The Navigator

Wealth Management

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Update on private company tax proposals

On July 18, 2017, the Department of Finance released a consultation paper, along with explanatory notes and draft legislation, proposing a number of tax changes that were aimed at private corporations. The changes were intended to remove the perceived unfair tax advantages available to owners of private corporations. Finance provided a consultation period and requested comments on their proposals by October 2, 2017. Following a review of the submissions received during the consultation period, Finance announced a number of changes to the original proposals, some of which they will not proceed with.

In light of these proposed changes, if you are involved, either directly or indirectly, in a private corporation, you will want to review the current corporate structure and any tax planning strategies you have implemented that relate to the private corporation. To help you prepare for a conversation with your tax and legal advisors, this article provides an overview of the proposals, the subsequently announced changes, the possible impact of the proposals, and some planning considerations.

Please contact us for more information about the topics discussed in this article.

Proposals not being implemented

Lifetime capital gains exemption

The government has decided to not move forward with the proposals that were intended to constrain the ability to claim the lifetime capital gains exemption (LCGE). The proposals would have limited access to the LCGE by denying the exemption to individuals under the age of 18 or where property was held by a trust, for example. Concerns were raised that the measures had unintended consequences on intergenerational transfers of family businesses.

Converting regular income into capital gains

The government has also decided to not move forward with the proposals that addressed converting regular income into capital gains. These proposals would have prevented certain advanced tax planning strategies that involved shareholders extracting surplus cash from a private corporation at lower tax rates. During the consultation period, concerns were raised that these measures were too broadly worded and had unintended consequences such as disallowing the "pipeline strategy" which is commonly used to avoid double taxation on the death of a shareholder.

Proposals being implemented

Small business tax rate decrease

Currently, the small business deduction reduces the federal

If you currently use your private corporation to split income with family members, you may be affected by these rules.

corporate income tax rate to 10.5% on the first $500,000 of active business income earned by a Canadian Controlled Private Corporation (CCPC). On October 16, 2017, the government announced that it intends to decrease this rate to 10%, effective January 1, 2018 and to 9%, effective January 1, 2019.

In conjunction with the proposed reduction in the small business tax rate, the government has announced that it will adjust the gross-up factor and dividend tax credit applicable to "non-eligible" dividends in order to maintain integration of corporate and personal taxes.

The effect of this measure will allow corporations to retain more funds for reinvestment. However, the overall impact on the corporate and personal integrated tax rate, when the corporation's income is flowed out to its shareholders, is likely very small.

Income splitting using private corporations

There are currently "tax on split income" (TOSI) rules, commonly referred to as "kiddie tax" rules, which limit splitting certain types of income with minor children. The TOSI rules currently apply to many types of income received from a private corporation, such as dividends, but they do not apply to salaries or bonuses. Where TOSI applies, the income is subject to tax at the highest marginal rate and the minor child loses the ability to claim personal tax credits, such as the basic personal tax credit, on the split income.

The proposals announced on July 18, 2017 would expand the types of income on which TOSI applies. The proposals would expand the application of the current TOSI rules to include other family members (such as spouses, adult children, aunts, uncles, nieces, and nephews) resident in Canada, regardless of their age, who receive split income. For individuals age 18 or older, a reasonableness test will be applied and only the amount considered to be unreasonable would be subject to TOSI. The basis for reasonableness would be what an arm's length party would have agreed to pay the individual, considering labour and capital contributions, the risk assumed, as well as previous returns and remuneration paid to the individual. The reasonableness test will be more restrictive to those age 18-24 as opposed to those age 25 and older.

On October 16, 2017, the government announced that it intends to move forward with these measures while ensuring that the rules will not impact businesses to the extent there are "clear and meaningful contributions" by spouses, children and other family members. They intend to better target and simplify the proposed measures as well as reduce the compliance burden associated with establishing the contributions of spouses and family members.

The government intends to release revised draft legislation later this fall outlining the proposed changes, which will be effective beginning January 1, 2018.

Income splitting planning considerations

If you currently use your private corporation to split income with family members, you may be affected by these rules. If you use a family trust that allocates dividends received from a private corporation out to your spouse or children, you may be affected by these rules. If you or your family made loans to your private corporation and receive interest in return, you may be affected by these rules. These are just some situations in which these new rules could impact you or your family.

We recommend that you review your business structure, remuneration, financing, and succession strategy with your tax and legal advisors to

ensure you understand how the changes could affect your specific situation. Below we have provided a non-exhaustive list of some general items you can discuss with your advisors, but it is important to note that the suggested planning considerations assume that the draft legislation will be passed as is. As previously mentioned, the government intends to revise the draft legislation.

- Consider paying dividends or increasing the amount of dividends you pay to adult family members in 2017 since the proposed rules will only apply starting in 2018.
- Consider what type of documentation you can use to evidence reasonableness. For example, keep timesheets to document the hours worked.
- Analyze your current business practices with regards to paying salaries and dividends and consider paying salaries instead of dividends since it is easier to establish a reasonable amount of salary. Be mindful of the additional cost of paying salaries in the form of payroll taxes, CPP/QPP, EI, and other payroll expenses such as provincial workers' compensation and health taxes.
- Consider whether a share reorganization is required so that each shareholder holds a different class of shares to enable dividends to be declared and paid in different amounts on each class to reflect what is reasonable for that shareholder.
- In reviewing your business structure, if you determine that your corporation has no purpose other than to split income with family members, you may want to consider whether it needs to remain in place or whether it should be dissolved.
- Consider other income splitting strategies such as a prescribed rate loan to your spouse or children directly or indirectly through a family trust.

Holding passive investments inside a private corporation

Currently there is a perceived tax deferral advantage for business owners who retain after-tax income in their corporation. This is because corporate business income is generally taxed at lower rates than income earned personally, which can result in incorporated business owners having more after-tax money to invest. The government intends to introduce tax changes that will make the value of the after-tax portfolio of a business owner investing within a corporation equal to that of someone investing in their personal account who is taxed at the top marginal tax rate.

On October 18, 2017, the government announced that they are moving forward with the measures to limit the deferral benefits of holding passive investments within private corporations. However, there will be no tax increase on $50,000 of passive income earned annually. This $50,000 threshold is intended to provide flexibility for business owners to hold savings for business contingencies or future investments such as the purchase of equipment, hiring staff or business expansion, as well as savings that can be used for personal benefits such as sick leave, parental leave, or retirement. Further, the government pointed out that only 3% of CCPCs with taxable passive income were above the $50,000 threshold in 2015 so that the majority of businesses will not be affected by these tax proposals.

The government reiterated that these measures will not apply to existing passive investments inside a private corporation as well as the future income earned on those investments. It seems as though this will require some sort of tracking mechanism of grandfathered and non-grandfathered investments. They stated that these measures will only apply on a go-forward basis, however there is uncertainty as to the effective date of these rules.

As of now, there is uncertainty as to how the $50,000 threshold will apply. We do not know if the threshold will increase each year to account for the accumulation of the investment income. We do not know if the threshold applies only if the investment portfolio is derived from income subject to the small business tax rate. We do not know how the threshold will apply if you own multiple corporations. There are also questions as to whether withdrawals from the investment portfolio will be considered to be made from past investments, which are grandfathered, or those investments which are not grandfathered.

The government announced that draft legislation will be released at the 2018 federal budget. There will hopefully be more clarity on these rules once the draft legislation is released.

Passive income planning considerations

The proposed changes will generally affect business owners who are using some of their corporate surplus for passive investments. It is likely premature to consider removing passive assets from your corporation or winding up your corporation before these proposals are better understood. Any type of asset transfer or sale could create a prepayment of taxes. At this point, it would be prudent to review the level and the types of passive investments held within your corporation and consider if these investments serve a business purpose.

If the reason for keeping excess funds in your corporation is to save for retirement, you can consider retirement vehicles that are set-up within the corporation, such as

Please contact us for more information about the topics discussed in this article.

an Individual Pension Plan (IPP) or Retirement Compensation Arrangement (RCA). These retirement vehicles allow you to use surplus corporate assets while deferring tax and they should not be affected by the proposed changes.

In addition, you may want to consider the benefits of re-allocating some of the excess funds in your corporation to a tax-exempt life insurance policy. Speak with a licensed life insurance advisor to determine if holding insurance in your corporation is right for you.

Conclusion

There is still great uncertainty as to how some of these wide-reaching proposed measures will apply. If you are involved either directly or indirectly in a private corporation, we strongly recommend that you reach out to your tax and legal advisors to determine how the proposed legislation could impact you and your future plans.

Although the consultation period has ended, Finance has stated that they will continue to solicit and listen to input on the proposed measures.

This article may contain several strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal or tax advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax and/or legal advisor before acting on any of the information in this article.

Wealth Management

This document has been prepared for use by the RBC Wealth Management member companies, RBC Dominion Securities Inc. (RBC DS)*, RBC Phillips, Hager & North Investment Counsel Inc. (RBC PH&N IC), RBC Global Asset Management Inc. (RBC GAM), Royal Trust Corporation of Canada and The Royal Trust Company (collectively, the "Companies") and their affiliates, RBC Direct Investing Inc. (RBC DI) *, RBC Wealth Management Financial Services Inc. (RBC WMFS) and Royal Mutual Funds Inc. (RMFI). *Member-Canadian Investor Protection Fund. Each of the Companies, their affiliates and the Royal Bank of Canada are separate corporate entities which are affiliated. "RBC advisor" refers to Private Bankers who are employees of Royal Bank of Canada and mutual fund representatives of RMFI, Investment Counsellors who are employees of RBC PH&N IC, Senior Trust Advisors and Trust Officers who are employees of The Royal Trust Company or Royal Trust Corporation of Canada, or Investment Advisors who are employees of RBC DS. In Quebec, financial planning services are provided by RMFI or RBC WMFS and each is licensed as a financial services firm in that province. In the rest of Canada, financial planning services are available through RMFI, Royal Trust Corporation of Canada, The Royal Trust Company, or RBC DS. Estate & Trust Services are provided by Royal Trust Corporation of Canada and The Royal Trust Company. If specific products or services are not offered by one of the Companies or RMFI, clients may request a referral to another RBC partner. Insurance products are offered through RBC Wealth Management Financial Services Inc., a subsidiary of RBC Dominion Securities Inc. When providing life insurance products in all provinces except Quebec, Investment Advisors are acting as Insurance Representatives of RBC Wealth Management Financial Services Inc. In Quebec, Investment Advisors are acting as Financial Security Advisors of RBC Wealth Management Financial Services Inc. RBC Wealth Management Financial Services Inc. is licensed as a financial services firm in the province of Quebec. The strategies, advice and technical content in this publication are provided for the general guidance and benefit of our clients, based on information believed to be accurate and complete, but we cannot guarantee its accuracy or completeness. This publication is not intended as nor does it constitute tax or legal advice. Readers should consult a qualified legal, tax or other professional advisor when planning to implement a strategy. This will ensure that their individual circumstances have been considered properly and that action is taken on the latest available information. Interest rates, market conditions, tax rules, and other investment factors are subject to change. This information is not investment advice and should only be used in conjunction with a discussion with your RBC advisor. None of the Companies, RMFI, RBC WMFS, RBC DI, Royal Bank of Canada or any of its affiliates or any other person accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or the information contained herein. ® Registered trademarks of Royal Bank of Canada. Used under licence. © 2017 Royal Bank of Canada. All rights reserved. NAV0219 (10/17)