The End of Corporate Tax Planning As We Know It?

Proposed Changes to Tax Planning Using Private Corporations

In response to the Liberal government's March budget, where it signalled its plan to look at measures to address what it considers tax-fairness issues, federal Finance Minister Bill Morneau announced on July 18, 2017 the release of a consultation paper and draft legislation specifically targeting tax planning arrangements using private corporations. The proposed changes represent one of the most significant changes to corporate taxation – and planning – in Canadian tax history.

The consultation paper focuses on three specific areas where the government perceives there to be unintended tax advantages available to private corporations and its shareholders, which include income sprinkling, the deferral of passive investment income earned in a corporation, and the conversion of income into capital gains.

Sprinkling income using private corporations

Under current legislation, private corporations that earn active business income, have been able to split income by issuing shares (directly or through a Trust) to relatives who are subject to lower personal income tax rates. With respect to dividends received, there had not been a limit on the amount that could be paid. The draft legislation proposes to subject income distributions to specified individual (essentially family members) to a "reasonableness" test. The measures fall into three general categories: extension of the tax on split income rules, limitations on multiplying the claim of lifetime capital gains exemption, and improvements to the administration of the income tax rules to specifically address income sprinkling. These rules would be effective in 2018 and subsequent years.

Holding a passive investment portfolio inside a private corporation

The consultation paper outlines several approaches the government is considering to "neutralize" what it perceives as an unfair benefit of investing undistributed retained earnings (after-tax profits) within a private corporation to earn passive investment income. These approaches are complex and all have the effect of significantly increasing corporate income tax on passive investment income generated from accumulated active business profits.

Conversion of a private corporation's regular income or dividend distributions into capital gains

The consultation paper and draft legislation include proposals to prevent surpluses accumulated in private corporations that are usually disbursed through dividends or salary from being converted to a capital gain (which are taxed at reduced rate). These proposed changes would be effective in respect of distributions received or receivable as of July 18, 2017.

The Department of Finance is encouraging the public to share their views and ideas about the proposed changes. The deadline for submissions is October 2, 2017.

The proposed changes are complex and will be far-reaching with respect to how private corporations are taxed in the future. Logan Katz will continue to monitor these developments to be able to provide you with timely updates and advice.