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Leadership in advocacy and innovative advanced planning solutions.

CALU Mission

CALU educates and mentors members and influences government tax policy and legislation for the benefit of its members and their clients.

Finance Consultation on the Taxation of Private Corporations

CALU SPECIAL REPORT | AUGUST 2017

CALU Special Report

Finance Consultation on the Taxation of Private Corporations

Introduction

On July 18, 2017, the Department of Finance ("Finance") released a consultation paper and draft legislation that will significantly and negatively impact the tax and succession planning arrangements of many shareholders of private corporations.

CALU is very concerned with this legislation – it demonstrates a lack of understanding and appreciation of the role played by entrepreneurs in Canada. The small business sector is the largest employer in Canada and a major contributor to the growth of the economy. Small business owners assume significant ongoing business and financial risks and should be entitled to benefit from their success – their tax treatment should not be benchmarked against that of salaried individuals. We believe that if these proposals are enacted as described in the consultation paper it will send a very negative message that will stunt the growth of the small business sector. CALU plans to work with other stakeholder groups to communicate this message to the federal government (the "Government"), opposition parties and possibly directly to the general public.

To ensure our members are familiar with the Government proposals, this CALU *Special Report* provides a "condensed" version of the consultation paper as well as our preliminary observations on the potential impact of the proposals on small business owners and life insurance ownership. Further information will be provided to members as we develop our formal response to the proposals with committee input, and have the opportunity to consult with other stakeholder groups.

Excerpts from Finance's Consultation Paper on the Taxation of Private Corporations

A. Private Corporations – Tax Planning Strategies

As indicated in Budget 2017, the review of federal tax expenditures highlighted a number of issues regarding tax planning strategies using private corporations. These strategies include:

- Sprinkling income using private corporations, which can reduce income taxes by causing income that would otherwise be realized by a high-income individual facing a high personal income tax rate to instead be realized (e.g., via dividends or capital gains) by family members who are subject to lower personal tax rates (or who may not be taxable at all).

- Holding a passive investment portfolio inside a private corporation, which may be financially advantageous for owners of private corporations compared to other investors. This is mainly due to the fact that corporate income tax rates, which are generally much lower than personal rates, facilitate the accumulation of earnings that can be invested in a passive portfolio.
- Converting a private corporation's regular income into capital gains, which can reduce income taxes by taking advantage of the lower tax rates on capital gains. Income is normally paid out of a private corporation in the form of salary or dividends to the principals, who are taxed at the recipient's personal income tax rate (subject to a tax credit for dividends reflecting the corporate tax presumed to have been paid). In contrast, only one-half of capital gains are included in income, resulting in a significantly lower tax rate on income that is converted from dividends to capital gains.

B. Income Sprinkling

Background

What is income sprinkling?
Income sprinkling describes a range of tax-planning arrangements that result in income that, in the absence of the particular arrangement, would have been taxed as income of a high-income individual, but is instead being taxed as income of another lower-income individual, typically a family member of the high-income individual. The effect of the arrangement can be to have income subject to a lower effective income tax rate. This is achieved by accessing tax attributes of the lower-income individual, including the individual's lower marginal tax rates, personal tax credits (such as the basic personal amount) and, in some cases, certain deductions in computing taxable income (such as the lifetime capital gains exemption (LCGE)).

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Income sprinkling arrangements effectively allow high-income individuals, in particular the principals of private businesses, to 'opt out' of all or part the progressivity of the personal income tax system to their own advantage. This is fundamentally unfair, and erodes the tax base and the integrity of the tax system.

Who benefits from income sprinkling?
Income sprinkling arrangements are possible because the private ownership of a business permits its principals to more easily control or influence the legal form of the ownership of the business and the circumstances in which profits are distributed. Specifically, the principals of private businesses can arrange for distributions to be made (typically by way of dividend payments in the case of a corporation) to other individuals (typically family members) in a way that minimizes the overall amount of personal income tax paid on that income. The income distributed to the family member may exceed what would have been expected, having regard to the family member's

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labour and capital contributions to the business, in arrangements involving arm's-length investors.

Family members receiving sprinkled income may not have contributed to the business and, in some cases, may not be permitted, under the laws governing the business, to carry on the revenue-earning activities of the business (e.g., due to a requirement for individuals to be licensed or certified to carry on the activity).

Not all business owners or principals are able to benefit, or benefit to the same degree, from income sprinkling. The tax benefits increase with income and with the number of family members who can receive the sprinkled income. In absolute terms, the tax benefits are potentially the greatest for individuals who, in the absence of the arrangement, would pay income tax on the income at the highest personal tax rate (which at the federal level is 33 per cent for taxable income, for 2017, above $202,800).

More generally, income sprinkling provides tax benefits to individuals engaged in the tax planning where:

- The family member who receives the sprinkled income is in a lower tax bracket than the individual, or has deductions or credits that would otherwise be unused. For example, there is no direct tax benefit to sprinkling dividends where the only potential family member with whom to sprinkle income has taxable income from other sources that exceeds the threshold at which the top personal tax rate applies.
- The tax savings justify the initial and ongoing transaction costs associated with the arrangements. These costs include service fees paid to financial and tax advisors who advise on implementing and maintaining the arrangements, and any costs related to maintaining the intermediaries – such as corporations, trusts and partnerships – typically used as part of the arrangements.
- The individual as a business principal can control or influence the payment and legal form of the income, allowing for different amounts to be used and different family members to participate from year-to-year, based on the available tax attributes of the family.

In the case of private corporations, tax data, as well as tax commentaries, suggest that the ability to reduce the effective rate of tax on personal income, including through income sprinkling, is an important consideration in deciding whether to incorporate a business and how to structure ownership of a private corporation. Tax data and commentary also suggest that in other circumstances, including where ownership of a corporation by family members is not permitted – which is the case with certain incorporated professionals – separate partnership and family trust arrangements are used to facilitate income sprinkling.

Effectiveness of Current Rules

The income tax system includes rules to curtail the use of income sprinkling, and the Canada Revenue Agency (CRA) has challenged inappropriate arrangements.

These rules include the following:

- A longstanding rule, set out in section 67 of the Income Tax Act, provides that only "reasonable" amounts can be deducted when a corporation or other business owner pays a salary or management fee, or claims other outlays or expenses, that benefit another person including a family member.
- Tax "attribution rules" can attribute property income to an individual if it is determined that the individual transferred or loaned the property

(including a right to income) on non-arm's-length terms or with the intention of conferring a benefit on another person, typically a non-arm's-length individual. These rules are for the most part found in sections 56 and 74.1 to 75.1 of the Act. In addition, in the case of a transfer or loan by an individual to certain private corporations, a minimum income return can be imputed to the individual under a special rule contained in section 74.4 of the Income Tax Act.

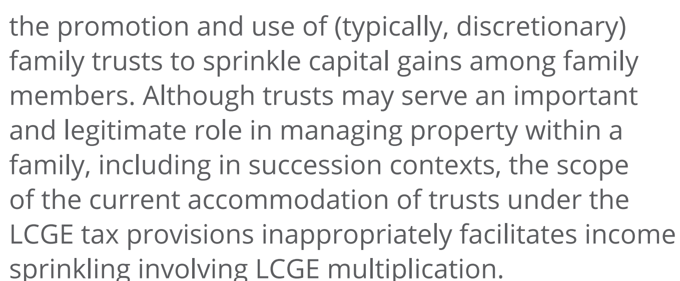
- A special 'tax on split income' (TOSI), set out in section 120.4 of the Income Tax Act, was introduced in 1999 to address sprinkling of certain income to minor children (i.e., individuals under the age of 18 years). The rules apply to income from private business arrangements, such as dividends on unlisted shares, or income in the form of a trust or partnership distribution derived from a business or rental activity of a related individual. The TOSI also denies access to the LCGE in respect of the disposition of shares as part of a non-arm's-length transaction. In cases where the TOSI applies, the income is subject to top flat-rate personal income taxation in the hands of the minor, and personal tax credits (with the exception of the dividend tax credit and foreign tax credit) are denied with respect to the amounts.

The current tax rules have proven effective in responding to some, but not all, forms of income sprinkling. Tax benefits of income sprinkling continue to be available with respect to certain arrangements. For example:

- The current tax rules do not fully respond to income sprinkling involving adult family members, and where the rules do apply to cases involving adult family members, they are typically limited to arrangements involving a spouse or common-law partner.
- Some high-income individuals are using arrangements involving tax-deductible interest payments to sprinkle income to minors and other family members, circumventing the TOSI in the case of minors.
- Current tax rules, including both tax attribution rules and the TOSI, that seek to constrain income sprinkling do not apply to "compound" income (i.e., second- and later-generation income earned from the investment of an initial amount of income that is subject to the tax attribution rules or the TOSI). This has led to some arrangements that obtain the tax benefits of income sprinkling on investments of the after-tax proceeds of sprinkled income.

A related concern is that jurisprudence has, in some cases, narrowly interpreted some of the existing anti-avoidance rules that seek to address sprinkling, or determined the context and purpose of the rules as not demonstrating a rationale supporting the general prevention of income sprinkling, reducing the prospect of success from the costly and time-consuming process of challenging these arrangements, including using the general anti-avoidance rule. Although the CRA may seek to challenge some existing arrangements using the current tax rules, it has become clear that amendments to the income tax provisions are required to address the ongoing tax policy concerns with income sprinkling.

The current tax rules do not appropriately constrain the multiplication of access to the Lifetime Capital Gains Exemption (LCGE), with the result that the LCGE may be claimed by several members of the business principal's family in circumstances where those individuals may not have effectively contributed to the business in respect of which the exemption is being claimed. A particular concern is



the promotion and use of (typically, discretionary) family trusts to sprinkle capital gains among family members. Although trusts may serve an important and legitimate role in managing property within a family, including in succession contexts, the scope of the current accommodation of trusts under the LCGE tax provisions inappropriately facilitates income sprinkling involving LCGE multiplication.

Proposed Measures

1. Extension of the tax on split income (TOSI) rules

The TOSI rules currently apply to a specified individual's split income for a taxation year. A specified individual is a Canadian resident who has not attained the age of 17 before the beginning of the year (a "minor") and who has a parent resident in Canada. Split income generally includes dividends on unlisted shares of a corporation (other than a mutual fund corporation), and income from a partnership or trust that is derived from a business, profession or rental activity of a related person. The TOSI does not apply to income received by the specified individual as salary or wages (i.e., employment income), although other rules in the Income Tax Act may apply, including a limitation on the deductibility of salary or wages that exceed a reasonable amount.

The TOSI takes precedence over other anti-avoidance rules that apply to income sprinkling, meaning that, to the extent that an amount is subject to the TOSI, the other mechanisms (such as the attribution rules described above) do not apply.

Measures are proposed to extend the TOSI to apply to certain adult individuals who have amounts included in split income, but generally only to cases where the amount is unreasonable under the circumstances. In addition, the measures would expand the circumstances in which the TOSI applies, including the types of income that are considered to be split income. The TOSI would continue to not apply to income received by an individual as salary or wages (i.e., employment income).

Generally, these measures would apply the TOSI to a Canadian resident adult individual who receives split income (i.e., income from the business of a related individual, including a corporation over which a related individual has influence), when the amount in question is unreasonable under the circumstances. An adult individual in receipt of split income would be liable for the TOSI on the unreasonable portion of the income.

Proposed measures will:

- Expand the meaning of 'specified individual.' As described above, only specified individuals are liable under the TOSI. The measures would extend the meaning of 'specified individual' to include Canadian resident individuals, whether minor or adult, who receive split income. Adult individuals who do not receive split income would not be affected by the measures.
- Introduce a reasonableness test. A reasonableness test would be introduced for the purpose of determining whether TOSI applies to a specified individual who is an adult. If a split income amount received by an adult specified individual is reasonable within the meaning of this test, then the amount that would otherwise be split income of the individual would be excluded from split income and thus not be subject to the TOSI. As described in detail below, the test is proposed to apply differently based on the age of the adult specified individual (i.e., whether the individual is between 18 and 24 or is 25 or older), recognizing the opportunities for income sprinkling with younger adult family members.
- Introduce the definition 'connected individual.' A connected individual test would be introduced to determine whether an adult specified individual's

income from a corporation would be treated as being split income. A Canadian resident individual with a certain measure of influence over a corporation would be treated as connected with the corporation. For example, adult family members of the 'connected individual' who receive dividends on an unlisted share issued by the corporation would be required to determine whether a portion of the amount received is unreasonable.

The measures also propose that in two cases, the TOSI would apply to the split income of adult specified individuals regardless of the reasonableness test:

- The first case involves 'compound income,' meaning income derived from the investment of split income and certain other amounts, of an individual under age 25. This is intended to discourage income sprinkling capital 'seeding' arrangements used by high-income individuals. These arrangements involve income being sprinkled to lower-income family members and the after-tax (e.g., after the TOSI applies) proceeds of that sprinkled income being invested by the family members or a family trust. The resulting investment income is available to be sprinkled with the lower-income family members, instead of at the high-income individual's higher tax rate, as it would have been in the absence of the arrangement.
- The second case involves amounts brought into split income under a proposed anti-avoidance rule that applies in respect of certain property held or acquired to circumvent the TOSI rules. In the case of the anti-avoidance rule, the reasonableness test would be inapplicable given that the purpose of holding or acquiring the property is to circumvent the TOSI rules.

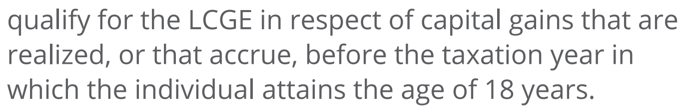
Additional changes to the TOSI rules are proposed in order to improve the existing rules and to support the measures set out above. These proposed changes are set out in the related legislative proposals. The following is a list of the material proposed changes.

- The current exclusion from a minor's split income in respect of certain inherited property (e.g., property inherited from a parent) would be extended to apply to adult specified individuals aged 18-24.
- An individual's split income would be included in determining whether the individual qualifies for certain income-tested benefits (e.g., personal tax credits that depend on income).
- The current joint and several tax liability rule with respect to the TOSI rules would be extended to apply in the case of adult specified individuals aged 18-24. A related individual who has sprinkled income with an adult specified individual aged 18-24 may be assessed joint liability with the adult specified individual for the adult specified individual's unpaid TOSI that arises in respect of that sprinkled (i.e., that part of the split) income.

2. Constraining multiplication of claims to the lifetime capital gains exemption (LCGE)

As discussed above, tax planning has promoted so-called "multiplication" arrangements with respect to the LCGE. A particular concern is the use of family trusts to facilitate arrangements under which the LCGE limits of multiple members of a family may be used to reduce capital gains tax. Individuals have used these arrangements in a way that permits them to claim the exemption even though they may not have invested in, or otherwise contributed to, the business value reflected in the capital gains they realize on the disposition of property that is eligible for the exemption.

Three general measures are proposed to address LCGE multiplication. First, individuals would no longer



qualify for the LCGE in respect of capital gains that are realized, or that accrue, before the taxation year in which the individual attains the age of 18 years.

Second, the LCGE would generally not apply to the extent that a taxable capital gain from the disposition of property is included in an individual's split income.

Third, subject to certain exceptions, gains that accrued during the time that property was held by a trust would no longer be eligible for the LCGE. An exception would be provided for capital gains that accrue on property held by a spousal or common-law partner trust or alter ego trust (or a similar trust for the exclusive benefit of the settlor during the settlor's lifetime), where the individual claiming the LCGE is the trust's principal beneficiary. This exception recognizes that the current tax rules constrain the terms of these trusts in a way that prevents the sprinkling of capital gains.

The measure would apply whether the trust realizes the capital gain and makes it payable to a beneficiary or alternatively, the trust distributes (by way of a so-called "rollover") property with an accrued gain to a beneficiary where the gain is later realized on a disposition of the property. The measure would not prevent trusts that are currently eligible to undertake rollovers to beneficiaries from continuing to do so; however, unless one of the above exceptions applies, no deduction would be allowed under the LCGE in respect of the capital gain that is "transferred" from a trust on a rollover of property to a beneficiary.

The proposed measures would apply to dispositions after 2017. However, special transitional rules are proposed. The transitional rules would allow affected individuals to elect to realize, on a day in 2018, a capital gain in respect of eligible property by way of a deemed disposition for proceeds up to the fair market value of the property. The election would be available for property owned by the individual continuously from the end of 2017 until the day of the deemed disposition. Capital gains realized under the election would generally be eligible for the LCGE using the current tax rules (i.e., the rules as they apply to dispositions before 2018). For this purpose, certain requirements (e.g., regarding the ownership of, value of and, in some cases, activities in respect of, the property), that in order to claim the LCGE in respect of the disposition of a property must be met over a 24-month period before the disposition, would be treated as satisfied if they are met during the 12-month period preceding the elective disposition.

3. Supporting measures to improve the integrity of the tax system in the context of income sprinkling

The Government is seeking input on whether the reasonableness test provides an appropriate mechanism for responding to income sprinkling. The Government recognizes that the proposed reasonableness test depends 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.

However, a legislative response to income sprinkling is needed to ensure that the broader tax system has an appropriate level of fairness for all. Previous efforts to constrain income sprinkling involving private corporations – which included seeking to apply the tax attribution rules based on the lack of labour contributions by the shareholders receiving dividends – have not been successful in the courts. Reasonableness standards are already used elsewhere in the tax rules to respond to some forms of income sprinkling. The Government believes that through a measured administration of the rules, a reasonableness standard can act as an important constraint on income sprinkling.

C. Holding Passive Investments Inside a Private Corporation

Corporate income is taxed at lower rates than personal income, giving businesses more money to invest in order to grow their business, find more customers and hire more people. But there are times when private corporations earn income beyond what is needed to re-invest and grow the business. In these cases, those who own and control a private corporation have the opportunity to hold passive investments inside the corporation.

Passive investment income earned in a private corporation is subject to specific taxation rules, further described in this chapter. These rules were introduced in 1972, but an important component of the system that was envisioned at the time, the refundable tax in respect of ineligible investments, was rescinded shortly after its introduction. The rules that remain in place today in many cases fail to ensure that corporate owners are indifferent between holding passive investments within their corporation or in a personal savings account. When a corporate owner uses earnings taxed at the corporate income tax rates to fund passive investments held within the corporation, it results in the realization of returns that exceed what individual investors saving in a personal investment account can achieve. The tax advantage conferred on private corporations – the lower rate of tax – was never intended to be used to realize higher personal savings.

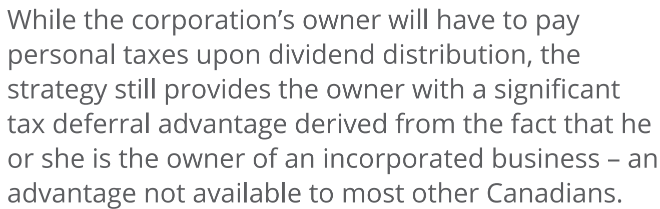
The Government is considering approaches that will improve the fairness and neutrality of the tax system, such that savings held within corporations are taxed in a manner that is equivalent to savings held directly by individuals, for example salaried employees.

Background

In general terms, the objective of the current rules is to ensure that a dollar of passive investment income earned via a corporation bears a tax burden, when corporate and personal taxes are combined, that is roughly similar to that of a dollar of passive investment income earned directly by an individual. For instance, under current rules, an individual who has inherited $100,000 would generally be indifferent between investing this amount directly in securities, or making the same investment through a corporation set up for that specific purpose – in both cases, expected returns would be similar. Individuals referred to as "corporate owners" throughout this section are those who both own and control the private corporation.

Tax Planning Using Private Corporations

However, the rules dealing with the taxation of investment income in private corporations do not take into account the source of earnings used to fund the passive investment, and this can create advantages where the funds invested are retained earnings that have been taxed at the corporate tax rate. For instance, if a highly skilled individual with a regular salary of $300,000 receives $100,000 of income in the form of an employment bonus and decides to invest the after-tax amount passively, he or she will have roughly $50,000 in after-tax income to invest (assuming a 50 per cent marginal federal-provincial tax rate). In contrast, a successful entrepreneur earning an extra $100,000 of business income through his or her private corporation after paying him or herself $300,000 in employment income will have about $85,000 after tax to invest passively, if kept in the corporation (assuming the income is eligible for the lower tax rate on small business income). While the current system aims at ensuring that both individuals pay approximately the same combined tax rate on the passive income generated by their investment (about 50 per cent), it does not recognize that the individual using his or her private corporation has more capital to invest than the employed individual (that is, 70 per cent more in this case, or $85,000 vs. $50,000).



While the corporation's owner will have to pay personal taxes upon dividend distribution, the strategy still provides the owner with a significant tax deferral advantage derived from the fact that he or she is the owner of an incorporated business – an advantage not available to most other Canadians.

Taxation of Passive Investment Income Under Current Rules

Under the principle of tax integration, income earned by a corporation and distributed to shareholders as dividends should bear an amount of tax that is equivalent to what an individual earning the income directly would pay. If this were not the case, and income earned by a corporation and distributed to shareholders as dividends were taxed more lightly than income earned directly by individuals, there would be an incentive for individuals to incorporate; or in the opposite case, it would create a tax disadvantage to doing so.

As corporations are generally taxed at lower rates than individuals on their active business income, tax integration implies that dividends received by shareholders be taxable, such that:

> *Corporate taxes on earnings + Personal taxes on dividends = Personal taxes on income earned directly*

In line with the above formula, dividends received by shareholders are taxable via a gross-up and dividend tax credit mechanism, the objective of which is to achieve overall tax integration.

The benefits of the lower corporate income tax rates on active business income can therefore be accessed as long as the income is retained in the corporation, but these benefits end once the income is paid out to shareholders.

The tax system contains provisions that aim to equalize taxes payable by individuals and corporations on passive income, which have been in place since 1972. In contrast to active business income, for which tax integration is achieved only when dividends are paid out to shareholders, additional taxes apply to passive investment income the year it is earned. These additional taxes bridge the gap between the corporate and personal income tax rates, such that the tax payable by corporations on passive investment income is approximately what an individual in the top tax bracket would pay on that income.

Federal taxes on passive investment income of a private corporation are fully or partially refundable when the income is paid out to shareholders as dividends. These taxes can therefore be said to operate like a prepayment of the personal taxes that will eventually be paid:

- When a corporation earning passive income ultimately pays a dividend to shareholders, it can get back the refundable portion of taxes that it paid on passive investment income.
- Concurrently, shareholders pay personal taxes when they report their dividend income on their personal income tax return.

The current tax system applies additional refundable taxes on passive income generated within a corporation, but does not include provisions to differentiate between the source of earnings used to fund the passive investment:

- *Interest income and rental income*: Small Canadian Controlled Private Corporations (CCPCs) are generally eligible for the small business rate on their active business income. Interest and rental income is generally not considered active income, but rather passive income, and is not eligible for the small business rate. Passive income is subject

to provincial general-rate corporate income tax, which for example applies at a rate of 11.5 per cent in Ontario. At the federal level, the corporation is liable to pay tax on this income at 38²/₃ per cent, bringing the combined federal-provincial total to just over 50 per cent, which is approximately in line with the top federal-provincial personal income tax rate for an Ontario taxpayer. As noted, a portion of the federal taxes paid – 30²/₃ percentage points – is refundable upon the payment of taxable dividends. The refundable portion of taxes paid is added to a notional account called the refundable dividend tax on hand (RDTOH). Amounts set aside in this account are only refundable to the corporation when taxable dividends are paid out to shareholders.

When dividends are paid to shareholders, amounts in the corporation's RDTOH account are refunded to the corporation at a rate of $38.33 for every $100 of taxable dividends paid. This rate of refund is the same regardless of the type of income from which the RDTOH balance was generated. The shareholder is then taxed on this income using the gross-up and dividend tax credit mechanism.

When dividends are paid out from the capital dividend account (i.e., non-taxable portion of capital gains), the capital dividend account balance is reduced, dollar-for-dollar, by the amount of capital dividends paid.

Limitations of the Current System

The decision between holding passive assets in a personal account or within a corporation is generally neutral in the specific case where the corporate passive investment is funded with amounts on which personal income taxes were paid (for example, earnings saved at the personal level that are contributed to the corporation), and the refund of passive investment taxes is made at the end of the passive investment period. In this situation:

- There is no initial deferral – the funds used to purchase a passive asset have been subject to personal income tax, rather than corporate income tax. In other words, the corporate owner starts with a passive investment that is no bigger than he or she would have if investing outside the corporation.
- The returns from that passive investment are taxed similarly within the corporation as at the individual level: the taxes on annual returns equalize taxes payable at the top personal income tax rate.

The current system does not achieve its objective of removing incentives to hold passive investments within a corporation in a broad range of other situations. This leads to unfair tax results, whereby a corporate owner may frequently prefer to retain business income, for passive investment purposes, within his or her corporation, rather than to pay it out and invest directly as an individual.

The benefit of holding savings in a private corporation arises as a result of corporate income generally being taxed at lower rates than individual income:

- For example, a high-income individual living in Ontario who earns $100 of active business income inside his or her small corporation would pay 15 per cent corporate tax, leaving $85 of retained earnings to invest passively. If he or she earned an additional $100 in salary and is a high-income individual, he or she would pay personal income taxes, leaving him or her with a bit less than $50 to invest in a passive investment.
- Even though all of the income – the earnings used to fund the passive investment and the investment returns – is subject to personal income taxes once that income is paid out to shareholders, the value of the corporate passive investment will be higher.
- As noted above, the payment of taxable dividends can trigger a refund of passive investment taxes

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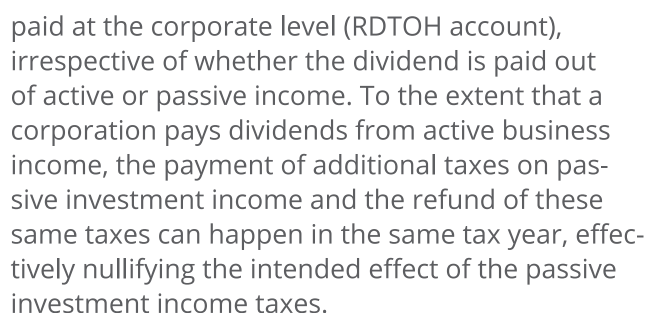

paid at the corporate level (RDTOH account), irrespective of whether the dividend is paid out of active or passive income. To the extent that a corporation pays dividends from active business income, the payment of additional taxes on passive investment income and the refund of these same taxes can happen in the same tax year, effectively nullifying the intended effect of the passive investment income taxes.

Holding savings within a corporation would typically be more beneficial for corporate owners in the highest income group. The tax advantage for private corporation owners has also grown due to the widening of the gap between personal and corporate income tax rates in recent years. This widening gap has largely resulted from reductions to corporate income tax rates at both the federal and provincial levels. That gap has widened from about 26 percentage points in 2000 to upwards of 37 percentage points today.

The tax benefit of saving within a private corporation can also exceed the tax benefits that individuals can receive from passive investments in registered retirement savings plans or tax-free savings accounts, and can provide more flexibility than investments in such vehicles.

Preferential tax rates for corporations were never intended to facilitate passive wealth accumulation, such as through passive investments.

Possible Approaches

The Government is considering the changes required to establish fairness in the tax treatment of passive investment income of a private corporation, so that the benefits of the corporate income tax rates are directed towards investments focused on growing the business, rather than conferring a personal investment advantage to the corporate owner.

The Government will consider approaches that can meet the following objectives:

- Preserving the intent of the lower tax rates on active business income earned by corporations, which is to encourage growth and job creation; and
- Eliminating the tax-assisted financial advantages of investing passively through a private corporation, and ensuring that no new avenues for avoidance are introduced.

This section outlines broad possible approaches to eliminate incentives to invest passively within a corporation. The Government is seeking the feedback of stakeholders on the design considerations associated with each possible approach.

The 1972 Approach

In 1972, Canada developed an approach that was aimed at limiting deferral opportunities associated with passive investments. That approach was composed of two elements:

- The refundable tax in respect of ineligible investments, which was designed to reduce the potential benefits of tax deferral on passive investments, by effectively imposing an additional refundable tax when preferentially taxed business income was retained and used to fund a passive investment. In effect, this provision denied the lower small business rate, and rather imposed the general corporate income tax rate (in 1972, the combined federal-provincial general corporate income tax rate was about 50 per cent). A corporation could obtain a refund of the upfront tax paid upon disposition of the passive investment asset, and reinvest the proceeds in business operations. This helped ensure that corporations were not denied the benefits of the small business corporate income tax rate if they redeployed the funds in business activities.

- The other element was the refundable tax on annual passive investment income, and this part of the structure is still in place today.

It is useful to understand that the current tax system was designed with these two components operating together. The refundable tax in respect of ineligible investments was retroactively repealed shortly after its implementation.

The Government is concerned that the inevitable lag between the time at which an investment is made and the time a refund is obtained could raise liquidity issues for certain businesses. Liquidity issues could also arise in other situations, for instance where there is a change in the use of an asset (at which point the refundable tax in respect of ineligible investments may need to be paid). The Government is not actively considering the reintroduction of a refundable tax in respect of ineligible investments at the present time.

Alternative Approach: Deferred Taxation

As an alternative to the system that was put in place in 1972, the current regime of refundable taxes on passive investment income could therefore be replaced with one that would maintain a rate of tax on the passive investment income of private corporations equivalent to top personal tax rates, as is the case under the rules in place today, but which would generally remove the refundability of passive investment taxes where earnings used to fund passive investments were taxed at low corporate tax rates. The new approach may also entail changes to how passive income is categorized, and subsequently taxed at the individual level when distributed as dividends.

It can be demonstrated that, if the refundable taxes on investment income ceased to be refundable, a corporate owner would be indifferent between investing his or her retained earnings in a passive investment held within the corporation, and holding this investment in a personal savings account.

In addition to denying refundability, the new system would ideally align the tax treatment of passive income distributed as dividends with that of the earnings that are used to fund passive investments – these earnings could either be subject to the small business rate or the general rate, but could also be funds taxed at the personal level and contributed by shareholders. The need to take into account the tax treatment of the source capital arises as it largely determines the extent of the tax benefit conferred to the corporate owner. For example, if earnings were taxed at the small business rate, the gap between the top marginal personal income tax rate and the tax rate applied at the corporate level is not the same as if earnings are taxed at the general rate.

It also follows that the tax advantage from holding savings within a corporation is larger if the income is taxed at the small business rate than if it is taxed at the general rate – as more money is left within the corporation to invest and generate passive returns. In contrast, if earnings used to fund a passive investment were initially taxed at the personal level, such as paid-up capital contributed by the corporate owner, there would generally not be a tax advantage when holding the passive investment within a corporation under the current rules. As such, and as further explained below, the tax treatment of passive income distributed as dividends would need to take into account how the earnings used to fund the passive investment were initially taxed, in order to properly eliminate the resulting tax advantage.

For the new system to be neutral between individuals and corporations, the proper categorization of passive income as “eligible” or “non-eligible” is important. That categorization would need to follow the tax treatment of the income that is used to fund a passive investment (for instance, small business income), rather than the tax characteristics of the passive income itself, in order to appropriately

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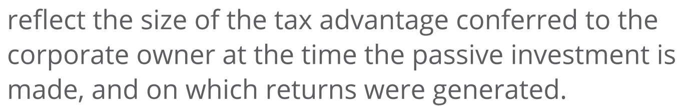


reflect the size of the tax advantage conferred to the corporate owner at the time the passive investment is made, and on which returns were generated.

Using the example of a passive investment funded from active small business income, this implies that all income generated by that passive investment would be treated as a "non-eligible dividend" upon distribution to shareholders:

- Dividend income from publicly traded stocks would no longer be treated as eligible dividends, as is currently the case, but would be treated as non-eligible dividends in this example, consistent with the tax treatment of small business income that is distributed to shareholders.
- The non-taxable portion of capital gains would not be attributed to the capital dividend account in this example.

a) Apportionment Method

In order to make sure that passive investment income is taxed in a way that achieves neutrality between individuals and corporations when it is paid out as dividends, one method would be to track the source of income used to acquire each investment asset owned by a corporation, along with the investment income that the asset generates. Obviously, such a system would be very complex in practice. Alternative and less onerous methods are contemplated.

One such method would involve an apportionment of annual passive investment income that would be based, going forward, on the corporation's cumulative share of earnings taxed at the small business rate and the general rate, as well as amounts contributed by shareholders from their after-tax income. This would translate into three possible tax treatments for these amounts when distributed as dividends: eligible dividends, non-eligible dividends, or dividends that would be received tax-free at the shareholder level.

The apportionment method would introduce the requirement that corporations keep track of the three pools described above. These additional requirements could be seen as introducing new complexity in the tax system, but they would be based on information that is either already computed for tax purposes or readily available to all corporations. The apportionment method would, at the same time, impose a tax treatment for passive income that readily adapts to the evolving characteristics of the corporation.

b) Elective Method

As an alternative to the apportionment method, the Government could introduce a method whereby private corporations would be subject to a default tax treatment, unless they elect otherwise. The choice between the default tax treatment or the elective treatment would determine whether passive income would be treated as eligible or non-eligible dividends when distributed to shareholders, without the need for tracking.

Specifically, under the default tax treatment, passive income earned in a CCPC would be subject to non-refundable taxes (at rates equivalent to the top personal income tax bracket), and dividends distributed from such income would be treated as "non-eligible" dividends. While corporations taxed under this default tax treatment could earn income taxed at the general rate, it would implicitly be assumed that the passive income is funded using earnings taxed at the small business rate. It would also be assumed that shareholders' contributions are not used to fund passive investments.

The implicit presumption that passive income is funded with earnings taxed at the small business rate may not hold for corporations that only earn income taxed at the general rate (or if a significant portion of the income is taxed that way). Corporations in that situation would be able to elect a tax treatment

that would apply additional non-refundable taxes on passive income, and would treat dividends paid out from passive income as eligible for the higher dividend tax credit rate. This election would remove the corporation's access to the small business rate.

Corporations Focused on Passive Investments

Under both the apportionment and elective methods, it is envisioned that a further election would be possible for corporations focused on passive investments.

As explained above, when a corporation uses earnings that were taxed at the personal level to fund a passive investment (e.g., paid-up capital), and that corporation is not engaged in an active business and only earns passive income, the current tax system is neutral and does not result in tax incentives to hold the passive investment inside a corporation. Maintaining the current tax system in these situations could be envisioned, for corporations that would make that election.

That election would result in all income generated by the entity being taxed as passive investment income (and therefore taxed at a level that approximates the top personal income tax rate). Where the shareholders of the corporation are not individuals, amounts transferred to the corporation (e.g., as dividends) would be subject to an additional refundable tax, the intent of which would be to bridge the gap between the corporate tax rate and the personal income tax rate.

This tax model would neutralize any deferral advantages and would allow the corporation to use the current regime. It is envisioned that corporations with a mix of active and passive income could, for instance, choose to hold passive investments in a corporation that could elect into this tax regime.

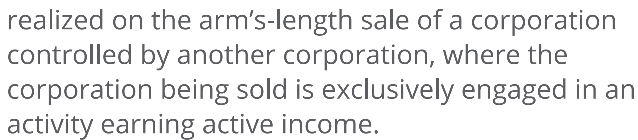
Marginal Tax Rate of the Corporate Investor

As is the case under the current tax system, taxes on passive income would be aligned with that of an individual earning income at the top personal income tax rate. Similar assumptions are also made in other sections of the Income Tax Act, for example, those that relate to the tax treatment of trusts. Under the new system, a corporate owner that pays personal taxes at a level below the top personal income tax bracket could have an incentive to withdraw corporate earnings not required for business reinvestments as they are earned, in order to invest in a personal savings account. This would maintain the ability to pay taxes on passive investment income at a lower rate.

Taxation of Capital Gains

The distinction currently made in the tax system between active and passive sources of income is embedded in jurisprudence and is well-established. Generally speaking, the Government intends to continue to use recognized practices in the development of a new taxation model for passive investment income.

In particular, the Government will continue to treat capital gains as eligible for the 50% inclusion rate and to apply passive investment taxes on such income. As discussed above, in order to preserve neutrality, the proposed system contemplates that the non-taxable portion of capital gains would no longer be credited to the capital dividend account under the proposed tax system, where the source capital of the investment is income taxed at corporate income tax rates. For example, the appreciation in value of a publicly traded stock giving rise to a capital gain would be subject to the new rules. That said, the Government will be considering whether additions to the capital dividend account should be preserved in certain limited situations, such as a capital gain



realized on the arm's-length sale of a corporation controlled by another corporation, where the corporation being sold is exclusively engaged in an activity earning active income.

Transition

Existing stocks of passive assets held in Canadian private corporations are significant. It is the intent that the new rules would apply on a go-forward basis. Once a new approach is determined for the tax treatment of passive investment income, the Government will consider how to ensure that the new rules have limited impacts on existing passive investments. The Government will bring forward a detailed proposal following these consultations, and time will be provided before any such proposal becomes effective.

Other Issues

Other issues relevant to the new system will be assessed over the coming months, including how to ensure that a new system:

- is applied in a way that does not leave avenues for tax avoidance open to certain types of corporations, at the expense of tax fairness. Currently, for example, non-CCPC private corporations are only subject to the refundable tax regime on their dividend income, while CCPCs are subject to the regime on all their passive income. Further consideration will be given to assess how broadly the rules should apply.
- is not undermined by complex cross-border corporate structures and activities.
- operates effectively within an overall tax system with varying provincial tax rates and structures, and can continue to be effective in the face of tax policy changes outside of federal control.

Expected Impacts

The proposed reforms would generally affect corporate owners who are setting aside some of their corporate profits for passive investments. The proposed system would not impact taxes payable by corporations with no passive investment income.

The initial benefit from the lower corporate tax rates would also be preserved when the corporate owner reinvests its passively invested funds to expand the active business. This will help ensure that our corporate tax system continues to support economic growth and job creation.

The Government will be designing new rules over the coming months to tax corporate passive income in a way that is more fair for Canadians. You are invited to share views on any aspect of these new rules that you feel are important to bring to the Government's attention.

D. Converting Income into Capital Gains

Background

A corporation distributes taxable dividends from its corporate surplus which, in general terms, is made up of its accumulated after-tax earnings and unrealized corporate value minus its liabilities. Through the operation of the dividend tax credit, an individual shareholder should in general retain on taxable dividends the same after-tax amount as the individual would have had if the corporate income had been earned directly by the individual. However, integration does not occur if corporate surplus is paid out in the form of tax-exempt, or lower-taxed, income. In effect, the income is not subject to the appropriate personal income tax and the income is subject to less tax than if the individual had earned the income directly.

Individual shareholders with higher incomes can obtain a significant tax benefit if they successfully convert corporate surplus that should be taxable as

dividends, or salary, into lower-taxed capital gains (such conversions are commonly referred to as "surplus stripping").

Section 84.1 of the Income Tax Act

Section 84.1 is an important anti-avoidance rule in the private corporation context. It seeks to ensure that a corporate distribution is properly taxed as a taxable dividend when an individual sells shares of a corporation to a non-arm's-length corporation (for example, to another corporation owned by the individual). Otherwise, the corporation could pay out some portion of its surplus to the non-arm's-length corporation as a tax deductible inter-corporate dividend, and the non-arm's-length corporation could then use that surplus to pay the individual. In effect, the individual could receive the equivalent of a dividend (i.e., an amount distributed from the corporation and received by the individual) but would have a capital gain on the sale for income tax purposes.

In general terms, section 84.1 applies when an individual sells shares of a Canadian corporation to another Canadian corporation on a non-arm's-length basis and the individual receives non-share consideration (e.g., cash) for the shares in excess of the greater of two amounts:

1. the adjusted cost base of the shares to the individual; and

2. the paid-up capital in respect of the shares.

Where it applies, section 84.1 treats the non-share consideration received by the individual in excess of the greater of the two amounts as a taxable dividend.

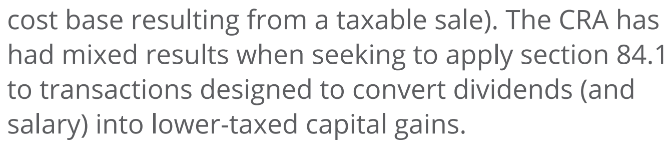
a) Tax planning under the current provision

The wording of section 84.1 is problematic in that the provision describes a specific type of avoidance transaction. As a result, the section does not apply to transactions that avoid its specific terms. In particular, the section can be avoided to enable an individual shareholder to obtain capital gains treatment rather than taxable dividend treatment with respect to taxable capital gains that are ineligible for the LCGE.

Section 84.1 effectively prevents surplus stripping to the extent that the cost to an individual of his or her share represents capital gains realized by the individual (or a non-arm's-length individual) and that were eligible for the LCGE (or that represent pre-1972 corporate surplus, which arose when there was no capital gains tax) – in other words, capital gains that were effectively tax-free to the non-arm's-length seller.

In such cases, Section 84.1 applies to a share sale of a corporation to a non-arm's-length corporation (including a related corporation that is a private corporation) only if the two corporations are 'connected' with each other. In general terms, if the two corporations are not connected, the related private corporation would be subject to a special dividend tax under Part IV of the Act on a dividend received from the other corporation, which is in general refunded when the dividend is distributed as a taxable dividend to individual shareholders subject to personal income tax. The individual's adjusted cost base of the shares excludes the portion of the purchase price representing those tax-free proceeds – what is sometimes referred to as "soft" cost base. Accordingly, if the individual purchaser subsequently sells those shares to a non-arm's-length corporation, this soft cost will not serve to prevent any cash or other non-share consideration received as proceeds on the sale from being taxed as a dividend.

However, section 84.1 does not specifically address cases where a so called "hard" cost base results from purchasing shares on a non-arm's-length basis (e.g.,



cost base resulting from a taxable sale). The CRA has had mixed results when seeking to apply section 84.1 to transactions designed to convert dividends (and salary) into lower-taxed capital gains.

The courts appear to be upholding the CRA's assessment of dividend taxation where the surplus is converted into capital gains eligible for the LCGE (or represents pre-1972 surplus). The CRA's assessment of dividend taxation has also been upheld by the courts where the extraction of corporate surplus occurs in the course of the winding-up, discontinuance or reorganization of the business of the corporation.

In comparison, individual shareholders have had success arguing that they can extract corporate surplus as capital gains if the extracted surplus does not result in a capital gain that is eligible for an LCGE (and does not involve pre-1972 surplus). While the CRA has traditionally applied the general anti-avoidance rule (the GAAR) to such conversions, it has narrowed its application in light of recent court cases. The courts have even suggested in at least one case that surplus stripping is not, in general, an abuse or misuse of the scheme of the Income Tax Act.

(b) Intergenerational business transfer

The Government indicated in Budget 2017 that, while reviewing the use of tax planning strategies involving private corporations that inappropriately reduce personal taxes, it would consider whether there are features of the current income tax system that have an inappropriate, adverse impact on genuine business transactions involving family members.

Section 84.1 does not apply to the sale of shares from one individual to another. Therefore, it has no impact on the sale of shares within a family (e.g., from parent to adult child) as long as the transaction occurs at the individual level. Shareholders of corporations, however, have expressed the concern that they are ineligible for the LCGE when they sell their shares to a corporation owned by their adult children because of section 84.1. In contrast, those shareholders can use their LCGE when they sell their shares to an arm's-length corporation, which transaction would not be subject to section 84.1 (the arm's length-corporation could also then use all or a portion of the purchased corporation's surplus to pay the shareholders). It is argued that this application of section 84.1 is an impediment to the transfer of a business from one generation to another within a family because the LCGE would not be available.

Although it has been suggested that a genuine intergenerational transfer of shares of a small business corporation to an adult child's corporation should be treated the same as a sale to an arm's-length corporation, a major policy concern is distinguishing a genuine intergenerational transfer from a tax avoidance transaction, like the one described above, undertaken among family members. The hallmarks that ensure a genuine transfer of a business to a new owner would generally include:

- the vendor ceasing on the transfer to have factual and legal control of the transferred business;
- the intent of the new owner to continue the business as a going concern long after its purchase;
- the vendor not having any financial interest in the transferred business; and
- the vendor not participating in the management and operations of the business.

For example, the United States has long-standing rules meant to distinguish cases where a parent "terminates" his or her interest in a corporation on the sale of shares to a family member including a corporation controlled by family members. In general terms, the approach of the United States is to rely on rules that establish a bright-line test that is not amenable to factual disputes about the genuineness of an intergenerational transfer of the

small business corporation. It does so by simulating a straightforward arm's-length sale in which the vendor has no interest or involvement in the transferred corporation after the sale.

The American approach arguably accommodates genuine intergenerational transfers because it does not prevent a parent/owner of a private corporation from having the corporation employ their children in the years leading up the actual transfer. During this period, the parent can transfer knowledge of the business to the child as well as assist the child in gaining the experience necessary to operate the business as a future owner.

Consequently, the Government is interested in the views and ideas of stakeholders regarding whether, and how, it would be possible to better accommodate genuine intergenerational business transfers while still protecting against potential abuses of any such accommodation.

Proposed Measures

In response to the planning noted above, the Government proposes that section 84.1 be amended to prevent individual taxpayers from using non-arm's-length transactions that 'step-up' the cost base of shares of a corporation in order to avoid the application of section 84.1 on a subsequent transaction.

In general terms, this will be achieved by extending the current rules in subsection 84.1(2) that result in a so called 'soft' cost base if the LCGE (or pre-1972 surplus) is claimed to cases where cost base is increased in a taxable non-arm's-length transaction, and by ensuring that those rules apply in a manner that is consistent with this policy objective. It is recognized that in some instances this change might give rise to both a capital gain on a 'step-up' transaction and a taxable dividend on a subsequent non-arm's-length disposition. This is consistent with discouraging taxpayers from entering into schemes that seek to avoid section 84.1. It is proposed that this amendment apply to shares disposed of on or after the date of the release of this consultation paper.

The Government also proposes that the Income Tax Act be amended to add a separate anti-stripping rule to counter tax planning that circumvents the specific provisions of the tax law meant to prevent the conversion of a private corporation's surplus into tax-exempt, or lower-taxed, capital gains. In general, the anti-stripping rule would apply to a non-arm's-length transaction where it is reasonable to consider that "one of the purposes" of a transaction or series of transactions is to pay an individual shareholder/vendor non-share consideration (e.g., cash) that is otherwise treated as a capital gain out of a private corporation's surplus in a manner that involves a significant disappearance of the corporation's assets. In such a case, the non-share consideration would be treated as a taxable dividend. It is proposed that the anti-stripping rule apply in respect of amounts that are received or become receivable on or after the date of the release of this consultation paper.

Next Steps

Draft legislation for the proposed amendment to section 84.1 and the proposed anti-stripping rule is being released for comment in conjunction with release of this consultation paper.

As noted above, the Government invites views and ideas on whether, and how, it would be possible to better accommodate genuine intergenerational business transfers in the Income Tax Act while still protecting the fairness of the tax system by ensuring that any such accommodation cannot be used as a means to circumvent other rules of the Income Tax Act. The Government invites interested stakeholders to contribute their views.

E. CALU Comments – Summary on the Impact of these Proposals

What is Not Changing

1. There are no proposed changes to the rules governing access to the small business deduction or the $500,000 capital gains exemption limit.
2. While there are no changes to the capital gains exemption for qualified shares of a small business corporation, the availability of the exemption to certain family members will be significantly restricted.
3. There appears to be no changes that will directly impact the tax treatment of corporate-owned insurance. However, there is the possibility that proposals to restrict the credit to the capital dividend account (CDA) arising from capital gains generated by passive investments funded by active business income may be extended to life insurance proceeds.

What is Changing and Impact

Income Sprinkling

1. The proposals to restrict income splitting of dividend income and multiplying the use of the capital gains exemption involving family members may result in the unwinding of many current strategies, and less frequent use of estate freezes and family trusts as tax and estate planning tools. It should be noted that transitional rules have been provided that could offer partial relief from the impact of these new rules on current arrangements.
2. The "reasonable test" in applying a tax on split income will introduce significant uncertainty in tax planning and increased potential for CRA audits/ assessments and tax litigation.

Passive Investment Income

1. Proposals to increase the taxation of passive investment income of private corporations, where active business income is used to acquire passive assets, may mean that less after-tax income is retained in a corporation for investment purposes or to acquire corporate-owned life insurance.
2. Although the Consultation Paper indicates there will be "grandfathering" for the tax treatment of passive investments currently within a private corporation, there are no further details at this time. This also creates significant uncertainty for small business owners.

Converting Surplus to Capital Gains

1. Changes to section 84.1 appear to eliminate pipeline planning that is currently used to minimize double taxation upon the death of a small business owner and winding-up of the company. In turn, this may make other types of planning including the use of life insurance more attractive.
2. The federal government appears to be open to amending section 84.1 to provide an exception for "genuine" business transfers between family members and is seeking more input.
3. The new general anti-avoidance rule (draft section 246.1) will provide the CRA with another avenue to recharacterize capitals gains as dividend income and reduce capital dividends arising from such transactions.

General Impact

1. The proposals introduce significant complexity and uncertainty in terms of their application. Therefore, if these proposals proceed as described in the Consultation Paper, small business owners will incur significant one-time and ongoing professional fees and expenses to minimize adverse tax consequences.

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