The Department of Finance's Proposals on Private Company Taxation

"Surgit amari aliquid", wrote Lucretius. If your Latin is rusty, the full line is this: "From the very centre of the fountain of delight something bitter arises that chokes us in our prime." It appears that the Department of Finance has determined we need choking.

On July 18, 2017 Finance released a white paper outlining various proposals that would significantly affect the taxation of private corporations. The government had said something was coming in the March 2017 budget, but almost everyone was surprised by the breadth of the changes. On October 3, Finance Minister Morneau admitted that changes were needed to his plan, but it appears the government is committed to keeping the core of the changes intact. 1917, 1972 and 2017 are going to be the three big years in Canadian history for sweeping tax changes.

Finance's four areas of concern

The proposals outlined in the white paper target:

1. Income splitting using private corporations;
2. Multiplying access to the lifetime capital gains exemption;
3. Distributions from private corporations that are taxed as capital gains; and
4. Passive investments owned by private corporations.

The government opened a public consultation period on the proposals until October 2, 2017.

Income Splitting

Income splitting with a private corporation usually involves the corporation paying a dividend to a family member of the controlling shareholder to take advantage of the lower marginal tax rate of that family member. At times the family member would receive the dividend directly, while in some cases it flows to him or her through a family trust. This planning works with a spouse with little other income, or with adult children with little other income. (The so-called "kiddie tax" only applies to minor children.)

Here is an example. Sally is a top tax rate income earner who owns all the Class A shares of her company ("OpCo"). Sally's son, Junior, age 19, owns the Class B shares of OpCo. Junior is in university and has little income. Junior has a $5,500 tuition bill to pay. OpCo could pay Sally a dividend of $10,000 on the Class A shares and the after-tax portion might be enough to pay Junior's university tuition. Alternatively OpCo could pay Junior a smaller cash dividend of $6,000 on the Class B shares, with the after tax portion being enough to pay his tuition bill. By splitting income in this way, Sally achieved tax savings of over $4,000.

Is this offensive? Well, employees of the Department of Finance cannot do it, which may explain why their advice to the Minister has been given in the way that it has. But this is a family business. In many cases, it really is a family that owns the business. The family is seeking to share in the profit of its business.

Finance's proposals – income splitting

There is already a kiddie tax in place that prevents income splitting as I just described with minors. Finance proposes to extend the kiddie tax to all Canadian residents, both adult and minor, who earn "split income" from a related private corporation (or partnership or trust) that has a "connected individual", unless the amount is reasonable in the circumstances. This reasonableness test generally adds subjectivity to any dividend paid to a shareholder who is related to another shareholder of the corporation. The test looks at the income recipient's labour and capital contributions to the corporation, including other income received from it as well. The test is stricter for adults aged 18-24. My suspicion is that very few spouses will accept that they did not make a reasonable contribution to the corporation, and the disputes over the next few years will be many.

Income on split income will be treated as split income as well. These measures are intended to come into effect in 2018.

Multiplying the capital gains exemption

Individuals can generally sell eligible shares of a private corporation and claim a lifetime capital gains exemption ("CGE") that shelters approximately $835,000 of realized capital gains from tax. A common planning measure puts shares in the hands of the controlling shareholder's family member(s), directly or indirectly through a family trust, so that each family member can use their CGE to shelter capital gains tax in the event of a sale. For example, with proper planning a business family with a controlling shareholder, a spouse and two children may sell an operating company and shelter approximately $3,340,000 from capital gains taxes.

Finance's proposals – multiplying the capital gains exemption

Finance views this type of planning as concerning, particular when the person using their CGE has not made material contributions to the business. Accordingly, Finance proposes that the CGE no longer be available;

- On gains accruing in years while the individual was under 18.
- If the taxable capital gain would otherwise be included in the new split-income tax regime, described above.
    - This may limit the ability of spouses and other adult family members from claiming the CGE if they didn't contribute their labour or capital to the business. Again, I suspect few spouses will accept that their contribution to the business was below the threshold reasonableness test.
- On gains that accrued during the time that the property was held in a trust.

These measures are intended to come into effect in 2018.

Capital gains planning

There are common strategies enabling shareholders to receive distributions from their corporations that are taxed at lower capital gains tax rates, instead of a higher dividend tax rates or even higher tax rates applicable to regular income. This is generally accomplished in one of two ways. The first is for the shareholder to trigger a capital gain by transferring shares to a related person (often a spouse) who uses the resulting high cost base on the shares to extract the

corporation's after -tax earnings. The high cost base shares would be transferred to the corporation in exchange for non-share consideration - like cash or a promissory note. This type of planning is the so-called "pipeline" transaction - the same pipeline transaction that is usually used after death to prevent double taxation (commonly called "post-mortem planning"). It wasn't clear, at first, if catching valid post-mortem planning was intended. It now seems likely that, whether intended or not, such planning will be gone by the end of the year.

The second way is to trigger a capital gain at the corporate level to generate a capital dividend account ("CDA") credit. The corporation would then distribute its after-tax earnings via a tax-free capital dividend and a taxable dividend.

Finance's proposals – capital gains planning

Finance proposes to prevent these two types of capital gains planning. In the case of the pipeline transaction, the receipt of the non-share consideration would be taxed as a dividend, not a capital gain. In the case of the second method discussed above, the capital dividend would be treated as a taxable dividend. These measures will apply to transactions that occur after July 18, 2017.

Passive investments owned by a corporation

Business owners achieve a tax deferral not available to, say, employees at the Department of Finance, when they save after-tax active business income at the corporate level instead of paying it out to themselves as a taxable distribution. Here is an example. Widget Co has a 13% small business tax rate. It earns $100 of active business income, and has $87 left over to invest after tax. If that same $87 was paid out as a taxable dividend to the shareholder, there would be about $51 left over after-tax for the shareholder to invest. The difference, $36, is a tax deferral because it will be subject to tax when it is eventually paid out of the corporation.

Passive income earned by a corporation (e.g. interest, and rent) doesn't benefit from a tax deferral because it is subject to tax at a high rate that is similar to a high income earning individual. More than half of this tax, however, is refundable to the corporation when it pays out a taxable dividend.

Finance's proposals – passive investments owned by a corporation

Finance's White Paper includes two possible methods of taking away the tax-deferral advantage enjoyed by business owners. Their preferred approach would focus on passive income, rather than passive assets. It does so by removing the refund of part of the corporate taxes levied on passive income when eventually distributed to shareholders (removing "RDTOH" for those who like the details). Instead they would be fully taxed corporately, then fully taxed again when distributed to shareholders. Their approach would also prevent a corporation from obtaining a CDA credit upon the sale of passive investments. The corporation would thus be prevented from distributing the non-taxable portion of these gains as tax-free capital dividends. The result is again double tax, once at the corporate level and again at the personal level, with no credit for the corporate tax already paid. The end result is that it would be very punitive to hold passive investments in a company.

The white paper states the government will consider how to ensure that these proposed measures have limited impact on existing corporate-owned passive investments. It is not clear when these proposed measures would be effective or if they will be enacted.

Impact of Finances proposals on estate planning and insurance

	How the proposals may affect *existing* insurance and tax planning	**How the proposals may affect *future* insurance and tax planning**
Corporate owned life insurance	Premiums on existing corporate owned policies could continue to be paid using after tax corporate dollars. It is unclear if the proposed measures would affect any policy gains realized by a corporation when taking funds from an existing life insurance policy. The issue depends on how the transition rules, if any, are drafted.	The proposals target passive income earned by a corporation rather than the accumulation of corporate retained earnings. As a result, corporations may continue to purchase tax-exempt life insurance policies using their after-tax dollars. Presumably, any policy gains realized by a corporate policy owner if making withdrawals from a policy purchased after the effective date of the new measures would be affected by the new tax regime.
Corporate owned annuities and segregated funds	Income earned by a corporation from taxable portions of annuity payments, if any, and allocations from segregated funds would appear to be unaffected. This issue depends on how the transition rules, if any, are drafted.	Segregated funds and annuities purchased after the effective date of the new measures will likely be affected by the new tax regime. This means income earned by a corporation from taxable portions of annuity payments, if any, and allocations from segregated funds would be subject to the non-refundable taxes on passive income. Personally held annuities will be much more attractive.
Insurance and Tax Planning	Business owners who have purchased life insurance coverage to fund an estate tax liability may need to reconsider their insurance needs based on the post-mortem planning likely contemplated in the past by their tax advisors. Pipeline planning was used to address the double taxation issue. This likely, will no longer work. The alternative of using loss carry back planning is good, but normally leads to a higher tax bill for your estate (the difference between capital gains tax rates and dividend tax rates).	You and your tax advisors will need to consider the post-mortem planning options available and what your final tax bill will be in light of these options. As noted, loss carry back planning will be a more attractive option for addressing the double taxation issue. You will pay more tax on corporate distributions which would have otherwise been taxed at capital gains tax rates or in the hands of family members with lower marginal tax rates. Estate freezes will continue to be important for minimizing tax on death, but will be less attractive than formerly with the curtailment of income splitting and multiplying access to the CGE. Tax advisors will need to consider if there is still an advantage to having holding companies continue to own passive investments other than life insurance. It may be these will be held personally.