



# Tax Planning Using Private Corporations: An Analysis



AUTOMOTIVE INDUSTRIES  
ASSOCIATION OF CANADA

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Automotive Industries Association of Canada

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# Word on the Street

“These proposals, while intended to target the wealthy, will hurt middle-class business owners from every sector of the economy. These are shopowners, farmers, doctors, financial planners, homebuilders and trades in all sectors — the entrepreneurial families who are the backbone of the economy and responsible for the majority of the job creation in Canada<sup>1</sup>,” — Dan Kelly. President of the Canadian Federation of Independent Business (CFIB).

“So you get someone who’s making \$50,000 a year who’s actually paying more taxes than someone who’s making \$300,000 a year because they have private corporation mechanisms and good accountants that allow them to get away from that.<sup>2</sup>” — Justin Trudeau, Prime Minister of Canada.

“They are provisions in the tax act that were brought forward by the government of the day. They were designed to reward or incentivize people for taking the risk of starting a business.<sup>3</sup>” — Doug Reevey. Owner, Autotec Inc.

“What the Liberals need now is nerve, a more detailed defence of their policy and faith that average Canadians will stand with them, despite the noise coming from a well-heeled minority, and their well-paid lobbyists, who are loudly protesting this unexpected attack on their long-standing privileges.<sup>4</sup>” — Susan Riley. Lawyer & Journalist

The above quotes highlight the opposing reactions to tax changes recently proposed by the Liberal government.

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1 Canadian Federation of Independent Business. August 31, 2017. *Business groups unite, call on Ottawa to drop federal tax changes for small business.* <http://www.cfib-fcei.ca/english/article/9607-business-groups-unite-call-on-ottawa-to-drop-federal-tax-changes-for-small-business.html>

2 Macleans. September 7, 2017. *Trudeau gets earful over tax reform at B.C. townhall.* <http://www.macleans.ca/politics/trudeau-gets-earful-over-tax-reform-at-b-c-townhall/>

3 Auto Service World. September 10, 2017. *Tax changes could impact auto businesses. Government efforts to ‘close loopholes’ for private corporations could impact small business too.*

4 The Hill Times. September 11, 2017. *Small business tax reform a test of Trudeau’s nerve.* [subscription only] <http://www.hilltimes.com/2017/09/11/small-business-tax-reform-test-trudeaus-nerve/118261>

# Introduction

The proposed changes are a product of the Liberal's 2015 electoral campaign promise to end unfair tax breaks by cancelling "income splitting and other tax breaks and benefits for the wealthy<sup>5</sup>". The government moved forward on their campaign promise in Budget 2017 by signalling "its intention to address specific tax planning strategies involving the use of private corporations.<sup>6</sup>"

On July 18, 2017, Finance Canada released a consultation paper that detailed tax planning strategies that involve the use of private corporations and policy proposals to close loopholes to bring greater fairness to the tax system. A public consultation, Tax Planning Using Private Corporations, was initiated in conjunction with the release of the consultation paper. The consultation, ending October 2, 2017, offers the public the opportunity to share their comments with Finance Canada on the proposed solutions to close loopholes.

The objective of this brief is to: provide a high-level overview of the tax planning strategies used by Canadian-Controlled Private Corporations (CCPCs) that are the target of the proposed tax changes; relay what input the government is looking for from the public on the proposed solutions to close loopholes; and to share some differing opinions on the proposed tax changes. The Automotive Industries Association of Canada is not in the business of accounting or financial management. Therefore, please review the consultation documents listed below for extensive details on the proposed tax changes.

**Read the  
consultation paper**

**Read the  
accompanying  
document to the  
consultation paper**

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5 Liberal Party of Canada. 2017. Ending unfair tax breaks. <https://www.liberal.ca/realchange/ending-unfair-tax-breaks/>

6 iPolitics. September 5, 2017. Trudeau's going to pay a heavy price for tax reform. [subscription only] <http://ipolitics.ca/2017/09/05/trudeaus-going-to-pay-a-heavy-price-for-tax-reform/>

# What is a Canadian-Controlled Private Corporation?

A Canadian-Controlled Private Corporation (CCPC) is a private corporation that is controlled by Canadian residents. Public companies do not qualify for CCPC status, nor do companies run by non-residents<sup>7</sup>. Some CCPCs are eligible for the small business tax deduction<sup>8</sup>:

“Small businesses benefit from a reduced federal corporate income tax rate of 10.5 per cent, as compared to the general federal corporate income tax rate of 15 per cent. The small business tax rate is provided through the small business deduction, and applies to the first \$500,000 per year of qualifying active business income (business limit) of a Canadian-controlled private corporation (CCPC).”<sup>9</sup>

Among the G7 countries, which include the United States, Japan and France, Canada’s small business tax rate is the lowest<sup>10</sup>.

The reason for the preferential small business tax rate, as articulated by Finance Canada, is “to help Canadian businesses reinvest and grow, find new customers, buy new equipment and hire more people.”<sup>11</sup>

In Canada, the corporate tax rate is much lower than the highest personal income tax rate that stands at 33% of taxable income over \$202,800 in 2017<sup>12</sup>.

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7 Barrett Tax Law. 2016. Canadian controlled private corporation. <http://barretttaxlaw.com/canadian-controlled-private-corporation/>

8 The balance. January 5, 2017. The small business deduction business limit in Canada. <https://www.the-balance.com/the-small-business-deduction-business-limit-in-canada-2948063>

9 Department of Finance Canada. July 18, 2017. Tax planning using private corporations. <http://www.fin.gc.ca/activty/consult/tppc-pfsp-eng.asp>

10 Globe and Mail. September 7, 2017. How Bill Morneau can really help Canada’s small businesses. <https://cfig.ca/wp-content/uploads/2017/09/Globe-column-Sept-2017.pdf>

11 Department of Finance Canada.

12 Government of Canada. 2017: Canadian income tax rates for individuals - current and previous years. <https://www.canada.ca/en/revenue-agency/services/tax/individuals/frequently-asked-questions-individuals/canadian-income-tax-rates-individuals-current-previous-years.html>

# Who Incorporates?

The study, Policy Forum: Private Companies, Professionals, and Income Splitting— Recent Canadian Experience, published in the Canada Tax Journal (2015) reported the following:

“For the bottom 50 per cent of income tax filers in 2011, those with incomes under \$51,600 (well under 10 per cent) had a non-trivial interest in a private company. But for the top one per cent with incomes over \$163,300, more than 50 per cent had a significant interest in a private company — and for the top 0.01 per cent with incomes over \$2.3 million, this figure jumps to almost 80 per cent.

## Why is the government focused on tax planning strategies that involve the use of CCPCs?

In recent years, there has been a marked increase in the number of CCPCs:

“The number of Canadian-controlled private corporations (CCPCs) has increased substantially, from 1.2 million in 2001 to 1.8 million in 2014. Growth has been particularly strong in some sectors; for instance, the number of corporations in professional services has tripled over the last 15 years.”<sup>13</sup>

The perception of government is that an increasing number of business owners are incorporating to take advantage of tax planning strategies (which are legal – but considered unfair) that are afforded to them through incorporation. The advantages are perceived as being used by some to benefit the individual by shifting portions of taxable income from the personal to the corporate tax rate. The strategies being targeted are not afforded to an individual that earns income through a salary or a business owner that does not incorporate who pays taxes on their income earned at their personal tax rate<sup>14</sup>.

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<sup>13</sup> Department of Finance Canada.

<sup>14</sup> Canada Business. 2017. Sole proprietorship, partnership, corporation or co-operative? <https://canadabusiness.ca/starting/before-starting-your-business/corporation-partnership-or-sole-proprietorship/>.

# Targeted tax planning strategies involving CCPCs

## (1) Sprinkling income using private corporations

### Government's position:

"Income sprinkling arrangements are possible because the private ownership of a business permits its principals to more easily control or influence the legal form of the ownership of the business and the circumstances in which profits are distributed. Specifically, the principals of private businesses can arrange for distributions to be made (typically by way of dividend payments in the case of a corporation) to other individuals (typically family members) in a way that minimizes the overall amount of personal income tax paid on that income. The income distributed to the family member may exceed what would have been expected, having regard to the family member's labour and capital contributions to the business, in arrangements involving arm's-length investors."<sup>15</sup>

### Canadian Federation of Independent Business (CFIB's) position:

"When you start a business, everyone in your family is involved and takes on risk—whether you directly employ them, or they provide other informal support."<sup>16</sup>

### Government seeking input on:

"...rules to distinguish income sprinkling from reasonable compensation for family members. The rules would help to determine whether compensation is reasonable, based on the family member's contribution of value and financial resources to the private corporation."<sup>17</sup>

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15 Department of Finance Canada.

16 Canadian Federation of Independent Business. 2017. How the proposed federal tax changes could affect you. <http://www.cfib-fcei.ca/english/article/9533-federal-tax-changes-add-new-threats-for-independent-business.html>

17 Department of Finance Canada.

## (2) Holding a passive investment portfolio inside a private corporation

### Government's position:

"Corporate income is taxed at lower rates than personal income, giving businesses more money to invest in order to grow their business, find more customers and hire more people. But there are times when private corporations earn income beyond what is needed to re-invest and grow the business. In these cases, those who own and control a private corporation have the opportunity to hold passive investments inside the corporation. The Government is of the view that fairness and neutrality require that private corporations not be used as a personal savings vehicle for the purpose of gaining a tax advantage. Passive investments held within privately-controlled corporations should be taxed at an equivalent rate to those held outside such corporations."<sup>18</sup>

### Canadian Association of Management Consultants (CMC-Canada's) position:

"Small business owners do not have access to pensions or the other benefits offered to many salaried workers and so often rely on passive income investments in their business to prepare for their retirement. It is difficult for small business owners to access financing and so business often use passive income to save for major investments. Passive income serves as insurance against emergencies and unforeseen costs."<sup>19</sup>

### Government seeking input on:

"...possible approaches to neutralize the tax-assisted financial advantages of investing passively through a private corporation. Potential directions for improving the current system are outlined in this paper. Modifications to the current system will be designed to preserve the growth objectives of the lower taxes on active business income earned by corporations."<sup>20</sup>

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18 Department of Finance Canada.

19 Canadian Association of Management Consultants. September 1, 2017. CMC-Canada's response to Finance Minister Morneau's proposed tax changes. <https://www.cmc-canada.ca/blogs/jac-van-beek/2017/08/31/cmc-canadas-response-to-finance-minister-morneaus-proposed-tax-changes>

20 Department of Finance Canada.

### **(3) Converting a private corporation's regular income into capital gains**

#### Government's position:

"Converting a private corporation's regular income into capital gains can reduce income taxes by taking advantage of the lower tax rates on capital gains. Income is normally paid out of a private corporation in the form of salary or dividends to the principals, who are taxed at the recipient's personal income tax rate (subject to a tax credit for dividends reflecting the corporate tax presumed to have been paid). In contrast, only one-half of capital gains are included in income, resulting in a significantly lower tax rate on income that is converted from dividends to capital gains."<sup>21</sup>

#### Coalition for Small Business Tax Fairness' position:

"...proposed changes could affect business value appreciations from the past, as almost a form of retroactive taxation. These changes could also result in the double taxation of some estates, and could make it more difficult for business owners looking to do intergenerational business transfers...Allowing for intergenerational transfers would be of significant help with succession planning, encouraging businesses to remain in the family and in their community."<sup>22</sup>

#### Government seeking input on:

"...changes to tax rules to prevent the surplus income of a private corporation from being converted to a lower-taxed capital gain, and stripped from the corporation...The Government also invites views and ideas on whether, and if so how, it would be possible to better accommodate genuine intergenerational business transfers in the Income Tax Act while still protecting the fairness of the tax system."<sup>23</sup>

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21 Department of Finance Canada.

22 Coalition for Small Business Tax Fairness. August 30, 2017. Coalition for small business tax fairness letter on proposed tax proposals. <https://www.cba.org/CMSPages/GetFile.aspx?guid=cdca2a24-99c1-4bdc-ae0-cbaaa-7be4c8d>

23 Department of Finance Canada.

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