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Equipment Dealers Association

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Proposed Tax Changes and Impacts to Private Corporations and Professionals

Income Sprinkling

Many professionals have benefitted by paying dividends to either family members or trusts as shareholders of their professional corporations. By paying dividends to family members, professionals were able to reduce their taxes, allowing them to support others in a tax efficient manner. This strategy was often used to help finance post-secondary education and to support aging parents.

The proposed changes would implement a "reasonability test" on dividends paid to family members and the realization of capital gains on shares owned by family members. Any dividends paid to, or capital gains realized by, family members the Minister of National Revenue deems to be "unreasonable" would be subject to the Tax on Split Income (TOSI). Amounts subject to TOSI would be taxed at the highest marginal rate of tax.

Holding Passive Investments Inside a Private Corporation

Under our existing tax system, business owners are able to take advantage of deferring taxes on excess earnings by retaining them within a corporation. Since the corporation is subject to corporate rates of tax, which are significantly lower than the highest personal marginal rates of tax, the corporation has a larger pool of capital to either reinvest in the business or to invest in passive investments.

Explanatory notes on the proposed legislation hold that individual shareholders personally benefit from this deferral when excess capital is not reinvested in the business itself but rather, is used to purchase passive investments. The federal government believes this creates an unfair tax advantage as that income would otherwise be subject to much higher personal tax rates if it were drawn from the corporation.

No draft legislation has been presented with respect to this proposal. However, the federal government is currently exploring a number of options, all of which are designed to eliminate the incentive to invest passively within a corporation

Converting Income to Capital Gains

Traditionally, an individual shareholder would typically receive either salaries, dividends, or a combination thereof as remuneration. In recent years, tax planning has been implemented allowing shareholders to withdraw corporate surplus as capital gains (surplus-stripping). As only 50 percent of a capital gain is taxable, this allowed shareholders of private corporations to realize significant tax savings when withdrawing funds from their corporation.

The federal government has proposed changes to existing anti-surplus stripping rules which will severely limit capital gains planning. Further, it has introduced a general anti surplus-stripping rule intended to capture strategies that circumvent the specific rules of the Income Tax Act.

While changes with respect to surplus-stripping transactions would not have a significant impact on professionals, they could have unintended consequences which would need to be considered. Common estate planning strategies may no longer be effective under the proposed changes and the general anti-surplus stripping rule will have to be considered whenever a taxpayer withdraws funds from their corporation in a tax-advantaged manner (e.g. payment of capital dividends).

If legislated as presented, these changes will have a significant impact on most professionals operating through a professional corporation. We have received a number of questions from our members looking for guidance in light of these proposals, and encourage them to contact their accounting firms for advice and guidance.