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CHANGES TO TAX PLANNING OPPORTUNITIES USING PRIVATE COMPANIES

September 2017

On July 18, 2017, the Department of Finance proposed important changes that will affect tax planning opportunities available to taxpayers who organize their affairs using private corporations. This development follows on concerns raised in the March, 2017 federal budget that private corporations were being used by shareholders to avoid paying their fair share of tax.

The proposed changes target four main areas of tax planning: income sprinkling (income splitting), multiplication of the lifetime capital gains exemption, passive investments made by private corporations, and the conversion of business income into capital gains.

Are your spouse and children, or a family trust, shareholders of your operating or holding company?

If so, you may be affected by the proposed changes that will limit a family's ability to reduce its overall tax burden by distributing income earned in a private corporation, partnership or trust to family members in lower tax brackets.

The proposed changes aim to restrict the ability to split income among related family members by extending to adult family members the Tax on Split Income or "kiddie tax" rules, which impose tax at the highest rate on dividends received by shareholders who are minors. Under the proposed changes, income received from the corporation by adult family members will be taxed at the highest rate unless they can show that their contributions to the corporation in the form of labour and / or capital are "reasonable". The rules will be more restrictive for shareholders aged 18 to 24 years.

The proposed rules will also expand the definition of which family members are "related" to include aunts and uncles, nieces and nephews.

Currently the Tax on Split Income rules do not apply to compound income (income earned from an investment that is subject to the Tax on Split Income rules). However, the revised rules, as drafted, will apply to compound income.

The new Tax on Split Income rules would have a direct impact on business owners in the following situation:

A taxpayer owns shares in and controls a holding company that owns a portfolio of marketable securities and/or rental properties (Holdco). A family trust owns common shares in Holdco. The taxpayer's spouse and adult children are the beneficiaries of the trust. The spouse does not work outside the home. The adult children attend university.

Holdco regularly declares dividends to the family trust which, in turn, allocates the dividends to the spouse and children. Under current rules, these dividends are taxed at the marginal tax rate of the individual who receives them (subject to the existing attribution rules). For example, a dividend of $40,000 paid in 2017 to one of the children who has no other income is taxed at the lowest marginal rate of approximately 15% (after factoring in the dividend tax credit and assuming the recipient is resident in Quebec).

If the proposed changes are adopted, dividends paid to the spouse and children would be subject to tax at the highest marginal tax rate of approximately 44% (after factoring in the dividend tax credit and assuming the recipient is resident in Quebec), unless the recipient is actively engaged in the affairs of Holdco on a regular, continuous and substantial basis.

The split income rules, if adopted, will take effect after 2017.

If this situation applies to you, you may wish to consider whether you can reduce the impact of the proposed changes by maximizing the payment of dividends to your spouse and children in 2017, before the new rules take effect.

<u>Does your family trust hold shares of your Opco?</u>

The proposed changes will also limit taxpayers' ability to multiply the lifetime capital gains exemption among family members. Previously, all family members could utilize their capital gains exemption to shelter capital gains on the sale of their private corporation shares, provided certain conditions were met. However, the proposed changes will prevent shareholders who are minors or who received shares as minors from sheltering the portion of the capital gain that accrued while the shareholder was a minor. In addition, any capital gains accruing while the shares were held in a family trust will also be ineligible to use the capital gains exemption. As currently drafted, this restriction would also apply to testamentary trusts.

Special transitional rules are proposed that would allow some affected individuals to elect to realize a capital gain in 2018 in order to crystallize the exemption. The election will not be available for shares held by minors.

The new rules limiting the multiplication of the capital gains exemption would directly affect a taxpayer in the following situation:

A few years ago a business owner implemented an estate freeze and a family trust subscribed for common shares of the operating company (Opco). One of the objectives of the reorganization was to allow family members to use their respective lifetime capital gains exemptions on the eventual sale of the shares of Opco.

If the proposed changes are adopted and the family trust sells its shares of Opco to a third party purchaser after 2018, no capital gains exemption would be available on the Opco shares held by the trust.

The rules preventing the multiplication of the lifetime capital gains exemption, if adopted, will take effect after 2017.

If shares of your operating company are held in a trust, there are strategies available that may allow your family members to continue to access the capital gains exemption. However, depending on your circumstances and the terms of the trust deed, you may need to take action before the end of 2017.

Does your Opco also earn investment income?

Targeting Passive Investments Earned by Private Corporations

The federal government plans to remove a perceived tax deferral advantage available to private corporations earning passive income in a private corporation in an effort to make the system tax-neutral. Because corporate income is taxed at lower rates than personal income, freeing more after-tax income to make passive investments, it is perceived that business owners have an unfair tax advantage over private individuals. The government has not yet released any draft legislation to address this issue.

Instead, among other things, it is examining the current refundable tax system by which a portion of the federal tax paid on passive income earned in a corporation is refunded when a taxable dividend is paid. One proposal for change would prevent the refund where the original investments were made from low rate active business income.

Converting Dividend Income into Capital Gains

The fourth major change targets taxpayers' abilities to convert dividend income, which is fully subject to tax (though eligible for the dividend tax credit), to capital gains, of which only 50% are currently subject to tax. The *Income Tax Act* (Canada) currently contains an anti-avoidance rule that seeks to ensure that corporate distributions are properly taxed as taxable dividends when a taxpayer sells shares of a corporation to a non-arm's length corporation. The proposed changes would extend this anti-avoidance rule to prevent individual taxpayers from using non-arm's length transactions that "step up" the cost base of shares to get around the application of the anti-avoidance rule in a subsequent transaction. The effect of the proposed rule would be to reduce the cost base of an individual's shares by an amount equal to the sum of the capital gains realized in the previous non-arm's length transactions.

If adopted, this change will be effective as of July 18, 2017.

The extended anti-surplus stripping rules would affect taxpayers in the following situation:

A taxpayer's father recently passed away. The taxpayer is the liquidator of her father's estate. The deceased held shares of a private corporation (Holdco). On death, a deemed disposition of the shares occurred, resulting in a capital gain. The deceased was subject to tax on this capital gain, and the estate acquired the shares at a cost equal to fair market value.

Without any planning, this situation would give rise to double taxation. The value of the assets of Holdco is taxed once on the deemed disposition occurring on death, and a second time when Holdco is liquidated and its surplus is distributed to the estate.

Prior to the proposed changes, it would have been possible to carry out a corporate reorganization (a "pipeline") allowing the corporate surplus of Holdco to be extracted without attracting a second level of tax by using the high cost basis of the Holdco shares representing tax which has already been paid. The proposed changes appear to put a stop to this kind of planning.

If you are the liquidator of the estate of a family member who recently passed away and who held shares of a private corporation on death, there may be alternative strategies to avoid double taxation.

The proposals also include plans to introduce a new anti-surplus stripping rule to address situations where one of the purposes of a transaction was to avoid specific provisions of the tax law that are designed to prevent the conversion of a private corporation's surplus into tax-exempt or low tax capital gains. Where applicable, the non-share consideration received in the transaction would be treated as a taxable dividend.

This very broad measure could affect most corporate divestitures and payments of dividends out of a corporation's capital dividend account. If you are contemplating such transactions, the impact of the proposed rules must be considered.

If adopted, these proposed changes will be effective as of July 18, 2017.

This newsletter is intended to provide examples of a few situations that are targeted by the proposed legislation. These proposals have been the subject of significant public commentary and, if implemented as currently drafted, they will have a lasting impact on both existing structures and future planning. However, the changes discussed herein are merely proposals. They are not yet law. The consultation period on the proposed changes ends on October 2, 2017. If you would like to know more about how these proposed changes, if adopted as drafted, might affect you, please contact us.

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