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Proposed Tax Changes to Private Corporations
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On July 18, 2017, the Department of Finance ("Finance") issued a consultation paper and draft legislations that proposed significant changes in the taxation of private corporations that target tax planning strategies that Finance perceived as tax loopholes and unfair tax advantages enjoyed by high-income individuals using private corporations.

1. Tax on income sprinkling using private corporations

Under existing legislation, taxpayers can shift income by using private corporations to distribute dividends and capital gains to their spouses, adult children and/or other related individuals who are taxed in a lower income tax bracket, known as "income sprinkling" or "income splitting". Only minor children are subject to the highest marginal tax rate, which is the "kiddie tax" on this split income.

Effective in 2018, Finance proposed in its draft legislation to extend tax on split income to additional types of income and income shifted to certain individuals, such as adult family members not actively involved in the business. The proposed rules would however exclude certain amounts received that are "reasonable". The reasonableness test would be based on factors such as labour and capital contributions, risk assumed, and previous returns and remuneration paid to the individual in respect of the business. The reasonableness test would be even more restrictive for family members between ages 18 to 24. If the reasonableness test is not met, the highest marginal tax rate would apply to the split income.

2. Lifetime capital gains exemption (LCGE)

The LCGE provides for qualified individuals to claim a deduction against capital gains realized on a disposition of shares of a qualified small business corporation and interests in qualified farm and fishing properties. The capital gains deduction limit for 2017 is $ 835,714. Under the current tax system for an arm's length sale, there are no restrictions for minor children or spouses to claim the LCGE, including capital gains distributed through a trust that is eligible for the LCGE.

Effective in 2018 under the proposed draft legislation, the LCGE would no longer be available on any gains accrued during the time that the property was held by a trust (exceptions are available for life interest trusts which include spousal or common-law partner and alter ego trusts). Also, LCGE would no longer be available on gains accrued during the years an individual is under the age of 18, as well as taxable gains from property that would otherwise produce "split income" as mentioned above.

The proposal contains special transitional rules that would allow an adult individual or trust to make an election to trigger accrued gains in order to utilize the LCGE in 2018.

3. Taxation of corporate reinvestments

Under the current tax integration system, business income that flows through a corporation to an individual should not be taxed differently, in total, from business income earned directly by that individual. However, since corporate income tax rates for active businesses are generally lower than personal income tax rates, there is an incentive to earn active business income through a corporation and then retain the after-tax funds within the corporation to earn passive income, creating a tax "deferral" advantage.

Finance is seeking to eliminate this deferral advantage. Two broad systems have been proposed for comments. The new systems would replace the current refundable taxes on passive income, so that the result would neutralize the deferral advantage of reinvestment in passive assets in a corporation. The new regime would also affect eligible dividends and capital dividend accounts. However, reinvestments in active business assets that generally do not produce passive investment returns are not affected by these proposed measures.

No draft legislation was released on these proposed measures, and significant uncertainty remains on how, when and if these proposals would be implemented.

4. Converting a private corporation's income or dividend distributions into capital gains
Currently, anti-avoidance rules under Section 84.1 of the Income Tax Act prevents corporate surplus from being extracted at the lower capital gains tax rate instead of the higher dividend tax rates. This would apply when an individual sells a greater than 10% investment in shares of the corporation to a non-arm's length corporation, or when corporate surplus is extracted from a closely held corporation where the LCGE was previously claimed.

Effective on July 18, 2017, Finance proposed in its draft legislation to expand the anti-avoidance rules under Section 84.1 by reducing the cost base of the individual's shares of a private corporation by the amount of capital gains realized on previous dispositions of shares by the individual and any non-arm's length parties, regardless of whether a LCGE was claimed on the previous disposition. The new proposed rules may result in double taxation to an Estate holding shares of a private corporation, as well as genuine business transfers between family members.

Further, Finance proposed a second new anti-avoidance rule in the draft legislation to prevent the conversion of a private corporation's surplus into tax-exempt or lower-taxed capital gains. In general terms, the new rule applies to amounts received by an individual from non-arm's length person where the transactions involve either a disposition of property or increase/decrease in paid-up capital, and if it can reasonably be considered that one of the purposes of the transactions is to effect a reduction of the corporation's assets such that an individual's tax on a distribution is avoided. If the new rule applies, an amount received or become receivable by an individual on or after July 18, 2017 would deem to be a taxable dividend.

Due to the broad interpretive nature of the draft legislation on the new anti-avoidance rules, it is unclear what extent to which the rules can apply to an ordinary course of transactions, such as repayment of shareholders' loans arising from sale of assets to corporation, or distribution of capital dividends from the corporation's capital dividend account arising from sale of assets to an arm's length party.

These proposed tax changes are broad and complex. Finance is seeking input from the public on its proposals by October 2, 2017. Our firm will continue to follow the progress of this consultation closely and assess the potential impact to private corporations. Please contact us for more information on the implications to you and your business.