at the top personal tax rate. Finance says that the new regime is intended to apply on a “go-forward basis”.

Apportionment method vs. elective method

Finance contemplates two broad methods to determine the tax treatment of dividends paid from passive investments: an apportionment method and an elective method. The apportionment method would require tracking income taxed at the small business corporate rate, income taxed at the general corporate rate, and amounts contributed by shareholders. Annual passive investment income of the corporation would be apportioned based on the corporation’s cumulative share of these three separate pools, which could be distributed to shareholders as non-eligible dividends, eligible dividends or tax-free dividends (e.g., return of paid-up capital), respectively.

Under the elective method, on the other hand, passive income earned in a CCPC would be subject to non-refundable taxes (generally equivalent to the top personal income tax rate), and dividends distributed from such income would be treated as non-eligible dividends by default. Corporations could elect, at the expense of foregoing a small business deduction, to treat the dividends paid out from passive income as eligible dividends.

Under both methods, there will be no refundable taxes. All passive income will be subject to a non-refundable tax. However, Finance envisions allowing taxpayers to make an election that would result in all income generated by the entity being taxed as passive investment income (and therefore taxed at a level that approximates the top personal income tax rate), yet subject to a refundable dividend tax regime. If the election is made, all income earned within the entity would be subject to refundable taxes, which would be refunded upon distribution of income via taxable dividends (similar to the current regime), effectively removing any deferral advantages.

Other considerations

This new regime could affect dividends from publicly traded stocks, which can currently be distributed as eligible dividends. Finance notes that in some cases, dividend income from publicly traded stocks could no longer be treated as eligible dividends, but would instead be treated as a non-eligible dividends.

Finance also contemplates that the non-taxable portion of capital gains would no longer be credited to the capital dividend account where the source capital of the investment is income taxed at corporate income tax rates. Finance says it will consider whether additions to the capital dividend account should be preserved in certain limited situations, such as a capital gain realized on the arm’s-length sale of a corporation controlled by another corporation, where the corporation being sold is exclusively engaged in earning active income.

Finance questions

Finance is seeking specific input on the following questions:

- What approach would be preferable to improve tax fairness on passive income?
- What criteria or broad considerations should Finance consider in selecting a method?
- What are the considerations for the tax treatment of corporations mostly engaged in passive investments?
- What would be the appropriate scope of the new tax regime with respect to capital gains, and what criteria should Finance use to make this determination?
- Are there key transition issues that should be brought to Finance's attention?
- Is there any reason why any aspects of the new rules should not apply to private corporations other than Canadian-controlled private corporations?
- Are there any gender equity impacts involved in these potential changes?

Finance indicates that, following these consultations, it will bring forward a detailed proposal to address the tax treatment of passive investment income and provide time before it becomes effective.

Impact of Finance's changes

These are significant changes that will surely affect many owners of private corporations across Canada. We will be following the progress of this consultation closely, including continuing to assess the impact on tax planning for these owners.

We can help

Your KPMG adviser can help you assess the impact of any potential changes to the taxation of private companies that may result from this consultation paper and the accompanying proposed legislation. For details on implications for your company, contact your KPMG adviser.

kpmg.ca



[Contact Us](#) | [KPMG in Canada Privacy Policy](#) | [KPMG On-Line Privacy Policy](#) | [Legal](#)



Information is current to July 18, 2017. The information contained in this *TaxNewsFlash-Canada* is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

© 2017 KPMG LLP, a Canadian limited liability partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. The KPMG name and logo are registered trademarks or trademarks of KPMG International.