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TAX NEWSLETTER

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CCPC PASSIVE INVESTMENT INCOME PROPOSALS

Overview

Readers may recall that, last July, the federal government proposed significant changes to the taxation of passive investment income earned by a Canadian-controlled private corporation ("CCPC"). Changes were subsequently introduced in the February 2018 Federal Budget (as noted in last month's Tax Letter), but the changes were more modest than the original proposals.

Under current law, a CCPC is subject to an annual tax rate on its investment income of around 50% or slightly more, depending on the province. However, when it pays out dividends to its shareholder(s), the corporation gets a refund out of its "refundable dividend tax on hand" ("RDTOH"), an account which tracks its investment income. After the refund, and taking into account the tax paid by a high income shareholder on the dividends, the overall tax rate on investment income is also about 50%. This means that there is "integration" between the corporate and personal income tax systems, such that income earned personally or through a corporation is ultimately subject to about the same total tax.

However, the government believes there is a problem with the current system. The problem stems from the fact that the first $500,000 of active business income of a CCPC is subject to a low rate of tax, typically around 13%, again depending on the province. This low rate results from the small business deduction ("SBD") that applies to the first $500,000 of such business income, thus lowering the tax rate from the general corporate tax rate of 27-30% to around 13%. If the CCPC then uses the after-tax business income to earn passive investment income, it obtains a deferral advantage not available to other taxpayers. That is, even though the investment income is subject to annual refundable tax as noted above, the CCPC has much more to invest initially because of the low 13% tax rate on business income, compared to business income earned by non-incorporated individuals which may be subject to a tax rate of 50% or more. Put another way, the CCPC has a significant "head start" in terms of how much it can invest relative to a high-income individual. Therefore, the CCPC ultimately comes out ahead relative to an individual who carries on a business personally and invests his or her after-tax high-rate business income.

Under last year's proposal, the RDTOH would have been scrapped, meaning that there would have been *no* refund for the CCPC when it paid out dividends from its investment income. This proposal would have significantly increased effective tax rates on the investment income when it was paid out as dividends, relative to the current rules. However, the proposal was never implemented, and as noted, was replaced by a more modest Budget proposal.

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<u>Main Budget Proposal</u>

In the February 2018 Budget, the government decided against repealing the RDTOH. As a result, the RDTOH will be retained and the refund of corporate tax will still apply when the CCPC pays out dividends.

The government introduced an alternative proposal. Under this proposal, the business income of the CCPC that qualifies for the SBD in a taxation year will be reduced, on a 5:1 basis, when its passive investment income (and that of its "associated" CCPCs) for the preceding taxation year exceeds $50,000.

For example, if the CCPC's passive investment income in a taxation year is $70,000, its maximum business income eligible for the SBD for the next taxation year will be reduced to $400,000 (that is, the maximum $500,000 small business income limit minus 5 x ($70,000 minus $50,000)).

In short, the business income of the CCPC that qualifies for the SBD will be reduced in a 5:1 ratio. The business income that does not qualify will then be subject to the higher general corporate tax rate, which, as noted, is about 27-30% depending on the province.

<u>Further Budget Proposal</u>

On a related note, the government introduced a measure that addresses the apparent "mismatch" that applies in certain cases where a CCPC pays dividends. Generally speaking, where a CCPC pays dividends out of income that was subject to the SBD or investment income that is eligible for the refundable tax out of its RDTOH, the dividends are considered "non-eligible" dividends. In the hands of the shareholder, these dividends receive a lower dividend tax credit than that which applies for "eligible dividends". The latter dividends earn a higher dividend tax credit for the shareholder, because they are normally paid out of business income that was not eligible for the SBD and was therefore taxed more heavily in the CCPC.

However, in certain cases, the current rules allow a corporation to pay eligible dividends even if they are paid out of income that was subject to the SBD or investment income that is eligible for the refundable tax out of its RDTOH. The government fixed this "mismatch". The Budget introduced a new rule that splits the RDTOH account into two accounts – one that tracks income that can qualify for eligible or non-eligible dividend tax treatment, and another that tracks income that qualifies only for the non-eligible tax treatment.

The above proposals apply to corporate taxation years that begin after 2018. They are included in Bill C-74, the 2018 Budget first bill, which is currently wending its way through Parliament and will almost certainly be enacted this June.

THE INCOME ATTRIBUTION RULES

Canada's income tax system uses the individual as a tax unit, rather than a spousal unit or family unit. In other words, each individual in a family is subject to tax on his or her income, because the income is not pooled with other family members.

Our income tax system also employs graduated or progressive tax rates. This means that as your income increases, the marginal tax rate on your income can increase. For example, in 2018 your first $46,605 of taxable income is subject to a 15% federal tax rate, whereas your taxable income exceeding $205,842 is

subject to a 33% rate. Taxable income between those thresholds is subject to three other rates (20.5%, 26%, and 29%), again depending on your level of taxable income. On top of that, each province levies progressive provincial income tax and those rates vary depending on the province.

As a result of the individual tax unit and the progressive tax rates, if a high-income individual can shift income to a lower income individual, there will be an overall savings in tax. For example, if you are a parent in the highest tax bracket and you can shift some of your income to your spouse or minor child in a low tax bracket, you will obviously save tax.

Of course, the government is aware of this, and the Income Tax Act contains various "income attribution" rules that can apply when you transfer property that is used tor investment purposes to your spouse (or common-law partner) or minor children. The main rules are summarized below.

Loans or transfers to spouse

If you lend or transfer property to your spouse (or common-law partner), then income or loss from the property is attributed to you and included in your income rather than your spouse's income. Income from property includes items such as interest, dividends, royalties and rent. A similar rule can apply to attribute taxable capital gains (or allowable capital losses) from your spouse's dispositions of the property or substituted property.

Fortunately, as discussed below, there are various exceptions to both rules.

There is also a "substituted property" rule, which means that attribution can continue even if your spouse sells or converts the lent or transferred property and uses the proceeds to acquire another property. For example, if you give your spouse cash and she uses the cash to purchase mutual funds, the income from the funds will be attributed back to you. Furthermore, if she sells the funds and uses the proceeds to buy another income-producing property, the attribution rules can continue to apply to the income or gain from that other property.

The income attribution rule stops if you divorce or are living "separate and apart" by reason of the breakdown of your marriage (or common-law relationship). The capital gains attribution ceases after divorce, but stops during your separation only if you and your spouse make a joint election with your tax returns.

Loans or transfers to minor children

A similar rule applies if you lend or transfer property to your child, grandchild, great grandchild, sibling, niece or nephew (including in-law relationship) under 19, or to any other child under 18 with whom you do not deal at arm's length.

As with the spousal attribution rule, income or loss from the property or property substituted for that property is attributed back to you.

This income attribution does not apply throughout the year in which the minor child turns 18 years or in later years.

Furthermore, the attribution rules do not apply to capital gains realized by minor children. For example, if you purchase publicly-listed common shares or equity mutual funds for your minor children, any taxable capital gains from the property will be included in their income and will not be subject to attribution.

So you can legitimately split capital gains with your minor children.

There is one notable case where capital gains splitting is not advantageous: if the minor disposes of shares in a *private* corporation to you (or any non-arm's length person), the gains will normally be subject to the Tax on Split Income (the so-called "kiddie tax") at the highest marginal rate of tax. This tax has been substantially extended as of 2018.

Exceptions

Fortunately, there are various exceptions where the attribution rules do not apply.

- The rules do not apply to income from business. Therefore, you can give or lend property to your spouse or minor children to earn income from their business and the income will not be attributed to you.

- As noted, the rules do not normally apply to capital gains of minor children. Therefore, you can split capital gains with children. However, attribution can apply if you transfer qualified farm or fishing property to your child under the tax-deferred "rollover" provisions of the Income Tax Act. There is also the potential kiddie tax issue discussed above.

- The rules do not apply if you lend money to your spouse or minor child at the prescribed rate of interest at the time of the loan, as long as they pay the interest each year or by January 30 of the following year. The prescribed rate is currently 2% (see below under "Prescribed Interest Rates").

  For example, if you lend money to your spouse and charge 2% annual interest and he uses the funds to purchase an investment that pays an annual return of 6%, the attribution rules will not apply. Your spouse will include the 4% net return in income (the 6% gross return minus the 2% interest paid to you). You will include the 2% interest received by you. However, if your spouse misses the January 30 deadline for even one annual interest payment, this exception from attribution ceases to apply.

  Interestingly, this exception can apply regardless of the length of the term of loan. So the loan can remain outstanding for 10 or 20 years or longer, and still qualify for the exception, as long as your spouse pays the interest on time for each year.

- The attribution rules do not apply if you receive at least fair market value consideration for the property. Similar to the lending exception above, if the consideration is debt, you must charge at least the prescribed rate of interest, and they must pay you the interest each year or by January 30 of the following year. Also, in the case of your spouse, if you transfer property under this exception you must elect out of the tax-free "rollover" on the transfer, which is otherwise available for transfers between spouses. This means that the transfer of the property will normally take place at fair market value, which could generate a capital gain for you if the value exceeds your cost of the property. So for transfers to your spouse, you will normally want to use property with little or no accrued gain.

- The rules do not apply to reinvested income (secondary income). Thus, if you transfer property to your spouse or minor child and they reinvest the income earned on the property, the income earned on the

reinvested income is not subject to attribution.

- The rules do not apply to transfers of property to children 18 years of age or older. However, in the case of loans, there is an attribution rule that can apply if you lend money to a child (minor or adult) or another non-arm's length person and one of the main reasons is to reduce your tax payable. As above, there is an exception to this attribution rule if you charge at least the prescribed rate of interest on the loan.

- Since the attribution rules do not apply if the lent or transferred property generates no income or capital gains, you can give your spouse and children cash to pay personal expenses, and that will not attract any attribution rules. As a planning point, you could pay your spouse's personal expenses (including his or her income tax payable) and common household expenses, thus freeing up your spouse's own income to invest in income-earning property. The attribution rules will not apply.

- Since income or capital gains from a tax-free savings account (TFSA) are not included in income, you can put cash into your spouse's or adult child's TFSA and there will be no attribution on any subsequent income. Similarly, if you contribute to your spouse's registered retirement savings plan (RRSP), there is no attribution when the funds and income are withdrawn by your spouse, generally as long as the withdrawal does not take place in the calendar year during which the contribution is made or the next two calendar years.

- If you receive the Canada Child Benefit in respect of your children, the benefit can be invested and the income or gains from the investment are exempt from attribution.

- You can split eligible pension income (e.g. income from your registered pension plan, annuity income from your registered retirement savings plan, and income from your registered retirement income fund) with your spouse or common-law partner. Normally, you can split up to 50% of that pension income per year. If you are under 65 years of age, the pension split is somewhat more restricted relative to the case once you are 65 years or older.

ADOPTION TAX CREDIT

If you adopt a minor child (under the age of 18), you will normally qualify for the adoption tax credit.

The federal credit equals 15% of up to $15,000 of your "eligible adoption expenses". Each province has a similar credit.

For the federal credit, the expenses must be incurred during the "adoption period", which is generally the period between your application for the adoption and the later of the time of the final adoption order and when the child begins to reside with you.

If you are married or in a common-law relationship, you and your spouse (partner) can share the credit. Alternatively, one of you can claim the entire credit. If you are single, you will claim the entire credit.

The eligible adoption expenses include:

- fees paid to an adoption agency licensed by a provincial government;

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- court costs and legal and administrative expenses related to the adoption order;
- reasonable and necessary travel and living expenses of you and the child (e.g. when you visit the child during the adoption process);
- translation fees;
- mandatory fees paid to a foreign institution (often required for foreign adoptions); and
- mandatory expenses paid in respect of the immigration of the child to Canada.

If the adoption period covers more than one taxation year, you must claim the credit for the year in which the adoption order is finalized.

Once the adoption is complete, your newly adopted child is considered your child for all tax purposes, including various tax credits and the child-care expense deduction.

PRESCRIBED INTEREST RATES

The Canada Revenue Agency (CRA) recently announced the prescribed interest rates that apply to amounts owed to the CRA and to amounts the CRA owes to individuals and corporations. The rates are subject to change every calendar quarter. These rates are in effect from April 1, 2018 to June 30, 2018. The rates increased by one percentage point for the first time since 2013, and for only the second time since 2009.

- The annual interest rate charged on overdue taxes, Canada Pension Plan contributions, and Employment Insurance premiums is 6%.
- The interest rate paid on refunds (late payments by the CRA) to corporations is 2%.
- The interest rate paid on refunds to other taxpayers is 4%.
- The interest rate used to calculate taxable benefits for employees and shareholders from interest-free and low-interest loans, as discussed above, is 2%.

AROUND THE COURTS

“Salary” paid to spouse not deductible in computing employment income

Under the Income Tax Act, an employee is allowed to deduct from his or her employment income salary paid “to an assistant or substitute, the payment of which by the officer or employee was required by the contract of employment”.

In the recent *Blott* case, the taxpayer was a market dealer with a securities firm, selling and promoting various products provided by the firm. In two taxation years, he purportedly paid $12,000 in “salary” to his wife for various administrative and management services that aided him in his employment duties. He deducted the salary under the above rule, but the CRA denied the deduction.

Upon appeal to the Tax Court of Canada, there were two main issues.

First, it was not clear whether the taxpayer actually paid the amounts to his wife. He simply deposited the amounts into a joint bank account he held with his wife, without specifying that it was salary paid to her spouse. The Tax Court Judge concluded that there was not enough evidence to say that

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this amount was actually paid to his spouse, even though she was named as a holder of the joint account.

Second, it was not clear whether the payment was “required by the contract of employment”. The Judge found that there was no explicit requirement under the contract, and he rejected the taxpayer’s position that there might have been an implicit requirement. In short, as with the first main issue, there again was not sufficient evidence to back up the taxpayer’s claim.

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This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with an expert before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.