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Private Company Tax Planning

Proposed Tax Law Changes

July 2017

The Department of Finance (Finance) recently introduced a consultation paper entitled "Tax Planning Using Private Corporations." This 63 page document outlined proposals (not law) that addressed tax planning and tax reduction strategies used by private companies in Canada. Finance is requesting input on their proposals by affected stakeholders by October 2, 2017. The major areas under review include:

- Income sprinkling through the payment of dividends to lower income shareholders.
- Capital gains income changes.
- Tax Treatment of passive investment income inside a private corporation.

The current federal government indicated it would be reviewing the tax treatment of private corporations as part of their election platform in 2015 so this review and proposal process was expected. The proposed changes generally apply to tax years starting in 2018 although again these are only proposed changes and not law at this point. Finance will consider input by affected stakeholders in finalizing their proposals into law. We encourage private corporations to express their views and concerns with these changes in writing. Please address your concerns in writing to the following:

Department of Finance

General enquiries

Phone: 613-369-3710
Facsimile: 613-369-4065
TTY: 613-369-3230
E-mail: fin.financepublic-financepublique.fin@canada.ca

This is the first time we have ever seen the government ask for commentary from taxpayers directly before implementing proposed tax law changes. The government is obviously concerned about the impact of these changes and we encourage you to express your views in writing if you are also concerned. The more concern they see the more likely they are to defer implementation or "soften" the changes.

Dividend Payments to Lower Income Shareholders

A common tax strategy in private corporations is to pay dividends to lower income shareholders who are generally related family members and thus reduce taxes payable by shifting income from a higher income taxpayer to a lower income taxpayer. This will reduce the tax payable on the income through a reduction of tax rates. The new proposals intend to apply a reasonableness test to dividends and only allow the beneficial tax result when a dividend payment to a shareholder is reasonable. Factors to consider in assessing the reasonableness of the dividend will include financial contribution by the shareholder, efforts expended and involvement in the business by the shareholder and risk assumed by the shareholder. Generally speaking, if the dividends are not found to be reasonable then top marginal tax rates would apply to the dividend paid, negating any tax savings. A reasonableness test is judgmental in nature and we would suspect that the challenge to dividends paid to adult children would pose the greatest risk. High risk would also exist for dividends paid to spouses or other family members who have no financial investment or involvement in the business. If a spouse or a family member is actively involved in the business the new proposals would have limited if any impact on tax results as the dividends would likely be reasonable.

One option to protect against this issue for shareholders who are not involved in the business is to have the shareholder inject capital into the business. This option will be feasible for those who have significant personal family capital available or significant corporate capital available. We would be pleased to review this option with you.

Capital Gains

A common strategy in private corporations is to maximize access to the capital gains exemption on the sale of qualifying small business corporation shares by utilizing a trust or direct shareholdings with family members.

The proposals will no longer allow individuals under the age of 18 to claim the capital gains exemption. In addition, if the shares are held by a trust or by any shareholder whose dividends would otherwise not meet the reasonableness test, they would generally no longer be eligible for the exemption. This strategy only benefits taxpayers who have business value that exceeds the capital gains exemption available to the primary shareholders. For example, if a husband and wife both have equal ownership shares in the company, the capital gains exemption available on the sale of the company shares is approximately $1,650,000. In this example the changes here would only affect value above $1,650,000. If there was only one shareholder the change would affect value exceeding approximately $825,000.

This proposal is effective for share sales after 2017. However, a special transitional rule will allow affected taxpayers to elect to trigger a capital gain on the affected shares in 2018 and utilize the capital gains exemption. This would then cause the cost base of the shares to be increased so that an actual future sale results in a lower taxable gain.

This issue is not relevant for medical professional corporations (except for dentistry) as medical professional corporations do not have significant share sale value for purposes of the capital gains exemption on qualifying small business shares.

Additional proposals relate to anti-stripping rules which are generally intended to prevent taxpayers from extracting retained earnings of their corporation as a capital gain. Additional rules are being proposed to make such structuring more punitive if taxpayers attempt to convert what would be a taxable dividend from retained earnings into a capital gain. Our practice never advises clients to complete such a transaction and thus we feel that this proposed change will have no impact on our clients.

Tax Treatment of Passive Investment Income

A common strategy in private corporations is to pay low rate corporate tax on active corporate earnings and reinvest the profit in an investment portfolio. As the corporate tax on the earnings is lower than the personal tax would have been, the corporation has more capital to invest and consequently will generate increased investment income. The proposals are investigating ways to reduce the benefit of this situation. Finance has not yet released proposed legislation relating to the tax treatment of passive investment income inside of a private corporation at this point, but changes are expected.

The topic of additions to the capital dividend account is under review. The capital dividend account allows payment of the non-taxable portion of investment income (generally capital gains) or other non-taxable corporate receipts (generally life insurance proceeds) to be paid out of the corporation on a non-taxable basis to shareholders. A review is being conducted to possibly limit what types of capital receipts can be included in the capital dividend account in the future. Any reductions to this account would make certain types of corporate investing less attractive.

The bottom line is that Finance is reviewing the tax treatment of corporate investment income to reduce the incentives to defer personal tax by leaving capital in a corporation and reinvesting the capital in passive investments.

Planning Considerations

We are reviewing all corporate client situations for any necessary action at this point. The difficulty is that we are dealing with proposals and not law. Action taken now may result in additional tax costs and professional fees and, depending on the final law, these actions may not be appropriate or relevant. We will be continuously monitoring releases from Finance for any changes to tax law or changes to the proposals. We will contact you directly if we feel any planning action is necessary currently. However, we ask you to keep the following in mind for the future:

- Reasonable possibility of increased tax payable in 2018 should be factored into long-term planning and budgeting. Major possible impact through dividends to adult children and additional tax payable for these dividends being taxed at higher rates. Maximum tax increase of approximately $15,000 per year per adult shareholder.

- Consideration to paying out larger dividends in 2017 to benefit from income sprinkling availability in 2017.

- Consideration to non-active shareholders investing capital in corporation to protect reasonable dividend payments.

- Utilization of capital gains exemption for minor children or trusts prior to elimination of exemption in these cases. This will involve a requirement to consider purification of assets prior to triggering capital gain. This planning consideration is only relevant if the company value exceeds the capital gain exemption for primary shareholders.

- Planning for less retention of corporate profit for investment purposes.

- Planning for increased taxation on passive investment income.

Overall the proposed tax changes are obviously not favourable. Please remember that income sprinkling with adult children generally has a short time-frame available, as once the adult children are earning reasonable income there are no real advantages. We certainly feel with the right documentation that spousal income splitting can be reasonably defended due to effort, financial support and risk relating to the spouse. Where possible, spouses should become more involved in business decisions to protect in this area. The capital gains exemption changes do allow one last chance to use the exemption so we will be monitoring this issue closely to see what can be utilized for our clients. What would be lost here is company growth that occurs after 2017. Changes to the taxation of passive investment income are currently not known, but we expect to see fewer advantages here.

The bottom line is that entrepreneurs who have benefited from the above noted tax issues may see increases in tax payable in the future and consideration will need to be given to amending budgeting and financial planning projections. We will always ensure that your tax position is optimized within the tax laws available. Currently we are in a bit of a "wait and see" environment.

If you have any concerns or would like to discuss any of these issues, please contact us directly. Again we encourage you to voice your concerns in writing to Finance to impact these changes, as they are changes that may affect your financial future.

Thank you as always for the opportunity to be of service to you.

Sincerely,

Parker Prins Lebano

Parker Prins Lebano Chartered Professional Accounts