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THE PASSIVE INVESTMENT RULES AND THEIR ASSOCIATES

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By now most advisors are aware that in Budget 2018 the Federal government introduced, among other things, draft legislation to amend the *Income Tax Act* (Canada) ("Act")[1] that is often referred to as the "Passive Investment Proposals". As with all of the other remnants of the July 18, 2017 Proposals,[2] the Passive Investment Proposals, while an improvement over what had initially been put forward, continue to be way too complex and ensuring compliance with the Passive Investment Proposals will be time consuming and costly for small business owners.[3]

Existing subsection 125(5.1) claws back the $500,000 annual small business limit[4] of a Canadian-controlled private corporation ("CCPC")[5] once taxable capital[6] of the corporation together with any corporation with which it is associated[7] exceeds $10,000,000.[8] The Passive Investment Proposals will extend the claw-back to situations where the CCPC together with any corporation with which it is associated earns what has been determined to be excessive passive income ("Passive Income Claw-Back"). Specifically, pursuant to proposed amendments to subsection 125(5.1), the Passive Income Claw-Back will begin once adjusted aggregate investment income[9] in excess of $50,000 has been earned by a CCPC "or [by] any corporation with which it is associated at any time in the particular taxation year, for each taxation year of the corporation, or associated corporation, as the case may be, that ended in the preceding calendar year." Once the CCPC together with any corporation with which it is associated has earned over $150,000 of adjusted aggregate investment income in such time period or periods, no amount of the small business limit will be available to the CCPC.

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[1] Unless otherwise noted all statutory references are to the Act.

[2] For a trip down memory lane use the Department of Finance link fin.gc.ca/n17/17-066-eng.asp, which includes documents relating to the July 18, 2017 Proposals.

[3] Many in the tax and business communities, myself included, continue to encourage (in vain) the Federal government to abandon all of the July 18, 2017 Proposals and to engage in a full review of the Act.

[4] As set out in subsection 125(2).

[5] As that term is defined in subsection 125(7).

[6] Determined in accordance with Part I.3 of the Act.

[7] The associated corporation rules are found in section 256.

[8] The entire small business limit is clawed back once taxable capital exceeded $15,000,000.

[9] See the proposed definition in subsection 125(7).

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Most advisors anticipate that the Passive Income Claw-Back will apply to many more CCPCs than the existing taxable capital claw-back rules in subsection 125(5.1). Consequently, many advisors are reviewing planning options to try and avoid the application of the Passive Income Claw-Back to their CCPC clients.[10]

The purpose of this article is to draw the attention of advisors to the risk that such planning may be for naught if their CCPC clients are deemed to exceed the Passive Income Claw-Back thresholds as a consequence of being required to account for passive income of associated corporations. In particular, while the combined application of the Passive Investment Proposals and the association rules to a CCPC owned by an individual who has direct ownership in a group of corporations that includes the CCPC should be readily apparent, the breadth of the potential application of the association rules in connection with CCPCs directly or indirectly owned by trusts, especially discretionary family trusts, may create unpleasant surprises.

Many advisors will be aware that, for the purposes of the association rules, a beneficiary of a discretionary family trust will be deemed to own all of the shareholdings of the trust[11] and a beneficiary of a non-discretionary family trust will be deemed to own a *pro rata* number of the shares owned by the trust, based on the relative fair market value of the beneficiary's beneficial interests in the trust.[12] In addition, where shares of a corporation are owned by a minor, the minor's parents will usually be deemed to own the shares for the purposes of the association rules.[13] Also, if a minor is a beneficiary of a trust, then the association rules will look through the trust and the minor and will usually deem the minor's parents to own the shares held by the trust as though the parents were a beneficiary of the trust.[14]

This wide breadth of application of the association rules to trusts has always been a concern to planners. As an example, an adult child who starts a business could inadvertently find her corporation associated with her parents' corporate group simply as a result of estate planning put in place by her parents years before, including testamentary planning involving trusts formed under a deceased parent's will.

Prior to the introduction of the Passive Investment Rules, unless taxable capital of the child's CCPC together with the associated corporate group owned by her parents exceeded $10,000,000, which tended to be somewhat rare,[15] and/or a CCPC in the parents' corporate group also carried on an active business,[16] the child's CCPC would still be eligible to utilize its full small business limit. However, because the Passive Income Claw-Back is a passive income based claw-back and since the claw-back starts at such a low $50,000 income threshold, a claw-back due to association is likely to become far more common and might even become insidious in situations involving discretionary family trusts.

It is likely that there are many situations, both under existing legislation and under the proposed Passive Investment Proposals, where an individual and his or her advisors might not even be aware that he or she is a beneficiary of a

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[10] For a useful list of planning options, see William Fowlis and Carolyn Hogan, "Planning for the New Passive Investment Rules Affecting Private Corporations", XXIII(2) *Insurance Planning* (Federated Press) 14-19 (2018) (https://sites-millerthomson.vuturevx.com/28/3564/uploads/passiveincome-tax.pdf).

[11] See subparagraph 256(1.2)(*f*)(ii).

[12] See subparagraph 256(1.2)(*f*)(iii).

[13] See subsection 256(1.3). There is an exception to this deeming rule where it is reasonable to consider the minor to manage the business or affairs of the corporation without a significant degree of influence from the parents.

[14] By virtue of the combined application of subsection 256(1.3) and subparagraphs 256(1.2)(*f*)(ii) or (iii), as the case may be.

The association rules could also be applicable as a consequence of the application of subsection 256(1.2)(*c*) and where a trust has certain rights or options described in subsection 256(1.4). It should also be kept in mind that the association rules could also apply to the trustees of a trust.

[15] This is due to the application of the "investment allowance" in subsection 181.2(4). Entities with holdings that do not qualify for the investment allowance, such as real estate holding corporations, would be more likely to be caught by the existing claw-back rules in subsection 125(5.1).

[16] Pursuant to subsection 125(2), if there is more than one CCPC eligible for the small business deduction in an associated corporate group, provided that the members of the associated group comply with subsection 125(3), they would be permitted to share a single small business limit.

trust.[17] Given the potential broad application of the Passive Investment Proposals, the failure to recognize that one is a beneficiary of a trust and to ensure compliance with the impact of association on the ability of a CCPC to utilize its small business limit will be far more likely to give rise to real tax consequences than under existing legislation.

One might be tempted to consider compliance with current legislation and the Passive Investment Proposals and the association rules as they apply to trusts as a matter that is beyond the control of advisors and their clients. However, keep in mind that the Canada Revenue Agency already has information concerning the private corporation shareholdings of a trust[18] and, beginning for all taxation years commencing after December 30, 2021, nearly all express trusts will need to disclose additional information, including providing the names as well as detailed information regarding the trustees, settlor, and all ascertainable beneficiaries of such trusts.[19]

[17] Even if the beneficiary is aware of being a beneficiary, the beneficiary may have difficulty compelling the trustees to provide the information that he or she would require to determine whether corporations are associated and to comply with the provisions of the Act, including the Passive Investment Proposals. For more on beneficiary rights to information see Sarah Dykema, "The Evolution of the Law with respect to Beneficiaries' Rights to Information: Where are We Now, and What are the Practical Implications?" (2017) 36:3 *Estates, Trusts & Pensions Journal* 250-263.

[18] As required pursuant to question 8 on the jacket of each trust's annual T3 Trust Income Tax and Information Return.

[19] See draft subsections 150(1.1) and (1.2) and draft Regulation 204.2 and the Explanatory Notes Relating to the Legislative Proposals Relating to Income Tax and Other Legislation, released July 27, 2018.

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