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LEGAL UPDATE: TAX PROPOSALS AFFECTING PRIVATE CORPORATIONS

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These are the dog days of summer, but while you may have been enjoying some well-earned sunshine and down-time, on July 18 the federal government released bombshell proposed amendments to the Income Tax Act that, if enacted, will fundamentally rearrange the system that has defined the taxation of private corporations and their shareholders in Canada for decades. Chief among the areas affected are the taxation of income split through family trusts and private company share structures, taxation of passive income earned by a corporation, and taxation of amounts extracted as capital gains rather than as dividends. The Department of Finance is accepting input from stakeholders during a consultation period that ends October 2, 2017. In the meantime, key aspects of the proposals in their current form have immediate effect as of July 18, 2017. As a result, we strongly recommend that any business owner operating through a private corporation or more elaborate corporate structure promptly reach out to a tax advisor to determine whether and how these proposals affect the taxation of income earned through the structure or the taxation of any current or proposed transactions involving a private corporation.

Key Proposals: The Highlights

Key among the proposed changes to the taxation of private corporations and their shareholders are the following:

1. Tax On Split Income: Until now, the Income Tax Act provided a fair degree of flexibility to business owners to income-split with adult family members through certain forms of share ownership and family trusts. It also made available to family trusts a mechanism through which the life-time capital gains exemption could be shared among family members following the disposal of qualifying shares.

   The proposals recently released significantly constrain the ability to income split and multiply the capital gains exemption in these once routine ways and, to the extent that the proposed new rules do allow income splitting, the rules introduce a high degree of uncertainty as to their scope and application. As drafted, the current proposals:

   - Extend the definition of "split income" to include forms of income not previously included, such as certain forms of interest income, taxable capital gains and indirect benefits.

   - Allow for income splitting with adult individuals only if the income is consistent with what would otherwise be a reasonable arm's-length return having regard to labour contributions made by the individual, capital contributed by the individual, risks assumed by the individual and historical rates of return.

- Deny family trusts the ability to allocate capital gains to beneficiaries in a manner that preserves access to the lifetime capital gains exemption.

- Deny the use of the lifetime capital gains exemption to minors, on any gain that accrued while the individual was a minor, that accrued while the shares were owned by a family trust or that would be considered “split income” under the new definition of split income.

- Contain transitional rules that allow some planning to be carried out now and into 2018 in order to crystallize or trigger gains ahead of the restrictions on the lifetime capital gains exemption.

2. Tax On Passive Investments: The regime for taxation of passive investments held by corporations has also been proposed to be fundamentally reorganized. The proposals have not yet been released as draft legislation but the intention expressed by the Department of Finance in its “White Paper” include removal of the existing RDTOH (“refundable dividend tax on hand”) regime, imposition of a non-refundable tax on passive income earned by corporations at the highest individual rate, and the creation of new notional pools from which the after-tax proceeds can be reinvested or extracted by shareholders. Under these new proposed rules, passive investing through corporations will no longer be possible in a tax efficient manner. Transitional rules for these proposals have not been released.

3. Tax on Dividends Converted to Capital Gains: Existing section 84.1 of the Income Tax Act and other provisions of the Act operate to prevent certain forms of “surplus-stripping” transactions whereby amounts that would otherwise be taxed as dividends are extracted in a manner so that they are taxed as capital gains. The draft legislation proposes to amend existing section 84.1 and to introduce a new section 246.1 so as to strengthen the existing anti surplus-stripping provisions of the Act.

   However, as currently drafted, the proposed amendments significantly constrain the ability of a non-arm’s length acquirer of shares to extract genuine cost base from a corporation on a tax-free basis. These new rules create significant consequences for previously complex but still routine tax planning such as:

   - Post-mortem pipe-line planning to avoid inherent potential double taxation on the death of a shareholder; and,

   - Intergenerational estate freeze planning and other non-arm’s length sales of businesses.

   The changes, if enacted, apply to any transaction that closes after the release date of July 18, 2017.

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What To Do

If you are a small or medium-sized business owner who operates through a corporation, has a family trust, or who has a more elaborate corporate structure, these new rules affect you now. As mentioned above, many of the new proposed rules will, once enacted, have effect as and from the announcement date of July 18, 2017. In addition, there are opportunities between now and the end of 2018 to prepare for and potentially mitigate some of the expected effects. All owners of private corporations are highly encouraged to seek advice from a tax specialist as soon as possible.

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