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Tax Alert — Canada

Finance releases consultation paper and draft legislation targeting tax planning using private corporations

EY Tax Alerts cover significant tax news, developments and changes in legislation that affect Canadian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor or EY Law advisor.

"Our Government is proposing solutions to close loopholes and deal with tax planning strategies that involve the use of private corporations. These are complex rules, and we recognize it will mean a big change for some. That's why, over the next 75 days, we are asking for your help in telling us where we have it right, and where we can make improvements. Our intention, it bears repeating, is to help businesses grow, create jobs and support their communities. That's the spirit in which we are making these proposals, and the spirit with which we hope to receive comments, and suggestions."

On 18 July 2017, federal Finance Minister Bill Morneau released for consultation a paper and draft legislative proposals addressing 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. These proposed measures represent the most significant amendment to the taxation of private corporations in Canada since the 1972 tax reform. If enacted, these proposals would generally have broad application including an increased income tax burden on distributions of income among family members, passive income earned on undistributed active business earnings, and the proceeds from the disposition of private corporation shares.

Building a better working world

The measures discussed in the consultation paper are intended to target three specific areas:

- **Sprinkling of income using private corporations** – The government has released detailed draft legislative proposals, generally effective for 2018 and later taxation years, to limit income sprinkling to family members receiving "reasonable" compensation from a private corporation. The proposed measures cover the following three general categories: (i) extending the tax on split income rules; (ii) limiting multiplication of claims to the lifetime capital gains exemption; and (iii) broadening measures within the tax system to limit income sprinkling.

- **Holding a passive investment portfolio inside a private corporation** – The government is seeking input on possible measures to "neutralize" the tax advantage of investing undistributed earnings from an active business using a private corporation. The perceived advantage results from the fact that corporate income tax rates on active business income are generally lower than personal income tax rates, thereby allowing a greater amount of undistributed earnings to be invested in a passive portfolio.

- **Conversion of a private corporation's regular income or dividend distributions into capital gains** – The government has released detailed draft legislative proposals, effective on 18 July 2017, intended to prevent a private corporation's surplus income from being converted into a capital gain. Since taxable dividends and salary are taxed at a higher personal income tax rate than capital gains, a tax benefit may be obtained by converting corporate surplus into capital gains.

In light of the complexity and broad scope of the proposed changes to the taxation of private corporations, EY will continue to analyze the implications of the proposals, participate in the consultation process, and provide further comment and guidance in the near future.

To learn more about how these changes may impact your private business, contact your local Private Client Services professional at ey.com/ca/private.

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