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Legal update

Tax proposals target tax planning strategies that use private corporations

April 2018
Tax

Recap

In its Budget 2017, the federal government signaled its intention to address certain tax planning strategies involving the use of private corporations. After that budget announcement, on July 18, 2017, Canada's' minister of finance (the Minister) released a consultation paper and draft legislative proposals to address the strategies of splitting income through the use of private corporations, holding passive investments through a private corporation and converting regular income into capital gains through a private corporation (*click here for our July 2017 legal update*).

In the wake of the considerable media coverage generated by the consultation process and after receiving 21,000 submissions, the Minister modified the legislative proposals, introducing changes that were partly confirmed by the October 24, 2017 economic statement (*click here for our October 2017 legal update*). However, despite those changes, several items were still pending, particularly with regard to income sprinkling and the holding of passive investments in a private corporation. The revised tax measures published on December 13, 2017 and the recent 2018 federal budget shed new light on these items (*click here for our Federal Budget 2018 legal update*).

Income sprinkling

Before 2018, certain types of income paid out by a private corporation were subject to income tax at the maximum marginal tax rate, including, among others, dividends received from a private corporation by an individual under the age of 18. The measures proposed on July 18, 2107 expanded the scope of those rules to make them applicable to any individual residing in Canada, irrespective of age, who receives income from a related business (including, among others, interest, dividends and capital gains).

However, the December 13, 2017 amendments tempered this new measure by providing more exclusions based on objective criteria. Generally, tax on split income will not apply to the following individuals:

- Individuals aged 18 or over who have worked for a related business for an average of at least 20 hours per week during the part of the year that the business operates (or during any five previous tax years);
- Individuals aged 25 or over who own shares representing 10% or more of the votes and value of a corporation (a) that is not a professional corporation, (b) that earns less than 90% of its income from the provision of services and (c) all or substantially all of the income of which is not derived from one or more other related businesses in respect of the individual;
- The spouse of the business owner, in respect of property income, provided such income would not have been split income for an owner aged 65 or over.

If none of these exclusions applies, a "reasonable return," based on certain criteria, received by an adult aged 18 or over will not be split income. The following factors will be considered: (1) the work performed in support of the business, (2) the property contributed in support of the business, (3) the risks assumed in respect of the business, (4) the total amounts paid or payable to or for the benefit of the individual and (5) any other relevant factor. Generally speaking, the exceptions are more restrictive for individuals between the ages of 18 and 24.

These new rules apply as of January 1, 2018.

Holding passive investment in a private corporation

Budget 2018 proposes to add two new measures to limit incentives for the holding of passive investments through a private corporation. The approaches contemplated in the July 18, 2017 consultation paper—the apportionment method and the elective method—were not adopted. The Minister instead chose to limit access to certain incentives and tax attributes, namely the small business deduction (SBD) for the purposes of reducing the business limit and the dividend refund (DR), which will be subject to new rules. These new measures will apply to taxation years commencing after 2018.

Business limit

Under the new measures, the $500,000 business limit for Canadian-controlled private corporations (CCPC) with investment income of between $50,000 and $150,000 will be reduced gradually on a straight-line basis. For example, the SBD of a CCPC with investment income of $100,000 will be limited to its first $250,000 of active income and anything above that amount will be taxed at the regular corporate rate. This business limit reduction will operate alongside (and not cumulatively with) the current business limit reduction that applies in respect of taxable capital over $10 million. The business limit will therefore be reduced by the greater of (1) the reduction under this measure and (2) the existing reduction based on taxable capital.

For the purposes of this reduction, a CCPC's investment income will be based on a concept of *adjusted aggregate investment income*. This concept will generally exclude taxable capital gains and losses from the disposition of property used principally in an active business carried on primarily in Canada by the CCPC or a related CCPC, the disposition of shares of another connected qualifying CCPC, and net capital losses carried forward from prior taxation years. However, it will include dividends from non-connected corporations (which generally include dividends from public corporations) and income from savings in a non-exempt life insurance policy.

Tax refunds on investment income

The new measures also limit refunds of refundable dividend tax on hand (RDTOH). The current concept of RDTOH (henceforth called the *non-eligible* RDTOH account) will be modified and a concept of *eligible* RDTOH will be introduced. Refundable income tax paid under Part I of the *Income Tax Act* (Canada) (Tax Act) on investment income and income tax paid under Part IV of the Tax Act on non-eligible dividends will be included in the *non-eligible* RDTOH account. The *eligible* RDTOH account will include income tax paid under Part IV of the Tax Act on eligible dividends received.

Only a *non-eligible* dividend will give rise to a DR from the *non-eligible* RDTOH account. The *non-eligible* RDTOH account of the payor corporation will now have to be at zero before that corporation can receive a refund from its *eligible* RDTOH account. As a result, no DR will be obtained for the payment of an eligible dividend while the corporation has a positive balance in its *non-eligible* RDTOH account. This will generally increase the tax burden of the shareholder, who will then be required to be taxed on the *non-eligible* dividends in order to bring the *non-eligible* RDTOH account down to zero.

As for inter-corporate dividends, the recipient corporation will continue to pay an amount of tax under Part IV of the Tax Act equal to the DR obtained by the payor corporation. The paid income tax to be added to the recipient corporation's RDTOH account is charged to the RDTOH account from which the payor corporation obtained its refund.

A transitional rule will allocate the existing RDTOH between the *eligible* RDTOH account and the *non-eligible* RDTOH account. Finally, an anti-avoidance rule will be implemented in order to prevent the deferral of the application of this measure through the creation of a short taxation year.

Conclusion

These legislative amendments are far narrower in scope than those presented on July 18, 2017. However, despite the simplifications that have been made, the application of these measures in practice will bring its share of technical problems and raise some highly subjective questions regarding the interpretation of certain concepts such as the notion of "*reasonable return*" for the split income rules. Also, some exceptions regarding split income may not apply in the case of service businesses and professional corporations. Furthermore, the tax provisions applicable to private corporations will be made more cumbersome by the addition of a new *eligible* RDTOH account.

Derek G. Chiasson
Antoine Desroches
Marc-Oliver Plante

For further information, please contact one of the following lawyers:

> Derek G. Chiasson	Montréal	+1 514.847.6114	derek.chiasson@nortonrosefulbright.com
> Antoine Desroches	Montréal	+1 514.847.4436	antoine.desroches@nortonrosefulbright.com
> Sébastien Gingras	Québec	+1 418.640.5903	sebastien.gingras@nortonrosefulbright.com
> Adrienne F. Oliver	Toronto	+1 416.216.1854	adrienne.oliver@nortonrosefulbright.com
> Barry N. Segal	Toronto	+1 416.216.4861	barry.segal@nortonrosefulbright.com
> Dion J. Legge	Calgary	+1 403.267.9438	dion.legge@nortonrosefulbright.com
> Darren D. Hueppelsheuser	Calgary	+1 403.267.8242	darren.hueppelsheuser@nortonrosefulbright.com
> Chris Speakman	Vancouver	+1 604.641.4835	chris.speakman@nortonrosefulbright.com