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July 18, 2017 Private Corporation Tax Proposals - What Do They Mean To You?

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Agenda

1. Background, history, and context.
2. Proposed expansion of “kiddie tax”/tax on split income (“**TOSI**”) rules.
3. Proposed limitation of lifetime capital gain exemption (“**LCGE**”).
4. Proposed preventive measures on conversion of income into capital gains.
5. Proposed regime for taxing investment income inside private corporations.
6. Illustrative examples.
7. What to do now?

So Where is All This Coming From?

So Where is All of This Coming From?
2015 Liberal Election Platform

- Liberals election platform contained some significant rhetoric involving the use of Canadian Controlled Private Corporations ("**CCPCs**").
- Now PM Trudeau suggested in some comments that the use of CCPCs was a platform for the wealthy to reduce or avoid income taxes.
- Most of the material came from a paper entitled "*Piercing the Veil – Private Corporations and the Income of the Affluent*" by Michael Wolfson, University of Ottawa, Mike Veall, McMaster, Neil Brooks, YorkUniversity http://www.allard.ubc.ca/sites/www.allard.ubc.ca/files/uploads/events/grad/veall_-_paper.pdf.
- The paper contains significant errors and very biased.

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So Where is All of This Coming From?
2017 Federal Budget

- March 2017 Federal Budget announced that the Department of Finance was studying certain aspects of the taxation of private corporations.
- Income splitting, build-up of assets in a private corporation and conversion of dividends into capital gains were under consideration and a consultation paper would be released later in the year for discussion with the public.
- The announcement was rather benign with very little detail.
- Most of the community relied on the following statement as evidence that there would be plenty to comment on: *The Government intends to release a paper in the coming months setting out the nature of these issues in more detail as well as proposed policy responses.*

Our Current Regime

- Tax policy over time has led to corporate tax rates which are materially lower than personal rates
  - Corporate tax rates have decreased
  - Top personal rates have increased
    - Above 50% in most provinces (53.5% in Ontario)
- Small business deduction creates an added deferral for CCPCs earning active income
- Lifetime Capital Gains Exemption (LCGE) has encouraged structuring to access the exemption
- Family trusts are used to facilitate estate and succession planning

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The July 18, 2017 Announcement

The July 18, 2017 Announcement

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Minister Morneau Announces Next Steps in Improving Fairness in the Tax System by Closing Loopholes and Addressing Tax Planning Strategies

July 18, 2017 – Ottawa, Ontario – Department of Finance Canada

The Government of Canada is working to create a healthy and growing economy in which businesses generate well-paying jobs, and where the middle class, and those working hard to join it, have confidence that they can succeed.

As part of this work, the Government is taking action to improve the fairness of Canada's tax system by closing tax loopholes and amending existing rules to ensure that the richest Canadians pay their fair share of taxes and that people in similar circumstances pay similar amounts of tax.

With this goal in mind, Finance Minister Bill Morneau today announced the launch of consultations on tax planning using private corporations. In Budget 2017, the Government signalled its intention to address tax planning strategies involving the use of private corporations; strategies that can result in high-income individuals gaining tax advantages that are not available to other Canadians. This is in addition to our work on international tax evasion and avoidance, designed to stop the use of tax havens.

Quote

"When you have an economy that works for the middle class, you have a country that works for everyone. That's the spirit in which we are asking Canadians for input into how to close loopholes and address tax planning strategies that give unfair tax advantages. Many of the richest Canadians are unfairly exploiting the tax rules designed to help businesses thrive. We know that businesses, including small businesses, help grow the Canadian economy. These tax advantages are in place to help these businesses reinvest and grow, find new customers, buy new equipment and hire more people. We want to make sure those rules are used to do just that, and not to give unfair tax advantages to certain – often high-income – individuals."

- Bill Morneau, Minister of Finance

Quick Facts

- This Government's first action was to introduce a middle class tax cut that is benefitting nearly nine million Canadians, and to raise taxes on the wealthiest one per cent.
- The Government has also introduced the Canada Child Benefit, which is lifting hundreds of thousands of children out of poverty. Nine out of ten families are receiving more in child benefits than they did under the previous system.
- In the 2016 and 2017 budgets, the Government made significant new investments to support the Canada Revenue Agency's efforts to crack down on tax evasion and improve tax compliance.
- The Government also took legislative actions – on both the international and domestic fronts – to enhance the integrity of Canada's tax system and give Canadians greater confidence that the system is fair to everyone.

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July 18, 2017 Announcement – Cont’d

- 63 page “Consultation Document” released.
- 27 pages of draft legislation and 47 pages of explanatory notes to address the income sprinkling and “capital gains to dividends” issues.
- And, in an unusual manner, a 20 page PowerPoint “Technical Briefing” document was released as well. Sales job?
- Very complex material….some of the most complex and pervasive we have ever seen.
- We do not have time to dive into the detail; we’ll simply skim the surface today.

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July 18, 2017 Announcement
The Rhetoric – The Minister's Letter

- The documents read like a class warfare manifesto against small business:
- "*But there is a sense that some may be getting a better deal than others.*"
- *"And it starts by making sure that we all pay our fair share of taxes – with no exceptions."*
- *"….our Government is taking steps to address tax planning strategies and close loopholes that are only available to some – often the very wealthy or the highest income earners – at the expense of others.*
- *"Currently there are signs that our system isn't working as well as it should, specifically when it comes to private corporations."*
- The Department of Finance stooped to using populist language when dealing with very complex material.

July 18, 2017 Announcement
The Draft Legislation

- The release of very detailed draft legislation for two of the topics was surprising.
- In all my years of practicing tax, when draft legislation is released, it is VERY rarely changed (except to accommodate technical errors / issues).
- The income sprinkling proposals have a proposed application date of January 1, 2018.
- The conversion of dividends to capital gains have application of July 18, 2017 forward. Really??
- Passive income / asset seeking inputs on alternatives.
- This was not smelling like a “consultation”.

July 18, 2017 Announcement
Draft Legislation and Consultation Document

- The draft legislation and consultation document is surprising in its complexity, pervasiveness and mean-spiritedness.
- It is rife with opportunities for double and retroactive taxation (even acknowledged as such in the material)….see examples later.
- If passed as proposed, outright massive tax increases for families….not just professionals and high income / wealthy individuals as many media reports suggest.
- Proposals will cause significant problems for transfers of family businesses.

This is NOT About Closing "Loopholes"
This is a MASSIVE Tax Policy Change

- The taxation of private corporations and its shareholders have followed similar principles – with various tweaks – for approximately the last 50 years.
- Much of the foundations of the Canadian tax system arose from the implementation of the recommendations from The Royal Commission on Taxation (so called "Carter Commission").
- Carter commenced his work in 1964 and released its landmark recommendations in 1966.
- After studying and debating the recommendations, many of the recommendations – not all – were implemented in 1972.
- The July 18, 2017 proposals are not about "closing loopholes" but instead represent a complete re-think of private corporation tax policy.

July 18, 2017 Announcement
75 Day Consultation Period

- Comments were requested no later than October 2, 2017….a mere 75 days later.
- In the dead of summer when most of the business community is on holidays.
- When kids finally start getting back to school in early to mid-September, the "consultation period" will be over.
- Minister Morneau's tweets and other social media postings are disturbing…..he's defending the proposals. Shouldn't he be listening rather than defending?

The “Consultation“ Questions

- No consultation questions asked for the income sprinkling and capital gains to dividend draft legislation…..presumably you are supposed to simply comment on the draft legislation.
- For the passive income / asset “consultation”, the paper asks the reader to provide comments on which method would best address the objective…..it is assumed there is an issue to begin with.
- Disingenuous. A true consultation would <u>not</u> have attached draft legislation to the material and would not have provided very misleading questions about the passive income / asset proposals.

Should Canada Look at Tax Reform?

- Absolutely! And *some* of the proposals contained in the July 18, 2017 material have sound rationale.
- The last significant tax reform / study was the Royal Commission on Taxation (so called "Carter Commission") which commenced its study in 1964 and released its landmark report and recommendations in 1966.
- Such recommendations, after tremendous debate and study, formed part of the foundation for 1972 tax reform.
- The tax profession has been calling for another "Carter" for many years.
- Many aspects of Canadian tax policy need review and "fixing".
- It's interesting, however, that the Carter recommendations have largely stood the test of time. "*A buck is a buck is a buck.*"

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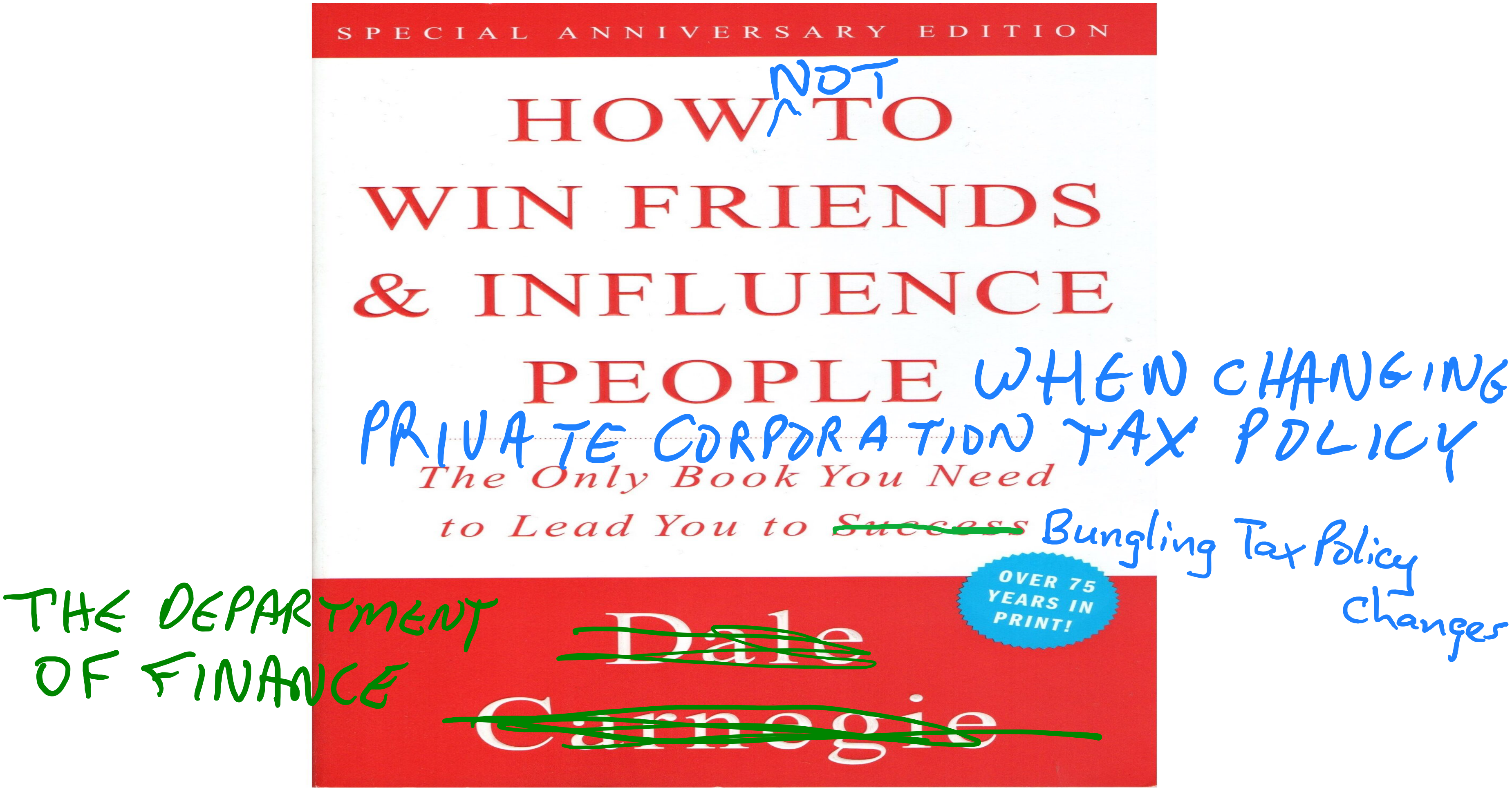
Carter Commission Recommendations Not Accepted

- Interesting that some of the recommendations that Carter made that were <u>not</u> accepted by our Government seem to be the cause of some of the current concerns by the Department of Finance.
- Examples: income splitting and passive asset accumulation.
- Carter recommended that since the family was the basic economic unity of society that it be the taxing unit. Was not accepted and thus income splitting has been a “cat and mouse” game ever since
- (Is family taxation really out of step around the world…especially when the US has a limited form of family taxation?).
- Carter also recommended full integration of corporate and personal income; for example, recommended that a corporation with a small number of shareholders could elect to be treated as a partnership (similar to the US system).

Good Tax Policy Changes – Lost in the Rhetoric

- Unfortunately, some of the good tax policy changes that may be worthy of implementation have been totally lost in the rhetoric.
- Very disappointing.



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July 18, 2017 Proposals – Income Sprinkling

INCOME SPRINKLING – What is the Tax Unit?

- The Carter Commission recognized the inequity of taxing an individual "*in almost total disregard for his inevitably close financial and economic ties with […] [his or her] family*".[1]
- Recommended taxing the aggregated income of a family unit (spouses, children < 21, and dependent children > 21) based on joint return filing.
- Recognized that taxing a family unit would largely eliminate income splitting, allowing for repeal of "*restrictive sections of the Act that are now necessary to prevent income splitting [that] have been sharply criticized as discriminatory and inconsistent.*"[2]
- Government did not accept Carter Commission recommendation when it implemented Tax Reform in 1972.
- Accordingly, "cat and mouse" game with income splitting ever since.

1 *Report of the Royal Commission on Taxation*, Vol. 3, Part A, Chapter 10, page 122 (the "**Carter Commission Report**").
2 Carter Commission Report, Vol. 3, Part A, Chapter 10, page 143.

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Income Sprinkling – Is it Really Offensive??

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Kim Moody and Kenneth Keung: One of the government's proposals is particularly egregious: new rules to prevent income splitting

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Income Sprinkling – What is it?

- Tax planning arrangements where income otherwise would have been taxed as income of a high-income individual, but instead is taxed as income of a lower-income individual.
- Access to lower-income earner's tax attributes, i.e.:
  - Lower marginal tax rates;
  - Personal tax credits; and
  - Deductions such as the lifetime capital gains deduction.
- Income sprinkling is accepted by Supreme Court of Canada in *Neuman v Queen*: *dividend payments are related to a shareholders' capital or share interest in a corporation and not to contributions provided by that shareholder to the corporation*.

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Income Sprinkling – Current Legislative Limits in the ITA

- Section 67 – Deduction from income must be reasonable.
- Sections 56, 74.1 to 75.1 – Income attributed back to transferor.
- Sections 15, 246 and subsection 56(2) – Tax benefit conferral
- Section 74.4 – Imputes income where attribution done indirectly through corporations.
- Section 120.4 - "Kiddie tax" or Tax On Split Income (currently applies to individuals under the age of 18).
- Most of the July 18, 2017 proposals are aimed at significantly expanding the application of TOSI.

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Highlights of Current TOSI Rules

Kiddie Tax (TOSI) - History

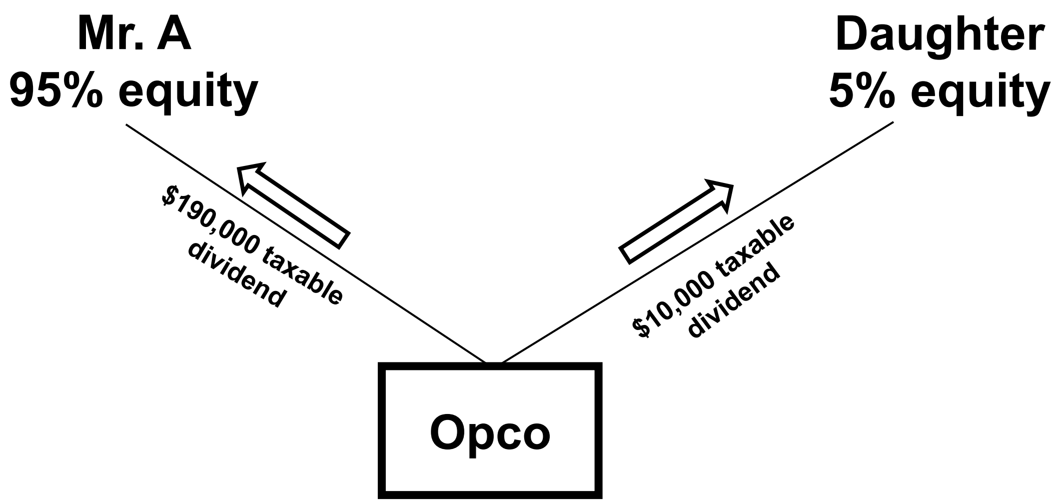
- "Kiddie tax" or tax on split income was introduced into Canadian tax law effective January 1, 2000.
- TOSI applies on certain types of income ("split income") received by a child under 18 with a Canadian resident parent.
- Where applicable, the minor pays income tax at the highest personal tax rate (48% in Alberta; approx 54% in Ontario) on TOSI income, and loses personal tax credits.
- Parents generally have joint and several liability for the tax.

What income caught under current TOSI rules

- Taxable dividends received on private corporation shares;
- Income from a partnership or trust that
  - Sells to/supports a business carried on by a related person; or
  - Runs a business, or property rental, in which a related person is actively engaged;
- Capital gains on the sale of private corporation shares to a non-arm's length person (in this case, lose 50% inclusion rate as well).
- Limited exceptions, e.g. property inherited on death of a parent.

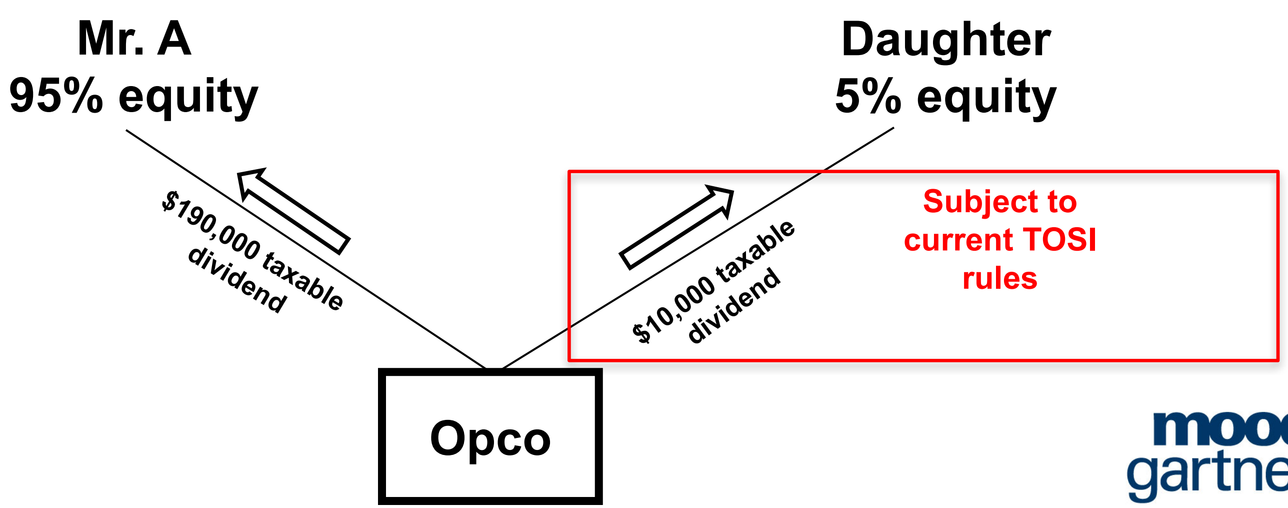
Current TOSI Rules - Example

Mr. A owns 95% of the common shares of Opco and his 16 year old daughter owns the remaining 5% of the same class of shares. During 2017, Opco pays a $200,000 dividend on the common shares. Mr. A's daughter has no other sources of income from employment or otherwise.



Current TOSI Rules - Example

Daughter’s $10,000 income is taxed at the top marginal rate in her hands (resulting in $2,300 of tax, but recall that corporate tax has already been paid). Without TOSI, the dividend would have been tax-free thanks to Daughter’s low marginal rate and the basic personal credit.



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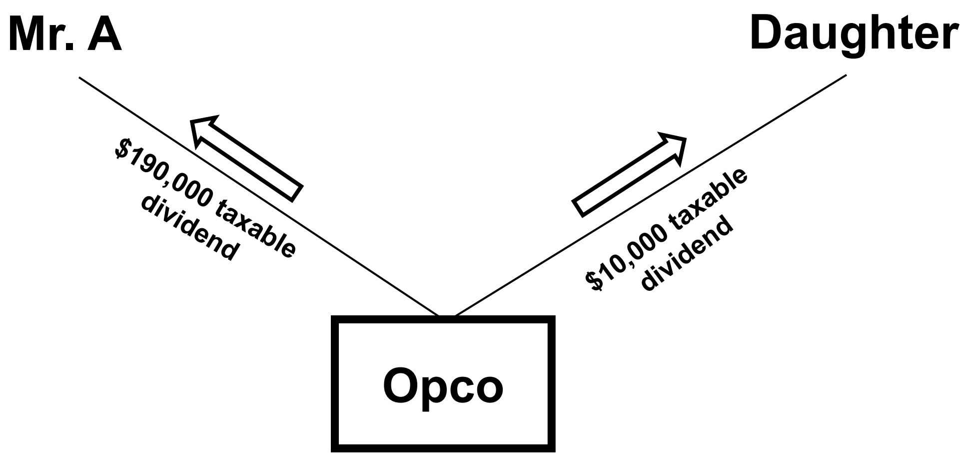
Planning Arrangements That are Currently Not Subject to TOSI

Planning Arrangements That Are Not Subject To TOSI

Current rules do not prevent dividend sprinkling with adult family members (18+).

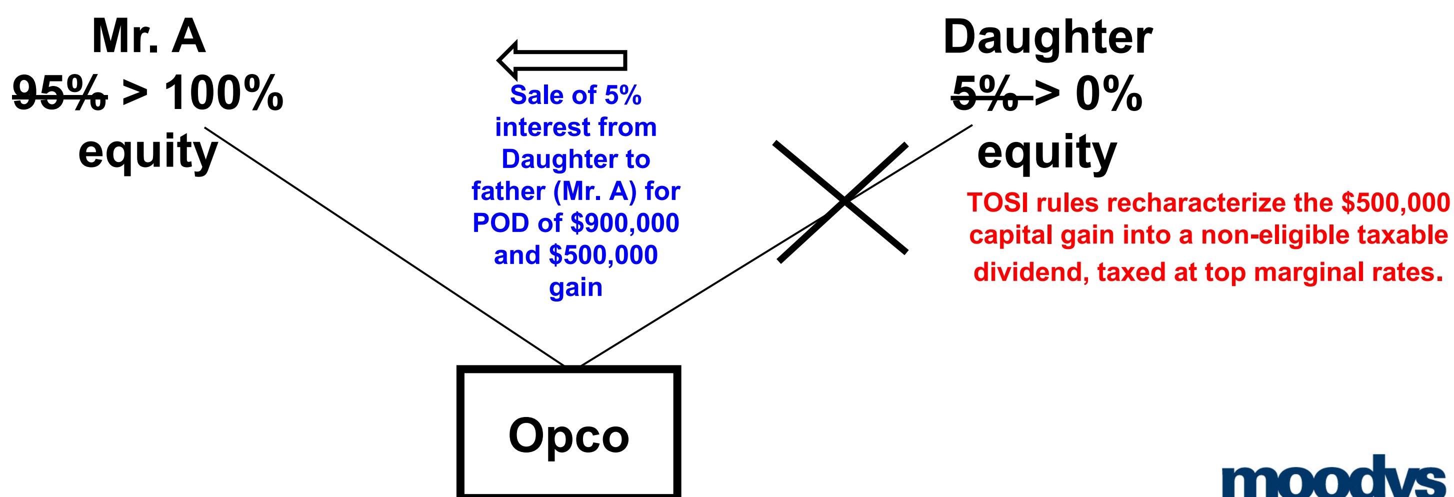


In the year she turns 18, the taxable dividend no longer caught by current TOSI rules

Planning Arrangements That Are Not Subject To TOSI

- Income that has been previously subject to attribution rules taxation or TOSI can be reinvested by a minor and the subsequent income from reinvestment is taxed in the hands of the minor at lower marginal rates.

Example: First level of taxation – spit income applies



Planning Arrangements That are Not Subject to TOSI

- Daughter invests $900,000 POD in investment portfolio and earns passive income, which is taxed at her marginal rates.
- TOSI does not apply to secondary income, i.e. income from reinvesting income previously subject to TOSI.

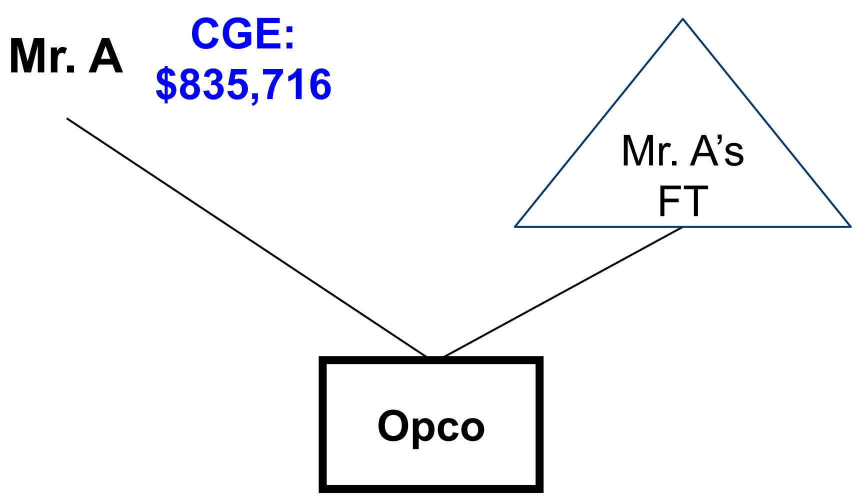
Daughter
(16 years old)

Investment income taxed at regular marginal rates

$900,000 FMV
Investment portfolio

Planning Arrangements That are Not Subject to TOSI

Multiplication of the lifetime capital gains exemption, i.e. the more beneficiaries a family trust has, the more opportunities to multiply the capital gains exemption ($835,716 for 2017).



Sale of Opco to a third party

Beneficiaries:	CGE:
• Mrs. A.	$835,716
• Daughter 1-minor	$835,716
• Daughter 2-minor	$835,716
• Daughter 3	$835,716
• Son 1	$835,716
• Son 2	$835,716

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July 18, 2017 Proposed Amendments – Expansion of TOSI Rules

How Not to Win Friends and Influence People When Changing Private Corporation Tax Policy – Income Sprinkling - Summary

- Extremely vague and complex. *Spoiler alert – the Joint Commission on this aspect of the proposals will be likely 30+ pages.*
- Not workable in practice.
- Will result in huge increase in litigation.
- Reasonableness test to receive property income? Show me another jurisdiction that has something similar.
- Does not consider marital property rights that spouses / common-law partners have notwithstanding negligible efforts.
- Family and non-arm's length "friends" financing will be caught.
- Retroactive taxation effect for utilization of capital gains deduction – "fresh start" rule property held by minors and trusts.
- Unquestionably harms "middle class". http://moodysgartner.com/private-corporation-tax-proposals-unquestionably-harm-middle-class-business-owners/
- Lower tax bracket family is hurt by these proposals by a much greater extent than high tax bracket families because the rules impose top marginal rates even if the total income would have been subjected to a lower tax bracket (with no sprinkling).

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Current TOSI Rules

Specified individual

Applies if

- Less than 18 years old
- Resident of Canada
- Parent resident of Canada

Excluded amount

Applies if:

- Income or gain in respect of property acquired from a deceased individual (parent or any other person if the individual is a student or disabled).

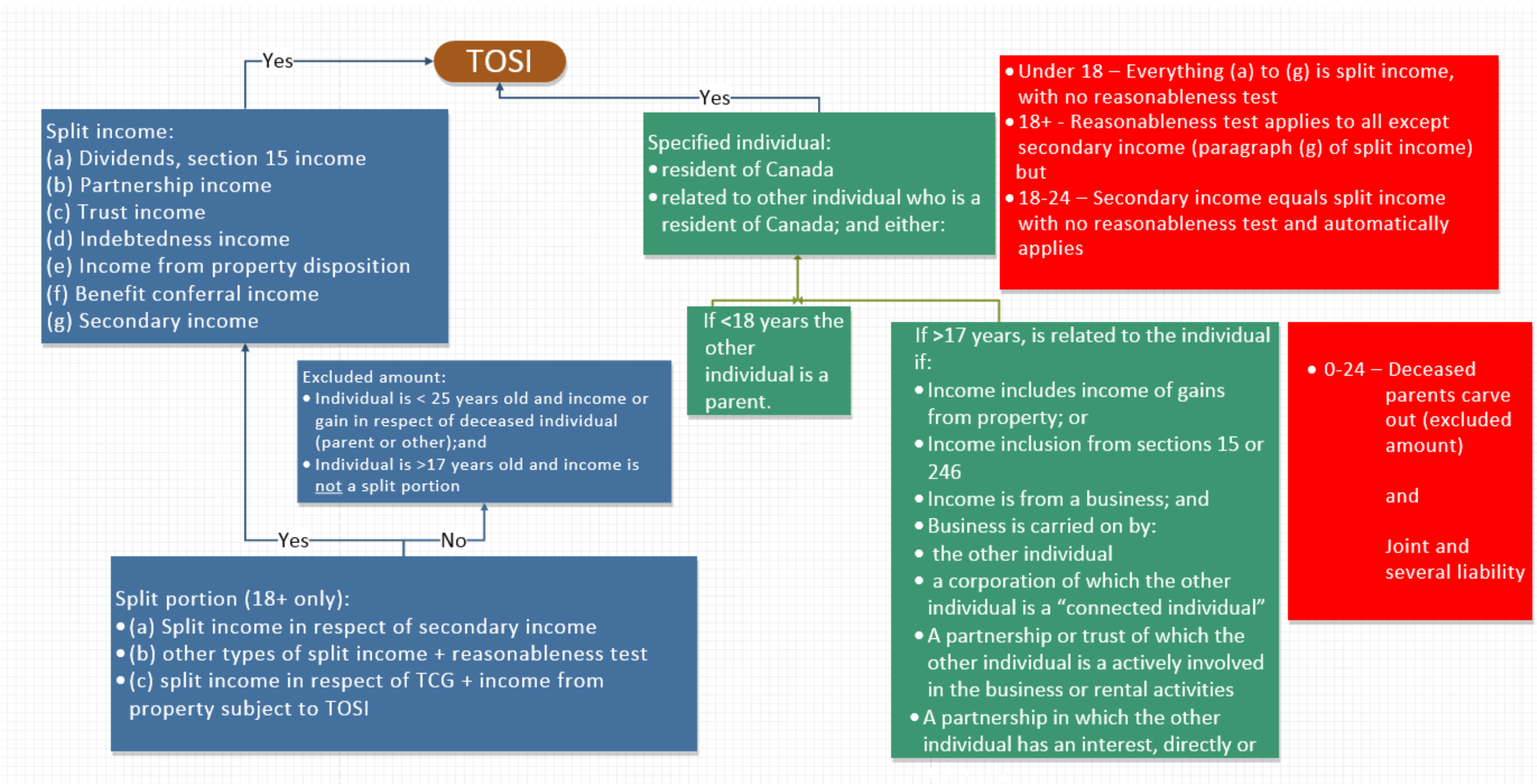
Split income

Applies if:

- not excluded income and
- income from non-public dividends,
- non-arm's length capital gains,
- partnership/trust income re business of a related person

TOSI

Proposed Expansion of the TOSI Rules



1. Whether an amount is included in split income, depends on whether it is an excluded amount,
2. Whether an amount is included in excluded amount, depends on whether it is a split portion; and
3. Whether an amount is considered split portion depends on whether it is included in split income.

Effective Date of Proposed TOSI Rules

- Proposed TOSI rules, if enacted, will apply for 2018 and subsequent years.
- Current rules apply throughout 2017.
- 2017 is the **last chance** to sprinkle.

What Types of Income are Caught Under Proposed TOSI?

- Proposed TOSI will apply to more types of income:

CURRENT DEFINITION	PROPOSED DEFINITION
(a) – Unlisted dividends and shareholder benefits	(a) – Unlisted dividends and shareholder benefits
(b) – Partnership income	(b) – Partnership income
(c) – Trust income	(c) – Trust income
	(d) – Indebtedness income
	(e) – income or gains from dispositions of property
	(f) – income from conferred benefit; and
	(g) – secondary income

Who Are Potentially Caught Under the Proposed TOSI Rules

- Every Canadian who:
  - Less than age of 17 before the year, or
  - Over 17, and earns income or gain from a business carried on by:
    - a related individual.
    - a corporation in which another individual is a “specified shareholder” or a “connected individual”
    - a partnership or trust in which a related individual is actively engaged.
  - For this purpose, “related individual” includes immediate family, grandparents, siblings & in-laws, aunts/uncles, nieces/nephews.

Who Are Potentially Caught – Example #1

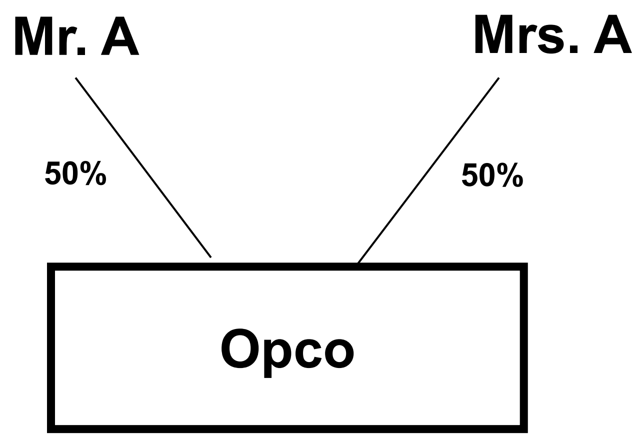
Mr. A — 50%

Mrs. A — 50%

Flip a Condo

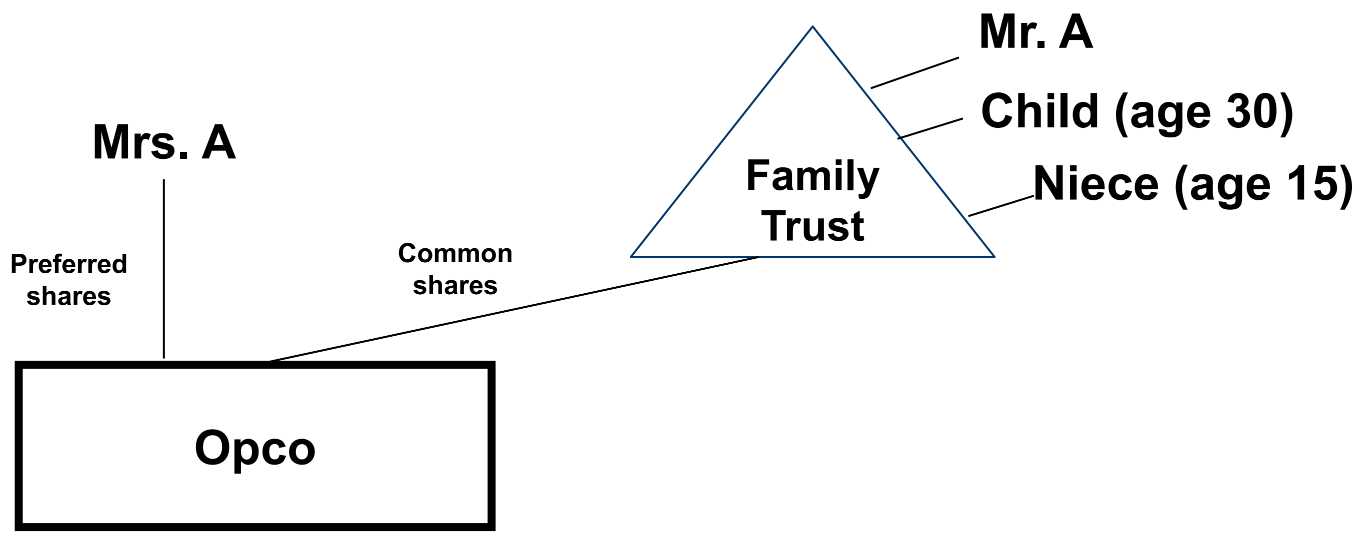
- "Flipping" is an "adventure or concern in the nature of trade", which is a "business"
- Arrangement constitutes a "partnership".
- Both Mr. and Mrs. A derives business profit from disposition of property; the business is carried on by a partnership in which a related individual is actively engaged in.
- Therefore, both Mr. A and Mrs. A potentially caught by proposed TOSI rules.

<u>Who</u> Are Potentially Caught– Example #2



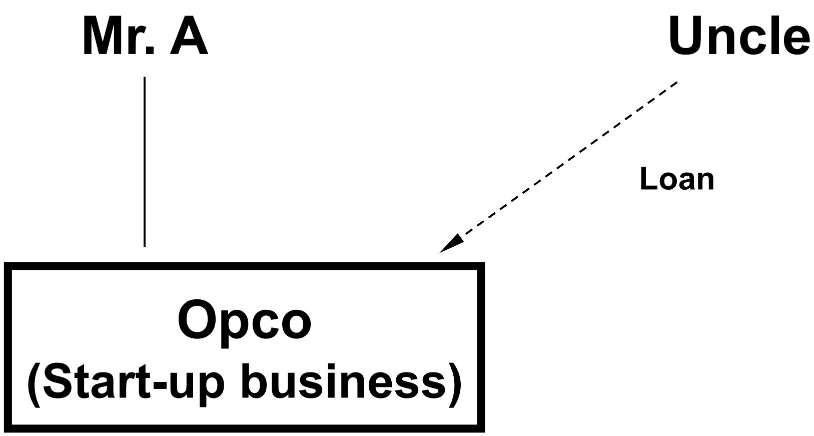
- Both Mr. A and Mrs. A earn income or capital gains from property (shares), and the underlying business is carried on by a corporation in which a related person is a "*specified shareholder*" or a "*connected individual*".
- Therefore, both Mr. A and Mrs. A potentially caught under proposed TOSI rules.

Who Are Potentially Caught– Example #3



- Mr. A, Child and Niece all potentially caught, because they earn income or capital gains from property (shares of Opco, or interest in a trust); underlying business carried on by a corporation in which a related individual (Mrs. A) is a "specified shareholder" or a "connected individual".
- Mrs. A also potentially caught, because related individuals (Mr. A, Child, Niece) are specified shareholders of Opco.

Who Are Potentially Caught – Example #4



- To help Mr. A, Uncle loans Opco money at interest.
- Uncle's interest income potentially caught by proposed TOSI rules, because a related person (Mr. A) is a "specified shareholder" or a "connected individual".
- Mr. A also potentially caught if Uncle is a "connected individual", which can be the case if Uncle, by virtue of its loan have *de facto* control over Opco.
- Uncle also caught if he makes share investment in Opco.

Who Are Potentially Caught – Example #5

Mr. A
(retired)

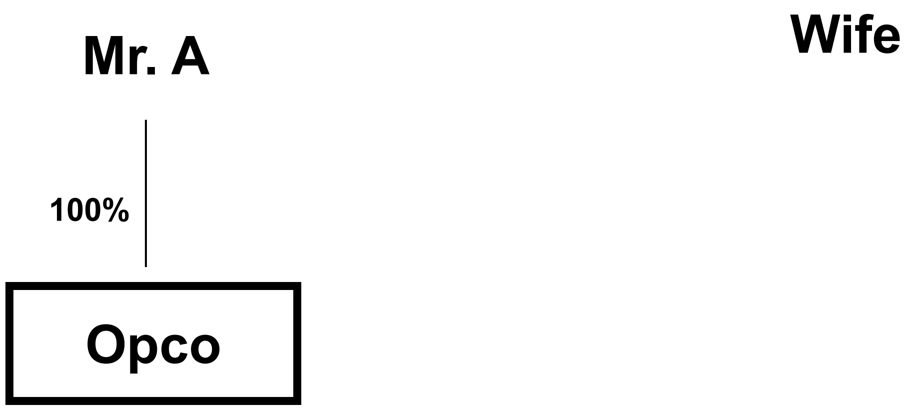
100%

Opco
(service business)

Daughter is primarily the one performing the services.

- Mr. A potentially caught under proposed TOSI rules, because a related person (Daughter) is a “connected individual” in respect of Opco.
- Where a business is one that provides services, and those services primarily performed by an individual, then that individual is a “connected individual”.
- Note that if those service are required under law to be registered (e.g. professional services), then no requirement for the services be “primary” – any amount of services performed will trigger these rules.

Who Are Potentially Caught – Example #6



- Under a strict reading of the proposed rules, it appears that anytime a shareholder is married / living common-law, the shareholder will be potentially caught. This is because a person is deemed to own the shares owned by a non-arm's length person (which includes spouses, amongst others), for purpose of the "specified shareholder" definition.
- Therefore, Mr. A does earn income/capital gain from a corporation in which a related person (wife) is a specified shareholder, and thus subject to proposed TOSI rules.
- Nonsensical result, hopefully not intended by Finance and will be fixed prior to enactment.

The Only Way Out of The Proposed TOSI Rules

- Under each of the situations described above, generally speaking, each individual can escape TOSI if:
  - Age under 24 - property is inherited from a deceased parent (or from another deceased, if full time student or impaired);
  - Age over 17 – it is "reasonable" that the income does not exceed what would have been paid by a business to an arm's length person, having regards to:
    a. Functions performed by the individual;
    b. Assets contributed by the individual;
    c. Risk assumed by the individual; and
    d. All historical amounts already paid to the individual.

Practical Difficulties with “Reasonableness” Test

- Every dividend paid to a person described previously is measured against the new “reasonableness” standards;
- Need to look at functions performed by the individual throughout history of the business;
- Often, competing factors, e.g.:
  - Husband works full time in business;
  - Wife works part time, but in more valuable aspects of the business;
  - Wife provided personal guarantee;
  - Husband contributed most of the capital;
  - Business paid the wife a significant bonus three years ago.
- So what is the “reasonable” amount of dividend to pay husband vs wife this year??

Practical Difficulties with “Reasonableness” Test – Cont’d

- For capital gains, reasonableness test is applied based on whether the capital gain is “reasonable” if the same amount had been received as a dividend or an interest … a very ambiguous test!
- CRA has immense power to reassess an income amount as exceeding what’s “reasonable”; taxpayer’s onus to disprove.
  - Extremely difficult to disprove why an amount is not unreasonable.
- Significantly increases annual tax planning and tax return compliance costs – to be discussed later - and costs of dispute with the CRA.
- Even if “reasonableness” determinable, not possible to pay different dividend to different shareholder if all hold same class of shares. Will need share reorganization → more costs.

Practical Difficulties with “Reasonableness” Test – Cont’d

- Completely ignores a stay-at-home spouse / common-law partner’s contribution to the success of a business.
- Completely ignores the fact that a business risks assets of the entire family.
- Completely ignores matrimonial law that generally requires both spouses to share growth of business.
- Disproportionately hurts female and seniors, who is predominately the non-active shareholder (the senior being the retired business founder).
  - as many may fail reasonableness test and be subject to top marginal rate of tax and lose basic personal tax credits.

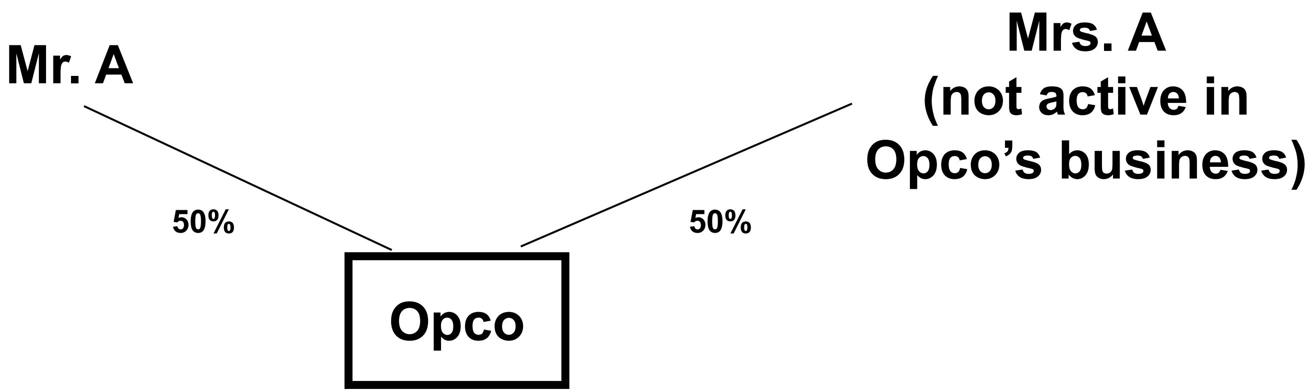
Additional Limitation on Applying Reasonableness Test

- If the business is an investment business, e.g. earning of rent, then the function test is ignored. Can only look at assets contributed, risk assumed, and historical payments.
- Assets contributed is ignored if a related person has guaranteed or provided any financial assistance (including traditional "prescribed loan arrangements").
- For individuals under 24:
  - efforts are ignored, unless she/he is "actively engaged on a regular, continuous and substantial basis" in the business. i.e. working part-time cannot be factored in.
  - generally any return over prescribed rate (currently 1%) on assets contributed would be considered unreasonable.

Capital Gains From Non-Arm’s Length Dispositions of Shares

- Under existing rules, capital gains earned by a minor from the disposition of private corporation shares to a non-arm’s length person loses 50% inclusion rate, lose benefit of the personal tax credit, and taxed at top marginal rates as a non-eligible dividend.
- Under proposed rules, if the individual is a person caught under these rules, then the “unreasonable” portion of capital gain subject to same punitive consequence.

Capital Gains From Non-Arm's Length Dispositions of Shares Example



- Opco is sold to a relative: substantially all of Mrs. A's capital gain could potentially be considered "unreasonable" → rather than a capital gain at 50% inclusion, entire gain taxed as non-eligible dividend at top marginal rates.
- Same punitive result if Mrs. A dies.
- Better if Opco is sold to an arm's length buyer, at least Mrs. A has capital gains treatment, albeit at top marginal rates.

Complexity of Proposed TOSI Rules

- What is presented here is a gross simplification of the rules
- The new legislation, not reproduced here, is extremely complex and broad.
- Likely not workable in practice….no way that the average general practitioner accountant and CRA auditor can be expected to interpret and apply such complexity.
- Not aware of any other jurisdiction in the world that applies a reasonableness test to the receipt of dividends or capital gains.

Proposed TOSI Regime Hurts “Middle Class” Business Owners

- Although the proposal is purported to target “high-income individuals”, it will likely hurt middle class entrepreneurs more:
  - Proposed rules automatically taxes non-active family members at top marginal rates, but most middle class business owners may not be in top rate tax bracket to begin with, even if no all income were earned by her/him. This imposes a higher tax than the family would ever have had to pay.
  - New complexity and reasonableness test results in costly professional fees relating to annual tax compliance and planning, and in many cases, share reorganizations. Costs that small business owners will find difficult to bear.
  - Start-ups often must reach out to family for financing, who will now be reluctant to do so in order to avoid the punishing effect of the proposed rules to them. In contrast, large private co’s have access to arm’s length financing.

Example – Spousal Income Splitting By A “Middle Class” Family

- Mr. A and Mrs. A are both over 30 years old.
- Mr. A is the founder of Opco and is actively involved in the strategic direction of the business.
- Mrs. A is not involved in the business of Opco (passive investor).
- Mr. and Mrs. A are both 50/50 respective owners in Opco.
- Each of Mr. A and Mrs. A annually receive $35K of non-eligible taxable dividends from Opco.

Example – Spousal Income Splitting By A “Middle Class” Family - Cont’d

Under the current rules:

- Both Mr. and Mrs. A pay tax based on their marginal tax rates (which is a very low marginal tax rate).
- Aggregate family personal income tax would be approximately $2,200 in AB (recall that corporate tax has already been paid).

Under the proposed rules:

- Based on the new reasonableness tests:
  - given Mrs. A’s lack of participating in Opco’s business;
  - nominal contribution of capital on share issuance;
  - minimal risks assumed; and
  - aggregate amount of dividends previously received

  The full amount of Mrs. A’s dividends in 2018 are considered unreasonable.
- Therefore the full amount of Mrs. A’s dividends are taxable at the highest marginal rate resulting in aggregate family personal income tax of approx. $10.5K…..an almost five-fold increase! Is that “fair”?

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July 18, 2017 Proposals – Limitation of the Lifetime Capital Gains Exemption

Current Rules

- Canadian residents are entitled to a $835,716 (indexed annually) lifetime capital gains deduction ("**LCGE**") on the disposition of qualified small business shares and qualified farm or fishing property.
- No age restriction (for minors, must be an arm's length disposition due to TOSI rules discussed).
- Capital gains allocated by a trust to an individual beneficiary also entitled to the LCGE, to the extent the underlying property qualifies.
  - A convenient way to multiply LCGE through the use of trust.

Finance's Concerns

- Minors and beneficiaries of family trusts may use their LCGE to reduce the taxable capital gains of a disposition, even though such beneficiaries may not have invested in or contributed to the gains.
- Finance perceives this to be an unfair advantage favoring business owners.

Overview of Finance’s proposals

- Finance has proposed the following measures:
  1. No LCGE for capital gains earned by minors;
  2. No LCGE for capital gains earned in the hands of most trusts; and
  3. No LCGE for capital gains subject to proposed TOSI;
- Apply to dispositions after 2017, but provides special grandfathering rules for 2018.

Capital Gains Not Eligible for LCGE After 2017

- Under the proposal, the following are examples of capital gains that will be ineligible for the LCGE, for dispositions after 2017:
  - Any capital gain allocated from a trust (with very limited exceptions);
  - Any capital gain of an individual who has not attained the age of 17 before the year;
  - Any portion of a capital gain accrued while that individual was under 18, (or in the hands of anyone else during the time the individual was under 18 if the individual acquires the property on a rollover basis);
  - Any capital gain that is subject to proposed TOSI rules, i.e. the portion of a capital gain exceeding what is “reasonable”;
  - Any capital gain accrued inside a trust, if the individual acquired the property on a rollover basis;

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Practical Challenges with Proposal

- Proposed rules sets a base line, so that gains accrued prior to reaching age of 18, or accrued under a trust, are not eligible for LCGE:
  - Requires knowledge of entire holding history;
  - Requires knowing the fair market value of the underlying private corporation shares or farming/fishing property at the time the individual turns 18, or the property leaves the hands of the trust;
  - Even more challenging if this valuation exercise has to be done many years after the fact, because the look-back is forever (no transitional or grandfathering rule).
    - E.g. A 35 year old sells shares in 2019: if he (or a trust) held the shares when he was a minor, i.e. back in 2001, need to compute and carve out portion of gain relating to pre-2002 years, for purpose of LCGE entitlement.

Grandfathering Period

- Keep in mind that the new LCGE and TOSI regime only apply to 2018 and subsequent tax years, so existing rules still apply for 2017.
- Therefore, crystallization transactions should ideally occur before end of 2017.
- In the event LCGE crystallization fails to occur within 2017, the proposals provide special 2018 grandfathering provisions.

2018 Deemed Disposition Election

- The new election is very similar to the old 1994 election when the $100K capital gains deduction was eliminated.
- An individual or trust may trigger a deemed disposition in 2018 on qualified small business corporation shares and qualified farm/fishing property:
  - Designate an amount of capital gain to claim the LCGE;
  - 24 month holding period and active assets test → 12 months
  - The old LCGE and TOSI regime will apply to the triggered gain;
  - Bump up tax cost base going forward.
- Limitations:
  - Only allowed for property held continuously from end of 2017;
  - For individuals who has not attained age of 17 before 2018, election not available for shares (qualified farm/fishing property only).

2018 Deemed Disposition Election – Cont'd

- Built in penalty for inaccurate valuation:
  - If designated proceeds of disposition triggered exceeds 110% of the correct fair market value, the ACB is ground down.
    - E.g. $0 ACB, $200 FMV, $250 designated amount
    - ACB becomes $170, even though $250 of capital gain triggered
  - Additional penalty should taxpayer over-designate so excessively that the excess > FMV.
    - Example: $0 ACB, $200 FMV, $500 Designated amount.
    - Property reacquired will have a negative ACB of $80.
- Practical challenge: difficulty of properly valuing private company shares.

2018 Deemed Disposition Election – Cont'd

- Late filing or amendment carries penalty = taxable capital gain triggered x # months late / 300.
  - E.g. $400,000 taxable capital gain triggered; 36 months late; penalty of $400,000 x 36 / 300 = $48,000. Beware! Significantly higher than any other election form late filing penalties.
- Excessive designation, exceeding 110% of FMV cannot be amended. Even if amendment permitted (i.e. valuation overstated by less than 10%), penalty is significant. Get proper valuation done if electing!
- Another practical challenge: because shareholding cannot be changed after end of 2017, only three months left to do any reorganization in order to purify entity to qualify for qualified small business corporation for the election! There is no second chance.

2018 Qualified Small Business Corporation Shares Disposition By Minors

As we noted earlier, deemed disposition election is not available for shares owned by minors.

Instead, minors with actual QSBC disposition within 2018 may be entitled to relief under a different provision:

- An individual, or a personal trust under which an individual is a beneficiary, disposes of shares in 2018;
- Individual not attained age of 17 before 2018;
- Share owned continuously, from end of 2017;

Then:

- New LCGE and TOSI regime does not apply; and
- 24 month tests in QSBC definition becomes 12 months.

Note: this requires an actual disposition.

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The July 18, 2017 Proposals Background: Dividend To Capital Gain Planning Permitted Under Existing Rules

History of Capital Gain and Dividend Taxation

- Favourable tax treatment had always applied to capital gains:
  - Prior to 1972, capital gains were tax-free;
  - Carter commission recommended full taxation of capital gains;
  - Government decided on partial inclusion; fluctuated between 50% to 75%, but inclusion rate has been 50% since October 2000.
- Dividends from Canadian corporations also subject to favourable tax treatment:
  - Dividends are grossed-up to approximate pre-corporate tax earnings
  - Dividend tax credit is an approximation of the underlying corporate tax paid.
- Since 2006, different treatment for eligible and non-eligible dividends.
- Non-eligible dividend primarily derived from corporate income subject to the small business deduction and corporate investment income.

History of Capital Gain and Dividend Taxation – Cont'd

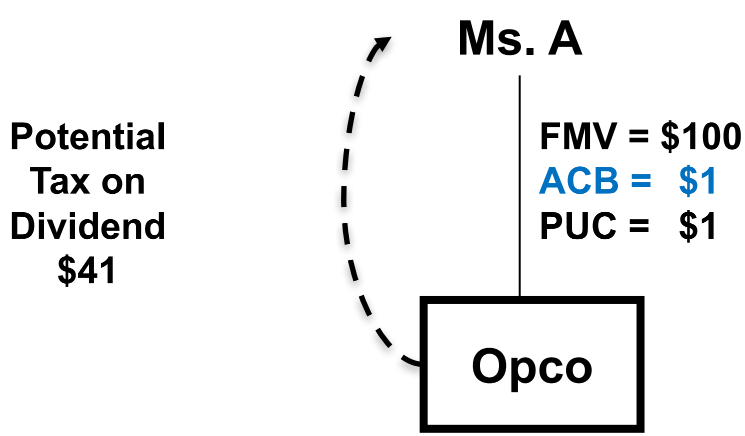
- In some provinces, e.g. Alberta, effective tax rate on eligible dividends equivalent to capital gain for a number of years.
- No longer true since 2016, due to widening gap between individual and corporate tax rates resulting in higher effective rates on dividends.

2017 Top Effective Marginal Rates	Capital Gains	Eligible Dividends	Non-eligible Dividends
Alberta	24%	31.7%	41.3%
British Colombia	23.9%	31.3%	41%
Ontario	26.8%	39.3%	45.3%

Taxpayer 'Self-Help'

Internal Transactions to Convert Dividend into Capital Gain

- CRA views scheme of the Act (s.84) requires after tax corporate profits extracted from corporation be taxed as dividends.
- However, even without a third party sale, shareholders could access capital gain treatment by triggering capital gain to create 'hard basis' which may then be extracted tax-free (called the "Pipeline").



Taxpayer 'Self-Help' - Cont'd

Internal Transactions to Convert Dividend into Capital Gain

Ms. A

- Recognizes capital gain and does not use capital gains deduction ("CGD")
- Tax of $25

FMV = $100
ACB = $100
PUC = $1

Opco

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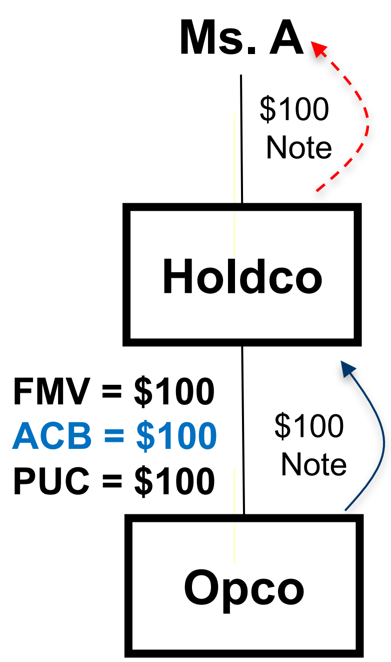
Taxpayer 'Self-Help'- Cont'd

Internal Transactions to Convert Dividend into Capital Gain

Ms. A transfers high ACB Opco shares to Holdco for either:
1) P-Note or
2) High PUC Holdco shares



② Shareholder loan of $100

① Opco pays dividend

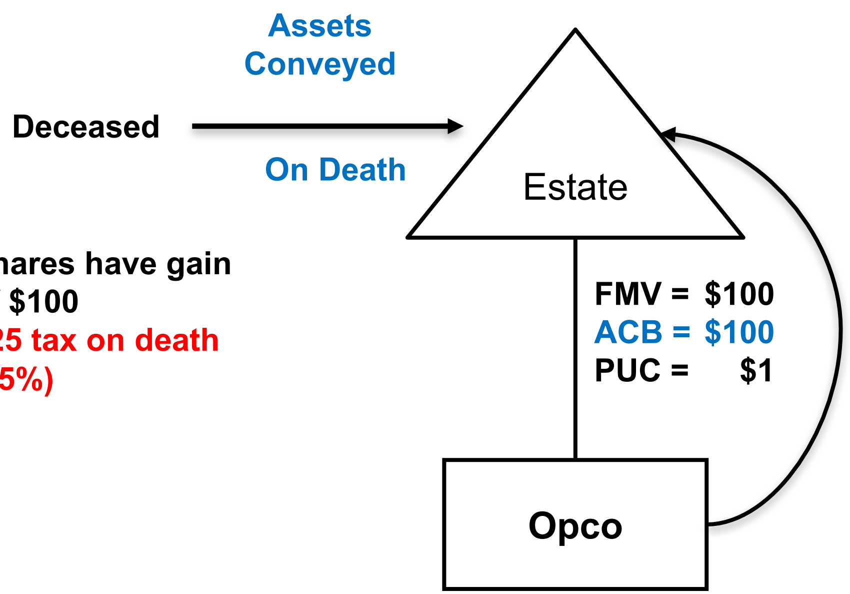
TAX SAVINGS OF 15%

Private Corporations Taxation on Death

- Upon death, an individual recognizes deemed capital gain on death on capital property – ITA 70(5).
  - Estate acquires capital property at ACB = FMV.
- Where capital property on death is shares of private corporation, there is inherently double tax:
  - Capital gain recognized on terminal T1 return;
  - Dividend tax rates on money extracted directly from corporation, since paid up capital ("PUC") not increased on shareholder death (can lead to double taxation);
  - Potential gain triggered by corporation on ultimate divestiture of its assets (i.e. potential triple tax).

Private Corporations Taxation on Death

- Estate may receive a capital loss of $100 – however not deductible against dividend income



- Shares have gain of $100
- $25 tax on death (25%)

$41 tax on distribution as dividend

- **POTENTIAL DOUBLE TAX!**

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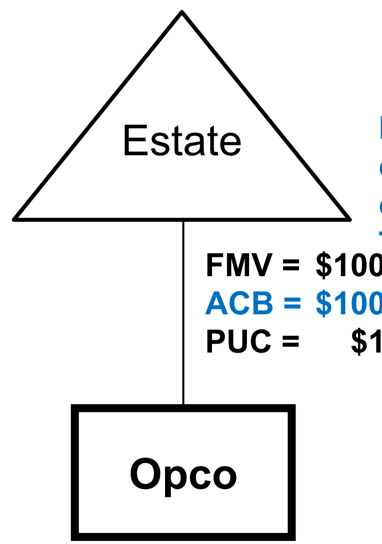
Post-Mortem Planning Under ITA ss. 164(6)

- Redemption planning scheme under ITA 164(6).

Mr. A
Terminal return

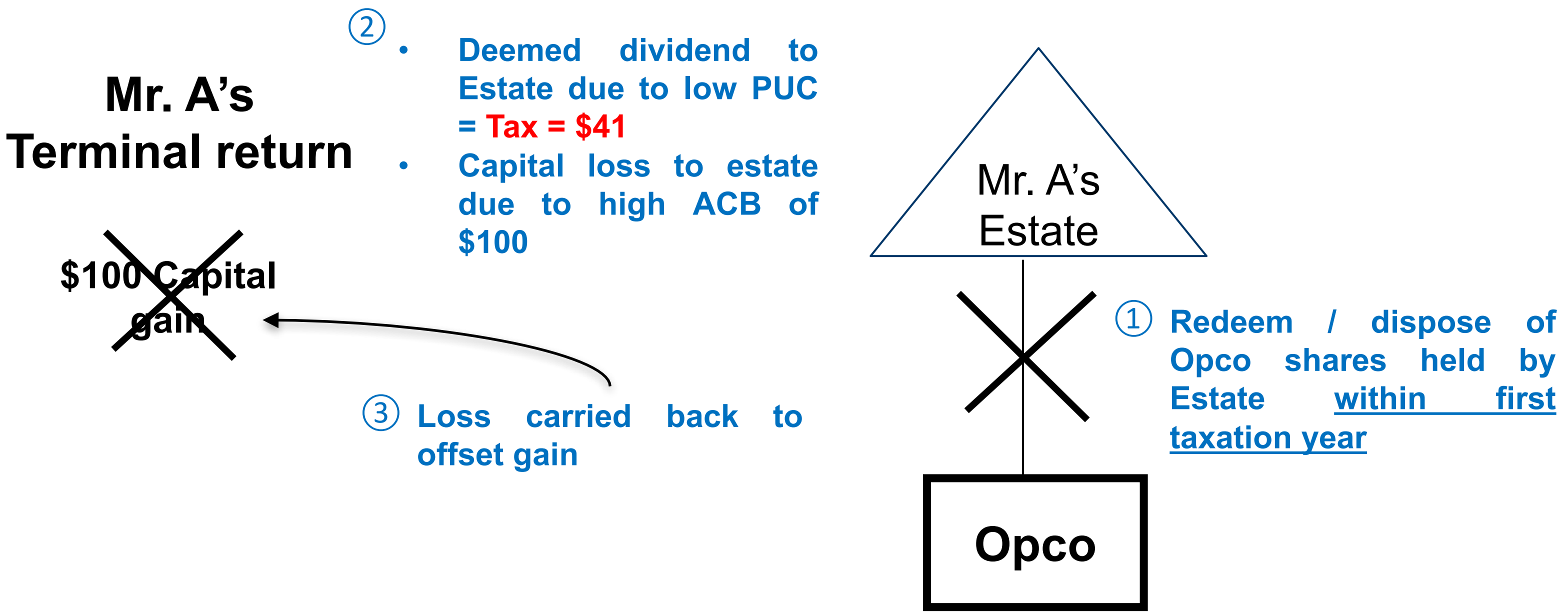
Capital gain of $100



Recognizes capital gain on Terminal T1

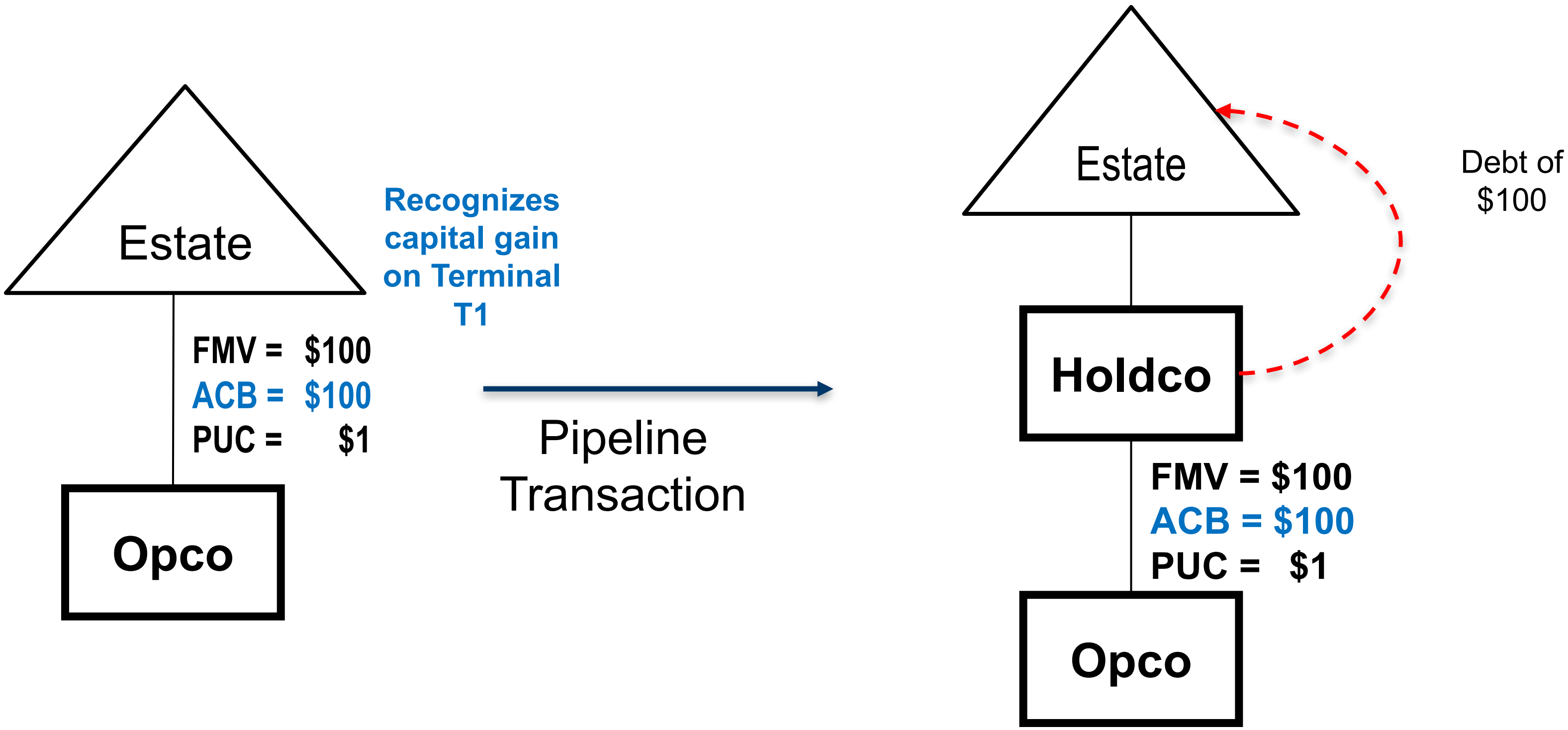
Post-Mortem Planning Under ITA ss. 164(6)

- Redemption planning scheme under ITA 164(6).



- ITA 164(6) allows carryback of Estate's capital loss to fully offset terminal return's T1. Result: only tax is the dividend to Estate.
- Limitation: must redeem within first taxation year of Estate.

Taxpayer 'Self-Help' Post-Mortem Planning: Pipeline



- Through use of pipeline, avoid tax implication to Estate. Result: only tax is the capital gain on Terminal T1, and bump potentially able to increase tax cost of Opco's assets. Better tax result than ITA 164(6).

- **No urgency to complete within one taxation year!**

Existing Obstacles To Pipeline Planning

ITA 84(2)

- ITA 84(2) imposes dividend treatment where corporate property distributed or otherwise appropriated in any manner whatever to or for the benefit of the shareholders, on the winding-up, discontinuance or reorganization of its business.
  - Potentially applies to *inter-vivos* or post-mortem pipeline, if the individual or estate receives Opco's funds in what is effectively winding up, discontinuance or reorganization of Opco's business.
- 2013 Federal Court of Appeal decision of *Macdonald*:
  - *Inter-vivos* pipeline transaction; Court found ITA 84(2) applied to repayment of the note to the former shareholder of Opco.
- CRA accepted post-mortem pipeline on case-by-case basis: cannot be 'cash box', Opco's business continues >1 year.

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Existing Obstacles To Pipeline Planning – Cont'd

ITA 84(2)

- ITA 84.1 prevents pipeline-type transactions by grinding PUC or deeming an amount to be a dividend, but only where the pipeline being created exceeds the 'hard basis' of the Opco shares.

- 'Hard basis' = Greater of:
  i. Paid up capital ("**PUC**"), immediately before the disposition
  ii. Adjusted cost base ("**ACB**") (<u>modified by ITA 84.1(2)(a) & (a.1)</u>), immediately before the disposition.

- ITA 84.1(2)(a) & (a.1) modifies ACB to subtract "soft" cost base:
  - 1972 V-Day value
  - <u>Any basis deriving from the claiming of the lifetime capital gains deduction by the taxpayer or any non-arm's length persons.</u>

Existing Obstacles To Pipeline Planning – Cont'd

ITA 84(2)

- The basic conditions for ITA 84.1(1) applying are:

  1. An individual resident in Canada disposes of shares that are capital property (the "taxpayer");
  2. The shares being disposed of are shares of a corporation resident in Canada (the "subject corporation");
  3. The disposition is made to another corporation (the "purchaser corporation") with which the taxpayer does not deal at arm's length; and
  4. After the disposition, the subject corporation is connected to the purchaser corporation (pursuant to ITA 186(4) and 186(2)).

Existing Obstacles to Pipeline Planning – Cont'd

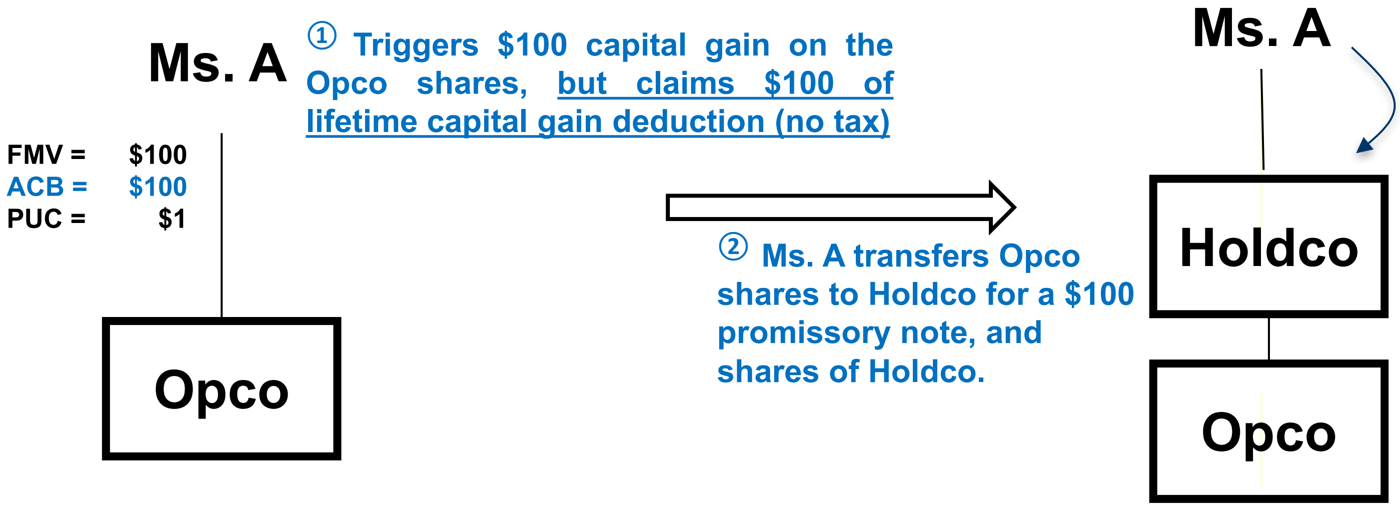
ITA 84(2)

- If ITA 84.1(1) applies, the consequences are two-fold:

  1. Grind of Purchaser Corp Shares' PUC
     - If the PUC of the Purchaser Corp shares taken back as consideration by the taxpayer exceeds Hard Basis, ITA 84.1(1)(a) grinds the PUC down to Hard Basis.

  2. Deemed dividend
     - Generally speaking, if the non-share consideration (boot) taken back as consideration by the taxpayer exceeds Hard Basis, ITA 84.1(1)(b) deems the amount to be a dividend.

Existing Obstacles To Pipeline Planning



- As a result of ITA 84.1, Ms. A will be required to report a $100 deemed dividend income inclusion, and the Holdco shares she receives will have $1 PUC.
- Similar application to a post-mortem pipeline if the deceased or a non-arm's length person claimed capital gain deduction.

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The July 18, 2017 Proposals
Proposed Amendment to ACB Modification Clause in ITA 84.1(2)(a.1)

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Proposed Amendment to:

ACB modification clause in ITA 84.1(2)(a.1)

Applies even if Opco shares acquired on arm's length transaction

… where a share disposed of by a taxpayer was acquired by the taxpayer after 1971 ~~from a person with whom the taxpayer was not dealing at arm's length~~, was a share substituted for such a share or was a share substituted for a share owned by the taxpayer at the end of 1971, the adjusted cost base to the taxpayer of the share at any time shall be deemed to be the amount, if any, by which its adjusted cost base to the taxpayer, otherwise determined, exceeds the total of …

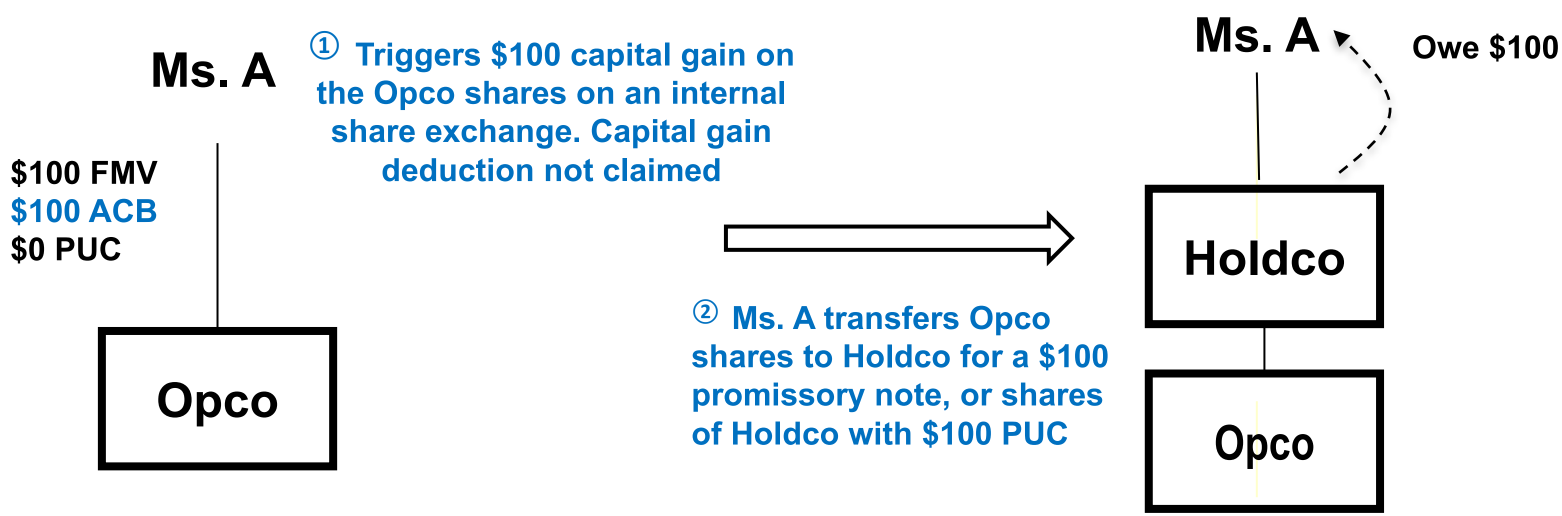
(ii) the total of all amounts each of which is an amount determined after 1984 under subparagraph 40(1)(a)(i) in respect of a previous disposition of the share or a share for which the share was substituted ~~(or such lesser amount as is established by the taxpayer to be the amount in respect of which a deduction under section 110.6 was claimed)~~ by the taxpayer or an individual with whom the taxpayer did not deal at arm's length;

ACB is reduced by <u>any capital gain</u> previously reported by taxpayer or a non-arm's length individual after 1984 in respect of the share or a substituted share !!

Proposed amendment effective for dispositions occurring after July 17, 2017

Proposed Amendment to ITA 84.1(2)(a.1)

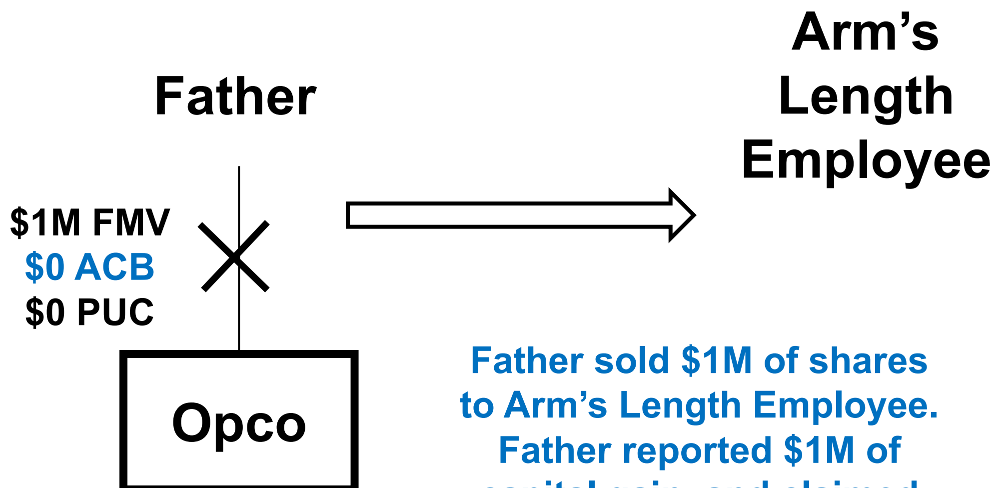
Application to *Inter-Vivos* Pipeline (Example #1)



- Under existing ITA 84.1, Ms. A entitled to receive either the P-Note or the full PUC shares, due to $1M of “Hard Basis”. **(TAX AT 24%)**
- Under proposed ITA 84.1, Ms. A has no Hard Basis since her basis in Opco derives from a capital gain in respect of a previous disposition by her. Therefore, if she receives the $1M p-note, ITA 84.1(1)(b) will deem the amount to be a dividend; alternatively if she receives the high PUC Holdco shares, ITA 84.1(1)(a) will grind the PUC to $nil. **(TAX AT 41%)**

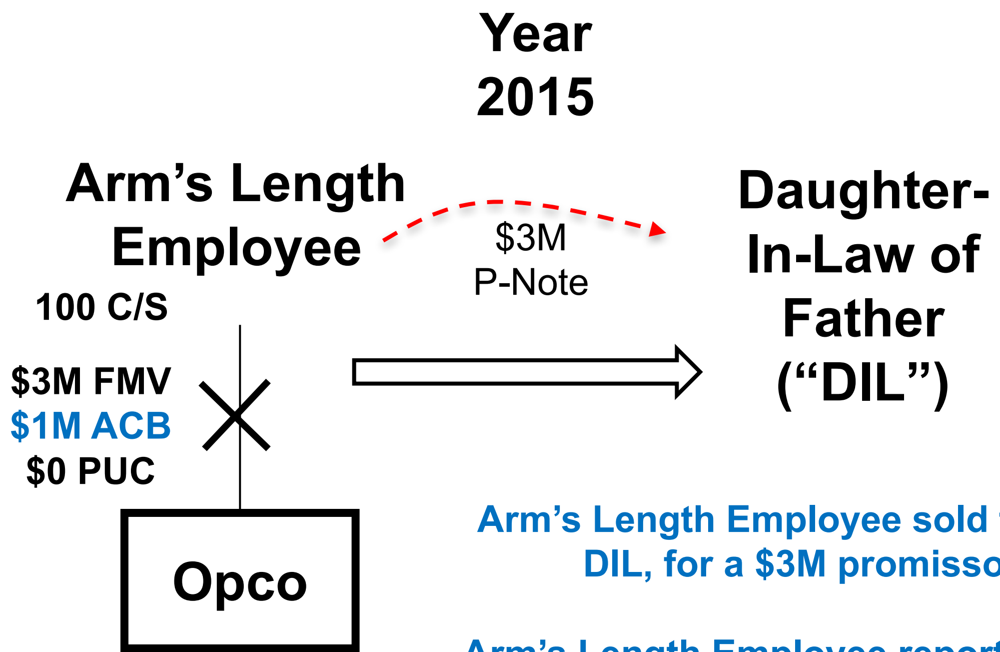
Proposed Amendment to ITA 84.1(2)(a.1) Application to *Inter-Vivos* Pipeline (Example #2)

Year 1990



Father sold $1M of shares to Arm's Length Employee. Father reported $1M of capital gain, and claimed $500K of capital gain deduction.

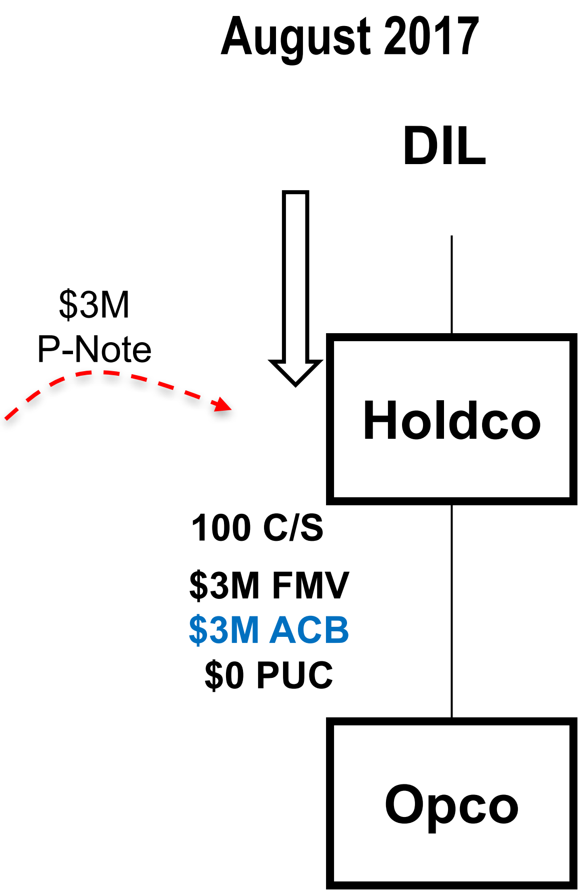
Proposed Amendment to ITA 84.1(2)(a.1) Application to *Inter-Vivos* Pipeline (Example #2)



Arm's Length Employee sold the 100 C/S to DIL, for a $3M promissory note.

Arm's Length Employee reported $2M capital gain, and claimed $800K capital gain exemption.

Proposed Amendment to ITA 84.1(2)(a.1) Application to *Inter-Vivos* Pipeline (Example #2)

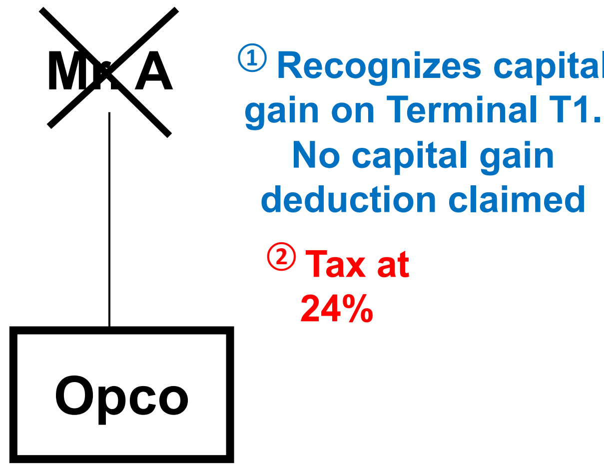


- To service the P-Note with corporate after-tax dollars, DIL disposes of Opco shares to Holdco. Holdco assumes DIL's liability under the P-Note.

- Under proposed ITA 84.1, DIL's Hard Basis in the Opco shares immediately before the disposition would be $2M. This is because amended ITA 84(2)(a.1) requires ACB be reduced by any capital gain in respect of a disposition of the share by an individual with whom DIL did not deal at arm's length. This is irrespective of the fact that she acquired the shares from an arm's length person.

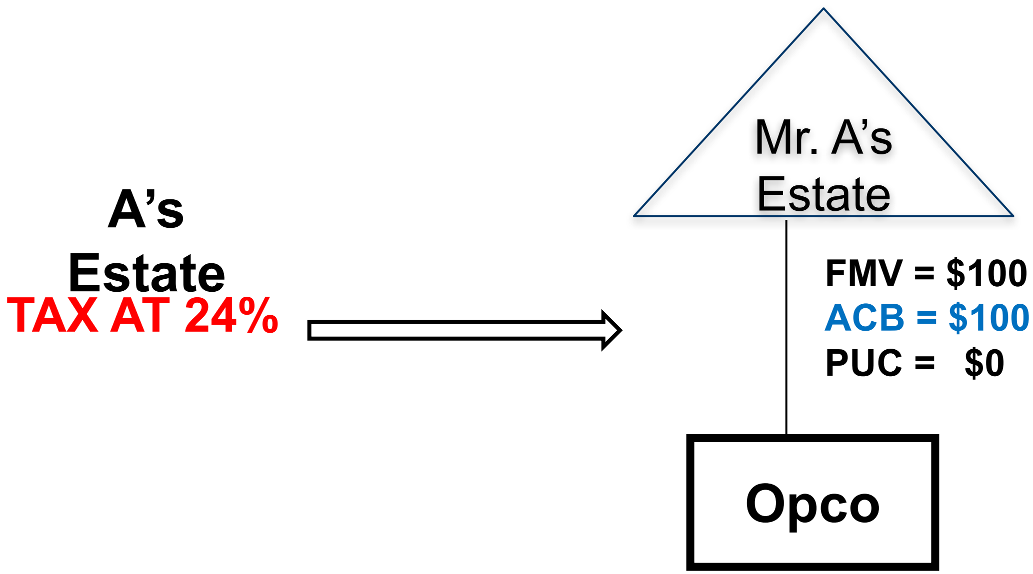
- Result: Daughter deemed to receive $1M of taxable dividend. In some situation, it may be difficult to determine the amount of capital gains historically claimed by a non-arm's length person, particularly where complex transactions took place in the past.

Proposed Amendment to ITA 84.1(2)(a.1) Implication to *Post-Mortem* Pipeline

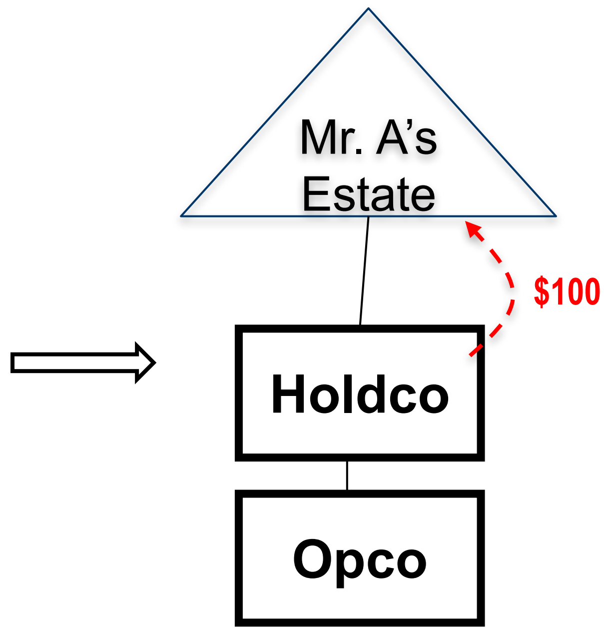


- Per CRA's longstanding views: Estate does not deal at arm's length with deceased.

Proposed Amendment to ITA 84.1(2)(a.1) Implication to *Post-Mortem* Pipeline



Proposed Amendment to ITA 84.1(2)(a.1) Implication to *Post-Mortem* Pipeline



- Per CRA's longstanding views: Estate not deal at arm's length with deceased.
- Under amended ITA 84.1, the Estate's Hard Basis in Opco shares must be reduced by any capital gain earned by Mr. A → will not include ACB from capital gain at death. Result: deemed dividend or PUC grind to Estate of $100.

Proposed Amendment to ITA 84.1(2)(a.1) Implication to *Post-Mortem* Pipeline

- Unless Department of Finance puts in a special carve-out for the ITA 84.1 amendment in favour of post-mortem pipeline planning, the post-mortem pipeline plan is now dead.

- Example: Finance amended the affiliated persons rules in 1997 causing a trust to be affiliated with certain beneficiaries, there was an outcry from the tax community that this could derail standard ITA 164(6) post-mortem share redemption planning. As such, Finance added ITA 40(3.61) to specifically allow capital loss to be triggered to facilitate ITA 164(6) planning.

- Unlikely Finance will introduce carve-out for post-mortem pipeline, given the overall policy objective of this amendment.

- **Should ask Finance for expansion / relaxation of subsection 164(6) – perhaps a 3 year (not taxation years) time-frame with a mechanism to make the disposition elective.**

- Should also ask Finance for grandfathering of existing Estate, particularly those currently holding private corporation shares.

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July 18, 2017 Proposals - New Section 246.1 Anti-Avoidance Rule for Corporate Surplus Stripping

New Anti-Avoidance Rule Against Corporate Surplus Strip Section 246.1

- As part of the amendments, Finance introduced a set of very broad rules aimed at corporate surplus stripping transactions.

- New ITA 246.1(1):
  - Applies if conditions in new ITA 246.1(2) are met;
  - If this provision applies to a portion of amount received or receivable, directly or indirectly, by an individual, the portion is deemed to be a taxable dividend received by the individual.
  - Effective for amounts received or become receivable after July 17, 2017.

New Anti-Avoidance Rule Against Corporate Surplus Strip Section 246.1

- Conditions in contained in new ITA 246.1(2):
  - ITA 246.1(1) applies to a portion of an amount, if as part of a transaction or series:
    - The individual is resident in Canada in the taxation year;
    - The amount received/receivable, directly or indirectly in any manner whatever, from a person with whom the individual was not dealing at arm's length;
    - As part of the series, there is (i) a disposition of property, or (ii) an increase or a reduction of PUC; and
    - It can reasonably be considered that one of the purpose of the transaction or series was to effect a significant reduction or disappearance of assets of a private corporation at any time in a manner such that any part of tax otherwise payable by the individual with respect to the portion, and in consequence of any distribution of corporate property, is avoided.

New Anti-Avoidance Rule Against Corporate Surplus Strip Section 246.1

- Finance explanatory notes:
  - "*In general terms, an individual is to be considered to be avoiding any part of tax otherwise payable … if the amount of tax payable … is less than the amount of tax that the individual would have had to pay … had the corporation instead paid a taxable dividend immediately before the transaction.*"
  - ***"The assets that could be reduced or disappear include assets acquired directly or indirectly in the series (e.g., cash received under a loan)."***

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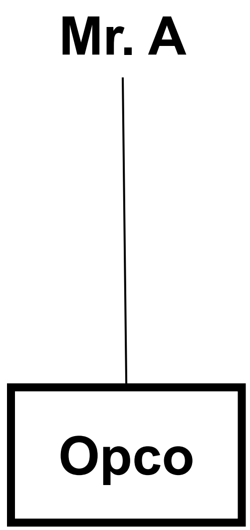
New Anti-Avoidance Rule Against Corporate Surplus Strip Section 246.1

- New ITA 246.1(3):
  - If ITA 246.1(1) applies to a portion of an amount that would have otherwise be a capital dividend at a particular time, the corporation's capital dividend account ("CDA") before and after the particular time cannot include any amounts derived from prior capital gains that is part of the same series of transactions.

New Anti-Avoidance Rule Against Corporate Surplus Strip
Corporate Capital Gain Surplus Strip Plan – Existing Rules



- If Opco pays a $1,000 dividend to Mr. A, Mr. A will be subject to 31% to 41% tax at top Alberta marginal rates, depending on whether the dividend is eligible or non-eligible. Result: personal tax of $310 to $410.

- Alternatively, if Opco undergoes certain transactions to create a $1,000 capital gain (e.g. sale of Opco's assets to an internal company, intentionally triggering ITA 55(2), etc.):
  - Opco will incur corporate tax at approximately 10%, after RDTOH refund. $1,000 x 50% inclusion rate x (50.67% – 30.67%) = $100 permanent corporate tax (ignoring potential changes to passive income taxation).
  - Opco pays $500 of tax-free dividend to Mr. A.
  - Opco pays remaining after-tax funds of $400 to Mr. A as a non-eligible dividend, resulting in $164 personal tax.

- Total tax under alternative plan is $264. A better result than $310 to $410.

New Anti-Avoidance Rule Against Corporate Surplus Strip Application of Section 246.1

- Mr. A received $900 from Opco:
  - Mr. A is resident in Canada.
  - The $900 is received from a person with whom Mr. A does not deal at arm's length (i.e. Opco).
  - As part of the series, there is a disposition of property or increase/reduction of PUC (here, there would have been a disposition of property which triggered Opco's capital gain).
  - It can reasonably be considered that one of the purpose of the series is to effect a significant reduction/disappearance of assets of Opco such that any part of tax otherwise payable is avoided..
    - Had Opco simply paid out the entire $90 as a taxable dividend, the entire $900 would be taxable;
    - Paying the $900 out as taxable and capital dividend is a significant reduction of Opco's assets; and
    - By undertaking transactions to trigger capital gain in Opco, Opco was able to pay out $500 as tax-free capital dividend. This was one of the purposes of undertaking that transaction.
- Therefore, ITA 246.1(1) could apply to deem the entire $900 as a taxable dividend.
- ITA 246.1(3) then correspondingly applies to remove the $500.
- Penalties relating to overpaying capital dividend will presumably also apply.

New Anti-Avoidance Rule Against Corporate Surplus Strip Application of Section 246.1

- ITA 246.1 worded extremely broadly.
- Could it technically apply to situations where a shareholder injects capital into a corporation and increase PUC. Subsequently, that PUC is withdrawn tax-free?
  - Based on the wording of ITA 246.1(2), potentially.
  - As part of the series, there is an increase and reduction of PUC.
  - One of the main purposes of the PUC increase could be viewed to facilitate a future tax-free PUC withdrawal.
  - If a dividends had been paid rather than a return of PUC, additional tax would have been applicable.
  - Would CRA apply ITA 246.1 in this manner?
- Could it technically apply to situations where the corporation sold assets to a third party, as the corporation could have first transferred the appreciated asset to the shareholder as a taxable dividend before the sale? CDA not available in that alternative scenario.

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July 18, 2017 Proposals – New Regime For Taxing Investment Income Inside Private Corporations

Finance’s Overall Objective With July 18, 2017 Proposal

- To remove perceived advantage of corporations’ ability to invest in passive investment using earnings that were subject to corporate tax rates (as opposed to having to invest with earnings subject to the much higher personal income tax rate).
- Therefore, to promote “fairness and neutrality”, under the new regime, earning passive income through a corporation or personally should yield the same after-tax return.
- Targets private corporations only.
  - Whether new regime will apply only to CCPCs appears to be undecided.

Current Taxation Regime for Passive Income

- Current rules already prevent tax deferral on the passive income itself.
- Corporate income tax rate (12.5% or 27% in AB) < personal tax rate (48% top rate).
- Lower corporate tax rate allows more after-tax retained earnings to reinvest in the corporation's business.
- In other words, monies can be accumulated in CCPCs using 87.5 / 73 cent dollars vs. 46 cent dollars for an individual (at the highest Ontario rate).

Finance's Objections To Current Regime

- Although refundable tax system already prevents tax deferral on passive income, corporate investor still perceived to have a significant head-start over an individual investor because of its ability to invest with retained earnings subject only to corporate income tax. Example:
  - Private corporation earns business income of $100,000
  - Subject to tax at small business rate of 12.5%
  - $87,500 of after-tax earnings available to invest inside corporation (if the same amount of income is earned by an individual as employment income, she/he will have only $52,000 of after-tax income available to invest).
  - Even with corporate refundable tax, and personal tax on eventual distribution, corporate shareholder end up significantly ahead due to power of compounding.

Finance's Objections To Current Regime – Cont'd

- The corporation having more starting capital to invest in passive assets (rather than reinvesting in the business) is an advantage that Finance says was unintended under the legislative scheme.
  - Despite the fact that Finance in 1972 clearly intended this result by repealing measures that imposes refundable tax on ineligible investments by corporations (to be discussed).
  - Prior to the introduction of the GRIP/eligible dividend regime in 2006, CCPCs typically bonus down. The GRIP/eligible dividend resulted in proper integration for CCPCs, removing the need to bonus down. This, plus the increasing rate differential, drove the build up of passive assets by successful CCPCs. This build up of passive assets was a deliberate policy choice.
- In some cases, the refundable tax system is ineffective in encouraging dividend distribution of corporate passive income, if regular substantial dividends already being made from active business income. In Finance's view, such practice supposedly nullifies the intended effect of the current refundable tax system.
  - But this was again a deliberate policy choice under the current legislative scheme.

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Current Taxation Regime for Passive Income

- Corporation's aggregate investment income (interest, rental, taxable capital gain, etc.) subject to ~50% tax (approximates top personal marginal tax rate on income).
  - 30.7% is eventually refundable upon future taxable dividends to shareholders.
  - Permanent corporate income tax of ~20% on aggregate investment income.
- Corporation's portfolio dividend income subject to 38.3% (approximates top personal marginal tax rate on dividends).
  - 38.3% is eventually refundable upon future taxable dividends to shareholders.
  - Permanent corporate income tax of 0% on dividend income.
- Capital gain: 50% included in aggregate investment income, 50% to capital dividend account (CDA), which can be paid out tax-free.

Finance’s July 18, 2017 Proposal

- Multiple options discussed to discourage corporate passive investments:
  1. The “1972 approach”
  2. The “deferred taxation” approach
     - Apportionment Method
     - Elective Method
     - Special election for corporations focused on passive investments
- No consideration for the fact that business owners invests surplus funds inside corporation because they have no pension and no safety net, and their need for a surplus to cushion business cycle, unforeseen expenses, act as security for better financing terms, or for future business expansion/acquisitions.

The 1972 Approach

- Carter Commission in 1996 recommended a fully integrated system of corporate taxation, but the Government of Canada did not adopt the Carter Commission's recommendation. To address corporate passive income, Canada enacted the following two-prong system in 1972:
  - Corporate refundable tax on passive investment income
  - Corporate refundable tax on ineligible investments.
- The refundable tax on passive investment income is still in place currently.
- The refundable tax on ineligible investments, which targets exactly what Finance is concerned about today, was retroactively repealed in 1973. The Hon. John N. Turner (Minister of Finance) – in his 1973 Budget Speech – explained the repeal was due in part to complexity and in part to encourage small business expansion, reinvestment and job creation.

The 1972 Approach – Cont'd

- Consultation paper proposes that an alternative today is to resurrect this 1972 refundable tax on ineligible investment. This would entail:
  - An additional 35% refundable corporate tax on earnings not used to acquire active assets.
  - Full refund of the additional tax when funds subsequently used in active business.
- Consultation paper goes on to say that the Government is "not actively considering" this alternative, stating concerns regarding complexity and liquidity issues with the payment and refund mechanism.
- Query why bring this up then? To make their 'real' proposal more palatable?

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The Deferred Taxation Approach

- Consultation paper proposes a ‘deferred taxation’ approach:
  - ~50% upfront corporate income tax on passive income as under existing rules;
  - But no part of the upfront corporate income tax will be refundable;
  - Non-taxable portion of capital gain no longer includable in CDA, and can no longer be distributed tax-free;
- Effectively, the ~50% corporate tax on passive income becomes a permanent tax.
- Individual shareholders then pay another layer of tax (up to 41% in AB) on the dividend income when the passive income is distributed.
- This intentional double tax results in up to >70% total tax on corporate passive income, leaving the shareholder with net proceeds similar to that of a salaried individual investing with after-tax employment income.

The Deferred Taxation Approach – Cont'd

- The deferred taxation approach presents a problem in terms aligning the tax treatment of passive income distributed as dividends with the tax treatment of the earnings that are used to fund said passive investments.
  - Passive investment funded with earnings subject to the small business tax rate has the largest initial capital head-start, and therefore dividend paid out from such passive investment should be subject to a higher personal tax rate;
  - Conversely, passive investment funded with earnings subject to the general corporate tax rate would have less of an initial head-start, and therefore dividend therefrom should be subject to a lower personal tax rate;
  - Lastly, where earnings used to fund passive investment were initially taxed at personal tax rate, e.g. capital contributed by the shareholder, no inherent advantage and should result in no further personal tax after the new corporate tax is levied on such passive income.
- To achieve this, an "apportionment method" or an "elective method" is proposed.

Deferred Taxation – Apportionment Method

- Private corporations to differentiate between passive income earned from
  i. Retained earnings subject to general corporate tax rate – this will likely be based on the existing general rate income pool (“**GRIP**”)
  ii. Retained earnings subject to the small business tax rate – a new small business income pool
  iii. Corporate capital from shareholder’s after-tax income – a new shareholders’ contribution pool
- After-tax investment income each year allocated to each of the three pools, based on the prior year-end balances. On the payment of dividends, the corporation could designate which pool the dividends are paid from:
  i. Dividend from GRIP → eligible dividend;
  ii. Dividend from small business income pool → non-eligible dividend;
  iii. Dividend from the shareholders’ contribution pool → tax-free distribution.
- Note: Pubco dividends not automatically eligible dividends and non-taxable portion of capital gain no longer CDA, but will be apportioned using this method.

Deferred Taxation – Elective Method

- The purpose of the Elective Method is to avoid tracking requirements. Under the Elective Method, all private corporations subject to the "default treatment", unless a corporation elects otherwise.
- Under default treatment, corporations assumed to earn all passive income from retained earnings subject to the small business corporate tax rate. Any passive income distributed automatically treated as non-eligible dividends.
- If election is made, the corporation loses access to the small business rate completely. However, eligible dividends can be paid from all after-tax passive and business income. Conceptually similar to the current non-CCPC election should a corporation chooses to forego tracking GRIP.
- Elective method provides no preferential treatment for passive income earned from shareholders' contribution (irrespective of whether election is made).

Example – Tax on Investment Income

- Comparison of $100,000 investment and 6% interest rate of return for one year, between Ontario corporation investing with corporate business income subject to small business tax rates and individual investor.

		Current Regime - Corporate		Current Regime - Individual
Capital for investment		$100,000		$100,000
Rate of return		6%		6%
Year 1:				
Investment income		$6,000		$6,000
Tax on investment income	50.17%	$3,010	53.5%	$3,210
After tax funds		$2,990		$2,790
RDTOH	30.67%	$1,840		$0
Amount to dividend		$4,830		
Tax on dividend	45.3%	$2,188		
Individual after tax funds		$2,642		$2,790
Individual effective tax rate	**56.0%**		**53.5%**	

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Example – Tax on Investment Income Cont'd

- The Apportionment Method and Elective Method - Default tax investment income at 71%, which does not include the initial corporate tax on the capital for investment.

		Apportionment Method		Elective - Default		Elective - Election
Capital for investment		$100,000		$100,000		$100,000
Rate of return		6%		6%		6%
Year 1:						
Investment income		$6,000		$6,000		$6,000
Tax on investment income	50.17%	$3,010	50.17%	$3,010	50.17%	$3,010
After tax funds		$2,990		$2,990		$2,990
RDTOH	0%	$0	0%	$0	0%	$0
Amount to dividend		$2,990		$2,990		$2,990
Tax on dividend	45.3%	$1,354	45.3%	$1,354	39.3%	$1,176
Individual after tax funds		$1,636		$1,636		$1,814
Individual effective tax rate	**72.7%**		**72.7%**		**69.8%**	

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Deferred Taxation – Special election for ‘Investcos’

- Government also contemplating a special election for corporations focused on passive investments (Investcos)
- Election result in <u>all</u> income of the entity being taxed as passive investment income, but the refundability under the existing rules will be retained, i.e. 30.7% will be refundable upon distribution of income via dividends.
- Where Investco receives funding from a corporate shareholder, additional refundable tax will apply to ensure the starting capital is subject to equivalent amount of tax as an individual investor at top marginal rates.
- Details are currently lacking regarding this election.
- Election would be available under either the Apportionment Method or the Elective Method.

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Policy Commentary

- Good reasons for corporations to keep excess cash in corporation:
  - Cushion for contingency and for maintaining line of credits;
  - Building up cash for future business expansion;
  - Building up personal savings because entrepreneurs have no pension plan and no safety nets.
- Ultimately, is it “fair” to compare entrepreneurs to employees when analyzing passive asset accumulation in a private corporation?
- In our opinion, no.
- But, ultimately, a thorough economic analysis / rebuttal is needed.
- We believe the government should tread slowly on this issue.
- Not done correctly, a misguided policy could have a significant negative impact on the Canadian economy.

Areas Where Government is Seeking Input

The government is inviting input on seven areas:

1. Which approach will best improve fairness?
2. Criteria/consideration should Government considered in selecting either the Apportionment Method or Elective Method.
3. Seeking input on tax treatment of corporations that focus on passive investments.
4. Appropriate scope of new taxation regime to capital gain, i.e. the exclusion of the non-taxable potion of capital gain from CDA, and based on what criteria? E.g., should there be exception for gain realized by a Holdco on arm's length sale of an Opco?
5. Key transition issues?
6. Any reason why the new regime should not extend to non-CCPC private corporations?
7. Gender implication/consideration from the new regime?

Areas Where Government is Seeking Input

- Notably **absent** from these consultation questions:
  - Whether the proposed changes themselves are necessary or appropriate to start with;
  - Whether it is fair to burden private businesses with so much more complexity (e.g. new pool balances to track in addition to all the existing pool balances, and one can anticipate broad and complicated anti-avoidance rules will accompany such proposed changes);
  - Whether an effective tax rate of over 70% is fair;
  - Additional tax that can be collected from the proposed change, versus cost of compliance, enforcement, the impact to private businesses from forcing the removal of their surplus asset cushion, and the impact from removing a large chunk investment dollars from the local economy (few people are willing to take risk to earn return that will be subject to over 70% of tax).
  - Whether it is fair to treat all passive investment the same? A GIC earning 2% a year has a very different risk profile than an angel investment in a local start-up.
  - Whether it is fair that public companies can build up passive investments whereas private corporations cannot, thus putting private businesses in a competitive disadvantage.
  - Measures like this discourages incorporation – what are the non-tax impact from reduced use of corporations by businesses, especially those businesses that need limited liability protection?
- A genuine consultation would recognize that past governments have made deliberate policy choices to encourage the current build up of passive assets inside CCPCs, and start with genuinely looking at the pros and cons of the current regime and asking whether there is now a compelling need to change the current regime.

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Illustrative Examples

Start-Up Example (Credit to STEP Canada for this example) BakeryCo

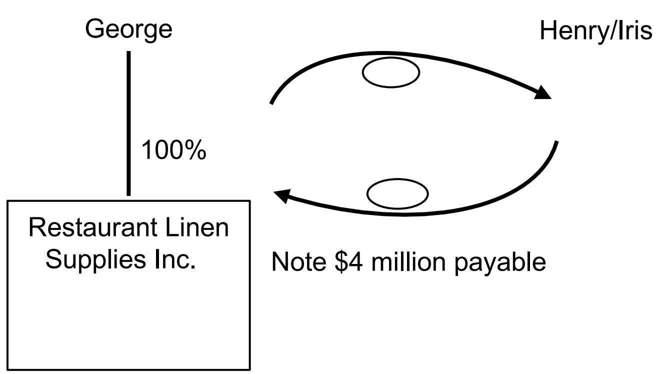
- Eugenio wants to start a bakery.
- Needs start-up capital.
- Mother Francesca has low income, pays no income tax.
- Francesca refinances her home for $120K to loan such funds to her son's new corporation ("**BakeryCo**") at a zero interest rate.
- Francesca obtains 50% of the issued shares of BakeryCo for $50.
- It is intended that Francesca will receive dividends from BakeryCo for her return on her invested funds.

Start-Up Example (Credit to STEP Canada for this example) BakeryCo

- Under existing rules, any amount of dividends received by Francesca from BakeryCo would be subject to her marginal rates of tax.
- Now, because she is subject to the new proposals and will likely fail all of the reasonableness tests, any dividends received by her would be subject to the highest rate of income tax – likely 41%.
- Is that fair?
- Also, if the loan was interest bearing and the CRA considered the interest to be “unreasonable”, the unreasonable portion would be taxed at a 48% tax rate in AB.

Business Succession Example – Credit to STEP Canada

- George owns Restaurant Linen Supplies Inc.
- Wants to sell business to children, Henry and Iris (who are active).
- FMV $4 million. Fund payment of $4 million from corporate income.



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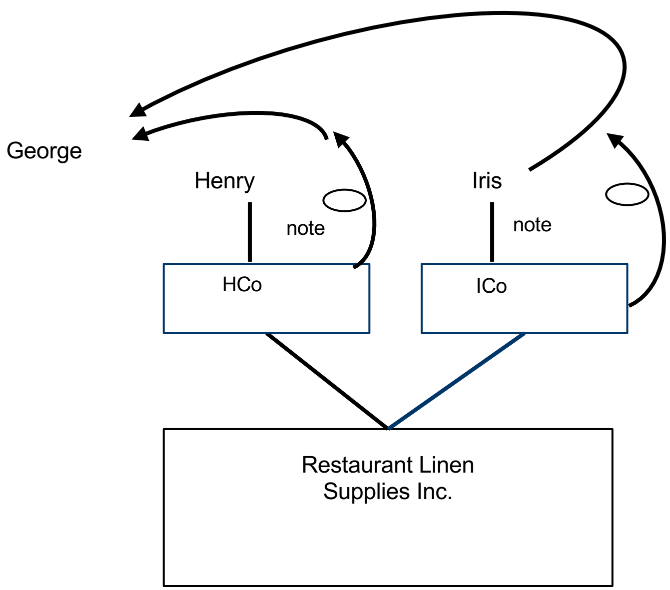
Business Succession Example

- Henry and Iris want to transfer their shares of Restaurant to their respective holding companies so as to facilitate tax efficient repayments.

- If so, George will not be able to claim his capital gains deduction since the existing section 84.1 would cause this to be a taxable dividend….George is aware of this and plans accordingly.



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Business Succession Example

- What is overall tax treatment under new rules?
- What if George sold to Mega Laundry Corp (unrelated)?

George – Selling the Business to Family

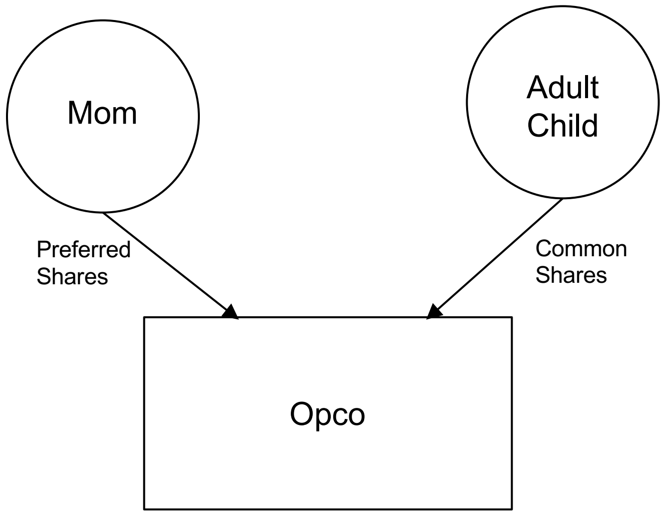
- Current Rules
  - $4 million capital gain.
  - Ontario resident – highest marginal rate for capital gains = 53.53% x 50% = 26.7265% = $1,069,000.
- Proposed Rules
  - $ 4 million dividend.
  - Ontario resident – highest marginal rate for ineligible dividends = 45.3%
  - Total taxes = $1,812,000.
  - Increase in taxes = $743,000.

George – Selling the Business to Mega Laundry

Comparative Results for George

	Current Rules Sell to Family	Proposed Rules – Sell to Family	Sell to Mega Laundry
Taxes on sale	$ 1,069,000	$ 1,812,000	$ 856,000

Post-Mortem Consequences – Example



- Mom introduced Adult child into the business via an "estate freeze" years ago.
- Adult child is not active in the business.
- Under current rules, if Adult Child dies, best case scenario tax liability would be 24% (using pipeline planning); liability would be 41% tax (using subsection 164(6) planning) and over 65% if no planning done.
- With new proposals, tax will be approximately 82% (93% in Ontario) with no ability to reduce.

Post-Mortem Consequences – Example (Cont'd)

- Normally, upon death, Adult Child would a deemed disposition immediately prior to death of his / her shares at FMV resulting in a terminal capital gain (if the FMV exceeds the ACB).
- Under the proposed TOSI rules, because the capital gain would exceed what is "reasonable" having regard to the new reasonableness tests, such a terminal gain is re-characterized as a non-eligible taxable dividend taxed at the top marginal rate of 41% in AB.

Post-Mortem Consequences – Example (Cont'd)

- Traditional post-mortem planning would one of two solutions to deal with double tax risks on death.
- 1st option is "pipeline" planning…..but no longer possible due to proposed changes under section 84.1 as previously discussed.
- 2nd option is "subsection 164(6) loss carry-back" planning which generally involves the triggering of a capital loss with a corresponding taxable dividend (also at 41%) by the Estate on the private corporation shares within one taxation year of the Estate's creation.
  - Such loss is able to be claimed by the deceased on his / her terminal return against the reported terminal gain.
  - However, in Adult Child situation, under the proposed TOSI rules, there is no terminal gain to apply such loss resulting in a permanent double tax. Fair?? No.

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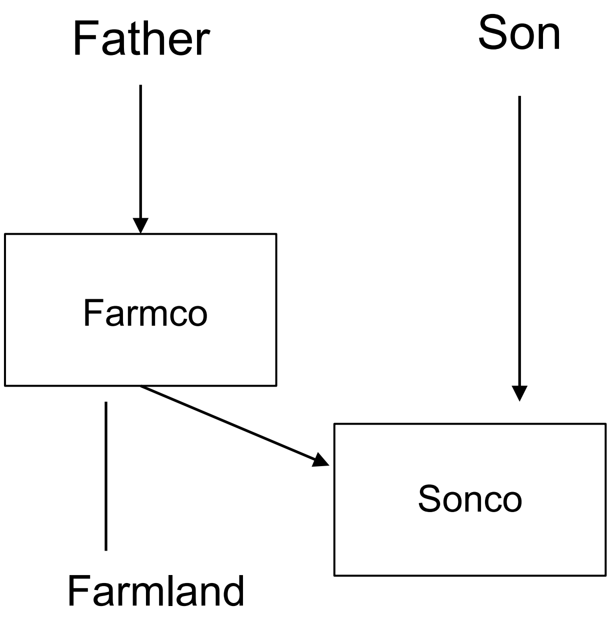
Example – Retroactive Effect of Proposals



- Farmco transfers land with a FMV of $1M and ACB of $300K to Sonco in year 2012
- Sonco assumes Farmco's mortgage on the land of $800K (the property has been refinanced over the years).
- Under a section 85 rollover, the lowest capital gain that must be reported is $500K resulting in an addition to the tax-free CDA pool of $250K.
- Farmco reported the $250K taxable capital gain, but has not paid out the CDA to date.

Example – Retroactive Effect of Proposals – Cont'd

- Under current rules, the $250K of CDA addition could be paid out to the ultimate shareholders tax-free at any time.
- This is the way it should be in order to preserve the 50% tax-free nature of capital gains (preserving overall integration).
- However, under new proposed section 246.1, if one of the purposes of the series of transactions was to create such CDA, then the CDA would eliminated if it had not been paid out by July 18, 2017.
- How is this fair??
- Injects unnecessary amount of uncertainty.
- A strict reading of the legislation suggests that this might apply to arm's length sales as well.

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What Canadian Entrepreneurs and Their Advisors Can Do to Deal With These Transformative, Invasive and Complex Changes.

FAQ #1 – Can Salaries Still Be Paid to Family Members?

- Yes…..subject to the normal restrictions under section 67 and paragraph 18(1)(a) of the Act.
- The July 18, 2017 proposals do not affect salaries paid to family members.

FAQ #2 – Should Family Trusts Be Used to Hold Private Corporation Shares?

- Family trusts are still very flexible and valuable estate planning tools.
- Recent amendments have taken away the ability to claim a principal residence exemption if a principal residence is held through a trust.
- New amendments prevent easy income splitting and multiplication of capital gains deduction.
- However, having growth of a private corporation accrete to a trust instead of directly to an individual can provide great flexibility.
- Useful for probate avoidance and capital gains deferral on death as well.
- Overall, trusts are great vehicles but new tax proposals need to be considered.

FAQ #3 – Will My Tax on Death Increase?

- Perhaps - for shareholders of private corporations.
- Post-mortem planning is now even more crucial.

FAQ #4 – Should I Be Taking All of My Passive Assets Out of My Private Corporation to Avoid These Proposals?

- No. Settle down.
- Taking out the assets will likely result in significant up-front tax.
- The passive asset / income proposals are simply discussions at the moment.
- The process needs to play out. If the proposals remain, hopefully there will be transitional rules that may impact whether to withdraw such assets or not.

FAQ #5 – Does Any Part of These Proposals Have Retroactive / Retrospective Effect?

- Yes. See proposed subsection 246.1(3) and the example previously illustrated.
- For example, if subsection 55(2) was intentionally triggered say in 2015 and there was a capital gain triggered at that time. The CDA of the private corporation would have been increased in 2015. If the capital dividend was paid out of the corporation's surplus post-July 18, 2017, then any attempt to pay out that CDA will be void.
- Other examples: the calculation of "hard basis" when determining whether or not section 84.1 applies and the "fresh start" rules for LCGE regarding trusts and minors.

FAQ #6 – Can My Minor Child Take Advantage of the Lifetime Capital Gains Election in 2018

- No. However, subject to the provisions of proposed subsection 110.6(30.1), an actual disposition by a trust or a minor of private corporation shares prior to 2019 may be available.

To Dos - #1 – Be Involved

- The July 18, 2017 proposals are foundational policy changes.
- Deadline for comments – October 2, 2017.
- Contact your MP.
- Advocate for another Carter Commission…..Canada deserves it.

To-Dos #2 – Determine the Possible Impact to You

- Carefully review to see how you may be affected by the new proposals.
- Seek tax expertise when developing alternate plans.
- Don’t underestimate the complexity and pervasiveness of the proposals.

To-Dos #3 – Dividend Sprinkle in 2017

- Recall the line by Prince – "….*we're going to party like it's 1999…*".
- Well…..


TONIGHT I'M GONNA PARTY LIKE
Sprin
kle
201
IT'S ~~1999~~!
7
imgflip.com

To Do #4 – Capital Gains Sprinkle in 2017

- Look for ways to crystallize capital gains deduction for shares of private corporations held by trusts / minors.
- For minors, consider actual dispositions for 2017.
- Consider 2018 election if 2017 actual dispositions not possible.
- But very little time left to do purification – **start planning now!**

To Do #5 – Review Private Corporate Structures

- If private corporations in a group have no other purpose other than to dividend sprinkle, then carefully consider unwinding such structures.
- The proposals are well beyond the capability of most general practitioner accountants.
- Seek tax expertise.

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Some Closing Comments – What to Do?

So What to Do?

- Slow the process down and do it right.
- Drop the rhetoric - on both sides - for a reasoned discussion.
- Ideally, commence “Carter 2” that would engage ALL stakeholders.
- Enable spouse / common-law sprinkling but expand existing “kiddie tax” to “adultolescents” – such as to age 24….similar to that of the US or bring in family taxation.
- Fix the double taxation problems with post-mortem extractions of assets (perhaps expand subsection 164(6) to a 3 year period and make it elective to deal with post-mortem concerns).
- Fix all other double taxation issues.
- Fix the family succession issues.

So What to Do?

- Completely abandon passive asset / income issues; or, at a minimum, restructure the proposals to enable entrepreneurs to build-up an “acceptable” level of assets.
- Consider repealing SBD; or expand the SIB rules to single employee professional corporations (develop minimum employee thresholds, example 3).
- (Note that pre-1984, professionals that were incorporated were “non-qualifying businesses” which were taxed at an intermediate rate of 33%).
- Enforce existing rules such as the personal services business rules to otherwise incorporated employees, various attribution rules and reasonable salaries.
- Seek to reduce complexity.

Can We All Just Get Along and Get Significant Tax Reform Right?

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