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Tax Alert — Canada

Private company insights: federal tax reform

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.

On 18 July 2017, federal Finance Minister Bill Morneau introduced draft legislation, explanatory notes, and a consultation paper ("the proposal documents") proposing to fundamentally overhaul the system of taxation for private companies, their shareholders and family members.

These proposals are broad based and primarily target Canadian-controlled private corporations, regardless of sector, industry or economic grouping. Many of the proposed measures may not extend to public companies or foreign-controlled private businesses.

The proposal documents contained 137 pages of material and potentially represent a change in tax policy towards private companies.

The following is an executive summary of the proposals, and EY's initial insights into the potential implication of the rules.

Corporate reinvestment: proposal to increase taxes

Current system

Today, private corporations may reinvest their after-tax active business earnings in the corporation that generated the earnings, or distribute such earnings to a holding company shareholder. The latter approach is often used for commercially prudent investing to mitigate assets exposed to business risks.

As corporate tax rates on active business income are lower than personal rates, an incrementally higher amount of after-tax earnings is available for reinvestment as compared to income earned personally. This incremental amount, referred to as the "deferral" of personal tax, is eventually taxed and eliminated when the retained earnings are distributed to individual shareholders as dividends. In some provinces, the total corporate and personal tax incurred on a distribution of business earnings may be higher than had the income been earned personally.

There is generally no restriction on what types of reinvestment can be made by the corporation. Typically, investments include: reinvestment in the active business, real estate, marketable securities, loans, permanent life insurance, and venture investments in other private companies.

Canadian-controlled private corporations' passive investment earnings (i.e., not relating to an active business) are taxed at high rates that approximate personal tax rates. When these passive earnings are distributed and taxed in the hands of individual shareholders, the corporation receives a refund of tax approximately equal to what the shareholder pays in dividend tax. The refund mechanism ensures that the overall passive investment income is not double taxed and that an individual is generally indifferent to earning passive investment income directly, or through a corporation.

Proposals to increase tax

The proposal documents outline the government's view that the deferral of tax associated with corporate reinvestment by private companies, namely that a corporation has (on a temporary basis) additional funds to reinvest, is a perceived and unfair tax advantage not available to unincorporated individuals.

The government has therefore proposed to increase the tax on corporate "passive investments" funded from after-tax active business earnings.

Reinvestment in active business assets that generally do not produce passive investment returns (for example, inventory) are not affected by the proposed measures. The proposed measures on passive investment taxation, when also factoring the proposals relating to capital gains taxation below, are unclear on how they may apply to the eventual taxation of capital gains arising on the sale of business assets such as goodwill or real-estate, or the shares of corporations that exclusively earn active business income.

Two broad approaches to the taxation of passive investments were outlined in the proposal documents:

Immediate taxation proposal

An up-front but eventually refundable tax would be levied at a rate equal to the differential between personal and corporate rates. This tax would immediately eliminate the deferral of tax available to corporate reinvestment in passive investments. The taxes would be refunded if the passive investment were sold, or if amounts were distributed to the shareholders as a dividend. The proposal documents indicated the government is not actively pursuing this approach due to its perceived complexity.

Deferred taxation proposal

Current systems of corporate taxation would generally be left *status quo*, except that the eventual distribution of passive investment earnings (funded from after-tax business income) would be double taxed by eliminating the refund of high-rate corporate income tax on the investments, and eliminating the tax-free capital dividend account addition for the 50% tax-free portion of the corporate capital gain on assets funded from after-tax business income.

Using the proposal documents' representative tax rates, the combined rates of corporate and personal tax on the passive income and capital gains for investments funded from after-tax business income would be 71% and 57%, respectively. Actual rates of tax will differ depending on the province of taxation.

The higher overall fully distributed rate of tax on corporate passive investments would eliminate the deferral advantage of having had additional corporate retained earnings under most scenarios of passive investment rates of return, and the typical time frame of asset retention. Using the proposal documents' representative tax rates, the resulting after-tax funds arising from a distribution of passive investment income (funded from accumulated after-tax business income) would proxy the same after-tax funds had the after-tax business earnings been distributed and invested by the shareholder personally.

A nominal advantage may remain to corporate reinvestment, depending on the specific province of taxation.

On a fully distributed basis, effectively 100% of additional investment income earned by the corporation on the tax deferred investment assets will be fully taxed.

Grandfathering and other uncertainties

The proposal documents recognizes that corporations currently have significant accumulated passive assets and outlined that "It is the intent that the new rules would apply on a go-forward basis…the Government will consider how to ensure that the new rules have limited impacts on existing passive investments."

The proposal documents provide no commentary on, or discussion of, what would be grandfathered, or tracked in the future, or how such a transitional system would be implemented. Ambiguity remains around whether such grandfathering would apply to any corporation with accumulated retained earnings, or how business assets or private company shares with accrued but untaxed/unrealized gains would be treated under grandfathering methodologies.

Additionally, no commentary was provided on what will be considered a "passive investment", particularly when investments are made in other private corporations. Also, absent from the proposal document was discussion on whether corporate investments in permanent life insurance may be affected by the proposals or future changes in legislation.

Several other technical complexities were addressed in the proposal document regarding the corporate investment tax regime, including preserving the current system of passive investment taxation under certain scenarios, querying when the non-taxed portion of

corporate capital gains would be available as a tax-free distribution from the capital dividend account, and stratifying how shareholder distributions from corporations' passive earnings should be taxed.

Next steps

The proposals on corporate investment taxation are subject to public input and comment, and draft legislation was not released. Significant uncertainty remains on how the proposals may be implemented, and what final form will result. While potential tax planning opportunities may remain or be prudent through the transitional period, their effectiveness may be contingent on the final proposed legislation. The proposal documents outline that a transition period would be provided, once the final rules are proposed. No specific timeframe for implementation of the eventual draft legislation was outlined in the proposal documents.

Income sprinkling: proposal to increase tax

Draft legislation has been introduced to limit income sprinkling. The proposals are both complex and far reaching. Some long accepted tax planning may no longer be effective if the new rules are enacted as proposed for the 2018 calendar year.

Current system

Existing legislation is already in place to limit dividend payments to minor children and to limit the ability to transfer investment-type income to a spouse. These rules are referred to as "kiddie tax" and "attribution".

When introduced, the existing rules were crafted such that a dividend from a private corporation to a minor child would be subject to the highest marginal tax rate. However, current law is written such that it is permissible to share profits from that same family business with adult children or a spouse. Many families have used the ability to income sprinkle as a means to utilize the marginal tax brackets available to a lower income spouse, or an adult child attending post-secondary education.

As a point of reference, the approximate maximum tax savings from income sprinkling may be $25,000 to $35,000 per person per year (depending on the province of taxation) where an individual without income fully utilizes their marginal tax rates on $220,000 of income, compared to a high-rate taxpayer. The savings are progressively reduced when the family member has other sources of income.

Proposals to increase tax

Effective 2018, the income sprinkling proposals will limit the ability to share income within a family by:

1) Expanding the base of people (i.e., specified individuals) subject to the "kiddie tax" to include children over 18 and other related adult individuals (including spouses and using an expanded definition of "related" to include aunts, uncles, nieces or nephews), and

2) Increasing the types of income that are subject to the "kiddie tax" (i.e., split income) to include:

- Income on previous split income (under the current rules, income on split income was excluded) if the individual is under 25 years old
- Gains from the disposition of property if income from the property would otherwise be split income
- Income from loans to a corporation, partnership or trust if certain conditions are met
- Amounts included in income because of a benefit conferred by another person

The proposed rules will however exclude certain amounts received by an individual 18 and over that are "reasonable" in the circumstances. The determination of reasonable will depend on the age of the individual. For example:

- If the individual is 25 or over, a reasonable amount will be based on what an arm's-length party would have agreed to pay considering labour contributions, capital contributions and previous returns/remuneration.
- If the individual is between 18-24, a reasonable amount will be more restricted to an amount for labour "only if" the person is actively engaged on a regular and continuous basis in the business. In addition, they would be allowed a prescribed maximum return on assets contributed by the individual in support of the business.
- The proposal documents also include an anti-avoidance rule that deems individuals not to have performed reasonable services or effort where the principal income from the business is from passive investment income and capital gains.

Based on the above available exclusion, it will be necessary to determine what contribution (financial or otherwise) has been made by any related individual to a private corporation in order to assess the application of the new "kiddie tax" regime. The proposal document recognizes that the reasonableness test will depend on the facts of each case, and questions concerning the measurement of contributed value, or the evidence required to support such contributions, will not always be straightforward. No additional comments or guidelines were provided by the Department of Finance on what may determine a reasonable amount.

The following is a non-exhaustive list of currently available tax planning which may be precluded by the new proposals:

- An estate freeze where parents transfer the future growth in value of a business to the next generation. Dividends paid to an adult child that has not yet provided services or capital to the business will be subject to the highest marginal tax rate, regardless of their age.
- A new operating corporation is owned equally by two spouses. Dividends paid to one spouse that provides no capital or services to the business will be subject to the highest marginal tax rate.

- A family business corporation pays a 20-year-old child a significant dividend from the operating business in which the child was not actively involved. "Kiddie tax" is paid on the dividend at the highest marginal rate. The child then invests in his or her own active business venture. When the child's new business is successful and pays a dividend to its only owner (the child), that dividend may be subject to the highest marginal tax rate at the time.

The following is a non-exhaustive list of examples of common planning that may remain acceptable:

- Dividends paid to a taxpayer already subject to the highest marginal rate of tax.
- Reasonable salaries paid to family members for services provided.
- A new operating corporation is owned equally by two spouses. Dividends paid to either spouse that do not exceed the amount that would otherwise be paid by an arm's-length party for their services provided.
- A dividend paid to a 25-year-old, or older, related party investor in a private corporation provided the amount of the dividend is reasonable considering the capital advanced or the services provided to the business.
- Income earned on a property received from a parent on death.
- Income earned from a public company investment portfolio from what is commonly referred to as a "spousal loan."

As the proposed legislation is highly complex, there are some scenarios where it is unclear how the rules would apply. For example, two spouses equally own shares of a private corporation that earns investment income with no capital investment (all investments were funded with debt) and nominal services are provided by the spouses as they have outsourced investment management services. Would all dividends paid to both business owners be subject to the highest marginal rate?

Accordingly, all dividends or other income payments to family members should be reviewed to determine the potential application of the newly proposed rules. It would be advisable to review and discuss all income planning arrangements with your professional advisor prior to making any future payments.

The draft legislation is proposed to be effective for the 2018 calendar year.

Constraining access to the lifetime capital gains exemption (LCGE)

Current system

The LCGE is an exemption available to all individual taxpayers to exempt an otherwise taxable gain on the disposition of certain private company shares and/or certain farm or fishing property. The amount of the lifetime exemption is indexed for inflation, and currently is approximately $835,000 ($1,000,000 for farm property) for gains occurring in 2017.

On an arm's-length sale, the current system does not restrict the ability to claim the LCGE for minor children or spouses. Further, the family members need not own shares directly in the private corporation that is being disposed; an indirect ownership and allocation of a taxable capital gain from a family trust is currently eligible for the LCGE.

Proposals to increase tax

Draft legislation has been introduced to limit access to the LCGE. These changes are effective for 2018 and onwards. There are three proposed changes to restrict the access to the LCGE:

1) The LCGE will no longer be available on gains accruing in years while the individual was under 18. While a minor may receive proceeds from the sale of private company shares, the proposals limit the ability to use the LCGE.

2) The LCGE will no longer be available if the taxable gain would otherwise be included in the "kiddie tax" regime and the extended definitions of "split income" and "specified individual". This may prohibit the use of LCGE where the value of the gain attributable to the individual is greater than the reasonable value of services or capital provided to the corporation by the individual. This proposal may limit the ability of spouses and other adult family members (for example, parents) from claiming the LCGE on gains where they are silent/inactive shareholders or did not contribute significant capital to the business.

3) The LCGE will no longer be available on capital gains incurred by a family trust and allocated to the beneficiaries. This proposal will also extend to limit use of the LCGE by a beneficiary on the portion of the gain that accrued while a trust owned the property and subsequently distributed it to a beneficiary.

The proposals contain transitional rules that would allow an individual or trust to "crystallize" accrued gains in 2018 and utilize the LCGE where it may not be available going forward. The benefit of a crystalization would be to increase the tax cost of the property, and ultimately reduce the capital gains tax incurred on a future disposition. Certain existing conditions on when the LCGE can be used have been made more favourable to facilitate the transitional rules (for example, the time period required to hold shares).

However, the proposals as drafted (and how they interact with existing tax rules) appear to prohibit any crystallization transaction for minors where a private company's shares are to be retained by a related family group.

The proposed 2018 transitional rules will require a tax election to be filed by 30 April, 2019 in most cases, and are subject to numerous technical measures; these include potential indirect penalties for overstating the crystallization gains.

The new proposals are complex and it is prudent to review existing tax planning arrangements to determine whether use of the transitional election is advisable; for example, alternative minimum tax may arise on the realization of these crystallization gains.

Continued uses of trusts within tax planning arrangements should also be reviewed in the context of the proposed rules, as well as existing considerations relating to family law, succession planning matters, and corporate governance over a family's assets and business.

While there are prudent reasons for continuing to use a trust, it may preclude what would otherwise be a fully tax-exempt capital gain on the disposition of private company shares, and create a fully taxable capital gain.

Converting capital gains into dividends: proposal to increase taxes

Current system

Capital gains tax rates are generally substantially lower for individuals than the rate of tax applied on salary or dividend distributions from corporations. Subject to the above-described proposals on corporate reinvestment, the tax rate applicable to capital gains in a corporation when fully distributed to the shareholders also approximates the individual's capital gains rate in some provinces.

While there was speculation leading up to the March 2017 federal budget that the tax rate on capital gains might be increased (in response to the tax planning addressed by the current proposals and described below), no such increase occurred.

Capital gains may be realized on dispositions of property, including shares of private companies, in arm's-length and non-arm's-length sales. The current leading anti-avoidance tax measure prohibits an individual from realizing a low-taxed capital gain when selling a greater than 10% investment in shares of a particular corporation to another related corporation; in such circumstances, the gain on sale may be re-characterized as a dividend.

Additionally, sales of fully tax-paid assets to corporations may provide a means of swapping assets with a closely held corporation for purposes of accessing the existing tax cost of the asset. This includes sales of private company shares with "hard" tax cost, meaning the tax cost arises because the shares have been subject to tax at some point (and other than tax cost arising from a related party sale where the lifetime capital gains exemption was used, or gains accruing on the shares prior to the capital gains tax regime in 1972).

Proposals to increase tax

The proposal documents outline that the use of lower tax rates on capital gains as a means to extract corporate surplus, being assets that may otherwise be subject to dividend tax on a distribution and in the absence of any tax planning, is an inappropriate and unintended tax advantage. The proposals below included draft legislation with an effective date of 18 July 2017.

The first proposal contained in the draft legislation is to extend the scope of the leading anti-avoidance measure by prohibiting the use of tax cost in shares of a particular corporation, where the tax cost to the taxpayer includes sales/gains realized by a person not dealing at arm's length. Such parties could include a related person, or a person considered to merely be accommodating the tax planning arrangements. This rule will apply regardless of whether the person not dealing at arm's length reported and paid capital gains tax, or claimed the lifetime capital gains exemption. By suppressing the tax cost of the shares arising from a non-arm's length party's gain, the re-characterized dividend under the existing anti-avoidance rule will be higher. This may give rise to the same gain being subject to capital gains and dividend tax.

The second proposal contained in the draft legislation is a new anti-avoidance rule that will re-characterize any distribution from a corporation into a taxable dividend under certain broad and ambiguous circumstances, regardless of whether the distribution's legal form may be a tax-free return of capital, tax-free capital dividend, or even potentially a repayment of a fully tax-paid loan. Where the anti-avoidance rule applies to recharacterize a capital dividend or any other tax-free amount paid to an individual to be a taxable dividend, the proposal also reduces the tax-free capital dividend account arising from the series of transactions. The simplified circumstances under which the new anti-avoidance rule may apply are:

- An individual receives an 'amount', as part of transaction or event or a series of transactions or events, from a person with whom the individual was not dealing at arm's length;
- There has been a disposition of property, or an increase or reduction of capital of a corporation's shares; and
- It can reasonably be considered that one of the purposes of the transaction, event or series, was to effect a significant reduction or disappearance of assets of a private corporation such that the tax otherwise payable by the individual with respect to the portion, and in consequence of any distribution of property of a corporation, is avoided (i.e., is less than what would have been paid on the receipt of a taxable dividend).

Implications of the proposals

While interpretation of the proposed rules will continue to evolve through the consultation period, the following are some potential applications of the rules to situations which may be unintended:

- Despite indicating that these proposals are effective on or after 18 July 2017, they may have a retroactive effect:

  Firstly, the extended anti-avoidance rule for sales of a greater than 10% investment in shares will apply to transactions on/after 18 July 2017; however it appears the proposed legislation will include the effect of related party gains arising at any time, including prior to 18 July. For example, could this include a sale of shares by parents to the next generation in a succession planning context, where a transfer of shares subject to capital gains taxation occurred prior to 18 July 2017? The next generation may now and forever be precluded from using corporate earnings or surplus to fund the acquisition of these shares, despite the parental payment of tax on such capital gains.

  Secondly, the new anti-avoidance rule relates to the receipt of an 'amount' on or after 18 July, 2017; however, it appears the proposed legislation can be applied to transactions, or a series of events, which commenced prior to 18 July 2017. It is strongly recommended that any distribution from a corporation arising directly or indirectly from a capital gain be reviewed to assess whether the new proposals may impact the arrangements.

- Tax on death will increase, or be subject to double tax, where the deceased holds a greater than 10% investment in shares of a corporation and passes that corporation to a non arm's length person (for example, an operating business transferred to a related family member).

Current estate planning techniques permit an estate to avoid being double taxed by paying tax on capital gains at death on the appreciated share value, and subsequently distributing the corporate assets to heirs without the further incidence of tax. Under the proposals, the non arm's length nature of the transfer on death to family members will generally preclude heirs from accessing the corporate assets without paying additional tax on a dividend (i.e., double tax, since the estate paid capital gains tax on the same value). To mitigate the double tax, an alternative estate planning technique may be required, within the year following death, which will result in the estate being subject to the higher tax rates on dividends on the shares, instead of the lower tax rates on capital gains.

- Families will forever be required to trace and track the history of their closely held corporate shares to identify whether a related person, regardless of whether that person is alive or not, incurred a capital gain on the sale of those particular shares. Although a sale to an arm's-length person is permissible, should the family ever reacquire the corporate investment, the historic gains arising from the arm's-length sale will be 'bad' tax cost for purposes of the anti-avoidance rule.
- Due to the broad interpretive nature of the draft legislation, the new anti-avoidance rule may apply to seemingly benign commercial transactions. These could include the realization of capital gains on corporate assets followed by the distribution of proceeds, or a repayment of shareholder loans funded from the transfer of assets to a corporation or disposition by the corporation of its assets. Further guidance on when these proposals may, or may not, apply was not provided in the proposal documents.

Next steps

The draft legislation on converting capital gains to dividends is subject to public input and comment. While the proposal document outlines and recognizes there may be challenges in applying these rules to inter-generational business transfers, family succession planning was not addressed in the draft legislation and instead input and comment from the public has been requested.

Webcast

1 August 2017 webcast: Join us for a candid discussion on how these proposals and measures may impact your Canadian private company. The session will be hosted by Gabriel Baron and Ryan Ball, Tax Partners in EY's Canadian Private Client Services practice.

Click here to watch the webcast.

A replay link will be available if you are unable to attend the webcast live.

Learn more

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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