CCPCs… Stay tuned

On July 18, Canada's Minister of Finance, the Honourable William Morneau, presented the highly anticipated discussion paper "Tax Planning Using Private Corporations."

The discussion paper is a follow-up to the 2017 Federal Budget, which indicated that certain tax-planning strategies employed by Canadian Controlled Private Corporations (CCPCs) and their individual shareholders were under review. The budget expressed the view that high-income Canadians can use these strategies to gain unfair tax advantages, as they are not available to other Canadians.

Timeline:

Stakeholders have been asked to comment over the next 75 days, until October 2, 2017. It's interesting to note that many of the proposed tax measures are slated to be implemented on January 1, 2018, just 90 days after the comment deadline. Given some of the proposed tax measures have not been finalized, this leaves very little time for CCPCs to adapt their structures or provide the relevant information to be compliant.

Need for Action:

In recent years, there has been a significant increase in the overall number of CCPCs, from 1.2 million in 2001 to 1.8 million in 2014. In certain sectors, such as professional corporations, the number has tripled in the last 15 years, and many contractors or consultants who were previously self-employed are now choosing to incorporate. As a consequence of the increasing number of CCPCs, the amount of taxable passive investment income they have reported has also tripled, from $8.6 billion in 2002 to $26.8 billion in 2015.

Executive summary:

Finance has extensively researched and has identified in each of the three strategies below where the perceived loophole or advantage originated. The government is proposing several complex tax measures to curb the perceived advantages. Its proposed tax measures target not only the initial transaction, but also any subsequent income or gains generated. As the discussion paper is comprehensive, at this time we have provided a brief outline of the three strategies under review with the accompanying proposed tax measures:

1. Sprinkling income using a CCPC

The proposed tax measures focus on:

- Extension of the current tax on split income (TOSI) rules – also known as the "Kiddie Tax" rules
- Restricting the use of the lifetime capital gains exemption (LCGE) where CCPC shares are owned by minor aged individuals or by way of a trust

- Improving the integrity of the tax system in the cont of income sprinkling.

Specifically, the proposed tax measures expand TOSI to related party adults, establish “reasonableness” measures for income and gains earned by family members by considering labour and capital contributions, introduce the definition of a “connected” individual in addition to expanding the definition of a “specified” individual, address particular planning scenarios where income sprinkling is most often used (spouses and other family members between the ages of 18-24), and restrict the ability to multiply the use of the LCGE by family members, or through the use of a trust, upon the disposition of the CCPC shares.

The government expects the proposed tax measures to generate an additional $250 million in tax revenues annually.

2. Holding a passive investment portfolio inside a CCPC

The government is seeking to neutralize the ability to invest greater amounts of investment capital in a CCPC, and has requested comments on the various tax measures outlined in the discussion paper to best achieve the following objectives:

- Preserving the intent of the lower tax rates on active business income earned by corporations, to encourage growth and job creation
- Eliminating the tax-assisted financial advantages of investing passively through a CCPC, and ensuring that no new avenues for avoidance are introduced.

Currently, active business income is taxed at lower, preferential corporate tax rates than if it had been reported personally. The tax-preferred rates are to encourage and provide CCPCs more money to invest in order to grow their business, hire employees, and expand their customer base. However, there are times when CCPCs earn income beyond what is needed to re-invest and pay salaries or dividends to cover the lifestyle needs of the owner-shareholder. In such cases, those who own and control the CCPC have the opportunity to invest more after-tax proceeds in the corporation than if they were investing personally, and thus a tax advantage is created. The preferential corporate tax rates were never intended to facilitate passive wealth accumulation at the corporate level.

Currently, Finance is considering several options involving the Federal Refundable Tax provisions to address this issue.

3. Converting a CCPCs regular income into capital gains

The government is proposing changes to the tax provisions that prevent the surplus income of a CCPC from being converted from a Canadian dividend to a lower-taxed capital gain and stripped from the corporation. This strategy is not often employed and requires complex restructuring to be set into play. While not common, it often results in significant tax savings for the shareholders involved.

The additional tax revenue from the proposed tax measures to prevent surplus income from being converted to tax preferential capital gains is unknown at this time.

What was not addressed in the discussion paper?

Many stakeholders anticipated new tax measures that would make it more difficult for CCPCs to access the small business deduction, thus the active business tax rate, in certain circumstances. The Province of Quebec first suggested such measures in its 2015 budget and implemented its legislation as of January 1, 2017.

In conclusion:

As we said, a consultation process is now underway. During this time, we will be providing additional communications delving into the proposed tax measures in further detail and outlining the anticipated impact of the proposed measures.

Two points on which we are certain are: 1) the impact of the proposed tax measures will be broad and it is probable that every CCPC (small business or professional) with multiple shareholders will be impacted; and 2) it is likely that compliance costs for preparing corporate tax returns, and the need for further organizational and operational reporting will increase in order to comply with the proposed tax measures.

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