

# Sweeping Proposed Tax Changes to Private Corporations

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# What we will cover.....

- Income Sprinkling
- Multiplication of the Capital Gains Exemption
- Tax Deferral of business income invested in passive investments
- Conversion of income into Capital Gains

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# Income Sprinkling

- Strategy to shift income from individual with a high personal income tax rate to family members with a lower tax rate (or no tax rate at all)
- Often achieved by use of family trust
- In Ontario, can receive about \$51,000 in eligible dividends tax-free (assuming no other income)

# Income Sprinkling – Current Regime

- No general prohibition in *Income Tax Act* against income sprinkling
- Specific rules to prevent sprinkling income among low-tax family members:
  - Salary and other remuneration subject to reasonableness standard
  - Income attribution rules
  - Tax on split income (“TOSI”), commonly referred to as “kiddie tax”

# TOSI – Proposed Changes

Proposed legislation significantly expands scope of TOSI:

- Broader definition of “specified individual” – would apply to minors and adults who receives “split income” from the business of a related individual where the amount exceeds what is reasonable
- More stringent reasonableness test if between ages of 18 and 24
- Broader definition of “related”
- TOSI extended to interest, gains from certain property, and “compound income” for individuals under age 25

# “Connected Individual” – Presumed Influence

- TOSI applies where related individual is “connected individual” to a corporation
- Individual will be “connected individual” if:
  - Factual control over the corporation (strategic influence);
  - Owns property representing 10% or more equity value (equity influence);
  - Services primarily attributable to the individual or the business is regulated (earnings influence); or
  - 10% or more of the property acquired from the individual or a corporation with which the individual is connected (investment influence)
- Similar concepts apply in determining whether income earned by trust or partnership is split income

# Reasonableness Test

- TOSI applies where amount paid to specified individual exceeds what would be paid to arm's length person having regard to:
  - Functions performed (i.e., labour contribution)
  - Assets contributed
  - Risks assumed
  - Total of amounts previously paid
- Stricter test for individuals between 18 and 24:
  - Must be actively engaged on a regular, continuous and substantial basis
  - Reasonable return limited to prescribed rate of return on assets contributed



# Looking Ahead

- Proposals still subject to change
- Maximize income splitting in 2017
- Higher compliance costs if paying family members
- Consider prescribed rate loans

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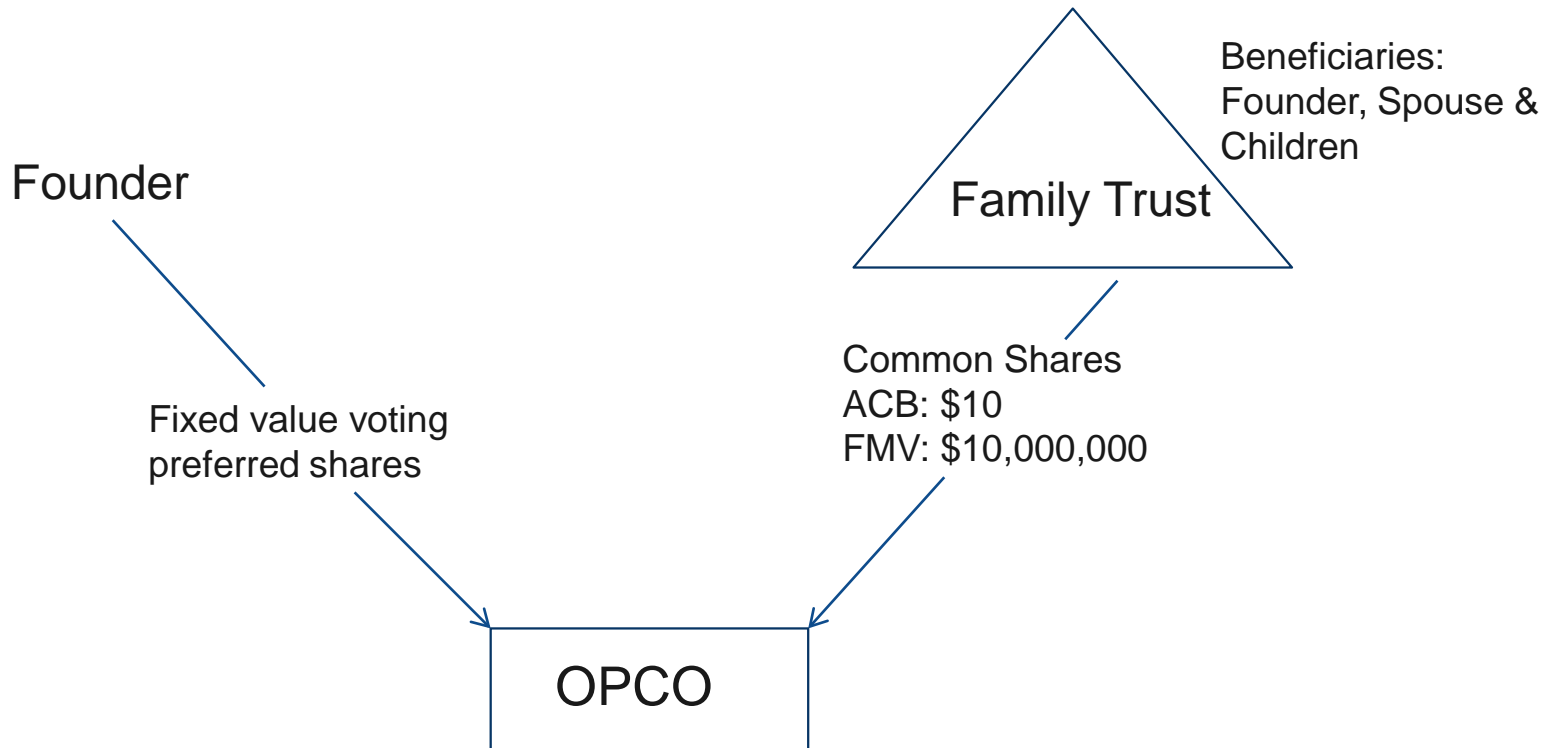
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# Lifetime Sprinkling – Multiplication of the Lifetime Capital Gains Exemption (“LCGE”) – Current Rules



Assume 3 children and a spouse and sale by the family trust of the common shares of Opco for \$10,000,000. If the shares qualified as shares of a “qualified small business corporation” (“QSBC”), the LCGE available through trust is  $\$835,716 \times 5 = \$4,178,580$  – Founder also gets LCGE.

# Application of the Changes – Time frame

- The changes will apply to dispositions occurring after 2017, subject to certain transitional rules

# Ineligible Capital Gains – No LCGE for Minors

- An individual will not qualify for the LCGE in respect of capital gains realized before the taxation year in which the individual turns 18
- An individual will not be entitled to claim the LCGE in respect of capital gains accrued before the taxation year in which the individual turns 18
- An adult individual transferee will not be entitled to claim the LCGE in respect of capital gains, where shares are transferred to the adult individual for less than their fair value and the gain accrued prior to the individual transferor turning 18

# Ineligible Capital Gains – No LCGE for Minors and Adults if Reasonableness Test Not Met

- The LCGE will generally not apply in respect of taxable capital gains that are included in an individual’s “split income”
- This has the effect of introducing a “reasonableness” test
- After 2017, non-arm’s length sales will be taxed as non-eligible dividends if split income

# Ineligible Capital Gains – Gains Allocated Through a Trust to a Beneficiary

- Unless the trust is an “eligible LCGE trust”, an individual will not be entitled to claim the LCGE in respect of gains that accrued on shares held by a trust
- An individual who is a beneficiary of a trust will not be entitled to claim the LCGE in respect of capital gains realized by a trust and taxable capital gain allocated to the individual beneficiary

# Eligible LCGE Trust – Gains Allocated Through a Trust to a Beneficiary

- If the trust is an alter ego trust, a spousal or common-law partner trust, or a joint spousal or common-law partner trust, an individual who is a beneficiary of the trust will be entitled to claim the LCGE in respect of capital gains realized by such trust and allocated to the individual beneficiary
- The exception also applies with respect to certain employee share ownership trusts
- Each of the foregoing trusts are referred to in the proposals as an “eligible LCGE Trust”



# Ineligible Capital Gains – Gains on Shares Received by a Beneficiary from a Trust

- If a trust distributed shares to an individual, who is a beneficiary of the trust, on a tax-deferred rollover, the beneficiary will not be entitled to claim the LCGE on the gain accrued while the shares were held in the trust unless the trust was an eligible LCGE trust

# Ineligible Capital Gains – Gains on Shares Received by a Beneficiary from a Trust

Consider the following example:

- A typical-family trust subscribed for the common shares of an Opco for \$10
- Years later, the family trust distributed the common shares to the beneficiaries on a tax-deferred rollover basis
- At the time of the roll-out, the common shares had a fair value of \$5,000,000

# Ineligible Capital Gains – Gains on Shares Received by a Beneficiary from a Trust

- The beneficiaries sold the common shares for \$5,000,000 to an arm's length buyer
- The beneficiaries will not be entitled to claim the LCGE on the capital gain realized
- As discussed above, if the family trust (not the beneficiaries) sold the common shares to an arm's length buyer, the beneficiaries of the trust will not be entitled to claim the LCGE in respect of capital gains realized by the trust and taxable capital gain allocated to the beneficiaries

# Transitional Rules: 2018 Elections

- Transitional rules will allow individuals (other than minors), personal trusts and trusts referred to in subsection 7(2) of the ITA to crystallize the accrued gain on the “eligible property” they hold
- Such individual or trust that makes an election to crystallize its accrued gain on a day in 2018 will be deemed to dispose of the eligible property for proceeds up to the fair market value of the property and reacquire the property at a cost equal to same
- A capital gain realized under the election will generally be eligible for the LCGE using the current tax rules, subject to a 12-month (not 24-month) period as set forth in the definition of eligible property (described below)

# Transitional Rules: 2018 Elections

- Eligible Property means property, other than property in respect of which any of the income attribution rules in sections 74.2, 74.3, 75 and 75.1 apply, that:
  - is identified in the election;
  - is owned continuously from the end of 2017 until the end of the taxpayer's disposition day;
  - is capital property at the taxpayer's disposition time; and
  - would be qualified small business corporation shares if the references in the definition to 24 months were read such that those references were changed to 12 months immediately preceding the disposition time.

# Transitional Rules: 2018 Elections

- The election will have to be made on the prescribed form and filed with the Minister by the tax filing deadline for the year in which the election is made, which generally means by April 30, 2019 for individuals

# Transitional Rules: 2018 Elections – Does Not Apply to Minors

- Minors will not be eligible to make an election pursuant to the transitional rules
- No crystallization of the LCGE in respect of capital gains on:
  - shares held by minors; and
  - shares held by a trust and allocated to a minor beneficiary.

# Transitional Rules: 2018 Arm's Length Sale by Minor

- A second transitional rule will allow for the LCGE to apply if the shares are actually disposed of by the minor (or by a personal trust under which the minor is a beneficiary) in 2018 to an arm's length buyer, provided that the minor (or the trust) held the shares continuously from the end of 2017 until the disposition



# Transitional Rules: 2018 Arm's Length Sale by Minor

- The reference to 24 months in the definition of qualified small business corporation shares is to be read as 12 months
- Under those circumstances, the capital gain will not be subject to the TOSI rules, which would otherwise apply in respect of the dispositions after 2017

# Are Estate Freezes Dead? Why Freeze?

- Minimize tax payable on deemed disposition at death
- Asset protection
- Some shares should be kept outside of the family trust in order to claim the LCGE

# Considerations

- Family law matters
- Succession planning matters
- May not be able to benefit from the deeming rule regarding TOSI on shares acquired as a consequence of death
- Corporate governance over the family's assets and business

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# Taxation of Passive Investment Income

Current rules:

- Corporate rates vs personal rates
- Canada adopted corporate tax integration concept vs U.S. (for example)
  - Lower corporate tax rates for active income but when distributed to shareholders as dividends, shareholders are taxed on dividends. Overall tax should be equal to same amount as if income earned personally
  - High corporate tax rates on passive income earned by corporations
  - To achieve integration, when dividends are paid to individual shareholders, a portion of corporate tax is refunded to corporation (“refundable dividend tax on hand”)

# Taxation of Passive Investment Income

## Tax Treatment of Different Types of Passive Investment Income (Dollars)

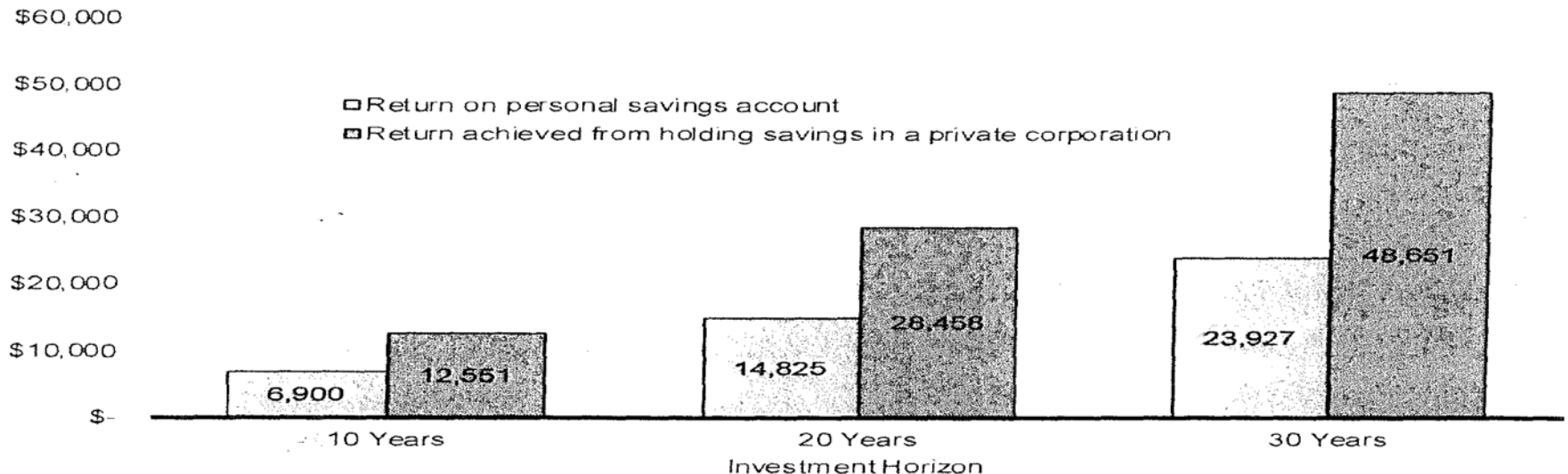
		Types of Passive Investment Income		
	Formula	Interest Income/ Rental Income	Portfolio Dividends	Capital Gains
A	Passive investment income	100	100	100
B	Taxable passive investment income	A, or 50% of A for capital gains	100	50
C	Provincial corporate tax	B * 11.5% or 0 for dividends	0	5.75
D	Federal tax on interest, rental income and capital gains	B * 38½%	n/a	19.34
E	Federal tax on dividends	B * 38½%	38.33	n/a
<b>Refundable taxes and exempt amounts<sup>(1)</sup></b>				
F	Refundable portion of taxes on interest, rental income and capital gains	B * 30%	n/a	15.34
G	Refundable portion of taxes paid on dividends	B * 38½%	38.33	n/a
H	Capital dividend account	A - B	n/a	50
<b>Distribution of income to individuals</b>				
I	Taxable Dividends <sup>(2)</sup>	B - C - D + F or B - C - E + G	80.50	40.25
J	Capital dividends	H	0	50
K	Personal income tax <sup>(3)</sup>	I * 45.30% or 39.34%	36.47	18.23
L	After-tax income (Corporate owner)	(I + J - K)	44.03	72.02

# Perceived Unfairness?

Comparing corporations to an individual earning employment income

- No deferral
- Incentives to hold passive investments in corporation

**Comparison of After-Tax Passive Investments Returns for an Individual Investing After-Tax Proceeds on \$100,000 of Earnings, Directly or Through a Corporation (interest income, 3 per cent return), over a Specified Investment Horizon**



# Alternatives to Tax Deferred Passive Income

- Finance seeks alternatives to tax passive investments in corporations
  - 1972 approach: Apply new refundable tax to passive investment income earned by private corporation. It was considered too complicated



# Deferred Taxation

- Second approach: No refundable tax on passive investments
  - This approach tracks three categories of income
    - Passive income earned on 15% small business income taxed at top rate (50.17%)
    - Ineligible dividend when paid out
    - No refundable tax
    - Only one-half of capital gain included in income (no capital dividend account for capital gains)
  - Passive income earned on 26.5%
    - Eligible dividend when paid out
    - No refundable tax

# Deferred Taxation

- Only one-half of capital gain included in income (no capital dividend account for capital gains)
- Passive income contributed by individual shareholder (current regime continues)
  - Apportionment method
  - Elective method
- Transition: new tax treatment (to be determined after consultation period) will have limited impact on existing passive investments
- Better to be a public corporation: only 26.5% and deferral

# Converting Income into Capital Gains

- Generally, capital gains are taxed at a much lower rate than other types of income

**2016 Top Marginal Personal Tax Rate by Income Type (Taxable Income \$300,000+)\***

Taxing Jurisdiction	Capital Gains	Salary**	Non-eligible dividends (e.g., active business income of CCPCs taxed at the low 10.5% small business rate)	Eligible Dividends (e.g., corporate income taxed at the 15% general rate)
Canada only	16.50%	33.00%	26.30%	24.81%
Canada/N.L.	24.90%	49.80%	41.86%	40.54%
			(after June 30)	
Canada/N.S.	27.00%	54.00%	46.97%	41.58%
Canada/P.E.I.	25.69%	51.37%	43.87%	34.22%
Canada/N.B.	26.65%	53.30%	45.81%	34.20%
Canada/Que.	26.65%	53.31%	43.84%	39.83%
Canada/Ont.*	26.76%	53.53%	45.30%	39.34%
Canada/Man.	25.20%	50.40%	45.74%	37.78%
Canada/Sask.	24.00%	48.00%	39.91%	30.33%
Canada/Alta.*	24.00%	48.00%	40.24%	31.71%
Canada/B.C.	23.85%	47.70%	40.61%	31.30%
Canada/N.W.T.	23.53%	47.05%	35.72%	28.33%
Canada/Nvt.	22.25%	44.50%	36.35%	33.08%
Canada/Y.T.*	22.90%	45.80%	37.60%	21.78%

# Finance's Concerns

- Finance's concern: taxpayers are triggering capital gains and distributing corporate after tax earnings instead of dividends
- Section 84.1 generally applies to recharacterize capital gains into dividends when an individual sells shares to a non-arm's length corporation for non-share consideration.
- Current section 84.1 does not apply if the seller does not claim the lifetime capital gains exemption (where there is "hard cost base")

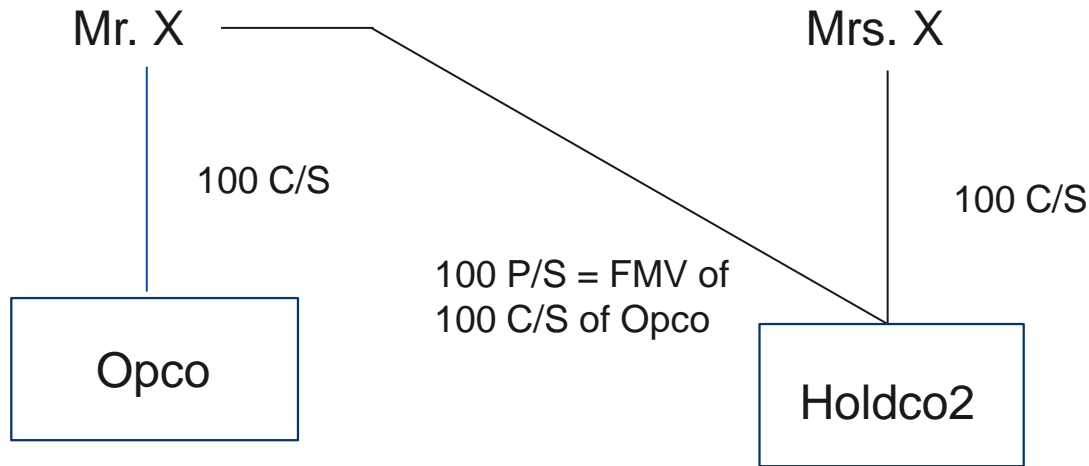
# Finance's Concerns

Example:

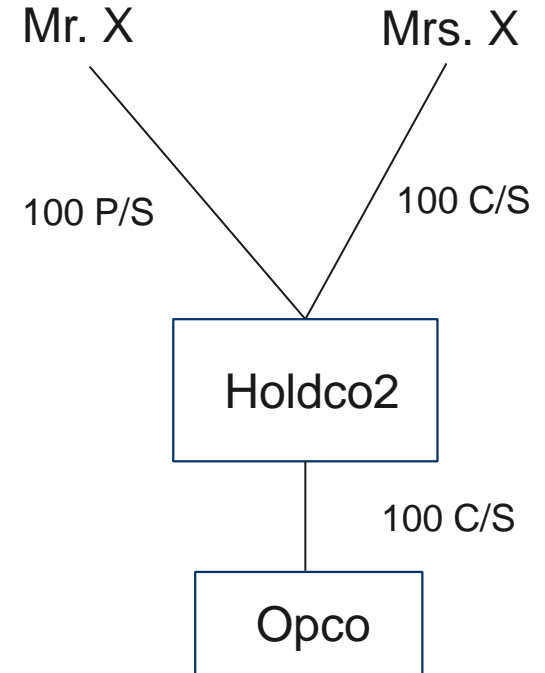
- Mr. X sells his shares in Opco at FMV to Holdco 2 (owned by Mrs. X) in exchange for shares in Holdco 2. Mr. X pays capital gains on the sale of his shares
- Mr. X sells his Holdco 2 shares (now with high ACB) to Holdco 3 (also owned by Mrs. X) for a promissory note
- Holdco 3 repays the promissory note held by Mr. X
- In this scenario, Mr. X paid tax on the capital gains
- Section 84.1 does not apply to recharacterize the capital gains into dividends

# Finance's Concerns

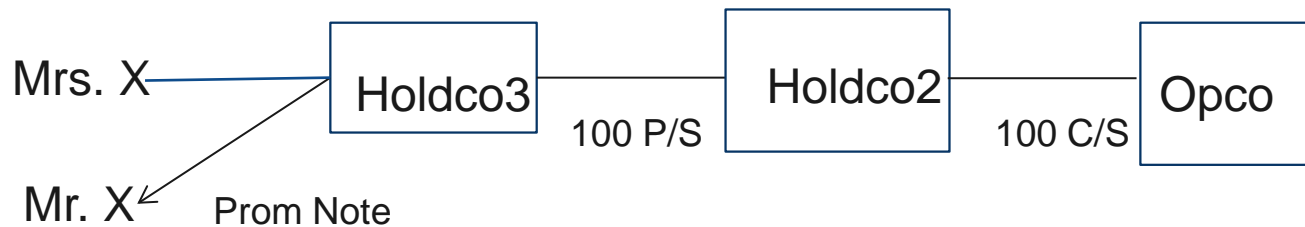
## STEP 1



## STEP 2



## STEP 3



# S. 84.1 Amended

- Section 84.1(2) will be extended to apply to transactions in non-arm's length situations where the cost base is increased in a taxable non-arm's length situation
- In above example, Mr. X will be deemed to have received a dividend when Holdco 3 repays the promissory note to Mr. X
- Finance is aware that in this situation Mr. X is taxed on the gain when shares of Opco are transferred to Holdco 2 and is subsequently taxed again by deeming the proceeds as a deemed dividend: "TOO BAD"
- Maybe increase capital gain inclusion rate?

# Intergenerational Transfer of Business

- Exceptions for intergenerational transfer of business?
  - Currently, the proceeds from the transfer of shares by one individual to the corporation of another family member will be recharacterized as deemed dividend if the individual claimed the lifetime capital gains exemption
  - Finance: ways to accommodate “genuine intergenerational business transfers”?



# Anti-Stripping Rule

- Proposed section 246.1
  - Anti-stripping rule will apply if one of the purposes of the transaction is to pay an individual non-share consideration that is otherwise treated as capital gain out of the corporation's surplus in a manner that involves a significant disappearance of the corporation's assets
  - Non-share consideration would be treated as taxable dividend
  - Applies to any amounts received or receivable on or after July 18, 2017
  - No arm's length test

# Post-mortem Planning: Inadvertent?

- Inadvertent impact of section 84.1?
  - Post-mortem pipeline transaction:
    - Mr. X dies owning shares of Xco. Capital gains are triggered at fair market value. Estate inherits the shares at high cost base
    - If nothing further is done, when Xco distributes assets to Estate, the Estate will receive and be taxed on deemed dividends
    - To minimize on double tax, shares of Xco are transferred to a holding corporation (owned solely by the Estate) in exchange for a promissory note. Holdco and Xco are amalgamated and Amalco repays the promissory note owing to the Estate on a tax-free basis
    - Under proposed amendment in s. 84.1, the repayment of the promissory note is deemed to be a dividend, resulting in double tax (capital gains on Mr. X's death and deemed dividend on repayment of promissory note)

# Arm's Length Sale: Inadvertent?

- Proposed section 246.1 could apply to a simple arm's length transaction:
  - Sale of assets by corporation
  - One-half of gain is added to tax-free capital dividend account
  - Payment of capital dividend is tax-free
  - Involves a significant disappearance of the corporation's assets
  - Under proposed section 246.1, the capital dividend is deemed to be a taxable dividend
  - Can this really be the intent?
  - Application to sale of goodwill transactions that occurred before December 31, 2016 since this provision applies to any payment (including capital dividends) made after July 18, 2017

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