TAX PLANNING USING PRIVATE CORPORATIONS

Technical Briefing

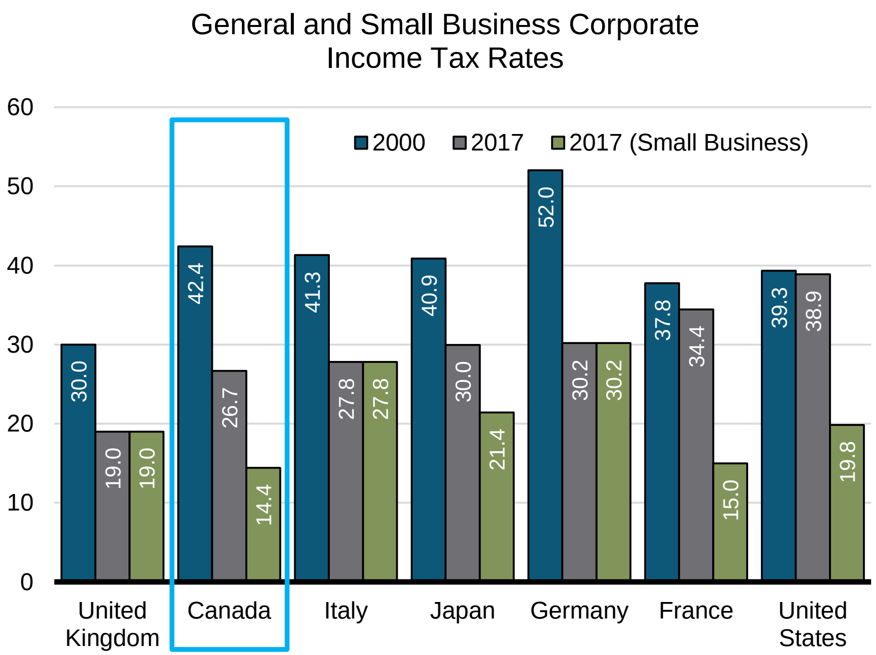
JULY 18, 2017

Outline

- Context
- Key Features of the Income Tax System
- First Strategy: Income Sprinkling
- Second Strategy: Passive Investment Income
- Third Strategy: Converting Income into Capital Gains
- Conclusion

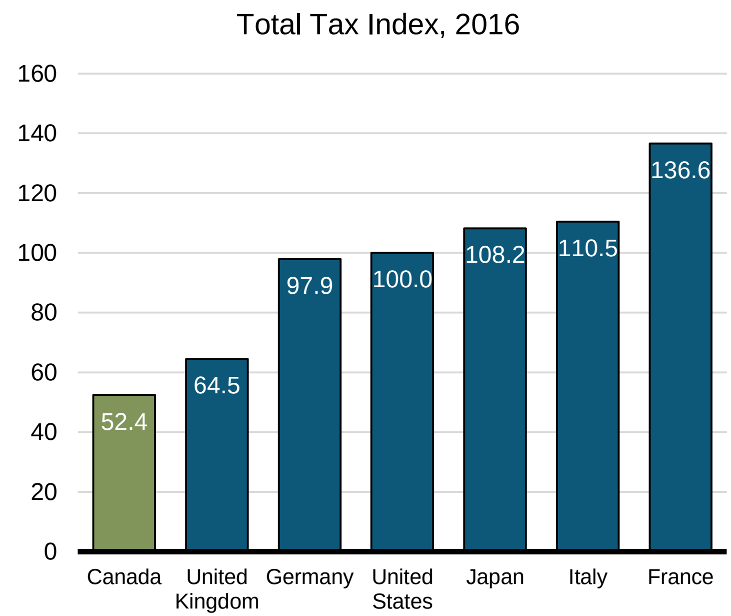
A Highly Competitive Tax System to Encourage Investment, Job Creation and Innovation

Canada has a highly competitive tax regime compared to G7 peers…



Source: OECD Tax Database

… and the lowest total tax costs according to KPMG



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

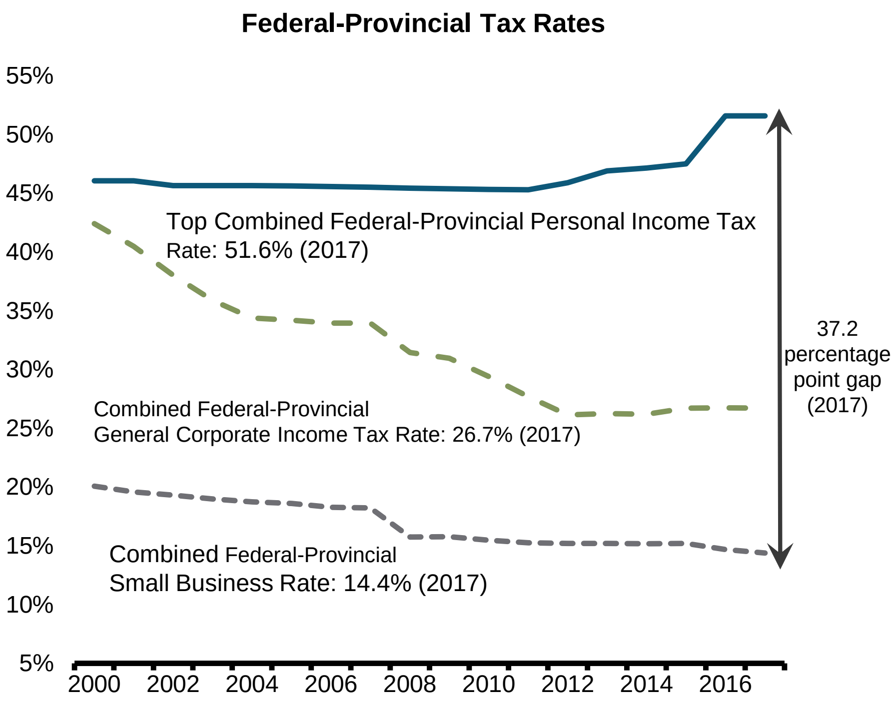
Need for Action

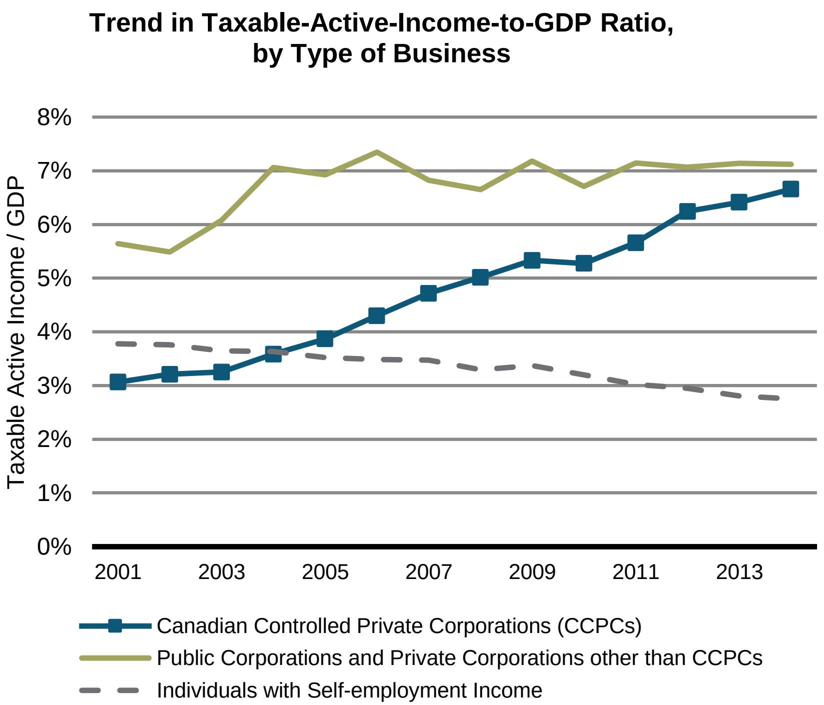
- The basic structure of the existing tax system has been in place since 1972
- Since that time:
  - The structure of the economy has evolved
  - The tax system has undergone important changes
  - Tax planning strategies used by private corporations have grown more sophisticated
- The focus is on private corporations given the scope of the tax planning they provide

Increasing Incentives for Tax Planning Using a Private Corporation

*The **growing gap** between corporate and personal income tax rates since 2000 has increased rewards associated with tax planning in a private corporation…*

… Over this period, a growing share of high-income self-employed individuals have chosen to incorporate





Key Features of the Income Tax System: Progressivity

- Canada’s personal income tax system is based on the individual’s ability to pay
- Those with higher ability to pay tax should bear a proportionally higher amount of tax than those with lower ability to pay

Taxable Income (2017)	Federal Personal Income Tax Rate
Up to $45,916	15.0
$45,916 to $91,831	20.5
$91,831 to $142,353	26.0
$142,353 to $202,800	29.0
Over $202,800	33.0

Key Features of the Income Tax System: Integration

- Low corporate tax rates on business income are intended to provide a tax advantage as long as income is retained for active business re-investments
- But income that is paid out of a corporation as a dividend is generally meant to be subject to the same amount of tax as income received directly by the individual

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

- This is the concept of ‘integration’ – it applies the progressive personal income tax schedule to income paid out of the corporation, adjusted for tax at the corporate level

Integration Example

- A high-income individual earns an extra $100. The overall after-tax outcome is generally similar whether that income is earned by an individual directly (i.e., via salary) or indirectly (i.e., via her corporation and paid out as a dividend)

Individual

Salary	**+ $100**
Personal income tax	-$50
After-tax income	$50

Corporate Owner

Business income	**+ $100**
Corporate income tax	-$15
Income after corporate tax	$85
On distribution as dividend: Personal income tax - Dividend income grossed up - PIT rates applied - Claim dividend tax credit	-$35
Total tax paid	*$50*
After-tax income	$50

Three Key Tax Planning Strategies

- **Sprinkling income using private corporations**
    - Shifts income from an individual facing a higher personal income tax rate to a family member who is subject to lower personal tax rates or who may not be taxable at all
- **Holding a passive investment portfolio inside a private corporation**
    - May lead to higher wealth accumulation than if the passive investment portfolio were held in a personal savings account
- **Converting a private corporation's regular income into capital gains**
    - Reduces income taxes by taking advantage of lower effective tax rates on capital gains

First Strategy:
Income Sprinkling – An Example

- Jonah and Susan are Ontario neighbours, each earning $220,000
  - As a **business owner**, Jonah is able to divert income to three adult family members who have no other sources of income
  - As an **employee**, Susan can't do this. She therefore pays $35,000 more in tax ($79,000 minus $44,000)

	Jonah	Susan
Total earnings	$220,000	$220,000
Salary paid	$100,000	$220,000
Dividends paid to family members (after corporate tax)	$102,000	-
Total tax paid (personal and corporate)	***$44,000***	***$79,000***
After-tax income	$176,000	$141,000

First Strategy: Income Sprinkling

- The *Income Tax Act* has rules that curtail income sprinkling. For example:
  - Expenses paid by a business, such as salary, must be reasonable in order to be deductible for income tax purposes
  - Tax on split income subjects minors (individuals age 17 and under) to top tax rate on dividends received from private corporations, as well as certain other income from businesses of family members
- However, current rules do not fully respond to many income sprinkling strategies

First Strategy: Income Sprinkling – Proposed Measures

- The Government proposes to extend the existing tax on split income for minors to apply to adults in certain circumstances
  - Dividends and other amounts received from a business, by an adult family member of the principal of the business, may be subject to a reasonableness test, which will be stricter for 18-24 year olds
  - Reasonableness will be based on the contributions made by the family member to the business
  - To the extent the amount is not reasonable, top-rate tax will apply
- Measures are also proposed to address other income sprinkling issues, including the multiplication of claims to the Lifetime Capital Gains Exemption

Second Strategy: Passive Investment Income - Context

- Corporations can earn **"active business income**" (income earned from conducting a business) and/or **"passive income"** (e.g., derived from portfolio investments)

- Proposed measures deal with passive income only and will not affect the taxation of active business income

Second Strategy:
Passive Investment Income - An example

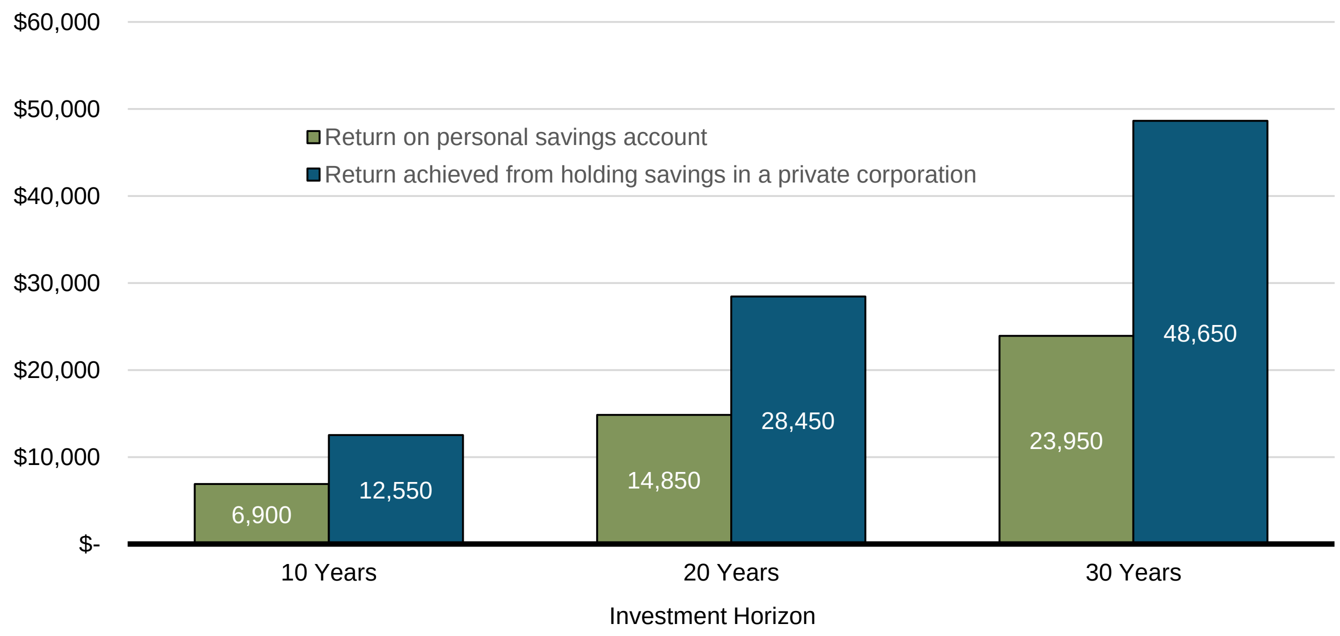
- An employee and a corporate owner each make one-time investments from $100,000 of pre-tax income, and hold them for ten years

	Employee	Corporate Owner
Gross Income to Invest	$100,000	$100,000
Corporate Income Tax	-	$15,000
Personal Income Tax	$53,550	-
Net Income Available to Invest	**$46,450**	**$85,000**

Passive Investment Income – Illustration of the Advantage

Comparison of After-Tax Passive Investments Returns

Individual Investing After-Tax Proceeds on $100,000 of Earnings, Directly or Through a Corporation (interest income, 3% return), over a Specified Investment Horizon



Passive Investment Income – Proposal

- The proposal would eliminate the tax deferral advantage on passive income earned by private corporations and
  - Preserve the intent of the lower corporate taxes: support growth and jobs
  - Re-establish fairness by ensuring that private corporations' owners do not have access to tax preferred savings options not available to others
- The objective is to make the system neutral on a **go-forward** basis

Third Strategy:
Converting Income into Capital Gains

- For higher-income individuals, dividends are taxed at a higher tax rate than capital gains, which are only one-half taxable
- As a result, income taxes can be reduced by converting dividends (and salary) that would otherwise be received from private corporations into lower-taxed capital gains
- There is an anti-avoidance rule that deals with transactions among related parties aimed at converting dividends and salary into lower-taxed capital gains
- This rule is being circumvented
- It is proposed to amend the income tax rules to address such tax planning

Tax Planning Strategies: Conclusion

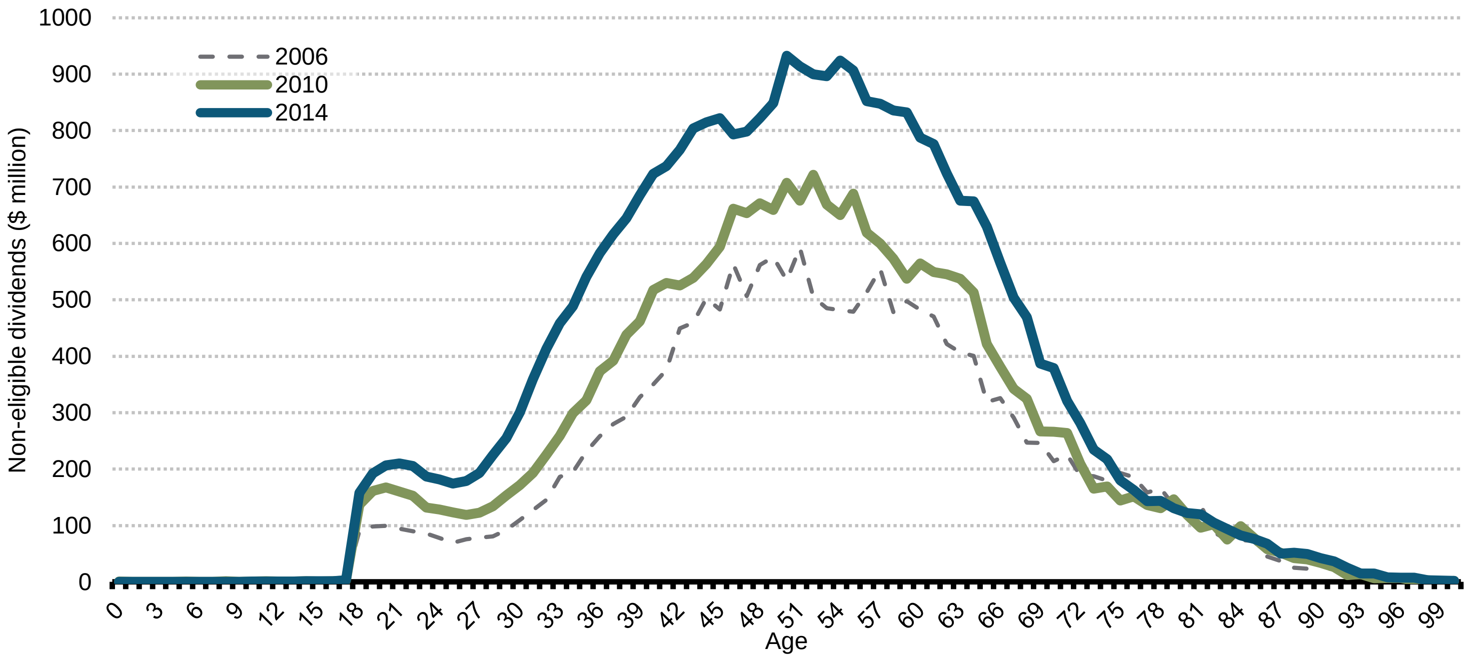
- Tax planning strategies by private corporations undermine the progressivity of the personal income tax system and raise fairness issues
- The Government is consulting Canadians on measures to close tax loopholes and tax planning by private corporations
  - Strategy 1 – Income Sprinkling: Detailed legislative proposals released for comment in conjunction with paper
  - Strategy 2 – Passive Investment Income: Seeking input on possible approaches. Potential directions outlined in paper
  - Strategy 3 – Conversion of Income to Capital Gains: Detailed legislative proposals released for comment in conjunction with paper

Annex: Proposed Measures to Address Income Sprinkling

- Under the proposed changes to the tax on split income (TOSI) rules, an amount paid to an adult family member will be considered reasonable if it is consistent with what a person who is not an adult family member would receive having regard to:
  - the **labour contributions of the individual** to the activities of the business;
  - the **assets contributed** or **risks assumed** by the individual in respect of the business; and
  - the **previous returns/remuneration** paid to the individual in respect of the business
- In recognition of the particular concerns with income sprinkling involving family members aged 18-24 under the current rules, the proposed reasonableness test is stricter for amounts paid to these family members

Annex: Income Sprinkling – Low-Rate Dividends

Low-Rate Dividends Reported on T1 Returns, By Age of Filers ($million)



- For high-income earners, benefits of income sprinkling are higher when adult children are younger