



Smart Decisions. Lasting Value.

Crowe Soberman | Canada

Proposed Changes to Tax Planning Using Private Corporations

Crowe Soberman's Tax Group

The Department of Finance released their much anticipated consultation paper Tax Planning Using Private Corporations.

Because the Liberals referenced this consultation paper in their 2017 Federal Budget, the overall attack on tax planning for private corporations does not come as a complete surprise to the accounting community. However, the extent of the proposed changes to the tax rules are more significant than expected.

The rhetoric throughout the consultation paper is strong. The government repeatedly notes that they are “closing loopholes” and “increasing fairness”, and in addressing the latter, the paper compares the after-tax earnings of an employee to the after-tax earnings of a small business owner. Ultimately the

Liberal’s proposed tax measures are aimed at eliminating private corporation tax planning strategies, such as dividend income splitting, lifetime capital gains exemption planning and the use of corporate tax deferrals to make passive investments within a corporation.

The proposed tax changes will change the planning landscape for many of our clients. The draft legislation extends the application of the Tax on Split Income (“TOSI”, commonly referred to as the “kiddie tax”) rules to adult family members. Under the current rules, an adult child (18 years of age in the

calendar year) of the business owner can receive dividend income, either directly or via a trust, from the corporation without the incidence of kiddie tax.

In addition to targeting dividend and other corporate income splitting strategies, the planning strategy whereby the lifetime capital gains exemption is multiplied amongst family members that are not active in the business will no longer be available under the proposed amendments.

Unfortunately, the effect of these changes is that the tax landscape continues to become complex and cumbersome for small businesses. We have highlighted some of the key proposed changes released in yesterday's consultation paper below.

Income Splitting*

1. Adults over the age of 18 are now caught in the kiddie tax rules if they reside in Canada

and they receive income derived from a business of a related individual (e.g., 18 year-old daughter receives dividend income from mother's corporation).

2. A reasonableness test has been introduced to determine if the income amount received by the individual is commensurate with what would be expected in a similar arm's length arrangement.

a. Labour contributions are considered for individuals of any age that are receiving the income from a business of a related individual, with a more stringent test for the 18-24 year old cohort. This test looks at the extent to which the individual is actively engaged on a regular and continuous basis in the business.

b. Capital investment contributions are also considered, with a more stringent test for the 18-24

year old cohort. This test looks at whether the income earned on the contributions (rate of return) exceeds that computed at the CRA prescribed interest rate.

c. Previous returns and remuneration (dividends and/or salary/wages) will also be considered in determining if the amount paid to the individual is reasonable.

Constraining Multiplication of the Claims to the Lifetime Capital Gains Exemption ("LCGE")*

Under the current rules, a typical tax planning strategy for private corporation shareholders is to introduce a family trust for the benefit of the owner's spouse and/or children, to own the growth shares of the corporation. On a future sale of the shares of the corporation, the capital gain would be realized by the trust and allocated to each individual

beneficiary to be taxed in their hands personally, enabling them to utilize their LCGE (\$835,714 for 2017) to shelter all or a portion of the capital gain. To the extent the shares of the corporation are sold to an arm's length party, the kiddie tax rules would not apply.

Under the proposed amendments, this type of planning is curtailed by the introduction of the following measures applicable to dispositions after 2017:

1. An age limit test has been introduced; individuals will no longer be able to qualify for the LCGE with respect to capital gains that are realized, or that accrue, before the taxation year in which the individual turns 18. To the extent the individual will later claim the LCGE, a valuation of the shares owned by him or her would be required to support the value of the shares when the individual is 18 at the time the individual attains the age of 18 and otherwise meets the other tests discussed below.

2. A reasonableness test. The reasonableness tests would be the same as those described above for income splitting. If a capital gain from the disposition of shares is included in an individual's taxable income under the kiddie tax rules, he/she will not be able to claim the LCGE in respect of the gain.
3. If a gain has accrued during a period in which a trust holds the shares, an individual (beneficiary) cannot claim the LCGE. This measure is targeting plans whereby the value of the shares of a corporation are "frozen" in favour of a family trust the beneficiaries of which could later claim the LCGE on a future sale of the shares. Absent the trust, the family members may still not be able to claim the LCGE personally due to the age and reasonableness tests above.
4. A special election will be available for the 2018 taxation year which will enable individuals to crystallize their

unutilized LCGE with respect to the accrued gain in the shares up to that point. This planning will require a valuation of the shares of the corporation. If this crystallization is implemented and the individual has little to no other sources of income, consideration must be given to the alternative minimum tax ("AMT"). If AMT is paid in the crystallization year, it may be carried forward for up to seven years to be credited against basic federal tax payable in one or more of those years.

Partnerships and Trusts will now have to prepare T5 slips

Under the current rules, partnerships and trusts are not required to file T5 returns (and slips) for interest payments.

Under the proposed amendments, partnerships and trusts will be required to prepare T5 returns with respect to interest payments. Trusts with a prescribed rate loan outstanding, for example, will now be required

to report the interest paid thereon in a T5 return, with a T5 slip issued to the lender.

Holding Passive Investments Inside a Private Corporation

Within this area, the consultation paper does not provide draft legislation at this time, however, it does provide a number of alternatives that the government is looking at to neutralize the benefits of investing after-tax active earnings in a corporation. The government is inviting the public's comments to determine which alternative should be implemented.

The impetus for a change to this area of taxation, according to the Liberals, is that private corporations should not be used as personal savings vehicles for the purpose of gaining a tax advantage. Moreover, the Liberals assert that tax integration was never intended to be used to realize higher personal savings in a corporation.

The alternatives presented in the paper are complex and would appear difficult to administer from a compliance perspective. In short, the Liberals want to eliminate the initial deferral available on earnings taxed in a corporation at 15% (small business deduction) or 26.5% (general business rate) when those after-tax dollars are used to invest in passive investments.

Converting Income into Capital Gains*

The proposed legislation aims to curtail transactions that are "self-dealing" that effectively allow surplus of a corporation to be stripped out of the corporation as a capital gain, rather than a taxable dividend. Non-arm's length transactions whereby the cost base of an individual's shares is "stepped up" (even when the LCGE is not claimed by a non-arm's length seller) will be targeted.

The government is still considering allowing intergenerational transfers

in qualified small business corporations (QSBC) to not attract dividend taxation.

The proposed measures are extremely complex and affect many of our clients and their corporate ownership structures. It is imperative that you discuss these proposals with your Crowe Soberman tax advisor as soon as possible.

*draft legislation was included with the consultation paper

This article has been prepared for the general information of our clients. Specific professional advice should be obtained prior to the implementation of any suggestion contained in this article. Please note that this publication should not be considered a substitute for personalized tax advice related to your particular situation.

Connect with the Author

This article was prepared by Crowe Soberman's Tax Group. If you have any questions relating to this article, we encourage you to contact one of them.

Aaron Schechter, CPA, CA, TEP

Adam Scherer, BA, CPA, CA

Alexandra (Ali) Spinner, BA, MMPA, CPA, CA, TEP

Karen Slezak, BBA, CPA, CA, CFP, TEP

Karyn Lipman, BComm, CPA, CA

About Crowe Soberman LLP

Based in Toronto, Crowe Soberman is one of the leading public accounting firms in Canada. The firm has been in business over 60 years and has built a strong reputation in the community because of the excellent work our teams of dedicated professionals produce.

Our core services are in Audit, Tax, and Advisory. Along with these, we have professionals who specialize in Business Valuation, Claims Valuation, Corporate Recovery & Turnaround, Forensics, Estates & Trusts, Global Mobility Services, HR Consulting, Commodity Tax (HST), International Transactions & Consulting, International Tax, Litigation Support, M&A Transactions, Management Services, Personal Insolvency and Succession Planning. Members of our various specialty services groups are available when required as a technical resource to assist the client service team.

Crowe Soberman is an independent member of Crowe Global. As a top 10 global accounting network, Crowe Global has over 200 independent accounting and advisory firms in 145 countries. For almost 100 years, Crowe has made smart decisions for multinational clients working across borders. Our leaders work with governments, regulatory bodies and industry groups to shape the future of the profession worldwide. Their exceptional knowledge of business, local laws and customs provide lasting value to clients undertaking international projects. At Crowe Soberman LLP, our professionals share one commitment: to deliver excellence.