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STEP Canada Tax Technical Committee

RE: July 18, 2017 Finance Consultation Paper and Draft Legislation

On Tuesday, July 18, 2017, the Department of Finance released a Consultation Paper and draft legislation addressing Budget 2017's proposal to study income tax issues relating to the strategic use of private corporations in tax planning. Budget 2017 had identified three main areas of concern:

- the use of private corporations to sprinkle income among family members with lower marginal tax rates;
- holding passive investments in private corporations to facilitate higher income accumulation due to the fact that the general corporate tax rate is generally lower than personal tax rates; and
- converting private corporation income into capital gains, instead of realizing it as dividends.

The Consultation Paper and accompanying draft legislation address these three concerns comprehensively, as follows:

- The draft legislation proposes to extend the scope of the "kiddie tax" rules to apply to a broader range of taxpayers and more types of income. The proposed new tax – referred to in the Consultation Paper as a "tax on split income" or "TOSI" - will apply where any taxpayer (not just those under 18 years of age) earns income derived from a business which is sufficiently linked to a related person. Included in the expanded concept of "split income" is any capital gain on shares where dividends on those shares would constitute split income.

These rules would apply for the 2018 and later taxation years.

- The draft legislation proposes three measures to address planning aimed at multiplying the capital gains exemption on QSBC shares:
    - the exemption would no longer be available in respect of gains that accrued prior to the owner attaining the age of 18;
    - the exemption would no longer apply if the gain is included in the owner's split income; and,
    - the exemption would no longer apply, subject to certain narrow exceptions, for gains accruing while the shares are owned by a trust.

These rules would apply for the 2018 and later taxation years. There are transitional rules which would permit a crystallization of capital gains accruing to 2017.

- The Consultation Paper proposes that passive income earned in a Canadian-controlled private corporation not be eligible for the refund of refundable dividend tax on hand where the investment income was earned on corporate earnings taxed at low corporate tax rates. As the Consultation Paper explains, the effect of this measure would be to remove the deferral advantage gained by retaining after-tax surplus in the Corporation.

There is no draft legislation for this proposal.

- The third proposal would change the scope of application of section 84.1 as well as introduce a new anti-avoidance rule to address surplus stripling more generally. The proposed amendment to section 84.1 will target situations where taxpayers intentionally realize a capital gain on a transfer of shares to a non-arm's length party that pays the purchase price using the corporate surplus extracted tax free following the transfer. The Department of Finance is concerned that in these circumstances the taxpayer should be paying tax at the dividend rate, not the capital gains rate. These proposals, for which there is draft legislation, will deem the capital gain realized in such situations to be a non-eligible dividend.

These rules, and the proposed general anti-avoidance rule targeting surplus stripping schemes, would apply to transactions occurring on or after July 18, 2017.

STEP Technical Tax Committee and STEP Public Policy Committee are reviewing the proposals and the accompanying draft legislation carefully and will be making extensive submissions to the Department of Finance.

The deadline for submissions is October 2, 2017. STEP members who have particular concerns or views in respect of the proposals and draft legislation should send their submissions to ttc@step.ca before **Thursday, September 10, 2017**. These will be forwarded to the STEP Technical Tax Committee and Public Policy Committee for review and consideration in the drafting of the STEP submission.

Yours very truly,

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