July 18, 2017 Private Corporations Legislative Proposals

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GENERAL OVERVIEW

- On July 18, 2017, Finance released Legislative Proposals and Consultation Document to profoundly change the taxation of private corporations and their shareholders
- Consultation process is until October 2, 2017 (75 days in the middle of the summer with the Minister of Finance initially using social media to defend the proposals) – sufficient to engage in constructive discussion with Finance?
- Proposed legislation targets four strategies believed to be unfair:
    1. Income splitting;
    2. Multiplication of the lifetime capital gains exemption;
    3. Holding passive investments in a private corporation;
    4. Converting a corporation's after-tax income into capital gains

GENERAL OVERVIEW

- Liberal Government political line is that tax proposals are purported to close “tax loopholes” and “strategies that can result in high-income individuals gaining tax advantage that are not available to most Canadians”
- Additional revenue expected (as per Finance’s Consultation Document):
  - “Proposed measures to address income sprinkling would result in additional revenue of some $250 million per year once fully implemented”.
  - Private corporations currently hold significant amounts of passive investments, which generated approximately $27 billion in passive income in 2015. “An estimate of additional revenues generated by the Government's actions will be provided once, taking into account the views expressed in consultations, the Government has made a decision on the final design of the new tax rules”.
  - “The fiscal impacts of the proposed measure to prevent surplus income of a private corporation from being converted to a lower-taxed capital gain cannot be determined based on currently available information”.

I. INCOME SPRINKLING (TOSI)

- Policy perspective
  - 1966 Carter Commission strongly recommended that the family unit be the appropriate taxing unit and noted the substantial contribution each family member usually makes to the family's finance
  - Government went against the Commission's recommendation and decided on the individual as the proper taxing unit
  - There is no general policy in the ITA that prevents income splitting – Neuman v. R., 98 DTC 6297 (SCC).
    - Par. 57: "Dickson C.J. seemed to be of the view that the character of a shareholder's dividend income is to be determined by that shareholder's level of contribution to the corporation. This approach ignores the fundamental nature of dividends; a dividend is a payment which is related by way of entitlement to one's capital or share interest in the corporation and not to any other consideration. Thus, the quantum of one's contribution to a company, and any dividends received from that corporation, are mutually independent of one another."
  - Specific tax avoidance provisions applicable to income sprinkling:
    1. Attribution rules
    2. Kiddie tax
    3. Direct or indirect benefits (15(1), 56(2), 246(1) ITA)

I. INCOME SPRINKLING (TOSI)

- Policy perspective
  - Various Provincial matrimonial property regimes grant property rights to spouses and common-law partners, regardless of who contributes to the business
  - Family members of an entrepreneur bear some degree of risk associated with their business (eg creditor's security on jointly-owned or family assets)
  - Non-active spouses contribute in some ways to the family business – how to quantify such contribution and what is reasonable?
  - In contrast, the government has allowed the splitting of pension income between spouses/common-law partners since 2007
  - In certain foreign jurisdiction (for instance in the U.S.), couples can file joint tax returns

I. INCOME SPRINKLING (TOSI)

Income Sprinkling – Issues

- Complexity of the rules
- What is reasonable?
- Open for CRA Interpretation
- Size does not matter
- Retroactive taxation?

I. INCOME SPRINKLING (TOSI)

Income Sprinkling – Retroactive Taxation?

- Husband and Wife incorporation Opco in 2000. Upon incorporation, Husband and Wife each subscribed for 50% of the common shares of Opco for a nominal amount
- Husband was active in the business while Wife was inactive
- Their daughter became involved in the business and by 2016, was running the business
- In 2016, Husband and Wife's shares of Opco were frozen. They each received fixed value preferred shares equal to the fair market value at the time. The daughter then subscribed for new common shares
- Husband and Wife will receive dividends annually by way of share redemptions of their preferred shares throughout retirement. This would be the extent of their retirement income

I. INCOME SPRINKLING (TOSI)

Income Sprinkling – Retroactive Taxation?

- Wife – Clearly subject to TOSI
- Husband – Possibly subject to TOSI, depending on reasonability of Husband's past contributions to Opco?

- Is it appropriate to now tax all that value at highest marginal rates?

I. INCOME SPRINKLING (TOSI)

Income Sprinkling – 2017 Planning

- Rules effective January 1, 2018
- Where appropriate, dividends to inactive age of majority family members should be maximized in 2017

Income	$50,000	$75,000	$100,000	$150,000	$200,000
Tax	$2,900	$7,800	$16,000	$34,190	$55,319
Tax Rate	6%	10%	16%	23%	38%

I. INCOME SPRINKLING (TOSI)

Income Sprinkling – 2018 Planning

- To the extent possible, get non- active family members more involved in the business
- Rebalance family compensation
- Retain records to support reasonability for any salary or dividends paid to family members
- Return to salary rather than declaring dividends?

II. CAPITAL GAINS EXEMPTION

Background

- Government is concerned that current CGE rules can be used to "multiply" the CGE with family members who are not involved in the business

Proposed Measures

1. Proposed age limit so that minors will no longer qualify for the CGE in respect of capital gains that are realized, or that accrue for dispositions after 2017 – 110.6(12)(a)
2. CGE will generally not apply if the taxable capital gain arising from a disposition is included in an individual's "split income" – 110.6(12)
3. New limits for beneficiaries of a trust from claiming any CGE on dispositions of capital property – 104(21.2)
4. 2018 deemed disposition election – 110.6(18.1)

II. CAPITAL GAINS EXEMPTION

1. Proposed age limit so that minors will no longer qualify for the CGE - 110.6(12)(a)

   - No amount is deductible under the CGE if the individual has not attained the age of 17 years before the year (applicable to dispositions after 2017)

   - An individual cannot claim the CGE in respect of a gain that arose for the disposition of property (whether held directly or indirectly) to the extent that the gain accrued before the year that the individual turned 18 years of age

     ➢ May be necessary to have a valuation of the shares completed at the beginning of the taxation year in which the minor turns 18 years old

II. CAPITAL GAINS EXEMPTION

2. CGE not available if taxable capital gain arising from a disposition is included in an individual's "split income" – 110.6(12)

- New paragraph (e) of the definition of "split income" would now include, inter alia, taxable capital gain from the disposition by an individual of shares of a private corporation after 2017
- Amount deductible as CGE is reduced by twice the amount of the taxable capital gain included in computing the individual's split income
- How to apply the proposed reasonableness test to carve-out the gain from being "split income" under the "split portion" definition?
  - Eg: Uncle's investment in a start-up business by way of loan and equity (STEP letter)
  - What do we do with existing structures where there is accrued gain on the shares of a non-active family member that will not qualify anymore for the CGE?

II. CAPITAL GAINS EXEMPTION

3. New limits for beneficiaries of a trust from claiming any CGE on dispositions of capital property – Amended 104(21.2)

   - Under current rules, a personal trust may make a designation under subs. 104(21) so that capital gains realized by the trust be preserved as such when flowed through to a Canadian beneficiary

   - In order for the beneficiary to be able to claim the CGE on such a gain, a further designation must be made by the trust under subs. 104(21.2)

   - Alternatively, the trust can "rollout" property to a Canadian beneficiary at cost by way of capital distribution pursuant to 107(2) (deeming rule for 24-month holding period test in 110.6(14)(c))

II. CAPITAL GAINS EXEMPTION

3. New limits for beneficiaries of a trust from claiming any CGE on dispositions of capital property – Amended 104(21.2)

   - Under Proposed rules, only an "Eligible LCGE Trust" will be able to make a designation under 104(21.2)

   - An "Eligible LCGE Trust" includes:
     a) a spousal or common-law partner trust or alter ego trust where the individual claiming the CGE is the trust's principal beneficiary
     b) certain employee share ownership trusts, where the individual beneficiary is an arm's length employee of the employer sponsoring the arrangement

   - In addition, proposed 110.6(12) provides that a trust beneficiary will not be able to claim CGE on the portion of a capital gain that has accrued on property at a time that is prior to the rollout of such property to the trust's beneficiary

   - Result: no more flexibility for estate freezes

II. CAPITAL GAINS EXEMPTION

3. New limits for beneficiaries of a trust from claiming any CGE on dispositions of capital property – Amended 104(21.2)

- Fundamental Non-Tax Advantages of Family Trusts:

1) Creditor-proofing
   - Protection for family members who are not seen to be financially knowledgeable
   - Protection from claims against family law or marital regime claims
   - Family trusts can help to protect assets from possible future creditors. Generally, if all income and capital distributions are at the discretion of the trustee, the beneficiaries' creditors cannot seize any of the family trust's assets.

II. CAPITAL GAINS EXEMPTION

3. New limits for beneficiaries of a trust from claiming any CGE on dispositions of capital property – Amended 104(21.2)

2) Useful succession-planning tool
   - providing a vehicle for ongoing management and control of the business
   - provides the flexibility to determine which children will participate as shareholders, and in what proportions the trust's holdings in the family business and the trust's income will be divided
   - A discretionary family trust survives the death of an individual. Therefore, the shares in the trust are not subject to estate proceedings nor probate fees. The deceased would be replaced as a trustee and the trust would continue.

3) Financial support for an adult relative, such as elderly parents or a child or sibling with special needs

4) Privacy
   - Unlike a will, which becomes public once it is probated, a family trust need not be disclosed to anyone other than the parties directly involved

II. CAPITAL GAINS EXEMPTION

3. New limits for beneficiaries of a trust from claiming any CGE on dispositions of capital property – Amended 104(21.2)

   - New structures: implementation of a structure with a family trust vs. no family trust (tax vs. non-tax considerations)

   - Existing structures with a trust holding common (growth) shares – solutions?

     a) Crystallization of CGEs prior to Dec. 31 2017 by way of internal reorganization to increase tax cost (ACB) of shares

     b) Election for deemed disposition in 2018 under proposed 110.6(18.1)

II. CAPITAL GAINS EXEMPTION

4. 2018 deemed disposition election – 110.6(18.1)

- Proposed 110.6(18.1) allows an individual to elect to realize in 2018, a capital gain on a deemed disposition for proceeds up to the FMV
- The 24-month holding period and 24-month 50% active asset tests under the QSBC definition is reduced to 12 months
- Election is not available for taxpayers under the age of 18 years if deemed disposition is in respect of shares (whether shares held directly or indirectly through a trust for which a 104(21.2) designation would otherwise be made for the child beneficiary to claim the CGE)
- Result: purification process must happen before Dec. 31, 2017 in order for the crystallization to occur in 2018
- Alternative: crystallization of CGEs prior to Dec. 31 2017 by way of internal reorganization to increase tax cost (ACB) of shares
  - Internal s. 85 share transfer with elected amount up to FMV – 104(21) and (21.2) designations in case of shares held by a trust in order for capital beneficiaries to use their CGEs or rollout of property to capital beneficiary followed by internal crystallization of CGE
  - Requires valuation and internal reorganization to be implemented prior to calendar year-end

III. Holding Passive Investments Inside a Private Corporation

- Consultation paper lays out two broad approaches

    1. Reintroduction of Part V tax, with adjustments
    2. Introduction of a deferred taxation model
        - ➢ Apportionment approach
        - ➢ Elective approach

- No legislation has been drafted, however it is clear that the government wants to eliminate any deferral advantages

III. Holding Passive Investments Inside a Private Corporation

ISSUES

- Incredibly high tax cost
- Issues for low rate taxpayers
- Unequal tax-assisted retirement wealth opportunities
- Compliance burden

III. Holding Passive Investments Inside a Private Corporation

HIGH TAX COST

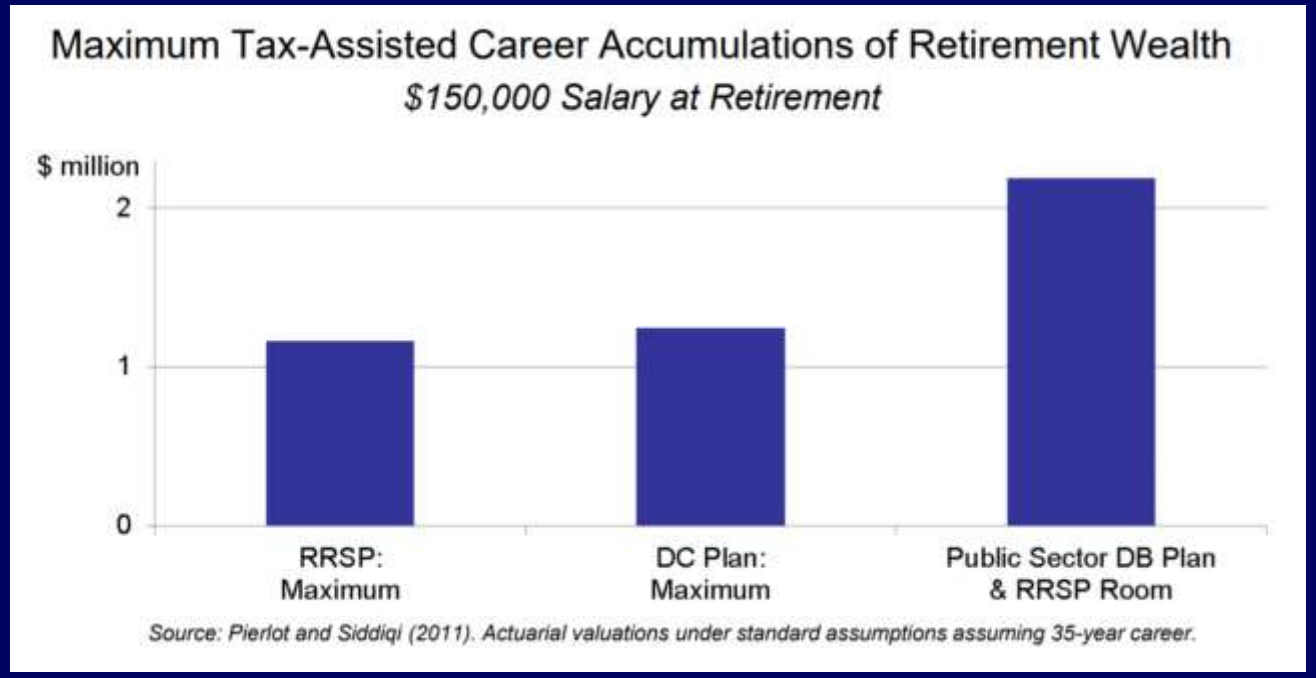
III. Holding Passive Investments Inside a Private Corporation

Issues for Low Rate Taxpayers

- “A corporate owner that pays personal taxes at a level below the top personal income tax bracket could have an incentive to withdraw corporate earnings not required for business reinvestments as they are earned, in order to invest in a personal savings account. This would maintain the ability to pay taxes on passive investment income at a lower rate.” (Tax Planning Using Private Corporations, page 51)

III. Holding Passive Investments Inside a Private Corporation

Unequal Tax-Assisted Retirement Wealth Opportunities



III. Holding Passive Investments Inside a Private Corporation

Compliance Burden

- Proposals suggest that existing wealth will be grandfathered
- Presumably this will require tracking of wealth in two pools
  1. Wealth that existed prior to the date of implementation
  2. Wealth accumulated after the implementation date
- Ordering rules will be required to determine which pool dividends will be paid from
- Changes are also proposed to the capital dividend account which will require consideration with respect to the source of the gain (passive vs active assets)

III. Holding Passive Investments Inside a Private Corporation

Are Changes Really Required?

- Investment income is already taxed at rates comparable to the highest marginal income tax rates
- The refundable tax system currently provides for near perfect integration in most provinces
- Finance indicates that on a 10-year net worth analysis of $100,000 the following results would occur:
  1. General Rate Business Income – advantage of $2,922
  2. Income Eligible for the Small Business Deduction – advantage of $5,672

Planning

- Difficult to plan without knowing for sure what the new rules will look like
- If taxpayers believe rules will eventually be repealed:
  - Invest in non-income producing investments
  - Use business profits to pay down debts instead of saving in the short term

IV. SURPLUS STRIPPING

- Amended 84.1
- New Section 246.1

IV. SURPLUS STRIPPING

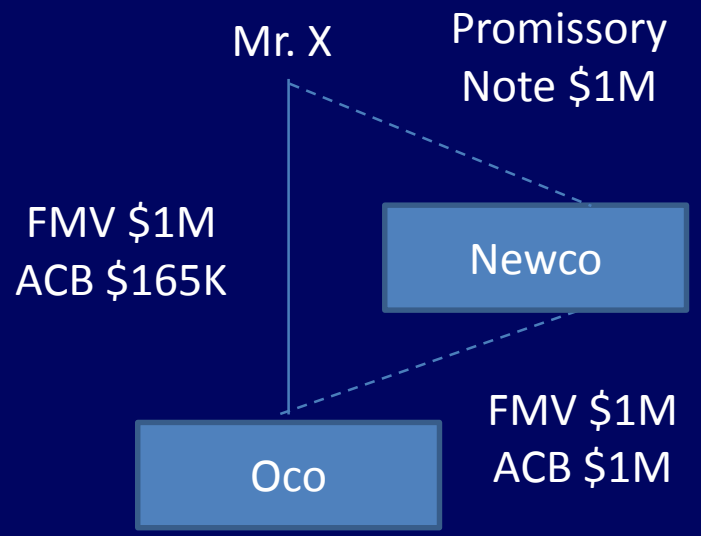
ITA 84.1

- Anti-avoidance provision
- Assume Mr. X wants to extract $1,000,000 from Opco
- He could take a dividend from Opco
- Effective tax rate would be 45.3%, resulting in $453,000 in tax

IV. SURPLUS STRIPPING

ITA 84.1

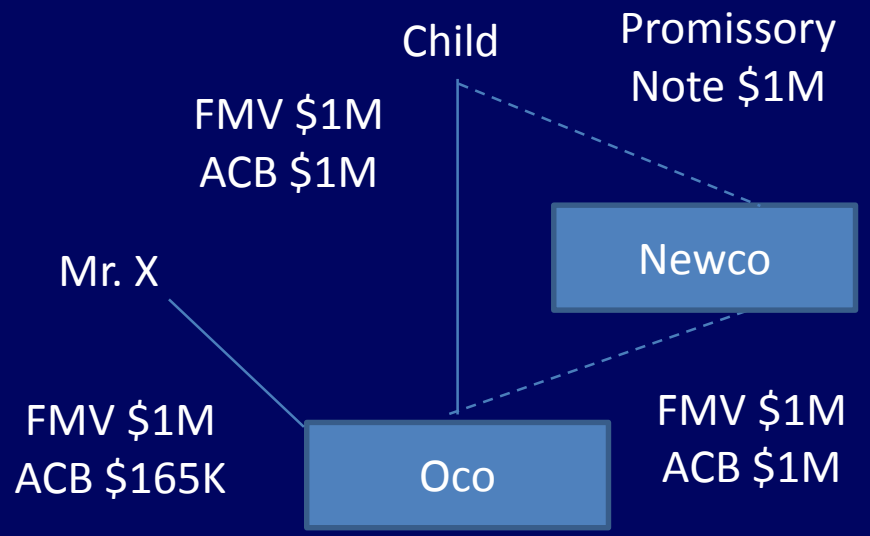
- Under existing rules (and no change under proposed rules)
  - 84.1(1)(b) – Individual deemed to receive a dividend of $835,000 instead of a capital gain of $835,000
    - Dividend equal to amount of note in excess of greater of "hard" ACB of Opco shares
  - Same result regardless of whether CGE is used



IV. SURPLUS STRIPPING

ITA 84.1

- Mr. X sells Opco shares to child for cash to realize a capital gain (Mr. X does not claim the CGE)
- Child sells Opco shares to Newco for Promissory Note
- Cash of Opco to be used to repay Promissory Note

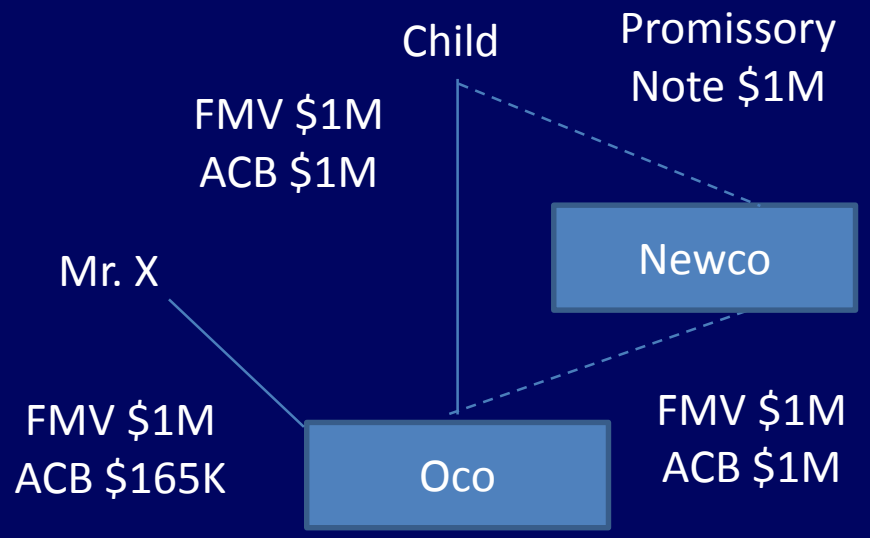


IV. SURPLUS STRIPPING

ITA 84.1

Under Existing Rules

- 84.1 does not apply
- Mr. X has capital gain
  - Mr. X has sold shares to child
  - 84.1 can only apply if Mr. X sells shares to a non-arm's length corporation
  - Child not deemed to receive a dividend
  - Child has "hard" ACB in shares of Opco
    - Provided Mr. X does not claim CGE

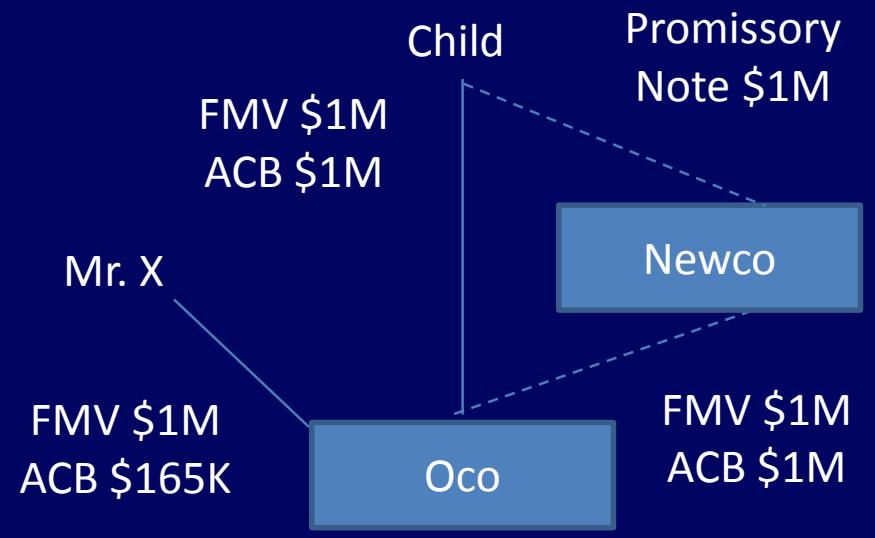


IV. SURPLUS STRIPPING

ITA 84.1

Under Proposed Rules

- 84.1 applies to Child
  - Child deemed to receive dividend of $835,000
  - Capital gain realized by Mr. X does not create “hard” tax ACB
  - See proposed amendment to 84.1(2)(a.1)(ii)
  - Previous dispositions by non-arm’s length persons does not create “hard” ACB



IV. SURPLUS STRIPPING

ITA 84.1

- Is it appropriate that our tax legislation encourages small business owners to sell the shares of their business to arm's length purchasers rather than to their own family members?

- Perhaps a reasonability test should be considered:
  - Active corporations only
  - Only applicable if a significant portion of the vendors shares are sold
  - Perhaps involvement of the purchaser could somehow be monitored subsequent to the transaction

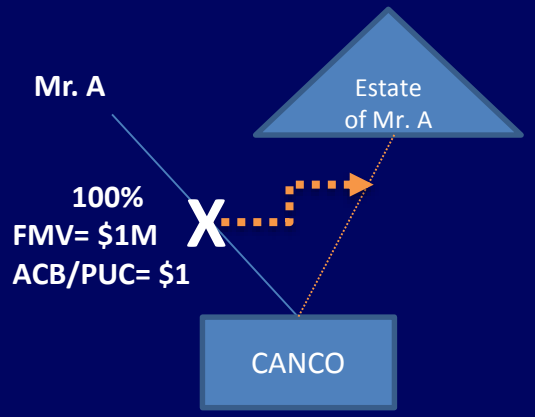
IV. SURPLUS STRIPPING

Post-mortem planning impacted by proposed rules

Pipeline transaction

- Objective: practical fix to prevent double taxation on death of a shareholder – limit tax liability on death of a shareholder to capital gain treatment as mandated by subsection 70(5) ITA
- Use of tax attribute (high ACB) generated by deemed disposition rule in subsection 70(5) ITA
- If no pipeline strategy is used, taxable capital gain for deceased and deemed dividend for estate on redemption of shares or wind-up dividend because no "inside basis" is created on death

- Mr. A dies – No CGE available
- Mr. A is deemed to have disposed of his shares immediately prior to death at FMV under 70(5) ITA = capital gain of $1M @ 26% = $266K
- Estate now holds shares of Canco with ACB of $1M by virtue of 70(5), but historic PUC of $1 remains – High "outside basis" / low "inside basis"



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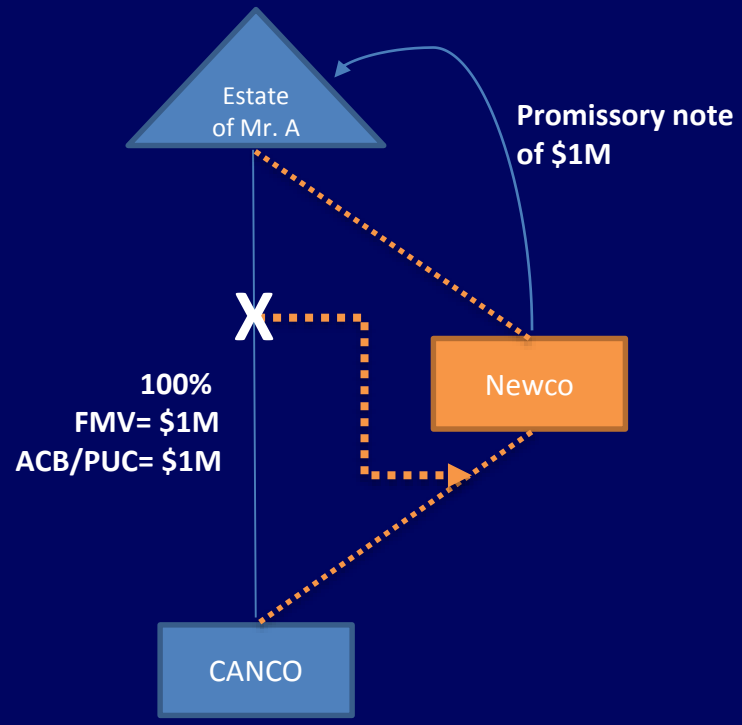
IV. SURPLUS STRIPPING

Pipeline transaction

Pipeline Steps:

1. Estate incorporates a new corporation (Newco) and subscribes for common shares for a nominal amount
2. Estate sells shares of Canco to Newco at FMV in consideration for a promissory note having a principal equal to FMV ($1M)
3. Amalgamation of Canco and Newco (88(1)d) bump strategy potentially available), redemption of Canco shares or intercompany dividends to Newco (potential 55(2) issue to consider)
4. Repayment of the promissory note to the Estate



IV. SURPLUS STRIPPING

Pipeline transaction

- Under existing rules:
  - Overall tax result of the pipeline planning is capital gain for the deceased on deemed disposition of shares at FMV
  - Existing subs. 84.1 not applicable because of "hard" ACB created by the automatic application of 70(5)
  - CRA has provided numerous rulings (including post-MacDonald case rulings) confirming that they would not apply 84(2) to pipeline transactions provided that certain conditions are met

IV. SURPLUS STRIPPING

Pipeline transaction

- Under proposed rules:
  - capital gain of $1M for the deceased because of the application of 70(5) = $266k tax
  - Estate would also be deemed to have receive a dividend of $1M on the transfer of Canco shares to Newco because no “hard” ACB anymore (see proposed 84.1(2)(a.1)(ii)) = $450k tax
  - Potential application of proposed 246.1 on repayment of promissory note to Estate? = again, deemed taxable dividend for the Estate if:
    - An amount is receivable (directly or indirectly) by a Canadian individual from a NAL person;
    - As part of a series of transactions, there is a disposition of property or increase of PUC of shares; and
    - It can reasonably be considered that one of the purposes is the significant reduction or disappearance of assets of a private corporation (in any manner) such that tax otherwise payable by the individual on a dividend from the corporation is avoided.

IV. SURPLUS STRIPPING

Alternatives to Pipeline Planning

- 164(6) loss carry-back = dividend tax rate instead of capital gains tax rate
    - Eliminates capital gain from deemed disposition on death
    - Overall result is dividend tax rate (45% in Ontario)
    - Loss carry-back planning must be implemented within one year of death and Estate must be GRE
- No planning = double taxation
- Life insurance to fund tax on death – sufficient coverage now?
- Spousal rollover = deferral of tax only

IV. SURPLUS STRIPPING

Technical Issues with Proposed Legislation

- No relief for individuals who have passed away prior to July 18, 2017 – 164(6) loss carry-back may not be available due to the one-year requirement

- Pipeline transactions already implemented – is repayment of outstanding promissory note caught by new 246.1?

QUESTIONS?

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