PROPOSED NEW TAX RULES - WHAT YOU NEED TO KNOW

On July 18, 2017, federal Finance Minister Bill Morneau released a consultation paper and draft legislative proposals (the "Papers") to address certain tax planning arrangements using private corporations. It is the government's view that these changes are necessary to close perceived tax loopholes and improve the fairness of the Canadian income tax system. It has been said that these proposed measures represent the most significant amendment to the taxation of private corporations in Canada since the 1972 tax reform. If enacted in their current form, these proposals would have generally broad application including increased income taxation on both distributions of income among family members and passive income earned on undistributed active business earnings. Additionally, there are proposals for transactions involving shares of private corporations and the "stripping" of corporate surplus accounts which will also increase the taxation thereof.

The Papers focus on three issues identified in budget 2017 and can be summarized as follows:

1. FURTHER LIMITATIONS TO INCOME SPLITTING AND THE CAPITAL GAINS EXEMPTION

Sprinkling income among family members (e.g., via dividends or capital gains) can reduce total income taxes of the family unit by causing income that would otherwise be taxed at the high personal income tax rate of one family member to instead be taxed at the lower rates of another family member. Multiple existing rules already target income splitting techniques such as this, including the "kiddie tax", which addresses income sprinkling with minors.

Effective from calendar 2018 onward, the Papers propose an expansion of the scope of the existing "kiddie tax" rules by applying them to a broader range of individuals and types of income:

- Individuals subject to the broadened rules would be those earning dividends or income derived from a business which is sufficiently linked to a related person, instead of being limited to persons under 18 years of age.
- Income subject to the "kiddie tax" rule would now include capital gains resulting from the sale of any share that, if dividends were paid on those shares, would have been subject to the rule.

The capital gains exemption permits individuals a one-time exemption from tax on the disposition of certain small business corporation shares, provided that the corporation being sold meets certain criteria. Under current rules, each shareholder of a corporation who is an individual may claim the exemption on the sale of his or her qualifying small business corporation shares.

The Papers propose three measures to address planning aimed at multiplying the capital gains exemption for gains realized on the disposition of certain qualified small business corporation shares. This would be accomplished by the following proposed changes:

- the exemption would be limited to capital gains that accrued on shares after the owner attains the age of 18;
- the exemption would no longer apply if the gain is included in the owner's "split income"; and
- the exemption would no longer apply, subject to certain narrow exceptions, to gains accruing while the shares are owned by a trust.

These rules would apply for the 2018 and later taxation years. However, there are certain transitional rules which could apply in limited and specific circumstances, permitting the crystallization of capital gains accruing through the end of 2017.

2. PASSIVE INVESTMENTS HELD WITHIN PRIVATE CORPORATIONS

It is common practice for a private corporation to invest its profits in an investment portfolio within the corporation, instead of paying those profits out to shareholders immediately. This may be for a variety of reasons, including permitting future use of the funds in the business, instead of relying on debt or capital contributions. Given that the highest corporate business income tax rate is generally much lower than the personal tax rate, the deferral potentially allows the compounding of profits invested in a passive portfolio.

The Papers contemplate rules whereby corporate profits of a Canadian controlled private corporation that are not reinvested into the active business would no longer benefit from the perceived corporate tax deferral.

The Papers contend that the effect of this measure would be to remove the deferral advantage gained by retaining after-tax surplus in the Corporation and would ultimately yield the same after-tax proceeds to an individual shareholder. The contention appears to be based on a very specific set of facts and assumptions. These proposals could very well cause a significant increase in the overall taxation of investment income earned by private corporations.

3. CONVERTING A PRIVATE CORPORATION'S REGULAR INCOME INTO CAPITAL GAINS

Given that the tax rate on capital gains is lower than the dividend tax rates, lower taxes can result where distributions which would otherwise be taxed as dividends would be taxed as capital gains. Transactions which deliberately convert dividend income into capital gains are sometimes referred to as "surplus stripping" transactions.

The Papers propose to broaden the existing rules on surplus stripping as well as to introduce a new general surplus stripping rule which applies to a much wider array of situations than current rules. The third proposal would change the scope of the application of section 84.1 of the Income Tax Act and introduce a new, more general surplus stripping rule at section 246.1 thereof. The proposed amendment to section 84.1 will target situations where taxpayers realize a capital gain on a transfer of shares to a non-arm's length party. The Department of Finance is concerned that in these circumstances the taxpayer should be paying tax at the dividend rate, not the capital gains rate. As currently drafted, however, the new rules would also apply to bona fide transactions that do not have a surplus stripping objective.

The proposed surplus stripping rules would apply to transactions occurring on or after July 18, 2017. The determination of whether the proposed rules apply to a given transaction, however, can be retroactive as currently drafted. If enacted, this retroactive effect may have significant negative tax consequences for tax plans that were put in place in prior years where those plans require transactions to take place after July 18, 2017.

PSB Boisjoli tax advisors are reviewing the Papers in great detail. We are contacting clients and other affected people, and will be making extensive submissions to the Department of Finance ("Finance"). We are proactively involved in making these submissions directly to Finance as well as through professional bodies such as the Canadian Tax Foundation, the Association de planification fiscale et financière (APFF) and the Society of Trust and Estate Practitioners.

Clients who have particular concerns or views in respect of the Papers should send their submissions to info@psbboisjoli.ca before Monday, September 11, 2017. These will be forwarded to our tax advisor for review and consideration in the drafting of their submission.

Here are a few key links and dates that may be of interest.

- To consult the documents: http://www.fin.gc.ca/activty/consult/tppc-pfsp-eng.asp
- To offer your written comments: fin.consultation.fin@canada.ca
- Deadline for input: October 2, 2017

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