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Sweeping Tax Proposals to Impact Private Corporations, Their Shareholders (including Family Trusts) and Post-Mortem Tax Planning

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By Ryan Morris

On July 18, 2017, becoming or staying an employee (particularly a government employee) became more attractive. That is the date the Trudeau government released the consultation paper that was promised in the 2017 Federal Budget regarding "the use of tax planning strategies involving private corporations that inappropriately reduce personal taxes of high-income earners." Draft legislation and explanatory notes for many of the proposals were also released with the consultation paper. The public has until October 2, 2017 to make submissions.

The most significant of the proposals are summarized below. In general, the proposals are to become effective after this year, with the exception of (i) the surplus stripping rules, which are proposed to come into effect immediately, (ii) a transitional rule allowing certain taxpayers to benefit in certain circumstances from the current lifetime capital gains exemption ("**LCGE**") rules until 2019, and (iii) the proposals pertaining to the taxation of passive investment income in a corporation, for which no effective date has been proposed.

Removing Benefit of Dividend Sprinkling

"Dividend sprinkling" refers to the practice of lowering a family's aggregate income tax liability through a corporation paying dividends on a class or classes of shares held by family members who are in a lower tax bracket (as compared to the owner-manager).

The proposed measures would tax sprinkled dividends at the highest marginal tax rate by extending the "kiddie tax" to dividends received by any individual (regardless of age) derived from a business of a related individual (including through a corporation of which the related individual can exert influence) where the dividend is unreasonable having regard to such circumstances as the dividend recipients labour and capital contributions to the business.

Broadening Split Income Tax on Capital Gains

Significantly, the proposals would also extend the tax on split income to capital gains from the disposition of property if the income on the disposed property would have been subject to the tax on split income.

Restrictions on Lifetime Capital Gains Exemption

Under these proposals:

- 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;
- 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 (see above); and
- subject to very limited exceptions, gains that accrued during the time that property was held by a trust would no longer be eligible for the LCGE.

A transitional rule would allow certain 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. However, in certain circumstances, minors cannot benefit from this transitional rule.

Removal of the Deferral Advantage of Corporations using Business Income to Fund Passive Investments

The consultation paper reflects an intention to introduce rules to remove the deferral advantage associated with a corporation using active business income to make passive investments. While the form of these proposals is less advanced than the other proposals in the consultation paper, it appears that the current preferred approach of the government would include taxing – on a non-refundable basis – passive income earned in a corporation at top personal tax rates to the extent that earnings used to fund passive investments held by the corporation were derived from business income of the corporation (which would have only been taxed at low corporate tax rates).

These rules are intended to apply on a going forward basis (i.e., they are not intended to impact, as much as possible, existing passive investments).

Preventing surplus stripping

The government proposes to expand an anti-avoidance rule that prevents individuals from transferring shares to non-arm's length parties in order to realize a capital gain rather than extracting cash through a dividend (to which a higher tax rate applies). More significantly, the proposed measures include a new anti-stripping rule that 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.

We Can Help

The proposed changes will have a significant impact on how private corporations and their shareholders (including family trusts and the beneficiaries thereof) will be taxed. It may also impact (i) the decision whether to (A) incorporate (particularly for professional corporations), or (B) wind-up or otherwise reorganize an existing corporate structure (including whether to rollout shares from a family trust this year or next), and (ii) the available post-mortem tax planning options for private company shares to avoid double (or triple) tax. Please call your WeirFoulds lawyer or the author below to confidentially discuss how you might be impacted.

The information and comments herein are for the general information of the reader and are not intended as advice or opinion to be relied upon in relation to any particular circumstances. For particular application of the law to specific situations, the reader should seek professional advice.

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