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Tax Planning Using Private Corporations

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On July 18, 2017, the Department of Finance released draft legislation that proposed to significantly alter the tax rules applicable to private corporations that operate a small business. In the months that followed, the proposals were met with resistance and criticism. At the time they were first introduced, these controversial proposals were intended to stop owners of private corporations from:

- "sprinkling" their income among their family members to reduce the family tax burden;
- multiplying the capital gains exemption by giving shares of the corporation to family members;
- using certain strategies to convert income into (lower tax) capital gains; and
- lowering their tax burden on passive income by funding an investment portfolio inside the corporation using earnings that are subject to the low small business tax rate.

On October 16, 2017, the Prime Minister and Minister of Finance announced that the government decided not to move forward with limiting access to the lifetime capital gains exemption. Three days later, the Minister of Finance announced that the government also decided not to move forward with the measures targeting taxpayers who convert income into capital gains.

Therefore, only the income sprinkling and passive income measures are expected to take effect. However, the government has promised to tweak the income sprinkling changes before enacting them into law. Details on the passive income changes will be revealed with the 2018 federal Budget. This article provides an overview of the current income splitting and passive income rules and discusses the pending changes to these rules.

Current Income Splitting Rules

The tax on split income ("TOSI") is intended to prevent income splitting with minor children, which is typically accomplished by having children subscribe for shares in corporations owned and run by their parents, or invest in partnerships which, typically, provided management services to a parent's professional practice. Often, the property generating the income to be split is held by a trust of which the minor child is a beneficiary.

The benefit of such income splitting is eliminated by taxing all children at the highest rate (33% for federal tax) on:

1. taxable dividends received on, or taxable benefits conferred in respect of, corporate shares not listed on a public stock exchange;
2. partnership income which can be sourced to a business carried on by a relative of the child directly or through specified corporate structures;
3. capital gains realized on a non-arm's length sale of shares, where dividends on the shares would be subject to the tax;
4. trust income which is essentially a flow-through of the kinds of income described in (i) and (ii); and
5. trust or partnership income derived from services to arm's length parties where a person related to the minor is engaged in providing those services or has an interest in the partnership.

An individual can be subject to the tax on split income only in respect of years in which he or she:

1. had not attained the age of 17 before the year (thus a child who turns 17 in the year is still subject to the tax);
2. was at no time in the year a non-resident of Canada; and
3. has a parent who is resident in Canada at any time in the year.

All three conditions must be met to be subject to the tax on split income. Given the high rate of tax applicable, it is generally best to avoid paying types of income that would be subject to the TOSI.

Expanding the Income Splitting Rules

The contentious "income sprinkling" measure proposes to expand the TOSI so it applies to additional family members and types of income as of January 1, 2018.

The TOSI currently applies only to individuals under 19 years of age but the government proposes to extend the TOSI to certain adults, and further expand the types of income to which the TOSI applies.

The TOSI will be expanded so that it also applies to the following types of income:

- interest on debt;
- gains from the disposition of property from which income received would be split income; and
- second-generation income (income that was subject to TOSI).

The TOSI will also be expanded to apply to spouses and adult children. Split income received by an adult child is subject to the TOSI if the amount received exceeds what would be considered a subjectively determined reasonable amount, having regard to:

- the labour contributed by the individual to the business;
- the capital contributed by the individual to the business;
- the risk assumed by the individual in respect of the business; and
- the total amounts paid to the individual before the end of the particular year.

The tax community is mostly apprehensive regarding this "reasonableness test" because it can be a subjective interpretation. A common concern is how taxpayers should be expected to demonstrate to the CRA that a payment is, in fact, reasonable. The government intends to introduce a simplified version of this reasonableness test, and further details on these changes are expected before the end of 2018.

Passive Income Earned in a Private Corporation

Currently, passive investment income earned by a Canadian-controlled private corporation is subject to a high refundable tax. This tax is levied on passive income in order to eliminate any potential tax advantage of investing in the corporation compared to if the owner merely earned the income directly. However, where a corporation earns small business income, it pays a low rate of tax on that income. If this after-tax income is used to invest in passive assets, the corporation has a much larger investment portfolio than what the owner would have if the income was paid as a dividend and then invested what was left. If the corporation's portfolio is invested for enough years, this tax deferral results in an absolute tax advantage (in certain provinces) that increases with time/returns.

The government proposes to significantly change the tax rules in order to eliminate this perceived tax advantage. At a glance, the government is proposing to introduce a higher rate of tax on income earned from investments that were funded by small business income. This high rate of tax is expected to eliminate any deferral advantage that would otherwise arise by reinvesting small business earnings.

Although no specific amendments have been proposed, the government plans to eliminate a perceived unfair advantage afforded to private corporations that hold passive investments. In the white paper released with the proposals on July 18, 2017, the government requested input from the tax community on how best to implement this policy, accompanied by potential legislative frameworks that the government is considering. The government has stated that the full details of these new rules will be revealed with the 2018 Budget.

On October 18, 2017, the Minister of Finance provided a preview what the government intends to introduce. Although few details were provided, the Minister revealed that:

- all past investments and the income earned from those investments will continue to be subject to the old tax rules;
- businesses can continue to save for contingencies or future investments in growth; and
- up to $50,000 of passive income in a year (equivalent to $1 million in savings, based on a nominal 5% rate of return) would be exempt from the new rules.