Some of you may be wondering why I’m quoting a Bananarama song. Well, it seems like it really has been a cruel summer. Not only have we had a rainy summer (I have not had to water my garden at all this summer), but then we got hit with the new proposed tax rules on July 18, 2017. They will have a profound effect on private corporations. The Liberal government had hinted that it was looking at new legislation with respect to private companies, and they came through on their promises, with sweeping changes that can be summarized in four basic categories noted below. So, if you have an interest in a private company, then read on. And hold on to your hats.

**Income Splitting**

Currently, the “Kiddie Tax” rules provide that dividends received by persons under the age of 18 from related private companies and income from related partnerships (whether directly or through a trust) would be taxed at the top marginal rate. These rules, under the new proposals, have been substantially extended to apply to all related persons (and not just minors) where such persons receive income from a related private corporation, unless the amount is reasonable in light of the circumstances, having regard to certain criteria. Essentially, spouses, siblings, parents-in-laws and extended family members can be caught under the new rules and have to pay tax at the top rates.

This Tax on Split Income (TOSI) is expanded to apply to not only dividend income, but also to include interest on loans, taxable capital gains, if the income on the shares would have been split income, as well as second-generation income, if it is earned on income that was itself split income (so it’s a compounded effect).

I noted that there is a “reasonable test.” Essentially, in order for income to not be subject to this top tax rate, the income must be reasonable, i.e., it cannot be more than what would be paid to an arm’s length person for the same activities provided to the company. Factors to consider include actual work performed, the capital contributed for the shares issued to such persons, risk assumed by them and compensation for services already completed. Note that the test is more stringent for persons between the ages of 18 and 24.

The short answer is that if a family member did not contribute money to the company, or is not involved in the company’s operations, then any dividend income paid to them will be subject to the top marginal tax rates. This will eliminate the ability to income split with any family member who is not involved in the business.

There is a specific exemption for minors and adult children who have income due to
the death of a parent, or for persons that are disabled or attending full time school.

**Capital Gains Exemption**

Currently, every Canadian resident (regardless of age) is able to claim the lifetime capital gains exemption on the sale of shares of a qualifying private corporation (which gives you the first $800,000 - as indexed - tax-free). There are three proposed changes to these rules:

1. **Persons under the age of 18 are no longer able to claim the capital gains exemption.** Specifically, any gains accrued before the person turns 18 will not be eligible for the exemption. So, even if a person is 19 years old, and the value of his or her shares accrued while such person was a minor, they could not claim the exemption.

2. **As a continuation of the tax on split income discussed above, if any amount of a taxable capital gain is included in split income, it will not be eligible for the capital gains exemption.** So, if a family member is not involved in the company's business, then arguably the exemption is not available.

3. **Any capital gains accrued during the time that shares were held by a Trust will no longer be eligible.** This is a big change and will affect many family corporate structures where estate freezes were put in place with family trusts.

These new rules will come into effect in 2018; however, there is some transitional relief. If you file an election by your personal tax return due date for 2018, you can take steps to crystallize the capital gain and claim the capital gains exemption before the end of 2018. This will bump up your cost base by the capital gains exemption amount, so any future sale will benefit from a reduced capital gains tax.

**Capital Gains within a Corporate Group**

New measures were announced to eliminate the ability to pull out cash from a corporate group by way of a capital gain triggered within the corporate structure, rather than paying a dividend and being subject to a divided tax (which is a higher rate than capital gains). Essentially, current section 84.1 (which re-characterizes capital gains as deemed dividends) will be expanded under the new proposals to deny the ability to trigger a capital gain at the corporate level and pay out a tax-free capital dividend to the shareholders. The new rules also include an anti-avoidance rule to deal with surplus stripping transactions through the use of capital gains to apply to situations that might not be captured by the newly expanded s. 84.1. Unlike the proposals for TOSI and the capital gains exemption, these new rules are to apply as of July 18, 2017.

**Accumulating Funds in Private Corporations**

One of the government's goals was to prevent the use of tax deferrals through the use of corporations, specifically on income derived from passive investments held in a corporation. Although the new proposals do not include actual legislation (like the first three proposals discussed above), the government outlined, at a very high level, certain options aimed at reducing the ability to defer tax on such types of incomes. These include:

1. Investment income earned by a corporation will be taxed at the highest personal federal tax rate (33 per cent) with the elimination of the refundable tax mechanism.

2. Capital gains on such income will still only be subject to 50 per cent tax; however, the tax-free portion on such capital gains can no longer be paid out tax-free to an individual shareholder.

3. Dividends taxed to individual shareholders will be based on the source of the funds (i.e., whether income was taxed at the small business rate or at the general corporate rate).

A gain, no draft legislation was announced in regards to the passive income tax proposals, so we are still unsure as to what the government is actually proposing or how they are going to go about it. All we know is that they are focusing on ways to reduce the ability for retained earnings that are reinvested to take advantage of the lower corporate tax rates. The government has announced a consultation period so submissions can be made.

In summary, if you are a shareholder in a private corporation, or/and your family members are also shareholders, then I would suggest you speak to your tax advisors to understand how these rules will affect you and what you may be able to do in order to minimize the effects.