Taxation of Private Corporations – An Update

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Topics to discuss

1. Introduction: tax reform in Canada and internationally
2. Proposals to prevent income sprinkling
3. Proposals to limit claims for the lifetime capital gains exemption
4. Proposals to modify the taxation of passive investment income of private corporations
5. Proposals to limit conversion of income into capital gains

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Proposal to prevent income sprinkling

- Income paid to a family member from a CCPC will be taxed at the highest personal rate, unless the member can demonstrate his/her contribution to the business (extension of the "kiddie tax")
- The Government will introduce reasonableness tests for adult family members aged 18-24, as well as those 25 and older

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Proposal to prevent income sprinkling ...cont'd

These adults will be asked to demonstrate their contribution to the business based on four basic principles—whether they have made a contribution through any combination of the following:

- Labour contributions;
- Capital or equity contributions to the business;
- Financial risks of the business taken on, such as co-signing a loan or other debt; and/or
- Past contributions in respect of previous labour, capital or risks.

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Proposal to limit claims for the lifetime capital gains exemption

- Proposal to limit the lifetime capital gains exemption to the patriarch/matriarch of the family business and not permit other family members to claim it
- The Government will not be moving forward with measures that would limit access to the LCGE

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Taxation of Passive Investment Income of a Private Corporation

- Proposal to deny refundable taxes on investment income earned by a CCPC, having claimed the small business deduction and invested the after-tax amount in so-called “passive investments”, resulting in tax rate of potentially 73% once fully distributed
- The Government will move forward with measures to limit tax deferral opportunities related to passive investments, while:
  - Ensuring that investments already made by private corporations' owners, including the future income earned from such investments, are protected. The measures will apply only on a go-forward basis;

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Taxation of Passive Investment Income of a Private Corporation

- Propose an annual passive income threshold of $50,000 (equivalent to $1 million in savings based on a nominal 5-per-cent rate of return)
- There will be no tax increase on passive income below this threshold. Further details will be released in Budget 2018, including a technical description of how the passive income threshold will be applied

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Taxation of Passive Investment Income of a Private Corporation ...cont'd

- The Government will work with the venture capital and angel investment sectors to identify how incentives can be maintained to invest in the next generation of Canadian innovation
- The Government will also examine all deferral benefits from passive investments and will continue to assess key design aspects. For example, consideration will be given as to the appropriate scope of the new tax regime with respect to capital gains, including whether in certain circumstances the new rules should exclude capital gains realized on the sale of shares of a corporation engaged in an active business

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Taxation of Passive Investment Income of a Private Corporation ...cont'd

- In this proposal, the Government remains committed to tax fairness, and the approach will ensure the measures are focused on a small number of high-income individuals who get the biggest advantage from existing rules. The Government will propose measures to limit tax deferral opportunities related to passive investments and release draft legislation as part of Budget 2018
- Small business corporate income tax rate (combined Federal and Ontario) will be lowered from 15% to 13.5% in 2018 and to 12.5% in 2019

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Conversion of Income into Capital Gains

- The Income Tax Act has rules intended to address the use of various transactions by some taxpayers "to avoid paying their fair share of taxes"
- Section 84.1 is intended to address the conversion of amounts that would otherwise be taxed as dividends into lower-taxed capital gains
- Proposed Section 246.1 would prevent "surplus stripping" by imposing the highest level of tax on corporate surplus being distributed to individual shareholders in certain cases

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Conversion of Income into Capital Gains …cont'd

- The consultation raised issues with respect to unintended consequences (blocking "pipeline transactions") and potential challenges with respect to intergenerational transfers of businesses, including farms
- Given these issues, the Government will not move forward with the proposed changes regarding the conversion of income into capital gains

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Questions?

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