QUESTION & ANSWER

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Q & A on private corporation tax changes

Proposed tax amendments could have a significant impact on various tax-mitigating strategies. In this Q&A, **Jack Courtney**, Investors Group's Vice President of Private Client Planning and **Sheryl Troup**, Director of Tax and Estate Planning, explain what's being considered.

Q | Why has it been advantageous for professionals and business owners to set up a corporation?

A |

TAX DEFERRAL

Income generated from an active business enjoys a low tax rate in comparison to personal rates of tax. Depending on the province, the first $500,000 of active income is only subject to tax ranging from 10.5% to 18.5%. Active income over $500,000 is subject to tax rates ranging from 26% to 31%, which still compares favourably to top personal rates.

This tax deferral allows a corporation to pay down debt at a faster rate, or invest more back into its business, or, alternately, have more money available to invest in investments such as stocks, bonds, mutual funds and real estate.

INCOME SPLITTING

Income splitting through the payment of dividends can reduce the overall tax bill for the business owner's family. In Canada, each family member is taxed separately and has access to their own set of graduated tax rates. Paying a salary can be used for some income splitting, but salaries are subject to a reasonability test in relation to the services performed. Until these recent proposals, dividends could be used to optimize the use of each family member's tax rates, creating greater after-tax spending power for each dollar earned.

LIMITED LIABILITY

The concept of a "corporation" was created to protect the assets of a shareholder from a company's creditors and thereby encourage investment and business expansion. Limited liability protection is still important for many forms of business, but not all. Professionals, for instance, cannot use a corporation to escape personal liability for the professional services they provide.

Q | What is "active business income" and "passive investment income"?

A | The term "active business" is activity that is required to generate income, such as manufacturing, the sale of goods or the provision of services. In contrast, investment income such as interest, dividends, royalties and rent is considered "passive" as little or no activity is required to generate such income. The *Income Tax Act* contains special rules for income earned from a rental business, deeming the income to be passive unless the business employs more than five full time employees.

This distinction is important, as corporate tax rates on passive income tend to be higher than top personal rates. A portion of the tax on passive income is refundable when dividends are paid to a private corporation's shareholders, however there is generally no tax deferral advantage to be gained by retaining investment income in a corporation.

Q | What was the original intent of the lower corporate tax rates on income from an active business?

A | Lower corporate tax rates for active income allow businesses to invest more money into their business and create more employment opportunities. Arguably, the original idea behind lower rates was not to encourage the retention of profit for passive investment. The July 18 policy paper from the Department of Finance points to the 1972 legislation that, along with the introduction of the small business deduction, introduced the present day refundable tax on investment income and a refundable tax when preferentially-taxed business income was retained and used to fund passive investments. This latter refundable tax was rescinded shortly after its introduction.

Despite the original intention, over the years provincial governments have extended the availability of incorporation to various professional groups, encouraging the accumulation on investment assets within private corporations.

Q | What changes have been proposed and subsequently amended?

A | The proposed changes can be summarized into three broad categories:

- Income Splitting: Limitations for income splitting with non-arm's length (related) persons. The initial proposals included restrictions on the ability to claim the lifetime capital gains exemption, however these were abandoned in a later announcement. Details on the amended proposals pertaining to income sprinkling are anticipated to be released late fall 2017.
- Passive investments: Rules to discourage the retention of earnings within a private corporation for passive investment. The draft legislation on these measures will be announced as part of Budget 2018, which is released in early spring.
- Conversion of income into capital gains: Rules to negate the effectiveness of these types of transactions were abandoned, however, Finance has indicated over the next year they will develop measures to

accommodate intergenerational transfers of family businesses while protecting the fairness of the tax system.

INCOME SPLITTING

Current Situation: There are several rules within the *Income Tax Act* that limit income splitting with non-arm's length persons, typically those related to you:

- Reasonability tests on salaries: salaries paid to family members must be in line with duties performed and align with what one would pay to a third party for similar work
- Attribution of Income
  - If property has been transferred or loaned to a related person to confer a benefit on that person, income will attribute back to the original owner of that property
  - "Corporate attribution" often applies in an estate freeze situation or whenever new shareholders are added to a corporate structure. The result is deemed an interest charge to the original shareholders when a spouse or minor children are brought on as shareholders, and 90% of the assets of the business are not utilized in an active business
- Kiddie tax on dividends and other forms of income splitting with a minor
  - Highest marginal tax rate applies, thus eliminating any benefit from splitting income with minor children.

Gaps Identified by Finance:

The above rules do not discourage the payment of dividends to:

- adult children, even if the children have had no involvement in the business of the corporation and even if the corporation derives all of its revenue from passive investments
- a spouse from a corporation that qualifies as a "small business corporation" – a company where 90% or more of the assets are used in an active business – even if the spouse has had no involvement in the business.

Additionally, even when the split income rules applied to minors, if those funds were subsequently invested by the minor, the income earned from that investment was no longer subject to the split income rules. As such, there may have been a continued incentive for private corporations to still pay minors a dividend that was subject to the split income tax provisions knowing that future investment income would be taxed at significantly lower personal tax rates.

PROPOSED LEGISLATION: Expansion of Kiddie Tax and Introduction of a New Reasonability Test

Under the proposed legislation, all dividends paid to adults 18 years of age or older who are related to a "connected individual" will be taxed at top personal rates unless a reasonability test is met. A connected individual is a person who has influence over the corporation. Reasonability will be assessed based on a demonstrated contribution to the business through any combination of labour, capital or equity contributions, financial risks assumed (i.e. co-signing for a bank loan), and/or past contributions in respect to previous labour, capital, or risks. The original measures included more rigorous tests for shareholders aged 18 to 24, and essentially require young adults to be actively engaged in the business on a regular and continuous basis. We anticipate the amended measures to have similar limitations for this age group.

Holding Passive Investments inside a Private Corporation

Finance has expressed its intention to limit the tax assisted advantage to retaining active earnings in a corporation for investment.

Announcements made on October 18 have provided some clarity on how the government is intending to proceed with these measures.

What do we know so far?

- All past investments, including future income earned on such investments, will not be subject to these new measures.
- On a go forward basis, there will be a limited ability to defer and passively invest within a private corporation without additional tax costs. For investments made after the implementation date (which is yet to be announced), there will be an annual $50,000 passive income threshold. For amounts earned under this threshold, the current tax rates on passive income will apply. For amounts above the threshold, the new tax measures will apply.
- The Government will ensure that venture capital and angel investors will be protected from these measures.

What don't we know?

- What will be the tax rate applicable on income earned above the $50,000 threshold? How punitive will the tax be and will it include a refundable portion?
- Will the $50,000 income threshold apply to gross or net investment income?
- How will passive income be characterized or calculated for the purpose of determining the amount of income subject to a new tax? Obvious inclusions would be interest, dividends, and capital gains, but less obvious inclusions could include growth in the cash value of a corporate owned life insurance policy (net of premiums paid). Will there be a preference to earning dividends or capital gains as compared with interest income? We cannot say.
- What will be included in the definition of "past investments"? Will excess profits already have to be in an investment vehicle in order to have grandfathering status apply? What about cash balances held in a chequing account that are clearly in excess of business requirements? Would the passive nature of the cash itself be sufficient for grandfathering status? Alternatively, will the new rules simply apply to investments made with active income earned after a certain date? We cannot say for certain.
- What will be the effective date of grandfathering? Several comments made from Finance indicate the measures will apply on a go-forward basis, so the assumption is that grandfathering status will apply at least up until Budget day 2018, however, there is no guarantee that this will be the case.
- If funds are removed from a grandfathered investment vehicle, can those funds later be replaced and retain their grandfathered status?

Q | What is "income sprinkling"?

A | Income sprinkling is the wording used in the government's proposals. It is meant to differentiate from other income splitting techniques deemed acceptable by the government, such as pension splitting. Income sprinkling is an arrangement whereby income that is claimed by lower-income persons would be claimed by a related higher- income earner, but for the arrangement.

Q | How important is the lifetime capital gains exemption?

A | The Lifetime Capital Gain Exemption for shares of a small business corporation is currently at $835,715. For qualified farm and fishing property, the exemption is $1 million. This can mean significant personal tax savings – anywhere from $185,000 to $223,000 depending on province of residency – for someone who is disposing of these types of qualified properties. The ability to multiply the exemption with respect to the disposition of a single business or qualified property reduces the overall personal taxation associated with the disposal of that qualified asset, often resulting in greater after- tax proceeds available for the individuals. As such, we are pleased the government abandoned measures aimed at limiting access to this exemption.

Q | What can we expect to happen in the next couple of months?

A | The proposals regarding the income sprinkling measures will be delivered sometime later this fall. The passive investment measures will be part of the 2018 Budget which is typically delivered in March or April.

Q | If I already have a corporation set up, is there anything I should do now?

A | Dividend Payments Prior to Year End – The draft legislation extending the application of the Tax on Split Income (Kiddie Tax) to adult shareholders, if passed into law, will be effective for the 2018 taxation year. If you are at or near the top personal bracket and there are shareholders in your family that are in lower tax brackets, it may be worthwhile paying dividends to your family that are greater than the dividends paid in prior years, as this may be the last chance to take full advantage of a particular shareholder's marginal tax brackets.

Passive Investments – Corporations with excess cash not being utilized by the business should be encouraged to invest the money in some type of investment vehicle to try to ensure grandfathering status. Based on the limited wording available, past investments will be safe, but the communication is vague as to what constitutes a past investment. Without income potential (such as cash in a chequing account) the "investment" status of certain passive assets may be in question.

There are other retirement investment strategies, such as the use of an Individual Pension Plan, which may become more attractive under this new legislation and will still require a corporation to implement.

Any changes to existing arrangements should be discussed with your accountant.

Q | If I was thinking about incorporation or reorganizing my existing company what should I do?

A | Any plans to incorporate or reorganize an existing company need to be re-evaluated in light of these proposals. If the primary motivation for incorporation is enhanced income splitting and significant tax deferred investing, then you should discuss with your tax advisors whether the implementation of plans should be put on hold until we have further clarity on the final proposals.

Corporate structures meant to reduce the owner managers' exposure to creditors, free up cash flow for the repayment of business debt or allow for an expansion of business operations still make sense.

Q | How can I keep track of my grandfathered investments?

A | We will not know for certain what is required until the new tax measures and grandfathering provisions are revealed in detail. Distinguishing your grandfathered investments from investments subject to the new rules may simply be a matter of opening a new corporate investment account. Any pre-authorized contributions would also be made to the new account. By having a separate account for non-grandfathered accounts, you should be able to separately track the income earned from non-grandfathered investments and know whether investment income is approaching the $50,000 annual threshold. We are not recommending any action in this regard until the date of grandfathering is announced.

Q | Will Corporate Class provide an advantage when structuring a portfolio to stay under the annual $50,000 Passive Income threshold?

A | Historically Investors Group Corporate Class has generated fewer taxable distributions and provided more tax deferral than comparable unit trust mutual funds. However as more shareholders of Corporate Class move to pricing options with a separate advisory fee, such as Series U and iProfile, the expenses of the Corporate Class structure will go down and the likelihood of taxable distributions from Corporate Class will increase. So while Corporate Class may still provide some tax deferral advantage, clients cannot rely on historical taxable distributions as a gauge for the future.

Q | How could the passive investment measures affect corporate owned life insurance?

A | None of the finance announcements to date have addressed or referenced the tax deferral available through the use of corporate owned life insurance with cash value. If Finance were to direct its attention towards cash value life insurance, it is unlikely that any new measures affecting the direct taxation of insurance or the capital dividend account would be retroactive. Clients should not hesitate to implement permanent insurance solutions where needed for estate and wealth transfer reasons. However it is not unreasonable to conclude that strategies designed to allow a shareholder borrow personally against the cash value of a corporate owned life insurance policy could come with an increased future tax cost. Financing retirement expenses through personal loans secured with a corporate owned life insurance policy already creates exposure to additional tax risks, as well as interest rate and longevity risks and as such is generally not recommended.

Q | Where can I go if I have specific questions?

A | A financial professional, such as an Investors Group Consultant, can help provide clarity on the long-term implications of the proposals once they are announced. Questions regarding contemplated transactions should be reviewed with an accountant and lawyer before implementation.

A **final word**

It's still not clear what the full impact of these proposed changes will be. Stay in contact with your accountant and financial planner, though, so when more concrete rules do come out, you'll be able to adjust quickly.