Department of Finance Canada Ministère des Finances Canada

Tax Planning Using Private Corporations

Canada

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Minister's Letter

One of our Government's first actions was to cut taxes for the middle class, and raise them on the richest one per cent. Because of our Canada Child Benefit, nine out of ten families with children are now receiving more in child benefits than they did under the previous system, leaving them with more money to spend on their groceries, summer camps and school supplies. Thinking about the long-term, we worked with the Provinces and Territories to strengthen the Canada Pension Plan so that workers today and future generations can look forward to a more secure retirement. And we increased the Guaranteed Income Supplement top-up benefit by over $900 annually for the most vulnerable single seniors. This focus on the middle class, the help we bring to those working hard to join it, as well as historic investments in our communities—on things like roads, bridges and water purification—have had a real, measurable impact.

In the last year, the economy added more than 300,000 new jobs. Unemployment is down, and many Canadians are more confident in their future. But we know there is more work to do. Too many people still feel as though the system is stacked against them. They work hard. When it comes to paying their taxes, they pay on time and in full. But there is a sense that some may be getting a better deal than others. It's time for the next steps in our plan to bolster the confidence Canadians have in their Government and in their economy. And it starts by making sure that we all pay our fair share of taxes—with no exceptions.

In addition to efforts to combat international tax evasion and avoidance, our Government is looking closer to home, and is taking steps to address tax planning strategies and close loopholes that are only available to some—often the very wealthy or the highest income earners—at the expense of others. Currently there are signs that our system isn't working as well as it should, specifically when it comes to private corporations. There are worrying trends. There is evidence that some may be using corporate structures to avoid paying their fair share, rather than to invest in their business and maintain their competitive advantage.

This advantage is a significant one. We have a highly competitive business environment. Canada has a general corporate tax rate that is 12 percentage points lower than our largest trading partner, the United States, and a small business rate that is the lowest in the G7. These tax advantages are in place to help Canadian businesses reinvest and grow, find new customers, buy new equipment and hire more people. Businesses big and small are the lifeblood of our economy. Our tax system is designed to help them thrive, and when the rules are applied as intended, everyone wins.

When the rules are used for personal benefit, they are not contributing to growing our economy. Rather, such practices can undermine confidence in our economy by giving tax advantages to a select few. We don't think that's fair.

Our Government is proposing solutions to close loopholes and deal with tax planning strategies that involve the use of private corporations. These are complex rules, and we recognize it will mean a big change for some. That's why, over the next 75 days, we are asking for your help in telling us where we have it right, and where we can make improvements. Our intention, it bears repeating, is to help businesses grow, create jobs and support their communities. That's the spirit in which we are making these proposals, and the spirit with which we hope to receive comments, and suggestions.

Addressing tax planning strategies, closing tax loopholes and making sure all Canadians pay their fair share is the next step in our plan; a plan that recognizes that Canadians deserve to feel confident that their Government is working for them. They deserve to feel confident in their future. My hope is that, through this consultation and the actions that result from it, we can strengthen that confidence, while protecting what makes us competitive as an economy and successful as a country.

The Honourable

William F. Morneau
Minister of Finance

Executive Summary

The Government of Canada is working to create a healthy and growing economy where businesses can create meaningful, well-paying jobs, strengthen the middle class and ensure that Canadians have confidence in their future. Essential to that confidence is knowing that the Government is working to ensure that everyone is paying their fair share of tax and that tax rules are being followed as they were intended. Confidence is fundamental to the tax system and our economy. This is why tax fairness is a part of the Government's long-term plan to create jobs and grow the economy.

In 2016, the Government launched a wide-ranging review of tax expenditures with the objective of eliminating poorly targeted and inefficient tax measures. In Budget 2017, the Government signaled its intention to address specific tax planning strategies involving the use of private corporations[1]—strategies that can result in high-income individuals gaining tax advantages that are not available to most Canadians. Over the last decade, the number of such private corporations has increased substantially and evidence indicates that a significant share of taxable income has been shifted from the personal to the corporate tax base.

This paper follows through on the Budget 2017 commitment by setting out the next steps in the Government of Canada's long-term plan to ensure greater fairness in the tax system and build the confidence needed for a growing economy. The Government is consulting Canadians on further actions to address tax planning that enables some owners of private corporations to gain unfair tax advantages.

This paper focuses on three issues identified in Budget 2017:

- *Sprinkling income using private corporations,* which can reduce income taxes by causing income that would otherwise be realized by a high-income individual facing a higher personal income tax rate to instead be realized (e.g., via dividends or capital gains) by family members who are subject to lower personal tax rates or who may not be taxable at all.
- *Holding a passive investment portfolio inside a private corporation,* which may be financially advantageous for owners of private corporations compared to other investors. This is mainly due to the fact that corporate income tax rates, which are generally much lower than personal rates, facilitate the accumulation of earnings that can be invested in a passive portfolio.
- *Converting a private corporation's regular income into capital gains,* which can reduce income taxes by taking advantage of the lower tax rates on capital gains. Income is normally paid out of a private corporation in the form of salary or dividends to the principals, who are taxed at the recipient's personal income tax rate (subject to a tax credit for dividends reflecting the corporate tax presumed to have been paid). In contrast, only one-half of capital gains are included in income, resulting in a significantly lower tax rate on income that is converted from dividends to capital gains.

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[1] Private corporations are generally corporations the shares of which are neither widely-held nor listed on a designated stock exchange.

Measures have been put in place over the years to limit the scope of some of the tax planning arrangements outlined above. Since such measures have not always been fully effective, further action is being considered:

- The Government is seeking input on proposed rules to distinguish income sprinkling from reasonable compensation for family members. The rules would help to determine whether compensation is reasonable, based on the family member's contribution of value and financial resources to the private corporation. Detailed legislative proposals to address income sprinkling are being released in conjunction with this paper.
- The Government is seeking input on possible approaches to neutralize the tax-assisted financial advantages of investing passively through a private corporation. Potential directions for improving the current system are outlined in this paper. Modifications to the current system will be designed to preserve the growth objectives of the lower taxes on active business income earned by corporations. The Government will continue to review this issue and, following consultations, will develop concrete legislative proposals.
- The Government is proposing changes to tax rules to prevent the surplus income of a private corporation from being converted to a lower-taxed capital gain, and stripped from the corporation. Detailed legislative proposals to implement the changes are being released for comment in conjunction with this paper. The Government also invites views and ideas on whether, and if so how, it would be possible to better accommodate genuine intergenerational business transfers in the *Income Tax Act* while still protecting the fairness of the tax system.

The Government has considered whether the actions proposed in this paper will be impacting men and women differently. The Government is committed to gender-based analysis, and will continue to refine its analysis of the gender impacts of the measures being contemplated with respect to private corporations. Comments on the manner in which the proposed measures may affect gender are invited.

Any changes the Government considers will maintain the benefits of a highly competitive tax regime, to the extent that these benefits are used to help corporations grow, create jobs, and innovate.

The Government is accepting submissions on these proposals until October 2, 2017. Comments may be sent to fin.consultation.fin@canada.ca.

A. Introduction

The Government of Canada has a long-term plan to grow the economy by making smart investments in the future and people of this country. The basic premise of the plan is that an economy that works for the middle class will result in a country that works for everyone.

For the benefits of economic growth to be shared widely, Canada needs a tax system that works fairly for everyone. This means ensuring that all Canadians pay their fair share. In this regard, closing tax loopholes, cracking down on tax evasion, and ensuring tax fairness are essential to preserving the ability of the Government to maintain its role in funding health care, housing, child benefits, the Coast Guard and other essential services and programs on which Canadians rely. Fairness is also essential to ensuring that Canadians have confidence that the tax system is serving the needs of everyone.

As part of the Government's next step in its long-term economic plan, Budget 2017 signaled the Government's intention to address tax planning strategies involving the use of private corporations—strategies that can result in high-income individuals gaining tax advantages that are not available to most Canadians.

As committed in Budget 2017, this paper provides details about the nature of these issues and sets out proposed policy responses to bring greater fairness to the tax system. A fundamental goal of these proposals is to ensure that corporations that actively invest in their businesses and contribute to job creation and economic growth continue to benefit from a highly competitive tax regime.

Putting an end to tax planning strategies involving the use of private corporations is part of the Government's ongoing actions to close tax loopholes and end tax planning strategies that give unintended advantages to some high-income earners at the expense of other Canadians. The Government welcomes the views of all Canadians who want to contribute to addressing the issues set out in this paper.

Tax Fairness for the Middle Class – Recent Actions

Since November 2015, the federal government's focus has been to grow the economy in a way that works for the middle class and those who are working hard to join it:

- To this end, the Government has introduced a middle class tax cut that is benefiting nearly nine million Canadians. Single Canadians who benefit are saving an average of $330 each year, and couples who benefit are saving an average of $540 each year. To help pay for this middle class tax cut, the Government raised taxes on the wealthiest one per cent of Canadians.
- It has also introduced the Canada Child Benefit (CCB). Compared to the previous system of child benefits, the CCB is simpler, more generous and better targeted to those who need it most. During the first benefit year, over 3.3 million families received more than $23 billion in CCB payments. Nine out of ten families are receiving more help than they did under previous programs, and hundreds of thousands of children are being lifted out of poverty.
- In both of its budgets, the Government increased funding for the Canada Revenue Agency's (CRA) efforts to crack down on tax evasion and combat tax avoidance, and closed tax loopholes that resulted in some taxpayers paying less than their fair share. The investment of nearly $1 billion over six years will enable the CRA to recover additional revenues of over $5 billion.

- Internationally, the Government of Canada is engaged in coordinated multilateral efforts to address base erosion and profit shifting (BEPS), including signing the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS on June 7th, 2017. The Government is also committed to increasing transparency through the automatic exchange between tax authorities of information on financial accounts held by non-residents and, accordingly, enacted legislation in December 2016 to implement the Common Reporting Standard in Canada.

In addition, Budget 2016 announced a review of federal tax expenditures with the objective of eliminating poorly targeted and inefficient tax measures. Following this review, Budget 2017 announced important steps to enhance the fairness, efficiency and effectiveness of the tax system.

A Competitive Business Environment

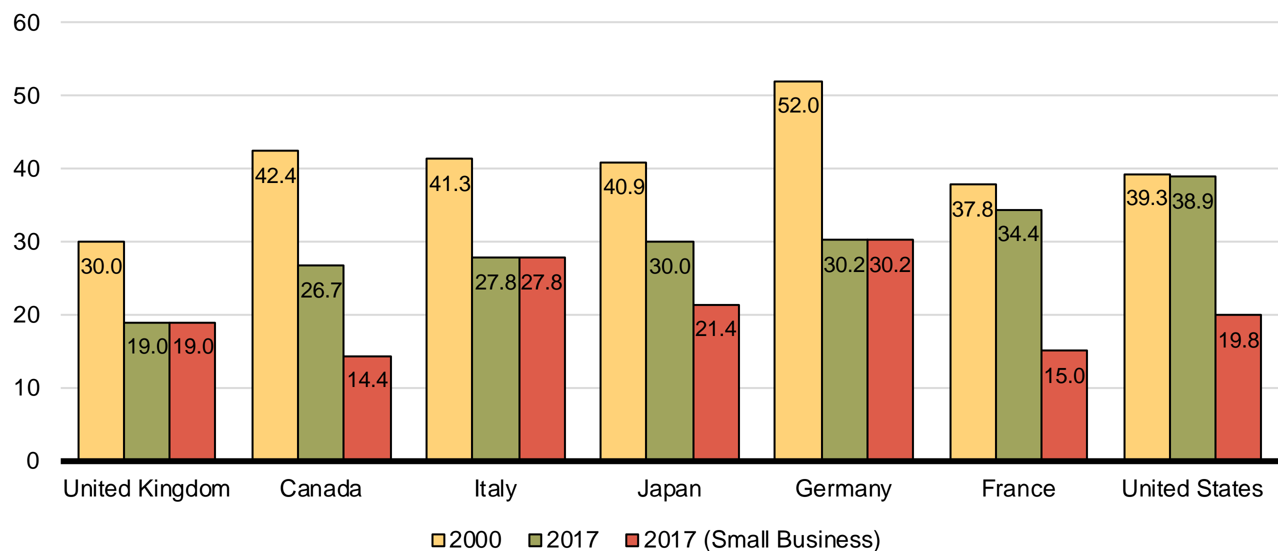
Canada's low tax rates on corporate income—including the preferential rate for small businesses—confer a strong competitive advantage to help businesses grow, create jobs and innovate. Canada has one of the most competitive corporate tax systems in the G7, as a result of significant steps to improve its corporate tax competitiveness:

- The federal general corporate income tax rate was cut nearly in half—from 29.12 per cent in 2000 to 15 per cent today.
- The federal small business tax rate has been reduced from 13.12 per cent in 2000 to 10.5 per cent in 2016. This reduction was supplemented by a series of increases to the amount of income eligible for the small business tax rate—from $200,000 in 2003 to the current $500,000 level.
- Most provinces and territories have lowered both their general corporate income tax rates and their small business rates over the 2000 to 2017 period: from 13.3 to 11.7 per cent (weighted-average) in the case of the general rate and from 6.9 to 3.9 per cent (weighted-average) in the case of the small business rate.

The combined effect of these actions is a considerable corporate tax advantage for Canada:

- In 2017, Canada's combined general corporate income tax rate of 26.7 per cent (weighted-average federal-provincial-territorial) is the second-lowest among G7 countries and close to the average general corporate income tax rate in member countries of the OECD. Canada's general corporate income tax rate is currently 12.2 percentage points lower than that of its largest trading partner, the United States.
- Internationally, Canada's combined small business corporate income tax rate of 14.4 per cent (weighted-average federal-provincial-territorial) is the lowest in the G7 and fourth lowest among OECD countries. Lower tax rates for corporations, including the preferential tax rate for small businesses, allow them to retain more earnings that can be reinvested to support growth and job creation.

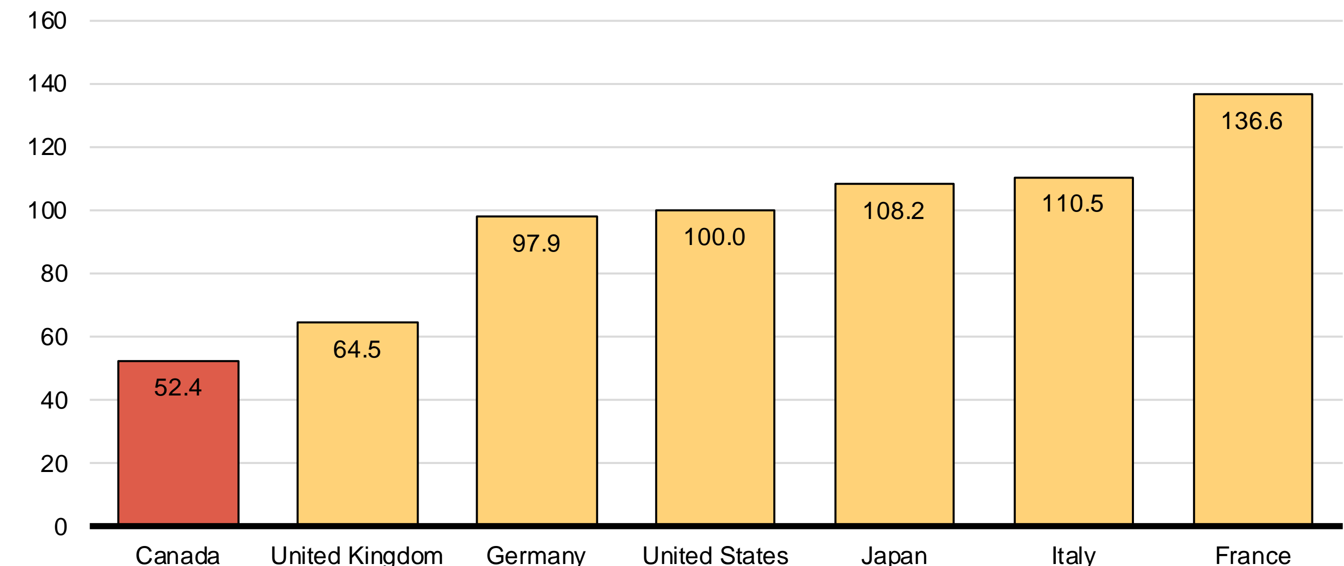
Chart 1
General and Small Business Corporate Income Tax Rates



Source: OECD Tax Database

Third-party analysis recognizes the competitiveness of Canada's tax system. For example, as illustrated in Chart 2 below, a report by KPMG, *Competitive Alternatives 2016 Special Report: Focus on Tax*, concludes that total business tax costs in Canada are the lowest in the G7 and 48 per cent lower than those in the United States.

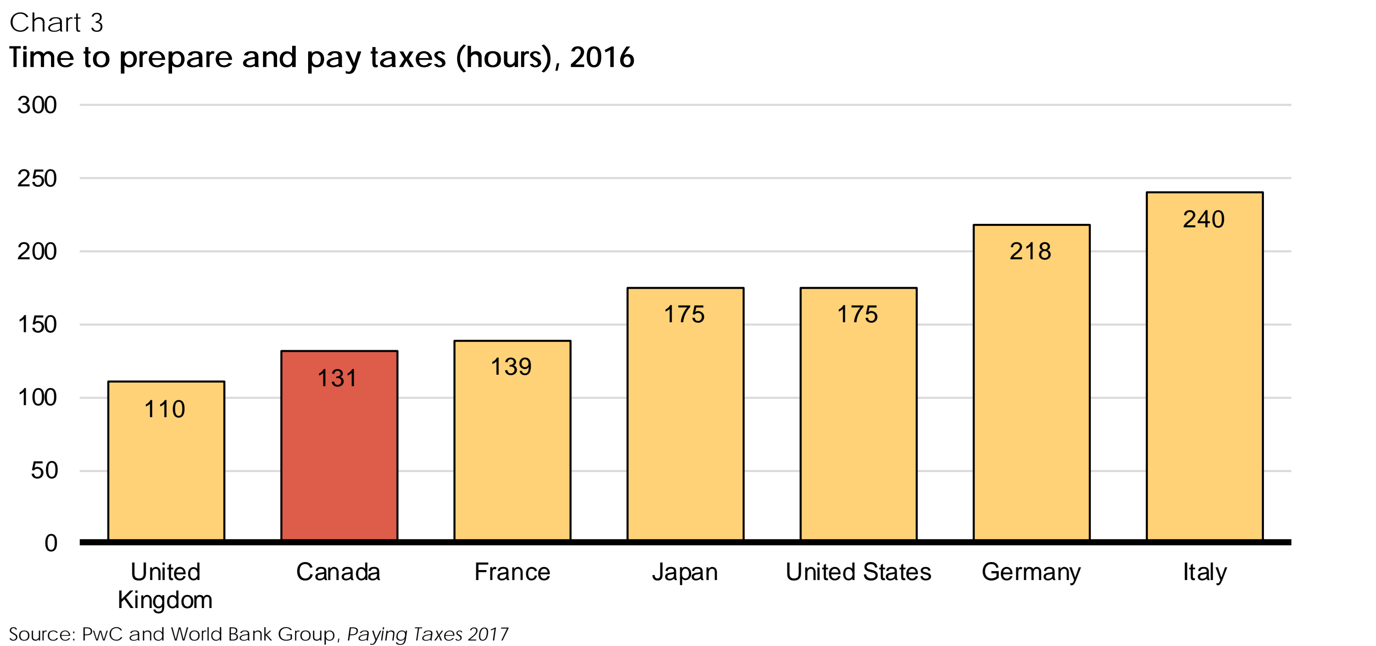
Chart 2
Total Tax Index, 2016



Source: *KPMG, Competitive Alternatives 2016 Special Report: Focus on Tax*

In addition, as shown in Chart 3, the 2017 edition of *Paying Taxes* by PwC and the World Bank Group calculates that it takes 25 per cent less time for a business in Canada to prepare, file and pay its taxes each year than is the case for a business in the United States.

Chart 3
Time to prepare and pay taxes (hours), 2016



Source: PwC and World Bank Group, *Paying Taxes 2017*

- In addition to generous tax support, small and medium-sized enterprises benefit from direct program support for scaling up, including assistance to access financing and foreign markets, support for innovation, and services to build entrepreneurial and management capacity. Of note are services and products offered by the Business Development Bank of Canada, the Canada Small Business Financing Program, Export Development Canada and the Canadian Trade Commissioner Service.

Canada's competitive business taxation and targeted program supports are reinforced by fundamental strengths including:

- A strong fiscal position, with the lowest net debt-to-GDP ratio in the G7 and a AAA credit rating.
- A sound and efficient financial system that is consistently ranked among the best in the world by the World Economic Forum (and was best-ranked for eight consecutive years).
- Preferential access to a significant and growing share of world GDP under trade agreements like CETA and NAFTA.
- A highly-skilled and diverse labour force with the highest proportion of working-age population with a post-secondary education in the OECD.

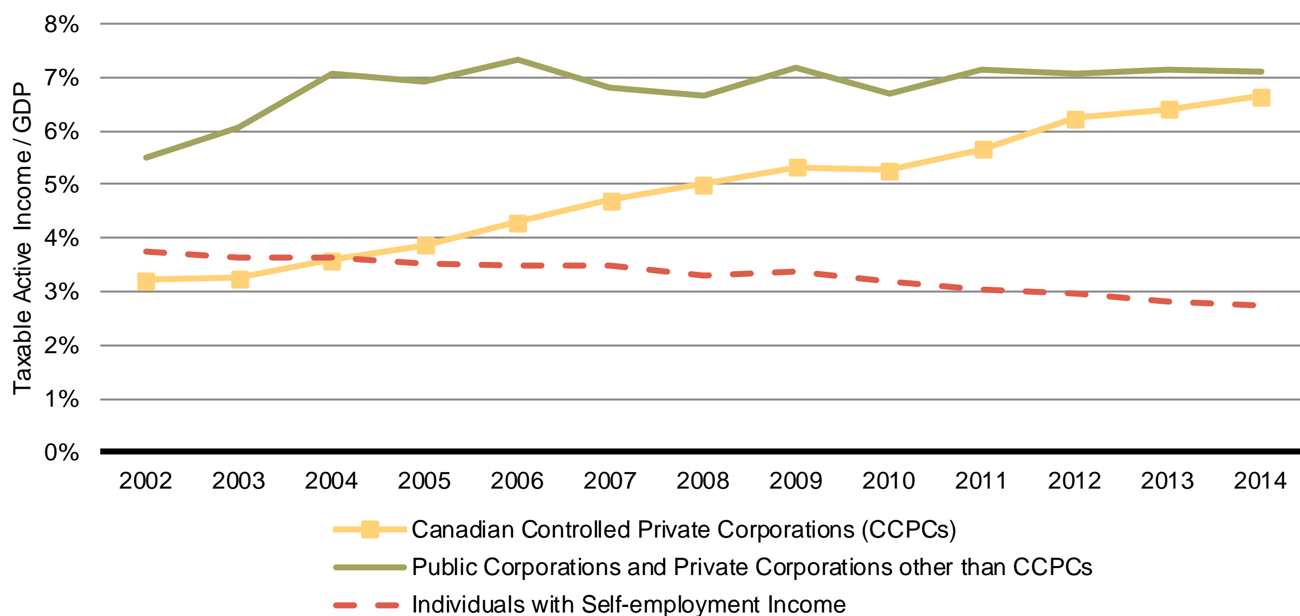
Need for Action

It is important that the tax system be reviewed on an ongoing basis, to make sure that tax rules remain fair and appropriate in light of changes in the structure of our economy. The actions discussed in this paper deal with tax measures that have been in place for a long time. In particular, the rules with respect to the taxation of passive investment income were introduced in 1972. Since then, the structure of the economy has undergone important transformations, and the tax system has also evolved significantly.

Recent years have seen a significant increase in the use of private corporations:

- The number of Canadian-controlled private corporations (CCPCs) has increased substantially, from 1.2 million in 2001 to 1.8 million in 2014. Growth has been particularly strong in some sectors; for instance, the number of corporations in professional services has tripled over the last 15 years.
- An increasing proportion of self-employed individuals—many of whom traditionally have been unincorporated—are choosing to incorporate. In some industries, the proportion of incorporated self-employed individuals almost doubled between 2000 and 2016.
- CCPCs now account for more than twice the share of taxable active business income (relative to GDP) that they did in the early 2000s (see Chart 4 below).

Chart 4
Trend in Taxable-Active-Income-to-GDP Ratio, by Type of Business



Source: T1 (Individuals) and T2 (Corporations) universe data sets, Canada Revenue Agency

In part, these trends are explained by structural changes in the economy, such as the shift toward a service economy, as well as strong economic growth in the construction and real estate industries in recent years. It is important to recognize that there are important non-tax reasons that may influence a business's decision to incorporate. However, the tax advantages afforded by tax planning in relation to private corporations have encouraged many individuals to incorporate their businesses.

In addition to strong growth in taxable active income, the amount of taxable passive investment income earned by private corporations increased from $8.6 billion in 2002 to $26.8 billion in 2015.

Increased rewards from incorporation flow in part from the growing gap—illustrated in Chart 5 below—between corporate and personal income tax rates. This growing gap has been the natural result of taking steps to improve the competitiveness of Canada's corporate tax system. Lower corporate taxes encourage new capital investment—for example, in better machinery and more efficient technology—that makes workers more productive and, in doing so, leads to economic growth, more jobs and higher wages. In an increasingly globalized economy where investment capital is highly mobile, a competitive business tax system is crucial. At the same time, the growing gap between corporate and personal income tax rates can lead to tax arbitrage behaviours.

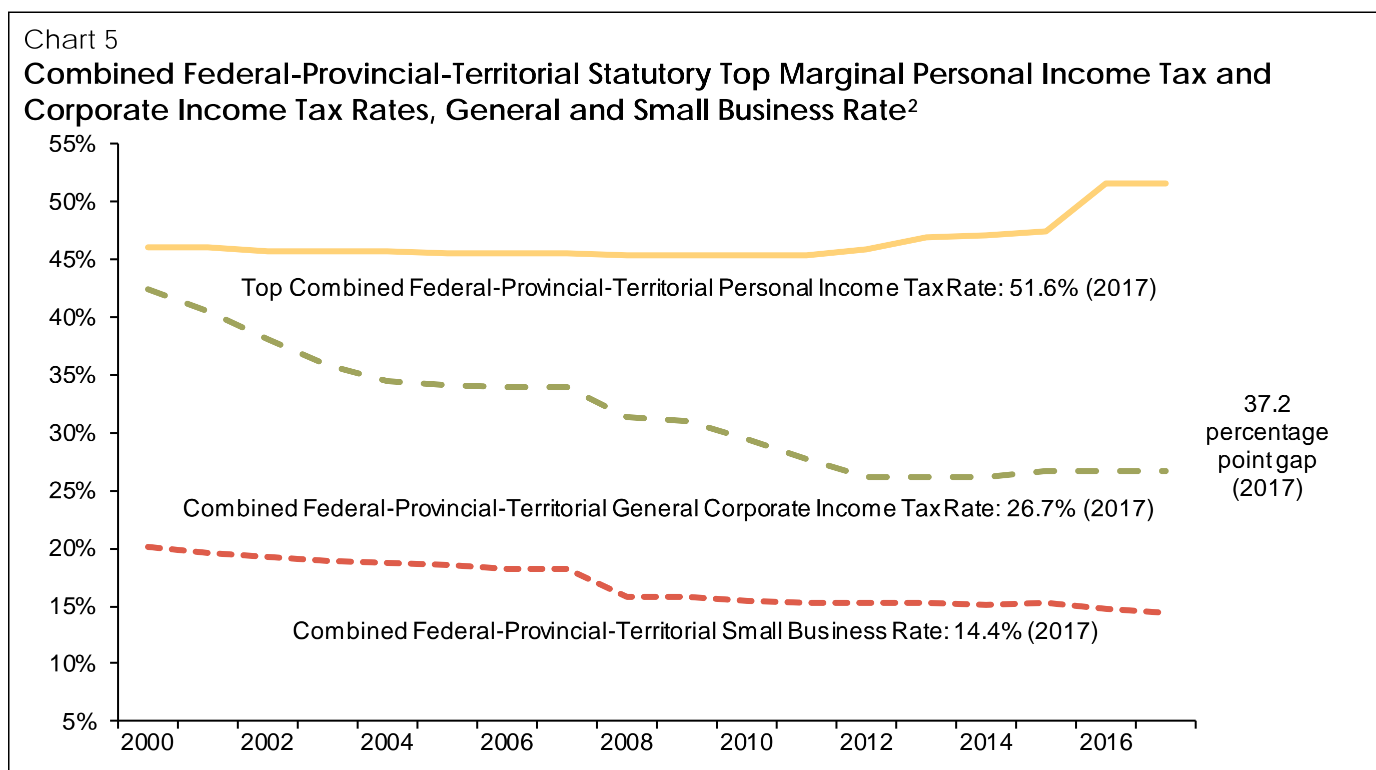


Chart 5
Combined Federal-Provincial-Territorial Statutory Top Marginal Personal Income Tax and Corporate Income Tax Rates, General and Small Business Rate[2]

Developments outside of the tax system have also contributed to the growth in the use of private corporations for tax planning. Notably, legal and regulatory changes made the use of corporations possible or more attractive in certain industries. The non-tax costs of incorporation may also have decreased, reflecting progress in information technology and management systems and the greater sophistication of small business owners more generally.

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[2] The small business tax rate of 10.5 per cent applies on up to $500,000 of active income of a CCPC. This benefit is gradually clawed back for CCPCs with taxable capital between $10 million and $15 million. The provincial-territorial figure does not account for Quebec's introduction of a lower small business rate for the manufacturing and primary sectors. This would have a marginal impact on the weighted average.

The increased use of private corporations, where it is for tax planning reasons, is raising concerns about the fairness of the tax system. It also has important fiscal implications, with evidence suggesting that a significant share of taxable income appears to have been shifted from the personal to the corporate tax base (see Chart 4).

Private Corporations – Tax Planning Strategies

As indicated in Budget 2017, the review of federal tax expenditures highlighted a number of issues regarding tax planning strategies using private corporations. These strategies include:

- *Sprinkling income using private corporations,* which can reduce income taxes by causing income that would otherwise be realized by a high-income individual facing a high personal income tax rate to instead be realized (e.g., via dividends or capital gains) by family members who are subject to lower personal tax rates (or who may not be taxable at all).
- *Holding a passive investment portfolio inside a private corporation,* which may be financially advantageous for owners of private corporations compared to other investors. This is mainly due to the fact that corporate income tax rates, which are generally much lower than personal rates, facilitate the accumulation of earnings that can be invested in a passive portfolio.
- *Converting a private corporation's regular income into capital gains,* which can reduce income taxes by taking advantage of the lower tax rates on capital gains. Income is normally paid out of a private corporation in the form of salary or dividends to the principals, who are taxed at the recipient's personal income tax rate (subject to a tax credit for dividends reflecting the corporate tax presumed to have been paid). In contrast, only one-half of capital gains are included in income, resulting in a significantly lower tax rate on income that is converted from dividends to capital gains.

These three strategies are illustrated using examples in the next section of this Introduction. The subsequent chapters of this paper are dedicated to examining each strategy in detail.

Tax Planning Strategies – Examples

Sprinkling income using a private corporation

Jonah and Susan are neighbours living and working in Ontario. Jonah and Susan live with their spouses and children who have no significant sources of income, other than as described below. Although Jonah and Susan each earn $220,000 in 2017, Susan's household pays about $35,000 more tax than Jonah's household.

This is because Susan earns $220,000 as an employee. As an individual with $220,000 in employment income, she pays about $79,000 in income tax for the year.

Jonah has an incorporated consulting business that earns $220,000 before taxes and salary. Jonah provides the consulting services for the corporation. The corporation qualifies for the small business deduction in respect of its income from the business.

Jonah owns the voting shares in the corporation. Jonah's spouse and two children, ages 19 and 21, also own shares in the corporation, for which they paid very little. The corporation pays Jonah $100,000 in salary, and pays its remaining after-tax profits in equal amounts to the spouse and children as dividends. The dividends are taxable income of the spouse and children.

After accounting for corporate income tax, taxes on Jonah's salary, and dividend tax credits claimed by the spouse and children, about $44,000 in total tax is paid on the $220,000 earned in the year through the corporation and distributed to Jonah's family—$35,000 less than the amount of tax paid by their neighbour, Susan, on the $220,000 she earns to support her household.

- This type of tax planning strategy is most likely to be used by higher income individuals, facing high personal tax rates. The tax benefits of sprinkling increase with income and are potentially the greatest for individuals who, in the absence of the arrangement, would pay income tax on the income at the highest personal tax rate.

Holding passive investments inside a private corporation

Andrea's private corporation owns a manufacturing plant in Saskatchewan. Last year, the corporation generated $800,000 of taxable business income (after payment of employee salaries and other expenses). The corporation is large, and is not eligible for the small business rate. The applicable federal-provincial corporate income tax rate in Saskatchewan was 25 per cent in 2016, leaving the corporation with after-tax income of $600,000. Andrea would like to use $200,000 of that amount to modernize her plant next year, and keep the balance, or $400,000, for longer-term personal savings. As the controlling shareholder, she can either pay herself a dividend or invest the $400,000 in an account held within her corporation. Andrea has already made contributions to her Registered Retirement Savings Plan and her Tax-Free Savings Account up to the maximum limits.

Andrea will be better off if she keeps a diversified passive investment portfolio inside the corporation, rather than investing it as an individual.

- If she invests **within the corporation**, Andrea has an after-tax amount of $400,000 to add to her portfolio.
- If she were to invest **in a personal account**, she would have about $280,000 to invest (her marginal personal income tax rate is about 48 per cent in 2016, given that Andrea is a high-income earner, and dividend income is subject to the dividend tax credit).

When Andrea invests through her corporation, she benefits from a bigger initial portfolio, which compounds to larger investment income every year that can be reinvested. Although there is some reconciliation at the end—when Andrea winds down the portfolio and pays personal income taxes on it—she still ends up better off than if she had chosen to invest in a personal account. After 30 years, she would end up with about $570,000 more, after payment of corporate and personal income taxes, if she invests inside her corporation.*

Unlike Andrea, an individual earning salary income would have no alternative but to invest in a personal account. As a business owner, Andrea can realize a personal portfolio advantage that is the consequence of the low corporate income tax rate, which is intended to support the growth of active businesses—not to confer a personal savings advantage.

(*) Saskatchewan has announced reductions in their corporate and personal income tax rates. These announcements are reflected in the calculations.

- Holding a passive investment inside a private corporation is a strategy available to those earning enough business income to hold savings within a corporate entity. Generally, the unintended advantages are realized by higher-income individuals, such as those whose annual savings go beyond the limits of tax-assisted savings vehicles (such as Registered Retirement Savings Plans (RRSPs) and Tax-Free Savings Accounts (TFSAs)).[3]
- Conversely, many smaller or less profitable private corporations would not be in a position to make significant passive investments, after paying out an income to the shareholders, paying the owner and employees' salaries, paying down their debts or reinvesting for future growth (such as by buying new, up-to-date equipment).

[3] The annual dollar contribution limit for RRSPs is $26,010 for 2017. The annual contribution limit for TFSAs is $5,500 for 2017.

Converting a private corporation's income (dividends or salary) into capital gains

Jean-Paul owns a large landscaping business in Manitoba. He operates the business through a private corporation (JPCo) which is eligible for the small business tax rate (10.5 per cent federal and 0 per cent in Manitoba on active business income of up to $500,000 federally and $450,000 provincially). He has operated the business for a number of years. In recent years, the business has earned about $650,000 annually after deducting expenses other than any salary paid to Jean-Paul.

In 2016, JPCo earned $400,000 of income after paying Jean-Paul a salary of $250,000. JPCo would pay corporate tax of $42,000 on the $400,000 (10.5 per cent of $400,000). In 2016, Jean-Paul wanted to withdraw another $300,000 from JPCo.

Alternative 1: If JPCo paid Jean-Paul $300,000 of additional **salary** (i.e., his total salary would be $550,000), additional personal tax based on Manitoba's top personal income tax rate would have been **$151,200.** JPCo would have deducted the $300,000 thereby reducing the corporate taxes paid by the business by $31,500. As a result, the net corporate and personal income taxes paid on the additional $300,000 in salary is about $120,000.

Alternative 2: If JPCo paid Jean-Paul the $300,000 as a **dividend**, additional personal tax would have been **$137,220.** This is based on Manitoba's top personal income tax rate on dividends received out of income eligible for the small business deduction after June 30, 2016.

Alternative 3: If the $300,000 were converted into a **capital gain**, additional personal tax would have been even less – **$75,600**, based on Manitoba's top personal income tax rate on capital gains.*

* Through a series of self-dealing private corporation transactions.

Further Action

Measures have been put in place over the years to limit the scope of some of the tax planning arrangements outlined above. Since such measures have not always been fully effective, further action is being considered:

- The Government is seeking input on proposed rules to distinguish income sprinkling from reasonable compensation for family members. The rules would help to determine whether compensation is reasonable, based on the family member's contribution of value and financial resources to the private corporation. Detailed legislative proposals to address income sprinkling are being released in conjunction with this paper.
- The Government is seeking input on possible approaches to neutralize tax-assisted financial advantages of investing passively through a private corporation. Potential directions for improving the current system are outlined in this paper. Modifications to the current system will be designed to preserve the growth objectives of the lower taxes on active business income earned by corporations. The Government will continue to review this issue and, following consultations, will develop concrete legislative proposals.
- The Government is introducing proposed changes to tax rules to prevent the surplus income of a private corporation from being converted to a lower-taxed capital gain and stripped from the corporation. Detailed legislative proposals to implement the changes are being released for comment in conjunction with this paper.

These actions will result in additional revenue for the government:

- Proposed measures to address income sprinkling would result in additional revenue of some $250 million per year once fully implemented.

- Private corporations currently hold significant amounts of passive investments, which generated approximately $27 billion in passive income in 2015. A proportion of this income is currently taxed appropriately under the current tax system, and would not be affected by the new tax rules. The overall revenue implications of actions to neutralize the tax-assisted financial advantages of investing passively would depend on the general approach followed to tax passive investment income, as well as specific design choices, including transitional rules. An estimate of additional revenues generated by the Government's actions will be provided once, taking into account the views expressed in consultations, the Government has made a decision on the final design of the new tax rules.
- The fiscal impacts of the proposed measure to prevent surplus income of a private corporation from being converted to a lower-taxed capital gain cannot be determined based on currently available information.

Finally, the Government has considered whether the actions proposed in this paper would impact men and women differently. This question is not straightforward. On the one hand, tax data shows that a majority of owners of private corporations are men, and that men receive a greater percentage of dividend income from the corporations they control. That said, the tax planning strategies outlined in this note would affect individuals other than the corporation's controlling owner. For example, it is likely that existing tax benefits are shared with family members—the owner's spouse and children—or in the case of the sprinkling of income, that family members are participants to the tax planning strategy.

With respect to direct corporate ownership, tax data show that:

- Men reported 74 per cent of the net capital gains from dispositions of qualified (private) small business corporation shares.
- Men received 66 per cent of non-eligible[4] dividends received by the shareholders of Canadian-controlled private corporations in 2014.

While the incidence of the measures is difficult to ascertain, additional statistics may assist in the determination of any gender impacts from the proposed measures:

- Data show that men represent over 70 per cent of higher-income earners initiating income sprinkling strategies. However, women are disproportionally represented among recipients of sprinkled dividends and income derived from trusts and partnerships (68 per cent and 58 per cent, respectively).
- A detailed analysis of the gender impacts of the proposal that relates to passive income will be conducted before the Government decides on the final design of the new tax rules. That said, the measure will affect individuals that own and control private corporations, which are mostly men as noted above. The extent to which benefits are currently shared with members of their families may be difficult to measure with available data.
- There is limited information available from tax data with respect to the proposed measure to prevent surplus income of a private corporation from being converted to a lower-taxed capital gain.

The Government is committed to gender-based analysis, and will continue to refine its analysis of the gender impacts of the measures being contemplated with respect to private corporations. Comments on the manner by which the proposed measures may affect gender are invited.

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[4] The concept of non-eligible dividends is discussed later in this paper. It refers to dividends that are "not eligible" for the higher dividend tax credit rate, and that were not paid out of income taxed at the general corporate income tax rate.

Consulting Canadians

As committed in Budget 2017, this paper provides details about tax planning strategies involving the use of private corporations and sets out proposed policy responses to close loopholes and bring greater fairness to the tax system. Stakeholders—including the affected business communities, provincial and territorial governments, tax advisors, commentators and other Canadians concerned about the fairness of Canada's income tax system—are encouraged to share their views and ideas about the proposals to address the tax planning strategies discussed in this paper.

The Government invites interested parties to submit comments by October 2, 2017. Please send your comments to fin.consultation.fin@canada.ca.

In order to add to the transparency of the consultation process, the Department of Finance Canada may make public some or all of the responses received or may provide summaries in its public documents. Therefore, parties making submissions are asked to clearly indicate the name of the individual or the organization that should be identified as having made the submission. Submissions should preferably be provided electronically in PDF format or in plain text to facilitate posting.

In order to respect privacy and confidentiality, when providing your submission please advise whether you:

- consent to the disclosure of your submission in whole or in part
- request that your identity and any personal identifiers be removed prior to publication
- wish any portions of your submission to be kept confidential (if so, clearly identify the confidential portions)

In addition, please note that information received throughout this submission process is subject to the Access to Information Act and the Privacy Act. Should you express an intention that your submission, or any portions thereof, be considered confidential, the Department of Finance Canada will make all reasonable efforts to protect this information.

B. Income Sprinkling

Background

Canada has an individual-based income tax system in which an individual's income tax liability is determined based on his or her income for a year, and generally without regard to the taxable income of family members or other related persons. Canada's personal income tax system is also progressive, meaning that the tax rate on taxable income increases as the amount of taxable income increases. This progressivity is reflected in the five different federal marginal tax rates of 15 per cent, 20.5 per cent, 26 per cent, 29 per cent and 33 per cent. Every Canadian resident individual can also claim a 'basic personal amount' tax credit, which is 15 per cent of $11,635 in 2017 federally, and which effectively offsets any federal personal income tax liability on taxable income up to that amount.

What is income sprinkling?

Income sprinkling describes a range of tax-planning arrangements that result in income that, in the absence of the particular arrangement, would have been taxed as income of a high-income individual, but is instead being taxed as income of another lower-income individual, typically a family member of the high-income individual.[5] The effect of the arrangement can be to have income subject to a lower effective income tax rate. This is achieved by accessing tax attributes of the lower-income individual, including the individual's lower marginal tax rates, personal tax credits (such as the basic personal amount) and, in some cases, certain deductions in computing taxable income (such as the lifetime capital gains exemption (LCGE)).

Income sprinkling arrangements effectively allow high-income individuals, in particular the principals of private businesses, to 'opt out' of all or part the progressivity of the personal income tax system to their own advantage. This is fundamentally unfair, and erodes the tax base and the integrity of the tax system.

Who benefits from income sprinkling?

Income sprinkling arrangements are possible because the private ownership of a business permits its principals to more easily control or influence the legal form of the ownership of the business and the circumstances in which profits are distributed. Specifically, the principals of private businesses can arrange for distributions to be made (typically by way of dividend payments in the case of a corporation) to other individuals (typically family members) in a way that minimizes the overall amount of personal income tax paid on that income. The income distributed to the family member may exceed what would have been expected, having regard to the family member's labour and capital contributions to the business, in arrangements involving arm's-length investors.

Family members receiving sprinkled income may not have contributed to the business and, in some cases, may not be permitted, under the laws governing the business, to carry on the revenue-earning activities of the business (e.g., due to a requirement for individuals to be licensed or certified to carry on the activity).

[5] Income sprinkling is also sometimes referred to as 'income splitting'. The tax rules use the term income splitting to describe both desirable and undesirable forms of this activity. For example, the tax rules permit income splitting of pension income. However, the tax rules seek to constrain other forms of income splitting – what is referred to in this paper as 'income sprinkling' – by means of certain anti-avoidance rules, as described in greater detail below.

Not all business owners or principals are able to benefit, or benefit to the same degree, from income sprinkling. The tax benefits increase with income and with the number of family members who can receive the sprinkled income. In absolute terms, the tax benefits are potentially the greatest for individuals who, in the absence of the arrangement, would pay income tax on the income at the highest personal tax rate (which at the federal level is 33 per cent for taxable income, for 2017, above $202,800). More generally, income sprinkling provides tax benefits to individuals engaged in the tax planning where:

- The family member who receives the sprinkled income is in a lower tax bracket than the individual, or has deductions or credits that would otherwise be unused. For example, there is no direct tax benefit to sprinkling dividends where the only potential family member with whom to sprinkle income has taxable income from other sources that exceeds the threshold at which the top personal tax rate applies.
- The tax savings justify the initial and ongoing transaction costs associated with the arrangements. These costs include service fees paid to financial and tax advisors who advise on implementing and maintaining the arrangements, and any costs related to maintaining the intermediaries—such as corporations, trusts and partnerships—typically used as part of the arrangements.
- The individual as a business principal can control or influence the payment and legal form of the income, allowing for different amounts to be used and different family members to participate from year-to-year, based on the available tax attributes of the family.

In the case of private corporations, tax data, as well as tax commentary (e.g., articles relating to owner-manager remuneration and incorporation in tax literature and on the websites of tax and other advisory firms), suggest that the ability to reduce the effective rate of tax on personal income, including through income sprinkling, is an important consideration in deciding whether to incorporate a business and how to structure ownership of a private corporation. Tax data and commentary also suggest that in other circumstances, including where ownership of a corporation by family members is not permitted—which is the case with certain incorporated professionals—separate partnership and family trust arrangements are used to facilitate income sprinkling.

Effectiveness of Current Rules

The income tax system includes rules to curtail the use of income sprinkling, and the CRA has challenged inappropriate arrangements. These rules include the following:

- A longstanding rule, set out in section 67 of the *Income Tax Act*, provides that only 'reasonable' amounts can be deducted when a corporation or other business owner pays a salary or management fee, or claims other outlays or expenses, that benefit another person including a family member.
- Tax 'attribution rules' can attribute property income to an individual if it is determined that the individual transferred or loaned the property (including a right to income) on non-arm's-length terms or with the intention of conferring a benefit on another person, typically a non-arm's length individual. These rules are for the most part found in sections 56 and 74.1 to 75.1 of the *Income Tax Act*. In addition, in the case of a transfer or loan by an individual to certain private corporations, a minimum income return can be imputed to the individual under a special rule contained in section 74.4 of the *Income Tax Act*.

- A special ‘tax on split income’ (TOSI), set out in section 120.4 of the *Income Tax Act*, was introduced in 1999 to address sprinkling of certain income to minor children (i.e., individuals under the age of 18 years). The rules apply to income from private business arrangements, such as dividends on unlisted shares, or income in the form of a trust or partnership distribution derived from a business or rental activity of a related individual. The TOSI also denies access to the LCGE in respect of the disposition of shares as part of a non-arm’s-length transaction. In cases where the TOSI applies, the income is subject to top flat-rate personal income taxation in the hands of the minor, and personal tax credits (with the exception of the dividend tax credit and foreign tax credit) are denied with respect to the amounts.

The current tax rules have proven effective in responding to some, but not all, forms of income sprinkling. Tax benefits of income sprinkling continue to be available with respect to certain arrangements. For example:

- The current tax rules do not fully respond to income sprinkling involving adult family members, and where the rules do apply to cases involving adult family members, they are typically limited to arrangements involving a spouse or common-law partner.
- Some high-income individuals are using arrangements involving tax-deductible interest payments to sprinkle income to minors and other family members, circumventing the TOSI in the case of minors.
- Current tax rules, including both tax attribution rules and the TOSI, that seek to constrain income sprinkling do not apply to “compound” income (i.e., second- and later-generation income earned from the investment of an initial amount of income that is subject to the tax attribution rules or the TOSI). This has led to some arrangements that obtain the tax benefits of income sprinkling on investments of the after-tax proceeds of sprinkled income. For example, a high-income individual’s incorporated business may pay a dividend on a share that the individual gifted to their minor child. Although the TOSI would impose the highest personal tax rate on the dividend received by the minor, the same tax rate would have applied if the dividend had been paid to the individual (i.e., the family does not pay higher income tax as a result of the TOSI). However, by paying the dividend to the child, the after-tax proceeds may be invested in portfolio investments, with the resulting “compound” income taxed in the child’s hands at the child’s personal tax rates instead of at the individual’s higher personal tax rates.

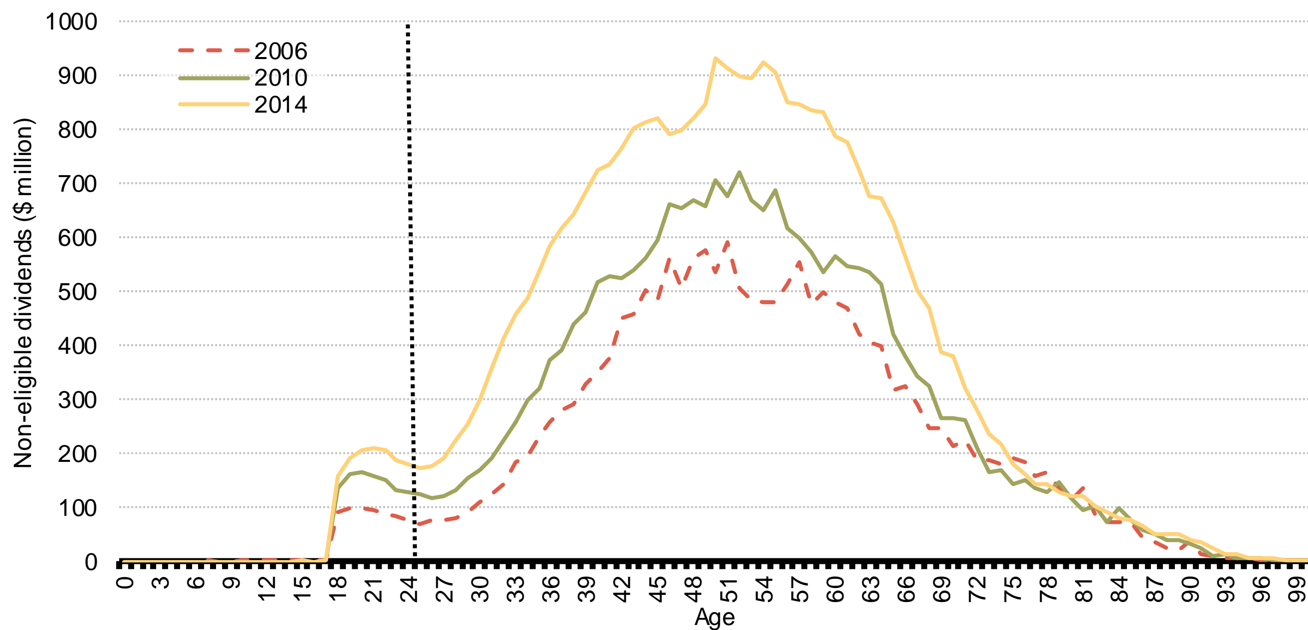
A related concern is that jurisprudence has, in some cases, narrowly interpreted some of the existing anti-avoidance rules that seek to address sprinkling, or determined the context and purpose of the rules as not demonstrating a rationale supporting the general prevention of income sprinkling, reducing the prospect of success from the costly and time-consuming process of challenging these arrangements, including using the general anti-avoidance rule. Although the CRA may seek to challenge some existing arrangements using the current tax rules, it has become clear that amendments to the income tax provisions are required to address the ongoing tax policy concerns with income sprinkling.

Chart 6 shows the distribution of non-eligible dividends (i.e., generally meaning dividends paid from income—such as income qualifying for the small business deduction—that has not been subject to the general corporate income tax rate) by age of tax-filer for the 2006, 2010 and 2014 tax years. In each year, a substantial amount of dividends earned by tax-filers under the age of 25 is earned by taxpayers who are not subject to the TOSI (area to the left of the dotted line). The total amount of dividends earned by those in the 18-21 age group exceeds the amounts earned by each of the 22-25 and 26-29 age groups. There is no economic rationale for why the 18-21 age group would earn more dividend income than the 22-25 and 26-29 age groups. In other words, dividend income resulting from the contribution of capital would be expected to increase with age for the population of tax-filers under the age of 30. This anomaly in the distribution suggests the presence of dividend sprinkling, because the tax benefits of income sprinkling are higher, on average, when adult children of high-income filers are younger and have lower income.

Individuals age 18-24 years appear to present particular advantages for those seeking to sprinkle income. This age group is not currently subject to the TOSI, but may have lower income levels for a variety of reasons, including due to post-secondary studies or being at an early stage of a career.

Chart 6

'Non-Eligible' Dividends Reported on T1 Returns, By Age of Filers ($million)



Source: T1 Universe datasets.

Note: No significant amount of actual 'non-eligible' dividends is received by individuals under age 18; these amounts are subject to personal income taxation at the top rate. The variable used is "actual amount of dividends, other than eligible," which is the net amount of dividends received, with no gross-up factor applied.

A further concern involves multiplication of access to the LCGE. The LCGE provides an exemption in computing taxable income in respect of capital gains realized by individuals on the disposition of qualified small business corporation shares and qualified farm or fishing property. An individual may shelter capital gains realized on the disposition of qualified small business shares up to a lifetime limit of $835,716 in 2017. This limit increases over time as it is indexed to inflation. The lifetime limit in respect of capital gains from the disposition of qualified farm or fishing property is $1 million. The lifetime limits for small business shares and farm or fishing property are integrated such that an individual's available LCGE is reduced to the extent that capital gains exemptions on either small business shares or farm or fishing property have been used in previous years.

The current tax rules do not appropriately constrain the multiplication of access to the LCGE, with the result that the LCGE may be claimed by several members of the business principal's family in circumstances where those individuals may not have effectively contributed to the business in respect of which the exemption is being claimed. A particular concern is the promotion and use of (typically, discretionary) family trusts to sprinkle capital gains among family members. Although trusts may serve an important and legitimate role in managing property within a family, including in succession contexts, the scope of the current accommodation of trusts under the LCGE tax provisions inappropriately facilitates income sprinkling involving LCGE multiplication.

Illustrative Example

While the potential benefits of income sprinkling will depend on the specific financial circumstances of each business, its principals and any related individuals, the following example seeks to illustrate the operation and effect of an income sprinkling arrangement.

In the example in Table 1, the individual earns $220,000 and, if she were self-employed, would have a personal tax liability of about $79,000 and an average tax rate of 36 per cent. By incorporating and sprinkling as taxable dividends 40 per cent of the after-tax corporate income (40 per cent of $187,000 ≈ $75,000) evenly between her spouse and adult child who have no other sources of income, the individual avoids about $25,000 in income tax. (This illustration is similar to the earlier example involving Jonah and Susan, but there is one less adult child and this illustration does not involve the payment of salary to shareholders.)

Table 1
Hypothetical Example of Tax Savings from Incorporated Business with Dividend Sprinkling vs. Unincorporated Business

	Base Scenario: Self-employed	Incorporated Professional			
	Net self-employment → Owner	Net profits of $220,000 → CCPC	Post-corporate income tax $187,000 dividend allocated 60%/20%/20% among Owner, Spouse and Child		
			$112,000	$37,000	$37,000
	Owner	CCPC	Owner	Spouse	Child
Federal corporate income tax (10.5%)	n/a	$23,000	n/a	n/a	n/a
Provincial corporate income tax (4.5%)	n/a	$10,000	n/a	n/a	n/a
Federal personal income tax	$49,000	n/a	$11,000	$200	$200
Provincial personal income tax (ON)	$30,000	n/a	$9,000	$500	$500
Total tax	**$79,000**	**$54,000**			
Average tax rate	**36%**	**25%**			

Proposed Measures

Income sprinkling is providing unintended benefits to higher-income individuals, principally through the use of private corporations. This is unfair and inconsistent with a tax system that works for all. Adjustments to the tax rules are required to address these concerns.

In response, the Government proposes a number of measures. These measures fall into three general categories:

1. Extension of the tax on split income (TOSI) rules;
2. Constraining multiplication of claims to the lifetime capital gains exemption (LCGE); and
3. Supporting measures to improve the integrity of the tax system in the context of income sprinkling.

These proposed measures are described below. Detailed legislative proposals and explanatory notes are provided separately.

1. Extension of the tax on split income (TOSI) rules

The TOSI currently applies to a specified individual's split income for a taxation year. A specified individual is a Canadian resident who has not attained the age of 17 before the beginning of the year (a "minor") and who has a parent resident in Canada. Split income generally includes dividends on unlisted shares of a corporation (other than a mutual fund corporation), and income from a partnership or trust that is derived from a business, profession or rental activity of a related person. The TOSI does not apply to income received by the specified individual as salary or wages (i.e., employment income), although other rules in the *Income Tax Act* may apply, including a limitation on the deductibility of salary or wages that exceed a reasonable amount.

The TOSI takes precedence over other anti-avoidance rules that apply to income sprinkling, meaning that, to the extent that an amount is subject to the TOSI, the other mechanisms (such as the attribution rules described above) do not apply.

Measures are proposed to extend the TOSI to apply to certain adult individuals who have amounts included in split income, but generally only to cases where the amount is unreasonable under the circumstances. In addition, the measures would expand the circumstances in which the TOSI applies, including the types of income that are considered to be split income. The TOSI would continue to not apply to income received by an individual as salary or wages (i.e., employment income).

Generally, these measures would apply the TOSI to a Canadian resident adult individual who receives split income (i.e., income from the business of a related individual, including a corporation over which a related individual has influence), when the amount in question is unreasonable under the circumstances. An adult individual in receipt of split income would be liable for the TOSI on the unreasonable portion of the income. Proposed measures will:

- *Expand the meaning of 'specified individual.'* As described above, only specified individuals are liable under the TOSI. The measures would extend the meaning of 'specified individual' to include Canadian resident individuals, whether minor or adult, who receive split income. Adult individuals who do not receive split income would not be affected by the measures.
- *Introduce a reasonableness test*. A reasonableness test would be introduced for the purpose of determining whether TOSI applies to a specified individual who is an adult. If a split income amount received by an adult specified individual is reasonable within the meaning of this test, then the amount that would otherwise be split income of the individual would be excluded from split income and thus not be subject to the TOSI. As described in detail below, the test is proposed to apply differently based on the age of the adult specified individual (i.e., whether the individual is between 18 and 24 or is 25 or older), recognizing the opportunities for income sprinkling with younger adult family members.
- *Introduce the definition 'connected individual.'* A connected individual test would be introduced to determine whether an adult specified individual's income from a corporation would be treated as being split income. A Canadian resident individual with a certain measure of influence over a corporation would be treated as connected with the corporation. For example, adult family members of the 'connected individual' who receive dividends on an unlisted share issued by the corporation would be required to determine whether a portion of the amount received is unreasonable.

Each of these measures is described in further detail below. These proposed measures seek to ensure that the TOSI applies as an effective mechanism for constraining income sprinkling while recognizing the legitimate contributions of different family members to the success of some private businesses. The measures would generally apply for the 2018 and later taxation years.

a) Meaning of Specified Individual

As noted above, the TOSI applies in respect of individuals who are specified individuals for a tax year. It is proposed that the meaning of specified individual be extended to apply to any Canadian resident individual, regardless of their age, where the individual receives split income derived from a business of a related individual who resides in Canada. A Canadian resident minor would also continue to be a specified individual if a parent of the individual resides in Canada at any time in the year.

Table 2 summarizes the current and proposed meanings of 'specified individual'.

Table 2

Age	Current TOSI	Proposed TOSI Measures
Under age 18 ('minor specified individual')	Canadian resident throughout the year	Canadian resident at end of the year
	Parent resident in Canada at any time during year	At any time during the year either • parent resides in Canada, or • a related individual resides in Canada, and the minor receives income derived from a business of that related individual
Age 18 or older ('adult specified individual')	Not applicable	Canadian resident at end of the year At any time during the year a related individual resides in Canada, and the adult receives income derived from a business of that related individual

b) Reasonableness Test—Individuals Age 18 and Over

The proposed measures would introduce special rules in determining the split income of an adult specified individual. Specifically, TOSI would generally apply to an adult specified individual's split income if the amount is unreasonable according to certain specified factors. The proposed test would seek to ensure that amounts received by an adult specified individual—in respect of a business in respect of which a family member is a principal (e.g., a 'connected individual' in the case of income derived from a corporation) — are included in the adult specified individual's split income to the extent that the amounts are not commensurate with what would be expected in arrangements involving parties dealing at arm's length. All adult specified individuals would be subject to the reasonableness test in respect of split income (i.e., income from the business of a related individual, including a corporation over which a related individual has influence). An amount would not be considered reasonable in the context of the business to the extent that it exceeds what an arm's-length party would have agreed to pay to the adult specified individual, considering the following factors:

- *Labour contributions,* the extent to which:
  - for an adult specified individual age 18-24, the individual is actively engaged on a regular, continuous and substantial basis in the activities of the business; and
  - for an adult specified individual age 25 or older, the individual is involved in the activities of the business (e.g., contributed labour that could have otherwise been remunerated by way of salary or wages).
- Capital contributions, the extent to which:
  - for an adult specified individual age 18-24, the amount exceeds a legislatively-prescribed maximum (using the same rate used for purposes of the tax attribution rules) allowable return on the assets contributed by the individual in support of the business; and
  - for an adult specified individual age 25 or older, the individual has contributed assets, or assumed risk, in support of the business.

- *Previous returns/remuneration*: All previous amounts paid or payable to the individual in respect of the business. For example, this would include amounts paid by a corporation to the individual as dividends on shares held by the individual, as well as salary or wages paid by the corporation to the individual for services rendered by the individual in respect of the corporation.

> Morgan carries on a freight forwarding business through a corporation. Morgan owns all of the voting shares of the corporation. Morgan's 26-year-old child, Jesse, is an accountant and, except as described below, does not participate in the freight forwarding business. Jesse owns dividend-eligible shares of the corporation, which Jesse purchased for $1. Jesse's shares do not participate in the growth of the corporation. Both Morgan and Jesse are resident in Canada.
>
> During a fiscal year, the corporation paid Jesse for accounting services he performed on behalf of the corporation. The amount paid by the corporation was equivalent to what the corporation would have paid an arm's-length party to perform the services. The corporation also declared, and paid, for the fiscal year a $100,000 dividend on the shares held by Jesse.
>
> Jesse received the dividend income from a related business source.
>
> The dividend income received by Jesse will not meet the reasonableness test and will therefore be subject to the TOSI. Although Jesse is involved in the activities of the business, Jesse's contributions were limited to providing accounting services. Jesse purchased the shares for $1, and therefore did not contribute assets or assume risks in respect of the business in any material way. Finally, although Jesse provided accounting services to the business, the business already paid Jesse for the fair market value of these services.
>
> If, on the other hand, Jesse had contributed significant assets to the corporation, for example by purchasing shares from the corporation for a cash payment of $100,000, then Jesse would be permitted under the reasonableness test to a reasonable return on this investment without the return being subject to the TOSI. Further, if Jesse had been 24 instead of 26 years old, the reasonableness of Jesse's dividend would be determined using a higher standard of labour contribution and imposing a prescribed maximum return on the $100,000 contributed to the corporation.

The measures also propose that in two cases, the TOSI would apply to the split income of adult specified individuals regardless of the reasonableness test:

- The first case involves 'compound income,' meaning income derived from the investment of split income and certain other amounts, of an individual under age 25. This is intended to discourage income sprinkling capital 'seeding' arrangements used by high-income individuals. These arrangements involve income being sprinkled to lower-income family members and the after-tax (e.g., after the TOSI applies) proceeds of that sprinkled income being invested by the family members or a family trust. The resulting investment income is available to be sprinkled with the lower-income family members, instead of at the high-income individual's higher tax rate, as it would have been in the absence of the arrangement.
- The second case involves amounts brought into split income under a proposed anti-avoidance rule that applies in respect of certain property held or acquired to circumvent the TOSI rules. In the case of the anti-avoidance rule, the reasonableness test would be inapplicable given that the purpose of holding or acquiring the property is to circumvent the TOSI rules.

c) Meaning of Connected Individual

The proposed measures would introduce the definition 'connected individual'. This definition applies in the case of split income from a corporation. The definition establishes a link for the purposes of the TOSI rules between the specified individual who receives an amount, the corporation from which the amount is derived and an individual (the 'connected individual') who is related to the specified individual and has a presumed degree of influence over the circumstances in which the amount is paid.

Generally, split income of an adult specified individual from a corporation over which the connected individual is presumed to exert influence would be subject to the TOSI if the amount is unreasonable according to those factors set out in the reasonableness test.

A 'connected individual' in respect of a corporation would mean an individual (other than a trust) who is resident in Canada where any of the following conditions are met:

- *Strategic influence*: the individual has factual control of the corporation alone or as part of a related group of persons.
- *Equity influence*: the individual owns property representing 10 per cent or more of the equity value of the corporation.
- *Earnings influence*: in the case of a corporation that carries on a service business, the individual or a related person owns shares in the corporation and either the individual's services are the primary contributor to the activities or revenues of the corporation's business, or the individual performs all or part of the services and, for the corporation to carry on the service business, the performance by individuals of those services is regulated under the laws of Canada or a province or territory.
- *Investment influence*: 10 per cent or more of the value of the corporation's property is derived from property acquired from the individual or from another corporation in respect of which the individual is a 'connected individual'.

There may be more than one connected individual in respect of a corporation, and an individual may be both a connected individual and a specified individual in respect of the same corporation.

The 'connected individual' concept would also apply in determining whether certain income of a specified individual from a partnership or trust is, in determining whether it is split income, derived from a business of a related person. In addition, for income received through a partnership or trust, certain tests that currently apply in determining whether income of a minor specified individual is derived from a business of a related person would be extended to apply to adult specified individuals. In the case of adult specified individuals, amounts included in split income under these tests would also be subject to the reasonableness test in determining whether the TOSI applies.

d) Additional Changes to TOSI Rules

Additional changes to the TOSI rules are proposed in order to improve the existing rules and to support the measures set out above. These proposed changes are set out in the related legislative proposals. The following is a list of the material proposed changes.

- The definition 'split income' would be extended to include:
  - income from certain types of debt obligations (e.g., debt that is issued by a private corporation and that is not publicly traded);
  - gains from dispositions after 2017 of certain property the income from which is split income; and
  - in the case of minor specified individuals and adult specified individuals under age 25, income (i.e., compound income) on property that is the proceeds from income previously subject to the TOSI rules or the attribution rules.
- The current exclusion from a minor's split income in respect of certain inherited property (e.g., property inherited from a parent) would be extended to apply to adult specified individuals aged 18-24.

- 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).
- Certain income arising in the context of a tax-avoidance arrangement, or compound income (as described above), would be subject to the TOSI without regard to the reasonableness test.
- The current joint and several tax liability rule with respect to the TOSI rules would be extended to apply in the case of adult specified individuals aged 18-24. A related individual who has sprinkled income with an adult specified individual aged 18-24 may be assessed joint liability with the adult specified individual for the adult specified individual's unpaid TOSI that arises in respect of that sprinkled (i.e., that part of the split) income.

Table 3 summarizes the main proposed changes to the TOSI rules.

Table 3

Element of TOSI Rules	Proposed Change
Specified individual	'Specified individual' would be expanded to include individuals resident in Canada at the end of the year, provided that an individual related to the first individual is resident in Canada at any time during the year and the first individual receives income derived from a business of that related individual.
Reasonableness test	For individuals over the age of 17, amounts would generally not be included in an individual's split income to the extent that the amounts satisfy the applicable reasonableness test.
Connected individual	An individual's income derived from the business of a related individual would include income derived from a corporation, if the related individual is connected to the corporation in a manner that indicates a level of influence over the amount.
Split income	Split income would be expanded to include: income from certain types of debt obligations; gains from the disposition of property the income from which is split income; and, for specified individuals under age 25, income (i.e., compound income) on property that is the proceeds from income previously subject to the TOSI rules or the attribution rules.
Inherited property	The current exclusion from a minor's split income in respect of certain inherited property (e.g., property inherited from a parent) would be extended to apply to adult specified individuals aged 18-24.

2. Constraining multiplication of claims to the lifetime capital gains exemption (LCGE)

As discussed above, tax planning has promoted so-called "multiplication" arrangements with respect to the LCGE. A particular concern is the use of family trusts to facilitate arrangements under which the LCGE limits of multiple members of a family may be used to reduce capital gains tax. Individuals have used these arrangements in a way that permits them to claim the exemption even though they may not have invested in, or otherwise contributed to, the business value reflected in the capital gains they realize on the disposition of property that is eligible for the exemption.

Three general measures are proposed to address LCGE multiplication. First, individuals would no longer qualify for the LCGE 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 LCGE 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. 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 LCGE.

The proposed measures would apply to dispositions after 2017. However, special transitional rules are proposed. The transitional rules would allow affected individuals to elect to realize, on a day in 2018, a capital gain in respect of 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 LCGE using the current tax rules (i.e., the rules as they apply to dispositions before 2018). For this purpose, certain requirements (e.g., regarding the ownership of, value of and, in some cases, activities in respect of, the property), that in order to claim the LCGE in respect of the disposition of a property must be met over a 24-month period before the disposition, would be treated as satisfied if they are met during the 12-month period preceding the elective disposition.

The key parameters of the proposed measures are as follows:

a) Age limits

The first measure would apply an age limit in determining LCGE eligibility. Specifically, individuals would no longer qualify for the LCGE in respect of capital gains that are realized, or that accrue, before the taxation year in which the individual attains the age of 18.

b) Reasonableness test

The second measure would introduce a reasonableness test in determining whether the LCGE applies in respect of a capital gain. The reasonableness test would be the same as that which applies in respect of the TOSI measures described above in respect of adult specified individuals. In effect, to the extent that a taxable capital gain from the disposition of property is included in an individual's split income, the LCGE would not apply in respect of the capital gain from the disposition.

c) Trusts

The third measure would no longer permit individuals to claim the LCGE in respect of capital gains that accrue during a period in which a trust holds the property. An exception would be provided for capital gains that accrue on property held by:

- A spousal or common-law partner trust or *alter ego* trust (or a similar trust for the exclusive benefit of the settlor during the settlor's lifetime), where the individual claiming the LCGE is the trust's principal beneficiary. This exception recognizes that the current tax rules constrain the terms of these trusts in a way that prevents the sprinkling of capital gains.

- Certain employee share ownership trusts, where the individual (i.e., as a beneficiary entitled to the capital gain) is, in general terms, an arm's length employee of the employer sponsor of the arrangement. This exception recognizes the use of employee trust arrangements, in appropriate circumstances, to encourage investment by employees in the businesses that employ them, thereby helping those businesses to grow, create jobs and innovate.

The measure would apply whether the trust realizes the capital gain and makes it payable to a beneficiary or alternatively, the trust distributes (by way of a so-called 'rollover') property with an accrued gain to a beneficiary where the gain is later realized on a disposition of the property. The measure would not prevent trusts that are currently eligible to undertake rollovers to beneficiaries from continuing to do so; however, unless one of the above exceptions applies, no deduction would be allowed under the LCGE in respect of the capital gain that is 'transferred' from a trust on a rollover of property to a beneficiary.

Table 4 summarizes the LCGE rules as they would apply having regard to the proposed measures.

Table 4

Age	Proposed LCGE Measures
Minor	Not eligible to claim the LCGE in respect of dispositions after 2017, subject to the transitional rule for dispositions in 2018.
Adult	No LCGE in respect of capital gains from a disposition after 2017, subject to the transitional rule for elective dispositions in 2018: • to the extent the capital gain accrued before the year in which the individual attained age 18; • to the extent the capital gain accrued during a period in which a trust held the property (with an exception for certain capital gains that accrue on property held by an eligible LCGE trust); and • to the extent the taxable portion of the capital gain from the disposition of property is included in an individual's split income under the TOSI.

3. Supporting measures to improve the integrity of the tax system in the context of income sprinkling

The following measures are also being considered to improve the administration of the income tax rules to address income sprinkling:

1. The introduction of tax reporting requirements with respect to a trust's tax account number that are similar to the requirements for corporations and partnerships in respect of their tax account numbers (known as "business numbers").
2. The introduction of measures so that the T5 slip requirements with respect to interest amounts apply to partnerships and trusts in the same circumstances in which they apply to corporations.

These measures would better ensure that trusts are subject to information reporting rules that parallel existing rules for corporations and partnerships, and would apply for the 2018 and subsequent taxation years.

Next Steps

The Government is committed to responding to income sprinkling to improve the fairness, efficiency and integrity of the tax system and ensuring that the tax system works for all. Detailed legislative proposals to address income sprinkling are being released in conjunction with the release of this paper.

The Government is seeking input on whether the reasonableness test provides an appropriate mechanism for responding to income sprinkling. The Government recognizes that the proposed reasonableness test depends on the facts of each case, and questions concerning the measurement of contributed value, or the evidence required to support such contributions, will not always be straightforward.

However, a legislative response to income sprinkling is needed to ensure that the broader tax system has an appropriate level of fairness for all. Previous efforts to constrain income sprinkling involving private corporations—which included seeking to apply the tax attribution rules based on the lack of labour contributions by the shareholders receiving dividends—have not been successful in the courts. Reasonableness standards are already used elsewhere in the tax rules to respond to some forms of income sprinkling. The Government believes that through a measured administration of the rules, a reasonableness standard can act as an important constraint on income sprinkling.

Stakeholders who choose to question the use of the mechanisms identified above are encouraged to identify in their submissions alternative mechanisms that would be effective in responding to income sprinkling arrangements. Stakeholders are also invited to comment on whether the proposed measures fully address income sprinkling, including whether alternative or additional measures should be considered.

C. Holding Passive Investments Inside a Private Corporation

Corporate income is taxed at lower rates than personal income, giving businesses more money to invest in order to grow their business, find more customers and hire more people. But there are times when private corporations earn income beyond what is needed to re-invest and grow the business. In these cases, those who own and control a private corporation have the opportunity to hold passive investments inside the corporation. 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. Passive investments held within privately-controlled corporations should be taxed at an equivalent rate to those held outside such corporations.

The principles of fairness and neutrality are core building blocks of our tax system. The tax system contains many provisions that are aimed at making sure that an individual is indifferent between earning income through a corporation or directly. This concept is generally referred to as "tax integration".

Passive investment income earned in a private corporation is subject to specific taxation rules, further described in this chapter. These rules were introduced in 1972, but an important component of the system that was envisioned at the time, the refundable tax in respect of ineligible investments, was rescinded shortly after its introduction. The rules that remain in place today in many cases fail to ensure that corporate owners[6] are indifferent between holding passive investments within their corporation or in a personal savings account. When a corporate owner uses earnings taxed at the corporate income tax rates to fund passive investments held within the corporation, it results in the realization of returns that exceed what individual investors saving in a personal investment account can achieve. The tax advantage conferred on private corporations—the lower rate of tax—was never intended to be used to realize higher personal savings.

The Government is considering approaches that will improve the fairness and neutrality of the tax system, such that savings held within corporations are taxed in a manner that is equivalent to savings held directly by individuals, for example salaried employees.

Background

In general terms, the objective of the current rules is to ensure that a dollar of passive investment income earned via a corporation 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. For instance, under current rules, an individual who has inherited $100,000 would generally be indifferent between investing this amount directly in securities, or making the same investment through a corporation set up for that specific purpose – in both cases, expected returns would be similar.

[6] Individuals referred to as 'corporate owners' throughout this section are those who both own and control the private corporation.

However, the rules dealing with the taxation of investment income in private corporations do not take into account the source of earnings used to fund the passive investment, and this can create advantages where the funds invested are retained earnings that have been taxed at the corporate tax rate. For instance, if a highly-skilled individual with a regular salary of $300,000 receives $100,000 of income in the form of an employment bonus and decides to invest the after-tax amount passively, he or she will have roughly $50,000 in after-tax income to invest (assuming a 50 per cent marginal federal-provincial[7] tax rate). In contrast, a successful entrepreneur earning an extra $100,000 of business income through his or her private corporation after paying him- or herself $300,000 in employment income will have about $85,000 after tax to invest passively, if kept in the corporation (assuming the income is eligible for the lower tax rate on small business income). While the current system aims at ensuring that both individuals pay approximately the same combined tax rate on the passive income generated by their investment (about 50 per cent), it does not recognize that the individual using his or her private corporation has more capital to invest than the employed individual (that is, 70 per cent more in this case, or $85,000 vs. $50,000).

While the corporation's owner will have to pay personal taxes upon dividend distribution, the strategy still provides the owner with a significant tax deferral advantage derived from the fact that he or she is the owner of an incorporated business—an advantage not available to most other Canadians.

Chart 7 illustrates that the tax-assisted benefits from holding passive investments inside a corporation can be very significant, particularly over a long investment horizon. It assumes that an individual who earns business income through a private corporation and a salaried employee each invest the after-tax proceeds on $100,000 of income, in an asset generating three per cent interest annually. The chart shows the cumulative after-tax returns that the corporate owner achieves if the asset is held within the corporation for 10, 20 and 30 years, compared to that of the salaried employee, who invests in the same asset in a personal savings account. Given that the corporate owner benefits from a lower rate of tax on business income, the amount of after-tax income that can be invested passively is larger than is the case for the salaried employee. The corporate owner is able to earn after-tax interest income that is about 1.8 times more than that of the salaried employee after 10 years (after distribution). After 30 years, the corporate owner's additional after-tax interest income is more than double the after-tax interest income of the salaried employee.

[7] In this section, all references to provinces include territories.

Chart 7

Comparison of After-Tax Passive Investments Returns for an Individual Investing After-Tax Proceeds on $100,000 of Earnings, Directly or Through a Corporation (interest income, 3 per cent return), over a Specified Investment Horizon

Notes: The chart shows the passive investment growth that a salaried employee living in Ontario and paying the top marginal tax rate would realize on personal savings (interest income), compared to the benefit that would be realized if that same investment were held inside a private corporation. In each case, the investor makes a one-time passive investment (for 10, 20 or 30 years), using $100,000 of income, less the payment of either the combined top marginal federal-provincial personal income tax (at 53.53 per cent) or corporate income tax (at 15 per cent, the combined federal-provincial tax rate for qualifying small business corporations in Ontario). Comparisons assume that the corporate passive investment is distributed to the corporate owner at the end of the holding period, and takes into account all income taxes payable on dividend income. The example assumes that the salaried employee has exhausted room to save in tax-assisted savings vehicles, such as RRSPs and TFSAs. Additional returns for the corporate owner reflect the impact of the higher initial passive investment, as well as the impact of annual refund of additional taxes payable on passive investment income (as discussed later on in this section).

Taxation of Passive Investment Income Under Current Rules

The taxation of passive investment income is a complex tax area. Prior to describing how the current tax system creates inequities, it is useful to set out how the rules currently operate.

Under the principle of tax integration, income earned by a corporation and distributed to shareholders as dividends should bear an amount of tax that is equivalent to what an individual earning the income directly would pay. If this were not the case, and income earned by a corporation and distributed to shareholders as dividends were taxed more lightly than income earned directly by individuals, there would be an incentive for individuals to incorporate; or in the opposite case, it would create a tax disadvantage to doing so.

As corporations are generally taxed at lower rates than individuals on their active business income, tax integration implies that dividends received by shareholders be taxable, such that:

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

In line with the above formula, dividends received by shareholders are taxable via a gross-up and dividend tax credit mechanism, the objective of which is to achieve overall tax integration.

The benefits of the lower corporate income tax rates on active business income can therefore be accessed as long as the income is retained in the corporation, but these benefits end once the income is paid out to shareholders.

The tax system contains provisions that aim to equalize taxes payable by individuals and corporations on passive income, which have been in place since 1972. In contrast to active business income, for which tax integration is achieved only when dividends are paid out to shareholders, additional taxes apply to passive investment income the year it is earned. These additional taxes bridge the gap between the corporate and personal income tax rates, such that the tax payable by corporations on passive investment income is approximately what an individual in the top tax bracket would pay on that income.

Federal taxes on passive investment income of a private corporation are fully or partially refundable when the income is paid out to shareholders as dividends. These taxes can therefore be said to operate like a prepayment of the personal taxes that will eventually be paid:

- When a corporation earning passive income ultimately pays a dividend to shareholders, it can get back the refundable portion of taxes that it paid on passive investment income.
- Concurrently, shareholders pay personal taxes when they report their dividend income on their personal income tax return.

As explained in more detail below, the current tax system applies additional refundable taxes on passive income generated within a corporation, but does not include provisions to differentiate between the source of earnings used to fund the passive investment:

- When passive investment is funded with earnings taxed at the low corporate tax rates, no provision applies to align the earnings available to fund the passive investment within the corporation with the after-tax amount that would be available to an individual. This gap in the rules is the main source of the tax advantage conferred to corporate owners, and can result in corporate owners being able to earn more passive income than individuals could.

The following describes the operation of current tax rules for different types of passive investment income earned by a small Canadian-controlled private corporation (CCPC)[8] [9]:

- *Interest income and rental income:* Small CCPCs are generally eligible for the small business rate on their active business income. Interest and rental income is generally not considered active income, but rather passive income, and is not eligible for the small business rate. Passive income is subject to provincial general-rate corporate income tax, which for example applies at a rate of 11.5 per cent in Ontario. At the federal level, the corporation is liable to pay tax on this income at 38⅔ per cent, bringing the combined federal-provincial total to just over 50 per cent, which is approximately in line with the top federal-provincial personal income tax rate for an Ontario taxpayer. As noted, a portion of the federal taxes paid—30⅔ percentage points—is refundable upon the payment of taxable dividends. The refundable portion of taxes paid is added to a notional account called the refundable dividend tax on hand (RDTOH). Amounts set aside in this account are only refundable to the corporation when taxable dividends are paid out to shareholders.

[8] CCPCs are private corporations that are not controlled, directly or indirectly, by one or more non-resident persons, by one or more public corporations (e.g., with shares listed on a public exchange), or a combination of non-resident persons and public corporations.

[9] Throughout the text, a "small CCPC" refers to a CCPC that is eligible for the small business rate.

- *Capital gains*: Similar to individuals, a corporation receives favourable treatment on capital gains. Only one-half of the gain is included in income (usually referred to as the "50-per-cent inclusion rate"). The taxable portion of the capital gain is taxed following the same rules as interest and rental income. The non-taxable portion of the capital gain is added to a special account—the "capital dividend account." Amounts set aside in the capital dividend account can be distributed tax-free to shareholders (by paying a "capital dividend"), meaning that shareholders will not bear any tax upon receipt of these dividends.
- *Portfolio dividends*: When a corporation receives a dividend from a connected[10] corporation, the tax system effectively exempts that income from tax, in recognition of the fact that the corporation that paid the dividend has already been subject to corporate income tax on its earnings, and that dividends are paid from after-tax income. In contrast, dividends received from a non-connected corporation are considered portfolio dividends and are subject to a fully-refundable federal tax of 38⅓ per cent. This tax rate is approximately equivalent to what an individual in the top tax bracket pays on dividend income eligible for the enhanced dividend tax credit. The tax is fully added to the RDTOH account of the corporation, and is refundable when the corporation pays out taxable dividends to shareholders.[11] No provincial tax applies at the corporate level to dividends received from another private corporation (resident in Canada).

When dividends are paid to shareholders, amounts in the corporation's RDTOH account are refunded to the corporation at a rate of $38.33 for every $100 of taxable dividends paid. This rate of refund is the same regardless of the type of income from which the RDTOH balance was generated. The shareholder is then taxed on this income using the gross-up and dividend tax credit mechanism.

When dividends are paid out from the capital dividend account (i.e., non-taxable portion of capital gains), the capital dividend account balance is reduced, dollar-for-dollar, by the amount of capital dividends paid.

[10] A corporation is connected with another corporation if one controls the other, or owns shares of the other representing at least 10 per cent of the votes and/or 10 per cent of the value of all shares of that corporation.

[11] Portfolio dividend income received by a non-CCPC private corporation is also subject to the passive investment income regime, as well as taxable dividends received from a connected corporation, where paying the dividend triggers a refund of the RDTOH account for the paying corporation.

Table 5 shows a step-by-step illustration of how the current passive investment income tax system works (using the example of a corporation resident in Ontario).

Table 5
Tax Treatment of Different Types of Passive Investment Income (Dollars)

		Formula	Types of Passive Investment Income: Interest Income/ Rental Income	Portfolio Dividends	Capital Gains
A	Passive investment income		100	100	100
B	Taxable passive investment income	A, or 50% of A for capital gains	100	100	50
C	Provincial corporate tax	B * 11.5% or 0 for dividends	11.50	0	5.75
D	Federal tax on interest, rental income and capital gains	B * 38⅔%	38.67	n/a	19.34
E	Federal tax on dividends	B * 38⅓%	n/a	38.33	n/a
	Refundable taxes and exempt amounts[1]				
F	Refundable portion of taxes on interest, rental income and capital gains	B * 30⅔%	30.67	n/a	15.34
G	Refundable portion of taxes paid on dividends	B * 38⅓%	n/a	38.33	n/a
H	Capital dividend account	A - B	n/a	n/a	50
	Distribution of income to individuals				
I	Taxable Dividends[2]	B – C – D + F or B – C – E + G	80.50	100	40.25
J	Capital dividends	H	0	0	50
K	Personal income tax[3]	I * 45.30% or 39.34%	36.47	39.34	18.23
L	After-tax income (Corporate owner)	(I + J – K)	44.03	60.66	72.02

Notes: (1) Refundable taxes represent the portion of federal taxes paid (D or E above) that will be refunded once the corporation distributes the income or capital gains to shareholders. (2) Dividends distributed to shareholders include the after-tax passive investment income, plus the refundable portion of federal taxes, which differ based on the type of income. (3) Effective dividend tax rate after dividend gross-up and dividend tax credit by a top-rate Ontario taxpayer. The effective dividend rate of 45.30 per cent applies to the distribution of corporate investment income such as interest or rental income, non-eligible portfolio dividends (defined later in this section), and the taxable portion of capital gains. In this example, the portfolio dividends are assumed to be eligible dividends received from a public corporation, and are subject to an effective dividend tax rate of 39.34 per cent.

Limitations of the Current System

The decision between holding passive assets in a personal account or within a corporation is generally neutral in the specific case where the corporate passive investment is funded with amounts on which personal income taxes were paid (for example, earnings saved at the personal level that are contributed to the corporation), and the refund of passive investment taxes is made at the end of the passive investment period. In this situation:

- There is no initial deferral—the funds used to purchase a passive asset have been subject to personal income tax, rather than corporate income tax. In other words, the corporate owner starts with a passive investment that is no bigger than he or she would have if investing outside the corporation.
- The returns from that passive investment are taxed similarly within the corporation as at the individual level: the taxes on annual returns equalize taxes payable at the top personal income tax rate.

The current system does not achieve its objective of removing incentives to hold passive investments within a corporation in a broad range of other situations. This leads to unfair tax results, whereby a corporate owner may frequently prefer to retain business income, for passive investment purposes, within his or her corporation, rather than to pay it out and invest directly as an individual.

The benefit of holding savings in a private corporation arises as a result of corporate income generally being taxed at lower rates than individual income:

- For example, a high-income individual living in Ontario who earns $100 of active business income inside his or her small corporation would pay 15 per cent corporate tax, leaving $85 of retained earnings to invest passively. If he or she earned an additional $100 in salary and is a high-income individual, he or she would pay personal income taxes, leaving him or her with a bit less than $50 to invest in a passive investment.
- Even though all of the income—the earnings used to fund the passive investment and the investment returns—is subject to personal income taxes once that income is paid out to shareholders, the value of the corporate passive investment will be higher (in the example, because the starting capital would be $85 rather than $50) and the corporate owner would end up with more after-tax income at the end of the passive investment period.
- As noted above, the payment of taxable dividends can trigger a refund of passive investment taxes paid at the corporate level (RDTOH account), irrespective of whether the dividend is paid out of active or passive income. To the extent that a corporation pays dividends from active business income, the payment of additional taxes on passive investment income and the refund of these same taxes can happen in the same tax year, effectively nullifying the intended effect of the passive investment income taxes.

Passive investments can be held by any type of business, including retailers, manufacturers, investment management businesses, incorporated professionals, and so on. Passive income can also take many forms, for example: interest, dividends, rental income, or capital gains. Holding savings within a corporation would typically be more beneficial for corporate owners in the highest income group:

- Individuals with higher incomes have a higher ability to save.
- As discussed below, the ceilings on the amounts that can be contributed to tax-assisted savings vehicles (RRSPs and TFSAs) may be below the annual savings of high-income individuals. In contrast, there is no limit on the amount that can be invested in a corporation.
- The progressivity of the personal income tax system causes the difference between corporate and personal income tax rates to increase with income, amplifying incentives to hold savings within a corporation.
    - The tax advantage for private corporation owners has also grown due to the widening of the gap between personal and corporate income tax rates in recent years. This widening gap has largely resulted from reductions to corporate income tax rates at both the federal and provincial levels. That gap has widened from about 26 percentage points in 2000 to upwards of 37 percentage points today.[12]

The tax benefit of saving within a private corporation can also exceed the tax benefits that individuals can receive from passive investments in RRSPs or TFSAs, and can provide more flexibility than investments in such vehicles. Among the factors providing an advantage are:

- Tax savings associated with assets generating capital gains or portfolio dividends would in many situations be greater if held in a private corporation than in a registered account. This follows from a number of factors, including:
    - Capital gains realized in an RRSP are fully taxed as regular income when withdrawn by the individual, while capital gains realized within a corporation are subject to the 50-per-cent inclusion rate.
    - Dividend income earned in an RRSP is also fully taxed as regular income when withdrawn by the individual, with no dividend tax credit available, in contrast to dividends received directly from a corporation, which are taxed at a reduced rate as a result of the dividend tax credit.
- There are no restrictions on the type of assets that can be held in a corporation, while some exist for tax-assisted savings vehicles (e.g., real estate). The rules pertaining to prohibited investments for registered accounts generally aim to prevent self-dealing arrangements and tax-planning opportunities.

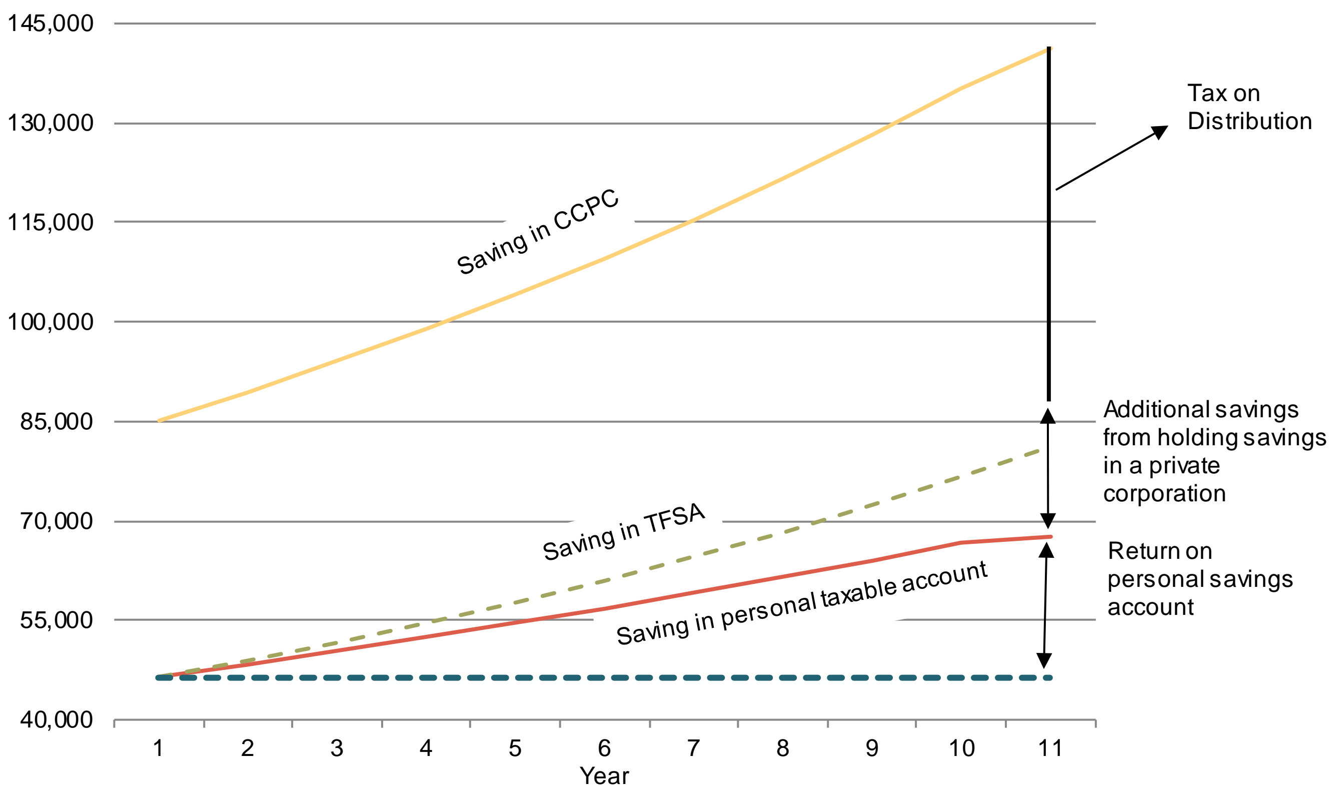
Preferential tax rates for corporations were never intended to facilitate passive wealth accumulation, such as through passive investments.

[12] In 1972, when the current tax rules on passive income were introduced, Canadian individual taxpayers earning up to about $240,000 in today's dollars had a combined federal-provincial marginal tax rate of about 50 per cent. Corporations paid a combined federal-provincial tax rate of 25 to 28 per cent on their small business income and of 50 to 53 per cent on their general rate income. Some individual taxpayers, those with income upwards of $360,000 in today's dollars, were subject to a marginal tax rate of about 60 per cent.

Chart 8 below illustrates the growth of a passive investment held within a corporation, compared to a passive investment held by an individual. In this stylized example, the corporate owner invests the after-tax proceeds on $100,000 of business income (taxed at 15 per cent), makes an investment in a diversified portfolio (half debt, half equity) and keeps it for 10 years. At the end of the 10-year period, the corporate owner pays out the proceeds to him- or herself. His or her portfolio is compared to that of an individual living in Ontario that invests after-tax proceeds on additional income of $100,000 (taxed at the individual level in Ontario at a rate of 53.53 per cent). If the individual has otherwise exhausted his or her ability to save in a TFSA, the corporate investor will be better off by about $19,000 after 10 years. If the individual has room to invest in a TFSA, the advantage from investing through the corporation would still be about $5,000.

Chart 8

Tax Advantage of Retaining Business Income in a CCPC for Personal Savings Purposes



Notes: The chart shows the passive income growth that a high-income individual living in Ontario would realize on personal savings in a personal taxable account, compared to what would be realized if that same investment were held inside a tax-assisted account (TFSA), or held inside a private corporation. In each case, the investor makes a one-time investment using $100,000 of income, less payment of either federal-provincial personal income tax (at 53.53 per cent) or corporate income tax (at 15 per cent). It is assumed the individual invests in a passive investment initially consisting of 50 per cent interest-bearing assets (debt), and 50 per cent in equities, half of which earns dividend income. The rates of return on interest, equities and dividend are 3 per cent, 6 per cent and 4 per cent, respectively. Comparisons assume that 20 per cent of accrued capital gains are realized in each year, with the full balance of accrued capital gains being realized at the end of the tenth year, at which point the corporate passive investment is distributed to the owner. The comparison takes into account all income taxes payable for a taxpayer from Ontario in the highest tax bracket. Additional returns for the corporate owner reflect the impact of the higher initial passive investment, as well as the impact of annual refund of additional taxes payable on passive investment income.

Possible Approaches

The Government is considering the changes required to establish 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.

The Government will consider approaches that can meet the following objectives:

- Preserving the intent of the lower tax rates on active business income earned by corporations, which is to encourage growth and job creation; and
- Eliminating the tax-assisted financial advantages of investing passively through a private corporation, and ensuring that no new avenues for avoidance are introduced.

Enhancing the fairness of the tax system in this area will necessitate the introduction of new tax rules. Limiting to the extent possible the complexity of these new rules will also be an important objective of the Government.

This section outlines broad possible approaches to eliminate incentives to invest passively within a corporation. The Government is seeking the feedback of stakeholders on the design considerations associated with each possible approach.

The 1972 Approach

In 1972, Canada developed an approach that was aimed at limiting deferral opportunities associated with passive investments. That approach was composed of two elements:

- The refundable tax in respect of ineligible investments, which was designed to reduce the potential benefits of tax deferral on passive investments, by effectively imposing an additional refundable tax when preferentially-taxed business income was retained and used to fund a passive investment. In effect, this provision denied the lower small business rate, and rather imposed the general corporate income tax rate (in 1972, the combined federal-provincial general corporate income tax rate was about 50 per cent). A corporation could obtain a refund of the upfront tax paid upon disposition of the passive investment asset, and reinvest the proceeds in business operations. This helped ensure that corporations were not denied the benefits of the small business corporate income tax rate if they redeployed the funds in business activities.
- The other element was the refundable tax on annual passive investment income, and this part of the structure is still in place today.

It is useful to understand that the current tax system was designed with these two components operating together. The refundable tax in respect of ineligible investments was retroactively repealed shortly after its implementation. In announcing the change, the Minister of Finance cited concerns that the provision was "complex and difficult", at a time when the *Income Tax Act* was not as detailed as it is today. The Minister also noted: "I believe that these small corporations which enjoy the benefit of the lower rate of tax will, in fact, use these savings to expand their businesses, to improve their technology and to create more jobs for Canadians." Many businesses do exactly that. In other cases, the benefit of lower tax rates is being used to confer a tax and financial advantage on what are, in essence, personal savings.

If the 1972 approach were to be adopted, it would have to be adapted in a number of ways, for example to take into account that today both the small business and general corporate tax rates are substantially lower than top personal rates. Table 6 provides an illustration of how the 1972 approach worked at a conceptual level, using simplified assumptions.

Table 6
Example of 1972 Approach

	$	Comments
Year 1		
Active small business income	100	
Taxes		
• Small business income tax	(15)	Federal and provincial component.
• Refundable tax in respect of ineligible investments	(35)	Additional refundable tax payable when earnings are not used to acquire active assets. Example assumes that a passive asset is acquired.
Net Income	50	Net after-tax income of the corporation would be approximately equal to that of an individual in the top tax bracket when earnings are used to acquire passive assets.
Year 2 – Three possibilities		
A. Continue to hold assets as passive investment		Passive investment income earned in Year 1 on the $50 investment (3 per cent return, interest) is subject to tax of 50 per cent (30⅔ percentage points of which is refundable upon the payment of taxable dividends).
• Passive investment income	1.5	
• Tax on passive investment income	(0.75)	
• After-tax value of passive investment	50.75	
B. Acquire an active asset at end of Year 2		Business disposes of its passive investment and invests savings in an active asset (e.g., equipment used in the business) and receives full refund of previously-withheld tax in respect of ineligible investments. (In practice, the refund may not be instantaneous). The amount available for active investments is the sum of the $50 earned in the first year, the $35 refund of the refundable tax in respect of ineligible investments, and the net passive investment value ($0.75).
• Refund of the refundable tax in respect of ineligible investments	35	
• After-tax value of passive investment	50.75	
• Total amount available for active business investments	85.75	
C. Distribute passive investments (including passive income) to shareholders at end of Year 2		Business disposes of its passive investment and distributes its value via a dividend. The refundable tax in respect of ineligible investments ($35) and refundable taxes on passive investment income ($0.46) are refunded.
• Refund of all pre-paid tax		
– Refundable tax in respect of ineligible investments	35	
– Refundable taxes on passive investment income	0.46	
• After-tax value of passive investment	50.75	
• Cash dividend paid out to shareholders	86.21	

Using an approach similar to the 1972 model could address key shortcomings of the current system. It would, however, not be possible to implement the 1972 approach as originally proposed, given the evolution of key tax concepts since then.

As illustrated in Table 6, the refundable tax in respect of ineligible investments is an upfront tax imposed at the time an investment in a passive asset is made, equal to the difference between the corporate income tax paid and the tax that would be payable by an individual in the top tax bracket. This tax would be refunded if the passive investment is disposed of. The funds could then be used for reinvestment in the active business of the corporation, for example, for a new machine or more up-to-date equipment. The Government is concerned that the inevitable lag between the time at which an investment is made and the time a refund is obtained could raise liquidity issues for certain businesses. Liquidity issues could also arise in other situations, for instance where there is a change in the use of an asset (at which point the refundable tax in respect of ineligible investments may need to be paid). The Government is not actively considering the reintroduction of a refundable tax in respect of ineligible investments at the present time.

Alternative Approach: Deferred Taxation

As an alternative to the system that was put in place in 1972, the current regime of refundable taxes on passive investment income could therefore be replaced with one that would maintain a rate of tax on the passive investment income of private corporations equivalent to top personal tax rates, as is the case under the rules in place today, but which would generally remove the refundability of passive investment taxes where earnings used to fund passive investments were taxed at low corporate tax rates. The new approach may also entail changes to how passive income is categorized, and subsequently taxed at the individual level when distributed as dividends.

Table 7 provides an example of the general operation of this approach, in the simple case of interest income on a one-time passive investment that is held for 10 years. It illustrates that, by the imposition of non-refundable taxes on interest income, the tax benefit that currently exists under the status quo is eliminated. Under the proposed approach, the passive investment of an individual investing in his or her small incorporated business would be equal to that of a salaried individual taxed at the top personal income tax rate who invested the amount in a personal savings account.[13]

[13] It can be demonstrated that, if the refundable taxes on investment income ceased to be refundable, a corporate owner would be indifferent between investing his or her retained earnings in a passive investment held within the corporation, and holding this investment in a personal savings account. The mathematical equivalence is demonstrated in the Annex.

Table 7

Illustration of Proposed System Mechanics (Dollars)

	Individual	Corporation	
		Current System	Proposed System
Source capital			
Income	100,000	100,000	100,000
Federal personal or corporate tax	33,000	10,500	10,500
Provincial personal or corporate tax	17,367	3,900	3,900
Starting portfolio	**49,633**	**85,600**	**85,600**
Return on investment in year 1*			
Interest (3 per cent)	1,489	2,568	2,568
Non-refundable personal or corporate tax	750	506	
Federal	*491*	*205*	
Provincial	*259*	*300*	
Non-refundable taxes (new system)			1,293
Refundable taxes (RDTOH)		788	
After-tax investment income (re-invested passively)	739	1,275	1,275
Portfolio value after 10 years	**57,539**	**99,235**	**99,235**
Refund of pre-paid tax (RDTOH)		8,424	
Distribution of taxable dividends		107,659	99,235
Personal income tax on dividends		45,235	41,696
Net worth	**57,539**	**62,424**	**57,539**

Notes: (*) This box illustrates the return on investment and its tax treatment in year 1 of the investment. It is assumed that passive investment income is earned for a period of 10 years, and the after-tax proceeds are reinvested passively each year. The returns in years 2 to 10 of the investment are not illustrated to simplify the presentation of the example.

This and the following examples in this section are based on simplified tax rate assumptions, chosen to remove small discrepancies that can arise due to imperfect integration of federal-provincial tax rates on dividends and differences between the top personal income tax rate that applies in each province and current tax rates on corporate passive investment income. The assumptions used are as follows:

- All investment income is assumed to be subject to the top personal income tax rate. For simplicity, the taxation of the income earned by the high-income individual that is used for consumption purposes is not illustrated in these tables. Rather, the examples only show how the additional funds used to undertake passive investments are taxed.
- Federal and provincial personal income tax rates of 33 per cent and 17.37 per cent, respectively.[14]
- Federal and provincial general corporate income tax rates of 15 per cent and 11.7 per cent, respectively.[15]
- Federal and provincial small business income tax rates of 10.5 per cent and 3.9 per cent, respectively.[16]
- Effective combined federal-provincial dividend tax rates of 32.29 per cent for eligible dividends, and 42.02 per cent for non-eligible dividends.[17]
- A federal non-refundable corporate passive investment tax rate of 8 per cent (0 percent for dividends)
- A federal refundable (or non-refundable under the new system) corporate passive investment tax rate of 30⅔ per cent (38⅓ per cent for dividends).

[14] As described above, current corporate taxes on CCPC passive investment income approximate the top combined marginal personal income tax. To show the results of the proposed system, it is assumed that the combined corporate taxes on investment income are equal to the combined personal income tax rate of the individual. For this equivalence to hold, it is assumed that the provincial personal income tax rate is equal to the sum of the provincial general corporate tax rate, and the refundable and non-refundable taxes on passive investment income, minus the top federal marginal income tax rate. For comparison, the weighted-average provincial top marginal personal income tax rate is 18.6 per cent.

[15] The provincial general corporate income tax rate for the examples is equal to the weighted-average provincial general corporate tax rate.

[16] The provincial small business tax rate for the examples is equal to the weighted-average provincial small business tax rate.

[17] The effective dividend tax rate needed to achieve integration is determined by taking the difference between the combined federal-provincial personal income tax rate and the combined federal-provincial corporate income tax rate, and dividing it by one minus the combined federal-provincial corporate income tax rate (using the general corporate income tax rate for eligible dividends, and the small business income tax rate for non-eligible dividends).

In addition to denying refundability, the new system would ideally align the tax treatment of passive income distributed as dividends with that of the earnings that are used to fund passive investments—these earnings could either be subject to the small business rate or the general rate, but could also be funds taxed at the personal level and contributed by shareholders. The need to take into account the tax treatment of the source capital arises as it largely determines the extent of the tax benefit conferred to the corporate owner. For example, if earnings were taxed at the small business rate, the gap between the top marginal personal income tax rate and the tax rate applied at the corporate level is not the same as if earnings are taxed at the general rate. It also follows that the tax advantage from holding savings within a corporation is larger if the income is taxed at the small business rate than if it is taxed at the general rate—as more money is left within the corporation to invest and generate passive returns. In contrast, if earnings used to fund a passive investment were initially taxed at the personal level, such as paid-up capital contributed by the corporate owner, there would generally not be a tax advantage when holding the passive investment within a corporation under the current rules. As such, and as further explained below, the tax treatment of passive income distributed as dividends would need to take into account how the earnings used to fund the passive investment were initially taxed, in order to properly eliminate the resulting tax advantage.

Under the current system, when a shareholder receives a taxable dividend, it must apply one of two possible dividend tax credit rates. The rate to be applied generally depends on whether the corporation paid tax at the general rate or the small business rate on its active business income. If the corporation paid taxes at the higher general corporate income tax rate, the dividend tax credit will be the higher of the two rates (and vice versa), to reflect the level of taxes paid at the corporate level. Taxable dividends eligible for the higher dividend tax credit rate are called "eligible dividends". Those that are not, and which receive the lower dividend tax credit, are called "non-eligible dividends". That category includes dividends paid out of small business income, as well as passive income.

For the new system to be neutral between individuals and corporations, the proper categorization of passive income as "eligible" or "non-eligible" is important. That categorization would need to follow the tax treatment of the income that is used to fund a passive investment (for instance, small business income), rather than the tax characteristics of the passive income itself, in order to appropriately reflect the size of the tax advantage conferred to the corporate owner at the time the passive investment is made, and on which returns were generated.

Using the example of a passive investment funded from active small business income, this implies that all income generated by that passive investment would be treated as a "non-eligible dividend" upon distribution to shareholders:

- Dividend income from publicly-traded stocks would no longer be treated as eligible dividends, as is currently the case, but would be treated as non-eligible dividends in this example, consistent with the tax treatment of small business income that is distributed to shareholders.
- The non-taxable portion of capital gains would not be attributed to the capital dividend account in this example.

The following example in Table 8 demonstrates the importance of aligning the tax treatment of passive income distributed as dividends with that of the earnings that are used to fund passive investments. It considers a case where the investor, which could be either an individual or a corporation, acquires an asset that generates only capital gains (e.g., a non-dividend-paying stock). Under the proposed system, the additional taxes payable on the capital gains by the corporation would cease to be refundable. The investor

disposes of the asset after 10 years, and pays personal income tax on the gains. Table 8 shows that treating what would have been a capital dividend as a non-eligible dividend achieves neutrality between the individual and the corporation.

Table 8

Example of Proposed System: Treatment of Capital Gains (Dollars)

	Individual	Corporation	
		Current System	Proposed System
Source capital			
Income	100,000	100,000	100,000
Federal personal or corporate tax	33,000	10,500	10,500
Provincial personal or corporate tax	17,367	3,900	3,900
Starting portfolio	**49,633**	**85,600**	**85,600**
Return on investment, realized in Year 10			
Capital gains (6 per cent/year)	39,252	67,697	67,697
Taxable portion of capital gains	19,626	33,848	33,848
Non-refundable personal or corporate tax	9,885	6,668	
Federal	*6,477*	*2,708*	
Provincial	*3,408*	*3,960*	
Non-refundable taxes (new system)			17,048
Refundable Taxes (RDTOH)		10,380	
After-tax investment income	29,367	50,648	50,648
Portfolio value after 10 years	**79,001**	**136,248**	**136,248**
Refund of pre-paid tax (RDTOH)		10,380	
Distribution of capital dividends		33,848	
Distribution of taxable dividends		112,780	136,248
Personal income tax on dividends		47,387	57,248
Net worth	**79,001**	**99,241**	**79,001**

Note: It is assumed that capital gains are earned each year, and accrued over 10 years. In the tenth year, the accrued capital gains are realized and the corporate passive investment portfolio is distributed to the owner.

In practice, the after-tax funds used by corporations to fund a passive investment could have been originally taxed in a number of ways depending on a range of factors:

- Certain corporations only earn income taxed at the small business rate.
- Certain corporations only earn income taxed at the general rate.
- Certain corporations benefit from the small business tax rate on a portion of their earnings, but pay the general tax rate on income above the income limit of the small business deduction.
- Irrespective of the tax rate it is subject to, any corporation could also use money contributed by individual shareholders, after personal taxes have been paid.

Two broad methods are being contemplated to determine the tax treatment of dividends paid from passive investments: an apportionment method and an elective method.

a) Apportionment Method

In order to make sure that passive investment income is taxed in a way that achieves neutrality between individuals and corporations when it is paid out as dividends, one method would be to track the source of income used to acquire each investment asset owned by a corporation, along with the investment income that the asset generates. Obviously, such a system would be very complex in practice. Alternative and less onerous methods are contemplated.

One such method would involve an apportionment of annual passive investment income that would be based, going forward, on the corporation's cumulative share of earnings taxed at the small business rate and the general rate, as well as amounts contributed by shareholders from their after-tax income. This would translate into three possible tax treatments for these amounts when distributed as dividends—eligible dividends, non-eligible dividends, or dividends that would be received tax-free at the shareholder level.[18]

For illustrative purposes, Table 9 provides a detailed example of a method that could be implemented. The example assumes that the corporation is a start-up business, and that the corporate owner contributes an amount of paid-up capital of $100,000. In the first year, the corporate owner only earns active income (no passive investment is made). After the end of Year 1, the corporate owner invests its retained earnings and paid-up capital in a passive asset that generates a 3-per-cent interest return.

At the end of Year 1, the corporate owner would allocate active income in two pools: the first pool would track income taxed at the small business rate, while the second pool would track income taxed at the general corporate tax rate. The corporate owner would also keep track of a third pool, comprised of amounts contributed by shareholders from income taxed at personal tax rates (paid-up capital in this example).

After Year 1, a passive asset is acquired, which will generate interest income in Year 2. The apportionment of the interest income at the end of Year 2 would work as follows:

1. The balance of the three pools at the end of Year 1 would be used to calculate their respective proportion of the total. For example, the proportion of the general rate income pool would be calculated as follows:

   (General rate income pool)/(General rate income pool + Small business income pool + Shareholders' contributions pool)

2. The passive income earned during the year would be attributed to each of the pools (general rate income, small business income and shareholders' contributions) using the proportions calculated in step 1. In the example provided in Table 9, the proportion attributable to the general rate income pool is 12.19 per cent, and the corporate owner has earned $8,953 in after-tax interest income. The corporate owner must attribute $1,091 (or 12.19 per cent*$8,953) to the general rate income pool.

3. If the corporate owner distributes a dividend to shareholders, it would deduct the amount of the dividend from the pool out of which it is designated as being paid.

4. The end-of-the-year balance of each pool would be equal to the sum of (1) the prior-year balance, (2) the active business income earned in the year and taxed at the small business rate / the active business income

[18] This example is illustrative only. Tax-free distributions in this example can be equivalent to maintaining the current refundable tax regime where passive investments are funded using income taxed at the personal level. Maintaining the current refundable tax regime on the proportion of passive income that is funded that way is an example of another avenue that could be contemplated by the Government.

earned in the year and taxed at the general rate / or tax-paid amounts contributed by the shareholder (depending on which pool is at issue), and (3) the net passive income apportioned in the year, minus any payment of dividends from that pool.

Table 9
Example of Apportionment Method (Dollars)

	Small Business Rate	General Rate	Shareholder Contributions	Aggregate
Year 1				
Paid-up capital	0	0	100,000	100,000
Active income				
Gross income	500,000	100,000	-	600,000
Corporate tax	72,000	26,700	-	98,700
Net income	428,000	73,300	-	501,300
Passive income	0	0	0	0
End of year pool balances	428,000	73,300	100,000	-
Year 2				
Active income				
Gross income	500,000	150,000	-	650,000
Corporate tax	72,000	40,050	-	112,050
Net income	428,000	109,950	-	537,950
Passive income				
Interest income	-	-	-	18,039
Corporate tax on investment income	-	-	-	9,086
Net passive income	-	-	-	8,953
Pool balances for apportionment (Prior end of year balances)	428,000	73,300	100,000	-
Passive income apportionment weights	*71.18%*	*12.19%*	*16.63%*	-
Apportioned net passive income	6,373	1,091	1,489	-
End of year pool balances	862,373	184,341	101,489	-
Pool balances available for distribution				
Return of capital	-	-	100,000	100,000
Capital dividends	-	-	1,489	1,489
Non-eligible dividends	862,373	-	-	862,373
Eligible dividends	-	184,341	-	184,341

The apportionment method would introduce the requirement that corporations keep track of the three pools described above. These additional requirements could be seen as introducing new complexity in the tax system, but they would be based on information that is either already computed for tax purposes or readily available to all corporations. The apportionment method would, at the same time, impose a tax treatment for passive income that readily adapts to the evolving characteristics of the corporation.

b) Elective Method

As an alternative to the apportionment method, the Government could introduce a method whereby private corporations would be subject to a default tax treatment, unless they elect otherwise. The choice between the default tax treatment or the elective treatment would determine whether passive income would be treated as eligible or non-eligible dividends when distributed to shareholders, without the need for tracking.

Specifically, under the default tax treatment, passive income earned in a CCPC would be subject to non-refundable taxes (at rates equivalent to the top personal income tax bracket), and dividends distributed from such income would be treated as "non-eligible" dividends. While corporations taxed under this default tax treatment could earn income taxed at the general rate, it would implicitly be assumed that the passive income is funded using earnings taxed at the small business rate. It would also be assumed that shareholders' contributions are not used to fund passive investments.

The implicit presumption that passive income is funded with earnings taxed at the small business rate may not hold for corporations that only earn income taxed at the general rate (or if a significant portion of the income is taxed that way). Corporations in that situation would be able to elect a tax treatment that would apply additional non-refundable taxes on passive income, and would treat dividends paid out from passive income as eligible for the higher dividend tax credit rate. This election would remove the corporation's access to the small business rate.

Table 10 provides an example of a corporation earning income taxed at the general rate, investing in an asset yielding a 3-per-cent interest return for a period of 10 years, at which point the passive investment is sold and a dividend is paid to the corporate owner, compared to an individual investing in the same asset. Under the default tax treatment, the corporate owner would end up with a slightly lower portfolio after the 10-year period than an individual would ($56,403, compared to $57,539). The proposed election would allow the corporate owner to treat dividends as eligible for the higher dividend tax credit, which would result in a portfolio that is worth the same as that of the individual.

Table 10
Example of Elective Method (Dollars)

	Individual	Current System	Default Treatment	Elective Treatment
Source Capital				
Income	100,000	100,000	100,000	100,000
Federal personal or corporate tax	33,000	15,000	15,000	15,000
Provincial personal or corporate tax	17,367	11,700	11,700	11,700
Starting Portfolio	**49,633**	**73,300**	**73,300**	**73,300**
Return on investment in year 1*				
Interest (3 per cent)	1,489	2,199	2,199	2,199
Non-refundable personal or corporate tax	750	433		
Federal	*491*	*176*		
Provincial	*259*	*257*		
Non-Refundable Taxes (New System)			1,108	1,108
Refundable taxes (RDTOH)		674		
After-tax investment income (re-invested passively)	739	1,091	1,091	1,091
Portfolio value after 10 years	**57,539**	**84,975**	**84,975**	**84,975**
Refund of pre-paid tax (RDTOH)		7,214		
Distribution of eligible dividends		73,300	73,300	84,975
Distribution of non-eligible dividends		18,889	11,675	
Personal income tax on dividends		31,603	28,572	27,436
Net worth	**57,539**	**60,586**	**56,403**	**57,539**

Note: (*) This box illustrates the return on investment and its tax treatment in year 1 of the investment. It is assumed that passive investment income is earned for a period of 10 years, and the after-tax proceeds are reinvested passively each year. The returns in years 2 to 10 of the investment are not illustrated, to simplify the presentation of the example.

Corporations Focused on Passive Investments

Under both the apportionment and elective methods, it is envisioned that a further election would be possible for corporations focused on passive investments.

As explained above, when a corporation uses earnings that were taxed at the personal level to fund a passive investment (e.g., paid-up capital), and that corporation is not engaged in an active business and only earns passive income, the current tax system is neutral and does not result in tax incentives to hold the passive investment inside a corporation. Maintaining the current tax system in these situations could be envisioned, for corporations that would make that election.

That election 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). Where the shareholders of the corporation are not individuals, amounts transferred to the corporation (e.g., as dividends) would be subject to an additional refundable tax, the intent of which would be to bridge the gap between the corporate tax rate and the personal income tax rate. The additional tax would, in effect, ensure that the corporate passive investment is funded with an after-tax amount that is comparable to what would be available to an individual investor at a top personal income tax rate. This would be necessary to ensure neutrality, as corporate owners could otherwise transfer funds taxed at low corporate income tax rates to another

corporation of the group, and continue to benefit from tax advantages. Under this election, and consistent with how the system is currently structured, all income earned within the entity would be subject to refundable taxes. The additional tax on passive investment income would be added to the RDTOH, and RDTOH balances would be refunded upon distribution of income via dividends.

This tax model would neutralize any deferral advantages and would allow the corporation to use the current regime. It is envisioned that corporations with a mix of active and passive income could, for instance, choose to hold passive investments in a corporation that could elect into this tax regime.

Marginal Tax Rate of the Corporate Investor

As is the case under the current tax system, taxes on passive income would be aligned with that of an individual earning income at the top personal income tax rate. Similar assumptions are also made in other sections of the *Income Tax Act,* for example, those that relate to the tax treatment of trusts. Under the new system, a corporate owner that pays personal taxes at a level below the top personal income tax bracket could have an incentive to withdraw corporate earnings not required for business reinvestments as they are earned, in order to invest in a personal savings account. This would maintain the ability to pay taxes on passive investment income at a lower rate.

Taxation of Capital Gains

The distinction currently made in the tax system between active and passive sources of income is embedded in jurisprudence and is well-established. Generally speaking, the Government intends to continue to use recognized practices in the development of a new taxation model for passive investment income.

In particular, the Government will continue to treat capital gains as eligible for the 50-per-cent inclusion rate and to apply passive investment taxes on such income. As discussed above, in order to preserve neutrality, the proposed system contemplates that the non-taxable portion of capital gains would no longer be credited to the capital dividend account under the proposed tax system, where the source capital of the investment is income taxed at corporate income tax rates. For example, the appreciation in value of a publicly-traded stock giving rise to a capital gain would be subject to the new rules. That said, the Government will be considering 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 an activity earning active income.

Transition

Existing stocks of passive assets held in Canadian private corporations are significant. It is the intent that the new rules would apply on a go-forward basis. Once a new approach is determined for the tax treatment of passive investment income, the Government will consider how to ensure that the new rules have limited impacts on existing passive investments. The Government will bring forward a detailed proposal following these consultations, and time will be provided before any such proposal becomes effective.

Other Issues

Other issues relevant to the new system will be assessed over the coming months, including how to ensure that a new system:

- is applied in a way that does not leave avenues for tax avoidance open to certain types of corporations, at the expense of tax fairness. Currently, for example, non-CCPC private corporations are only subject to the refundable tax regime on their dividend income, while CCPCs are subject to the regime on all their passive income. Further consideration will be given to assess how broadly the rules should apply.
- is not undermined by complex cross-border corporate structures and activities.
- operates effectively within an overall tax system with varying provincial tax rates and structures, and can continue to be effective in the face of tax policy changes outside of federal control.

Expected Impacts

The proposed reforms would generally affect corporate owners who are setting aside some of their corporate profits for passive investments. The proposed system would not impact taxes payable by corporations with no passive investment income.

The initial benefit from the lower corporate tax rates would also be preserved when the corporate owner reinvests its passively-invested funds to expand the active business. This will help ensure that our corporate tax system continues to support economic growth and job creation.

As an illustration, the example below compares the amount of money that could be available for active reinvestments in the business under the proposed system with non-refundable taxes on passive investment income, when compared to the current system (Table 11). Under the assumptions of the example, $100,000 is taxed at the corporate level, and the after-tax proceeds are invested for 10 years in a stock generating four per cent dividends. After 10 years, $109,219 is available for reinvestment in the corporation, under both the current tax system and the proposed new system. This equivalence exists under the assumption that, under the current system, refundable taxes are not refunded before the accumulated funds are used for reinvestment in the business, consistent with the implied objective of the example that savings are realized to provide a source of capital for active reinvestments.

Table 11

Example of Amounts Available for Active Reinvestments (Dollars)

	Current System	Proposed System
Source capital		
Income	100,000	100,000
Federal corporate tax	10,500	10,500
Provincial corporate tax	3,900	3,900
Starting portfolio	**85,600**	**85,600**
Return on investment in year 1*		
Dividends (eligible) (4 per cent)	3,424	3,424
Non-refundable taxes		
Federal		
Provincial		
Non-refundable taxes (new system)		1,313
Refundable Taxes (RDTOH)	1,313	
After-tax investment income (re-invested passively)	2,111	2,111
Portfolio value after 10 years	109,219	109,219

Note: (*) This box illustrates the return on investment and its tax treatment in year 1 of the investment. It is assumed that passive investment income is earned for a period of 10 years, and the after-tax proceeds are reinvested passively each year. The returns in years 2 to 10 of the investment are not illustrated, to simplify the presentation of the example.

In the example above (Table 11), when dividends are ultimately paid to shareholders, the amount of the dividend would be less in the new system, reflecting the payment of non-refundable taxes on the passive investment. This is consistent with the objective of making the tax system neutral with respect to passive income.

The example above assumes that refundable taxes are not refunded prior to the end period of the passive investment. That said, under the current system, if a corporation pays dividends from active sources, it is currently possible to trigger a refund of passive investment taxes prior to the end of the investment period, which is arguably a result that is not consistent with the spirit of the current rules.

Questions for Consultation

The Government will be designing new rules over the coming months to tax corporate passive income in a way that is more fair for Canadians. You are invited to share views on any aspect of these new rules that you feel are important to bring to the Government's attention.

1. In your view, what approach would be preferable in order to improve the fairness of the tax system with respect to passive income?
2. If you prefer the apportionment or elective methods described in this paper, what criteria or broad considerations should the Government consider in selecting a method?
3. Regarding the tax treatment of corporations mostly engaged in passive investments, are there considerations that you would like to bring to the Government's attention?
4. In your view, what would be the appropriate scope of the new tax regime with respect to capital gains? What criteria should be used by the Government in making this determination?
5. Are there key transition issues that you would like to bring to the Government's attention?
6. Is there any reason why any aspects of the new rules should not apply to private corporations other than Canadian-controlled private corporations?
7. The Government will consider the gender implications, and any other potential equity considerations, of potential changes to the tax treatment of passive investment income earned by private corporations. Are there any equity impacts involved in the potential changes that you would like to bring to the Government's attention?

D. Converting Income into Capital Gains

Background

Income earned by an individual indirectly through a corporation is subject to both corporate income tax (when the income is earned by the corporation) and personal income tax (when the income is distributed as a dividend from the corporation to the individual). The Canadian income tax system is designed so that the combined corporate and personal tax paid on income earned through a corporation and distributed as a dividend to an individual shareholder is roughly equivalent to the income tax that would have been paid if the income had been earned directly by the individual. This is commonly referred to as "tax integration".

A corporation distributes taxable dividends from its corporate surplus which, in general terms, is made up of its accumulated after-tax earnings and unrealized corporate value minus its liabilities. Through the operation of the dividend tax credit, an individual shareholder should in general retain on taxable dividends the same after-tax amount as the individual would have had if the corporate income had been earned directly by the individual. However, integration does not occur if corporate surplus is paid out in the form of tax-exempt, or lower-taxed, income. In effect, the income is not subject to the appropriate personal income tax and the income is subject to less tax than if the individual had earned the income directly.

Individual shareholders with higher incomes can obtain a significant tax benefit if they successfully convert corporate surplus that should be taxable as dividends, or salary, into lower-taxed capital gains (such conversions are commonly referred to as "surplus stripping"). By way of example, in 2016 an individual who is resident in Prince Edward Island, otherwise subject to the top marginal personal income tax rates and a shareholder of a private corporation could save about:

- $25,680 in federal/provincial personal taxes by converting a $100,000 salary paid by the corporation into lower-taxed capital gains;
- $18,180 in federal/provincial personal taxes by converting $100,000 of corporate surplus that would otherwise be non-eligible dividends[19] into lower-taxed capital gains; and
- $8,530 in federal/provincial personal taxes by converting $100,000 of corporate surplus that would otherwise be eligible dividends[20] into lower-taxed capital gains.

Table 12 sets out the combined federal/provincial personal income tax rates that apply to capital gains, salary and dividends for each province and territory. The table shows there is a significant tax rate advantage in converting dividends (and salary) into capital gains.

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[19] For example, dividends paid out of active business income of Canadian-controlled private corporations taxed at the 10.5 per cent small business rate.

[20] For example, dividends paid out of corporate income taxed at the 15 per cent general federal rate.

Table 12

2016 Top Marginal Personal Tax Rate by Income Type (Taxable Income $300,000+)*

Taxing Jurisdiction	Capital Gains	Salary**	Non-eligible dividends (e.g., active business income of CCPCs taxed at the low 10.5% small business rate)	Eligible Dividends (e.g., corporate income taxed at the 15% general rate)
Canada only	16.50%	33.00%	26.30%	24.81%
Canada/N.L.	24.90%	49.80%	41.86% (after June 30)	40.54%
Canada/N.S.	27.00%	54.00%	46.97%	41.58%
Canada/P.E.I.	25.69%	51.37%	43.87%	34.22%
Canada/N.B.	26.65%	53.30%	45.81%	34.20%
Canada/Que.	26.65%	53.31%	43.84%	39.83%
Canada/Ont.*	26.76%	53.53%	45.30%	39.34%
Canada/Man.	25.20%	50.40%	45.74%	37.78%
Canada/Sask.	24.00%	48.00%	39.91%	30.33%
Canada/Alta.*	24.00%	48.00%	40.24%	31.71%
Canada/B.C.	23.85%	47.70%	40.61%	31.30%
Canada/N.W.T.	23.53%	47.05%	35.72%	28.33%
Canada/Nvt.	22.25%	44.50%	36.35%	33.08%
Canada/Y.T.*	22.90%	45.80%	37.60%	21.78%

* The above tax rates also apply to taxable income over $200,000 with the exception of Ontario, Alberta and Yukon. Ontario's 2016 top marginal tax rate applies to taxable income over $220,000. Alberta's 2016 top marginal tax rate applies to taxable income over $300,000. Yukon's 2016 top marginal tax rate applies to taxable income over $500,000 (the Yukon marginal rate above $500,000 is 24 per cent (capital gains), 48 per cent (salary), 40.17 per cent (non-eligible dividends) and 24.81 per cent (eligible dividends)).

** In the case of salary, and unlike a dividend, a payor corporation would be entitled to deduct the salary payment, which would reduce its taxable income and corporate level tax. The reduced tax would increase the corporation's surplus, which would be taxable on distribution as a dividend (assuming it is not converted into a capital gain).

Section 84.1 of the Income Tax Act

Section 84.1 is an important anti-avoidance rule in the private corporation context. It seeks to ensure that a corporate distribution is properly taxed as a taxable dividend when an individual sells shares of a corporation to a non-arm's length corporation (for example, to another corporation owned by the individual). Otherwise, the corporation could pay out some portion of its surplus to the non-arm's length corporation as a tax-deductible inter-corporate dividend, and the non-arm's length corporation could then use that surplus to pay the individual. In effect, the individual could receive the equivalent of a dividend (i.e., an amount distributed from the corporation and received by the individual) but would have a capital gain on the sale for income tax purposes.

In general terms, section 84.1 applies when an individual sells shares of a Canadian corporation to another Canadian corporation on a non-arm's length basis[21] and the individual receives non-share consideration (e.g., cash) for the shares in excess of the greater of two amounts:

1. the adjusted cost base of the shares to the individual; and
2. the paid-up capital in respect of the shares.

Where it applies, section 84.1 treats the non-share consideration received by the individual in excess of the greater of the two amounts as a taxable dividend.

(a) Tax planning under the current provision

The wording of section 84.1 is problematic in that the provision describes a specific type of avoidance transaction. As a result, the section does not apply to transactions that avoid its specific terms. In particular, the section can be avoided to enable an individual shareholder to obtain capital gains treatment rather than taxable dividend treatment with respect to taxable capital gains that are ineligible for the LCGE:

- Essentially, an individual shareholder would sell a share (the 'transferred share') of their corporation for fair market value to another non-arm's length corporation in return for a share of the other corporation (the 'acquired share'). The sale of the transferred share results in a capital gain to the individual that increases the tax cost of the individual's acquired share to fair market value.
- The individual is then able to sell the acquired share to another non-arm's length corporation and in this case receive non-share consideration – e.g., cash – equal to the fair market value of the share without section 84.1 treating the cash as a taxable dividend.
- In contrast, if on the sale of the transferred share, the individual had received fair market value proceeds consisting only of cash, those proceeds in excess of the greater of the adjusted cost base and the paid-up capital of the transferred share would have been treated as a taxable dividend.

Section 84.1 effectively prevents surplus stripping to the extent that the cost to an individual of his or her share represents capital gains realized by the individual (or a non-arm's length individual) and that were eligible for the LCGE (or that represent pre-1972 corporate surplus, which arose when there was no capital gains tax) – in other words, capital gains that were effectively tax-free to the non-arm's length seller. In such cases, the

[21] Section 84.1 applies to a share sale of a corporation to a non-arm's length corporation (including a related corporation that is a private corporation) only if the two corporations are 'connected' with each other. In general terms, if the two corporations are not connected, the related private corporation would be subject to a special dividend tax under Part IV of the *Income Tax Act* on a dividend received from the other corporation, which is in general refunded when the dividend is distributed as a taxable dividend to individual shareholders subject to personal income tax.

individual's adjusted cost base of the shares excludes the portion of the purchase price representing those tax-free proceeds – what is sometimes referred to as "soft" cost base. Accordingly, if the individual purchaser subsequently sells those shares to a non-arm's length corporation, this soft cost will not serve to prevent any cash or other non-share consideration received as proceeds on the sale from being taxed as a dividend.

However, section 84.1 does not specifically address cases – such as the one described above – where a so-called 'hard' cost base results from purchasing shares on a non-arm's length basis (e.g., cost base resulting from a taxable sale). The CRA has had mixed results when seeking to apply section 84.1 to transactions designed to convert dividends (and salary) into lower-taxed capital gains.

The courts appear to be upholding the CRA's assessment of dividend taxation where the surplus is converted into capital gains eligible for the LCGE (or represents pre-1972 surplus). The CRA's assessment of dividend taxation has also been upheld by the courts where the extraction of corporate surplus occurs in the course of the winding-up, discontinuance or reorganization of the business of the corporation.[22]

In comparison, individual shareholders have had success arguing that they can extract corporate surplus as capital gains if the extracted surplus does not result in a capital gain that is eligible for an LCGE (and does not involve pre-1972 surplus). While the CRA has traditionally applied the general anti-avoidance rule (the GAAR) to such conversions, it has narrowed its application in light of recent court cases.[23] The courts have even suggested in at least one case that surplus stripping is not, in general, an abuse or misuse of the scheme of the *Income Tax Act*.

(b) Intergenerational business transfer

The Government indicated in Budget 2017 that, while reviewing the use of tax planning strategies involving private corporations that inappropriately reduce personal taxes, it would consider whether there are features of the current income tax system that have an inappropriate, adverse impact on genuine business transactions involving family members.

Section 84.1 does not apply to the sale of shares from one individual to another. Therefore, it has no impact on the sale of shares within a family (e.g., from parent to adult child) as long as the transaction occurs at the individual level. Shareholders of corporations, however, have expressed the concern that they are ineligible for the LCGE when they sell their shares to a corporation owned by their adult children because of section 84.1. In contrast, those shareholders can use their LCGE when they sell their shares to an arm's length corporation, which transaction would not be subject to section 84.1 (the arm's length corporation could also then use all or a portion of the purchased corporation's surplus to pay the shareholders). It is argued that this application of section 84.1 is an impediment to the transfer of a business from one generation to another within a family because the LCGE would not be available.

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 the same as a sale to an arm's length corporation, a major policy concern is distinguishing a genuine intergenerational transfer from a tax avoidance transaction, like the one described above, undertaken among family members. The hallmarks that ensure a genuine transfer of a business to a new owner would generally include:

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[22] *The Queen v. MacDonald* (Federal Court of Appeal, 2013).

[23] For example, see *Descarries v. The Queen* (Tax Court of Canada, 2014) and *Gwartz v. The Queen* (Tax Court of Canada, 2013).

- the vendor ceasing on the transfer to have factual and legal control of the transferred business;
- the intent of the new owner to continue the business as a going concern long after its purchase;
- the vendor not having any financial interest in the transferred business; and
- the vendor not participating in the management and operations of the business.

For example, the United States has long-standing rules meant to distinguish cases where a parent "terminates" his or her interest in a corporation on the sale of shares to a family member including a corporation controlled by family members. In general terms, the approach of the United States is to rely on rules that establish a bright-line test that is not amenable to factual disputes about the genuineness of an intergenerational transfer of the small business corporation. It does so by simulating a straightforward arm's length sale in which the vendor has no interest or involvement in the transferred corporation after the sale.

The American approach arguably accommodates genuine intergenerational transfers because it does not prevent a parent/owner of a private corporation from having the corporation employ their children in the years leading up the actual transfer. During this period, the parent can transfer knowledge of the business to the child as well as assist the child in gaining the experience necessary to operate the business as a future owner.

Consequently, the Government is interested in 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.

Proposed Measures

In response to the planning noted above, the Government proposes that section 84.1 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 the application of section 84.1 on a subsequent transaction.

In general terms, this will be achieved by extending the current rules in subsection 84.1(2) that result in a so-called 'soft' cost base if the LCGE (or pre-1972 surplus) is claimed to cases where cost base is increased in a taxable non-arm's length transaction, and by ensuring that those rules apply in a manner that is consistent with this policy objective. It is recognized that in some instances this change might give rise to both a capital gain on a 'step-up' transaction and a taxable dividend on a subsequent non-arm's length disposition. This is consistent with discouraging taxpayers from entering into schemes that seek to avoid section 84.1. It is proposed that this amendment apply to shares disposed of on, or after the date of the release of this consultation paper.

The Government also proposes that 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. In general, the anti-stripping rule would apply to a non-arm's length transaction 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) that is otherwise treated as a capital gain out of a private corporation's surplus 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. It is proposed that the anti-stripping rule apply in respect of amounts that are received or become receivable on or after the date of the release of this consultation paper.

Next Steps

Draft legislation for the proposed amendment to section 84.1 and the proposed anti-stripping rule is being released for comment in conjunction with release of this consultation paper.

As noted above, the Government invites views and ideas on whether, and how, it would be possible to better accommodate genuine intergenerational business transfers in the *Income Tax Act* while still protecting the fairness of the tax system by ensuring that any such accommodation cannot be used as a means to circumvent other rules of the *Income Tax Act*. The Government invites interested stakeholders to contribute their views.

Annex

Making corporate tax on passive investment income non-refundable: A conceptual explanation

This section provides a conceptual explanation as to why applying a non-refundable tax at the corporate level equivalent to the top marginal personal income tax rate on income from passive investment funded with retained earnings results in a neutral tax treatment. It also explains why, in the context of capital gains on assets funded with retained earnings, neutral tax treatment is obtained by removing the ability to flow the non-taxable portion of capital gains tax-free to shareholders (through the capital dividend account).

The illustration implicitly assumes perfect integration of corporate dividend income. This further implies:

- Integration parameters are aligned with the tax treatment of funds used to acquire the passive asset; and
- A single tax jurisdiction. (i.e., there are no differential tax outcomes due to different tax rates in different jurisdictions.)

A. Refundability of corporate tax on passive investment income

<u>Scenario A1 – Business income distributed and invested passively by the shareholder</u>

Mrs. Singh is a successful consultant who is running her business through a corporation. In this first scenario, Mrs. Singh decides to distribute to herself, as a dividend, the business income earned through her corporation and invest the proceeds in her personal saving account for one year.

Assume Mrs. Singh earns a certain amount "A" of active business income through her corporation. If t^{CIT} is the tax rate on active business income, then the after-tax profit available to be paid out as a dividend is (A x (1 – t^{CIT})). That dividend would then be subject to the integration mechanism, whereby the paid dividend is first grossed up, at a rate denoted by "G", to proxy the amount of pre-tax business income earned to fund that dividend. The grossed-up dividend is included in Mrs. Singh's income and taxed at her marginal personal income tax rate, t^{PIT}. A dividend tax credit, equal to the grossed-up dividend multiplied by t^{CIT}, is provided to recognize the corporate income tax paid on that dividend. The effective personal income tax rate on the paid dividend is therefore represented by G(t^{PIT} – t^{CIT}), and the after-tax amount of the dividend is obtained by multiplying the paid dividend by one minus that expression. Mrs. Singh then invests that after-tax dividend for one year at an interest rate of "i", which will generate passive investment income subject to her marginal personal income tax rate of t^{PIT}.

Putting all these terms together means that Mrs. Singh's after-tax savings after one year, under this first scenario, would be equal to:

$$A \times (1 - t^{CIT}) \times \left(1 - G(t^{PIT} - t^{CIT})\right) \times \left(1 + i(1 - t^{PIT})\right)$$

Scenario A2 - Business income retained and invested passively by the corporation

Under this second scenario, Mrs. Singh decides to use her corporation as a personal saving vehicle. She keeps the after-tax business profits (A x (1-t^{CIT})) in her corporation to be invested passively for one year, at the same interest rate (i), and distributes the net savings as a dividend at the end of the year. The interest income earned on the retained profits will be taxed in the corporation at a rate that approximates the top marginal personal tax rate, which is represented by t^{PIT}. So the after-tax rate of return on passive investment in the corporation is $i(1 - t^{PIT})$. A portion of that corporate tax, however, is refunded to the corporation when the dividend is paid out to Mrs. Singh at the end of the year. For simplicity, the amount of tax refund is not defined in algebraic terms, but simply represented as "RDTOH." After one year, the net savings in the corporation, including the refunded tax, is paid out as a dividend to Mrs. Singh. That dividend is then subject to the same integration mechanism as described above.

Putting all these terms together means that Mrs. Singh's after-tax savings after one year, under this second scenario, would be equal to:

$$\left[A \times (1 - t^{CIT}) \times \left(1 + i(1 - t^{PIT})\right) + RDTOH\right] \times (1 - G(t^{PIT} - t^{CIT}))$$

Comparing the two scenarios

It can be seen that the two equations, under scenarios A1 and A2, become identical if the term "RDTOH" is removed from the second equation. This demonstrates that tax neutrality is obtained between the two scenarios described above by imposing a non-refundable corporate income tax on passive investment income equivalent to the top marginal personal income tax rate. There is no need to refund any portion of that tax. This conclusion is not affected by the length of the saving period or the rate of return on the passive investment. The conclusion is also valid whether the passive investment income is in the form of ordinary income (e.g. interest, rental income), or taxable capital gains (the taxable portion of capital gains, equal to 50 per cent of the realized gains) is taxed similarly within a corporation as other forms of ordinary investment income (i.e., refundable tax regime applies). A question remains, however, as to how the non-taxable portion of capital gains (the other half of the realized gains) should be treated. This is addressed below.

B. Treatment of the non-taxable portion of capital gains

This section examines the two scenarios above in the context where Mrs. Singh invests in an asset generating capital gains instead of interest income. This will help demonstrate what should be the appropriate tax treatment of the non-taxable portion of capital gains earned by a private corporation. Currently, that portion of capital gains is allocated to the corporation's capital dividend account and can be flowed to shareholders tax-free. The question is whether this tax-free treatment is still warranted in a situation where the capital gains result from the disposition of a capital asset funded from retained active business income.

Scenario B1 – Business income distributed and invested passively by the shareholder

Under this scenario, using the same terminology as above, Mrs. Singh first distributes the after-tax business profits to herself as a dividend and receives a net after-tax dividend of: $A \times (1 - t^{CIT}) \times \left(1 - G(t^{PIT} - t^{CIT})\right)$. Mrs. Singh then invests that amount for one year, at a capital gain rate of return of "r". Recognizing that only half of the capital gains are included in her income for tax purposes, the net after-tax rate of return will be: $r(1 - 0.5t^{PIT})$.

Putting all these terms together means that Mrs. Singh's after-tax savings after one year, under this first scenario, would be equal to:

$$A \times (1 - t^{CIT}) \times \left(1 - G(t^{PIT} - t^{CIT})\right) \times \left(1 + r(1 - 0.5t^{PIT})\right)$$

Scenario B2 - Business income retained and invested passively by the corporation

Under this second scenario, Mrs. Singh keeps the after-tax business profits (A x (1-t^{CIT})) in her corporation to invest in a capital asset that will grow at a rate of r. In a year, she will dispose of the asset and distribute the net savings as a dividend. The taxable portion of the capital gains (i.e., 50 per cent of the realized gains) will be taxed in the corporation at a rate that approximates the top marginal personal tax rate, which is represented by t^{PIT}. The after-tax rate of return on the passive investment in the corporation is therefore $r(1 - 0.5t^{PIT})$. Similar to the treatment of interest income above, a portion of that corporate tax will be refunded to the corporation when the dividend is paid out to Mrs. Singh at the end of the year. As above, for simplicity, the amount of tax refund is not defined in algebraic terms but simply represented as "RDTOH."

After one year, the net savings in the corporation, excluding the non-taxable portion of the capital gains but including the refunded tax (RDTOH), is paid out as a taxable dividend to Mrs. Singh. As for the non-taxable portion of the capital gains, it is distributed to Mrs. Singh tax-free as a capital dividend. To formulate this in a manner that facilitates comparison with the first scenario above, assume that all of the net savings at the end of the year, including both the RDTOH and the non-taxable portion of the capital gains, are paid out as a taxable dividend subject to the integration mechanism. To account for the fact that the non-taxable portion of the capital gains can actually be paid out as a tax-free dividend, an additional term is added to the equation representing the tax benefit of flowing that portion of the capital gains tax-free. That benefit is equal to the personal income tax payable on an equivalent amount of taxable dividend. However, for simplicity, this term is represented as "CDA."

Putting all these terms together means that Mrs. Singh's after-tax savings after one year, under this second scenario, would be equal to:

$$\left\lfloor A \times (1 - t^{CIT}) \times \left(1 + r(1 - 0.5t^{PIT})\right) + RDTOH \right\rfloor \times \left(1 - G(t^{PIT} - t^{CIT})\right) + CDA$$

Comparing the two scenarios

It can be seen that the two equations, under scenarios B1 and B2, become identical if both the terms "RDTOH" and "CDA" are removed from the second equation. This demonstrates that tax neutrality is obtained between the two scenarios described above by imposing a non-refundable corporate income tax on passive investment income equivalent to the top marginal personal income tax rate, and by treating the distribution of the non-taxable portion of capital gains as taxable dividends, as opposed to a tax-free capital dividend. As was the case for interest income, this conclusion is not affected by the length of the saving period or the rate of return on the passive investment.