Department of Finance July 18, 2017 Release
Tax Planning Using Private Corporations

On July 18, 2017, the Department of Finance issued a consultation paper with respect to Tax Planning Using Private Corporations. While the Minister of Finance and his department describe the document as closing tax loopholes, it is in fact a major change in tax policy for private corporations. The proposed rules apply to all private corporations, however, as our practice consists primarily of Canadian Controlled Private Corporations (CCPCs) we have focused our comments on the impact on CCPCs. We believe that most Canadians, and all shareholders of CCPCs in Canada, should be concerned about this consultation paper for the following reasons:

- The paper was issued on July 18, 2017, with a consultation period ending October 2, 2017. If the Department of Finance was truly interested in comments they would not have issued the proposal in the middle of July with a comment period that effectively ends the end of September.

- The covering letter from the Minister of Finance and the comments in the paper are misleading in respect to the impact of the proposals. While there are many statements in the paper that run the gamut from misleading to wrong, we believe that the most egregious are:

  - The rules are not being followed as intended – in fact the rules in question are being followed exactly as intended. When the paper states "jurisprudence has, in some cases, narrowly interpreted some of the existing anti-avoidance rules" what it is really saying is that the courts have repeatedly concluded that this type of tax planning, which has been in place for decades, is in compliance with the Income Tax Act.

  - The paper stresses that the proposals are targeted at "some high-income individuals," in fact, as we will show below, these proposals are not targeted at all. These are broad, punitive, provisions that apply to all CCPCs. No small business owner can sit back and believe that these proposals will not apply to them.

- The 2016 Federal budget included complex rules designed to prevent perceived abuse of the Small Business Deduction. These rules were broadly drafted and many CCPC's will be surprised at their income that is no longer eligible for the Small Business Deduction. These rules were effective for year ends starting after March 22, 2016 and, so the first income tax returns that these rules apply to are now being filed. The Department of Finance released its proposal before it was in a position to evaluate the impact of the last major complex change to the taxation of private corporations. We believe that it is appropriate to wait until all corporations have filed tax returns to which those rules apply so that the impact of those changes can be considered.

The consultation paper is focused on three broad areas: income sprinkling, holding passive investments inside a private corporation, and converting a private corporation's regular income into capital gains.

Income Sprinkling

Canadian income tax is generally based on individual income and not family income. Income splitting has been available using spousal RRSPs since 1974 and with pension income splitting since 2007. In addition, self employed Canadians have been able to split income with adult family members by having them, or a trust they are a beneficiary of, own shares of the company. The ability to split income with minor children was removed with the introduction of the tax on split income in section 120.4 of the Income Tax Act (better known as the kiddie tax). Where the tax on split income applies, the income is taxed at the top marginal rate for ordinary income and the tax is not reduced by any of the personal tax credits.

The consultation paper includes proposed legislation to expand the tax on split income effective in 2018. The definition would be expanded to include:

- Individuals over age 17 unless it is "reasonable to conclude" that the income does not exceed what would be paid to an arm's length person considering functions performed, assets contributed, risks assumed, and all amounts paid before the end of the year (this would appear to look at amounts paid before the legislation becomes effective).

- Between age 17 and 25 functions performed are not considered.

- The definition of related parties, to which the tax on split income rules will apply, is expanded and includes parents, grandparents, siblings, in-laws, aunts and uncles, nieces and nephews.

- Income included is expanded to include interest on loans, capital gains, income from shareholder benefits, and income earned from income that was taxed as split income.

- The tax on split income applies if the business earns income from services primarily performed by the individual or if the individual performs any of the services and is required to be registered or a member of an organization to be authorized to provide those services.

These rules are complex and subjective. When the CRA decides that the amount is not reasonable it will be the taxpayer's responsibility to prove that it is reasonable.

Included with the proposals on the tax on split income, the Minister of Finance proposes to restrict access to the capital gains exemption. Starting in 2018 the capital gains exemption would not be available for shares owned by a minor, shares owned by a trust, or the gain accrued while the shares were owned by a minor or a trust. While the rules are applicable to dispositions after 2017 the denied portion of the gain will look back at share ownership prior to 2018. There are elective provisions to allow shares held at the end of 2017 to elect to realize the gain and increase the cost base in 2018. These rules include significant penalties if the elected FMV is greater than the actual FMV. Due to the difficulty and the subjective nature in differentiating personal and business goodwill in private corporations, taxpayers making these elections will likely want to consider a business valuation to support the value used.

Holding Passive Investments Inside a Private Corporation.

In many respects, these are the most offensive, complicated, and wide-ranging provisions in the consultation paper. They are also the only item with no proposed legislation or date for implementation.

A fundamental part of Canada's taxation of corporate income is integration. The basic concept of integration is that an individual should pay the same tax if they earn the income personally or if it is earned in a corporation and distributed to them as a dividend. The basic approach of the system is to gross up the dividend by the tax that the corporation would have paid on the income (the dividend gross up) and then to credit the individual for the taxes paid on the dividend (the dividend tax credit). Before 2006 integration for active business income was only truly effective for income eligible for the small business deduction. Since the introduction of eligible dividends in 2006 integration has been expanded to cover all active business income earned in a corporation (including public companies).

The integration system works slightly differently for passive (investment) income. For passive income, it is not the intent that the tax on investment income be deferred by earning it inside a corporation. To address this situation a corporation pays a refundable tax that increases the tax rate on passive income to roughly the top personal tax rate (in BC in 2017 the corporate tax including the refundable portion is almost 2% higher than the top personal rate). When the corporation pays a dividend, the refundable tax is paid back to the corporation and the individual pays the tax on the dividend. If the individual is at the top marginal rate the tax on the dividend will be close to the dividend refund.

The adjustments for integration, including the refundable tax, are all Federal adjustments based on notional provincial tax rates and assuming the individual is at the top marginal rate. As a result, while integration has generally worked reasonably well, the effectiveness of integration varies depending on the province of taxation and the individual's level of income.

The Department of Finance paper is concerned about the ability of a corporation to pay tax at the low active business rate (currently 12.5% in BC) or even the top active business rate (currently 26% in BC) and invest the after-tax income of either the remaining 87.5% or 74.0% inside the corporation. In contrast, they believe that a salaried individual (again at the top marginal rate) would only have (in BC) 52.3% left to invest.

The Department of Finance believes that to put shareholders of private corporations on the same basis as salaried employees they need to eliminate the refund of the refundable portion of tax.

The following table shows the flow through taxation at three different income levels following the approach proposed by the Department of Finance. The first two levels show the impact on "middle income" taxpayers. In 2016 the Federal Government introduced a tax cut for middle income taxpayers. This reduced the marginal tax rate on income between $44,700 and $89,401 of taxable income ($45,916 and $91,831 in 2017 after indexing). For these examples, we used active business income of $46,000 and $92,000 for the "middle income" taxpayers and the top marginal rates for the high-income taxpayer (taxable income over $202,801 in 2017). In each case we compared the effective tax rate to the effective tax rate for a salaried employee at the same income level.

Active business income in 2017	Top marginal rate Over $202,801	$92,000 and $1,000 of investment income	$46,000 and $1,000 of investment income
Investment income	1,000	1,000	1,000
Corporate tax (non-refundable) at 49.67%	(497)	(497)	(497)
After tax income (and dividend to shareholder)	503	503	503
Tax on dividend at (assume ineligible of 40.95%, 29.94%, and 18.13%)	(206)	(151)	(61)
After tax cash to the individual	297	352	412
Effective tax rate	70.30%	64.80%	58.80%
Marginal tax rate if earned by an individual	47.70%	38.29%	28.20%
Incremental tax cost (extra tax) of earning income in company	**22.60%**	**26.51%**	**30.60%**

As this example shows, rather than being targeted at high income individuals, the lower the income the more punitive these changes will be.

An important part of the integration system is the capital dividend account (CDA). The non-taxable portion of capital gains is accumulated in a corporation's CDA. The corporation can pay a capital dividend out of CDA and that dividend will be tax free to the individual shareholder. This ensures that integration is also effective for capital gains. The Department of Finance proposes to eliminate CDA as well as the refundable tax.

The proposed changes in this area are also exceedingly complex and will require additional work to track the various pools and determine what the treatment is for each pool of income earned in a corporation. It is important to note that the proposal states that some form of grandparenting will be required for existing investments inside corporations. However, there is no discussion of how this would work (we will go out on a limb – it will likely involve a complex tracking of something and then figuring out what income is reasonably attributable to).

Finally, we believe that the proposals by the Minister of Finance and the Department of Finance are flawed[1] because they do not consider:

- An employee with a salary can invest in an RRSP. In that case they will defer all of the tax (not just 12.5% or 26%) and they will be able to split the income with their spouse when they retire.

- Salaried employees have benefits that are not available to self-employed individuals and, where these are provided through a private corporation, the shareholder pays the

[1] In addition to the matters discussed above, our comments also relate to the examples that the Department used in the proposal to support these changes.

full cost. Not the least of these is a defined benefit pension – employees of the Department of Finance should be familiar with them.

- For a small business, investing in passive investments inside the corporation is one of the most effective was to prepare for a cyclical business downturn. If the funds are withdrawn and invested in an RRSP they need to be withdrawn from the RRSP and put back in the company during a downturn. This triggers additional personal tax (on the RRSP withdrawal) and hence less cash to put into the company. If the funds are invested inside the corporation the company can sell the investments and put the cash back into the business with little current tax cost.

- For many businesses, especially in cities with high real estate prices, it is difficult to afford to acquire a building for the business. A common strategy is to purchase a building where the business can operate out of a portion and the balance can be rented out until the business needs the additional space. The rental income is taxed as investment income and hence these proposals would apply and would hurt growing businesses.

Converting Regular Income to Capital Gains

Over the years the tax rate on dividends and capital gains have rarely been the same. In 1999 BC's top tax rate on capital gains was 39.21 % and the top tax rate on dividends was 35.30%. Planning was to pay dividends before triggering a capital gain (other than one eligible for the capital gains exemption). In 2000 the capital gains inclusion rate was reduced from 75% to 66-2/3% to 50%. As a result, in 2001 the top tax rate on capital gains was 22.85% and the top rate on dividends was 33.08%. Planning after 2000 focused on reducing the dividends and increasing capital gains. The Department of Finance consultation paper addresses this issue with two proposed changes, both effective after July 17, 2017.

The first proposed change is to clause 84.1(2)(a.1). The anti-stripping rules in section 84.1 apply to transactions after May 22, 1985. Clause 84.1(2)(a.1) provides that when a taxpayer disposes of a share acquired from a non-arm's length person the cost base on the share is reduced by the amount of the gain on which the non-arm's length person claimed the capital gains exemption. For example, Dad sold 100 shares of OpCo to son for $100,000 and had a capital gain of $100,000. He sheltered the entire gain with the capital gains exemption. If son sells the shares his ACB will be reduced by the amount of the gain sheltered by Dad.

The proposed changes do two things:

- The non-arm's length requirement in respect to the acquisition of the shares is removed.

- The reduction is based on any gain on the share or a substituted share by either the taxpayer or an individual related to the taxpayer.

While the application of these rules to many routine situations are cause enough for concern, the apparent application to the death of a shareholder of a CCPC is very concerning.

On the death of a shareholder, the individual is deemed to dispose of the shares at their fair market value (FMV). The estate will acquire the shares with a cost base equal to FMV on death but paid up capital (PUC) remains unchanged. When the shares are redeemed the estate will have a deemed dividend equal to the FMV (assuming the shares are redeemed for the FMV) less the PUC. This will result in a capital loss on the disposition of the shares in the estate. Providing that the disposition happens within a year of death the loss can be carried back to the date of death return. The result is that the combination of the estate and the deceased will have paid total tax equal to a dividend on wind up.

If the company can not be wound up within a year, the date of death return will still include the capital gain on death. Unless other steps are taken the estate or the beneficiaries will also be taxed on the deemed dividend. The result is double tax on the same gain. The solution has been a "pipeline" that essentially involved selling the shares of the company to a new company where the shares had high ACB and high PUC. The two companies could be amalgamated and then the shares redeemed without a deemed dividend and hence just a single instance of tax. In order to meet the requirements of a pipeline the company had to continue operations for more than a year. The proposed changes would appear to eliminate the ability of an estate to take advantage of a pipeline and either require the estate to wind up the corporation within a year or to accept the double tax on the shares held at death.

The situation will be even worse when these changes are combined with the proposed changes to the tax on split income. If the shares of the deceased are shares to which the tax on split income applies (for example growth shares owned by a spouse), the capital gain on death will be taxed as split income. As a result, there will be no capital gain to apply the loss in the estate to and since a "pipeline" will no longer be an option the share redemption will be taxed as a deemed dividend (assuming the tax on split income can not be applied to the estate). This will mean 47.7% tax on the gain on the date of death return and 40.95% tax (at the top rate) in the estate on the deemed dividend. The total tax will be 88.65%

The second proposed change is the addition of a new anti-avoidance rule in respect to stripping of retained earnings. As with the income sprinkling provisions these rules are very broadly drafted and would appear to apply to routine transactions. The new rule would deem payments received by an individual to be a taxable dividend. The rule applies if, among other things, it was received from a person (individual, corporation, or trust) with whom the individual was not dealing at arm's length, as part of a series of transactions that was a disposition of property or an increase in PUC (which as discussed above would reduce subsequent deemed dividends), and "it can be reasonably considered that one of the purposes was to reduce the assets in a private corporation such that "any part of the tax otherwise payable….is avoided.". The test only requires that it be one of the purposes and the Department of Finance notes with the draft legislation state that it could apply to "cash received under a loan.". A related provision would also remove any portion of a gain that was part of the series of transactions from the company's CDA and have the non-taxable half of the capital gain taxed as a dividend.

As noted above, all of the proposed legislation in respect to converting income to capital gains is effective for transactions after July 17, 2017.

In conclusion, the proposed changes to the tax planning strategies used by CCPCs would result in a significant increase in taxes paid by all owners of small businesses in Canada, not just high-income earners. This additional tax would reduce the ability of small business owners to invest in their companies and grow their businesses.

We encourage all of our clients to write to their member of parliament expressing their concerns over these potential changes. A sample letter can be found here:

Submissions can be sent to: fin.consultation.fin@canada.ca. The deadline for submissions is October 2, 2017.http://DraftLetterToMP-PM-or-MinisterOfFinance-Sept2017.docx

A list of all Members of Parliament by constituency is available at https://www.ourcommons.ca/Parliamentarians/en/constituencies if you select the member of parliament the full contact information, including email address, is available on the website.

The Department of Finance paper is available at: www.fin.gc.ca/activity/consult/tppc-pfsp-ng.asp At the time of writing it was also on the Department of Finance home page.

Other References

While this document may appear to be a detailed review, it is at best a high-level summary. Most of the major accounting and tax law firms have papers on their website in respect to these proposals. For additional information and analysis we recommend these excellent resources:

Moodys Gartner Tax Law LLP in has written some papers and blog entries on this topic. These are available on their website at www.moodysgartner.com then select “blog.”

Yale & Partners LLP, CPA’s has posted a letter they sent to the Minister of Finance on theses issues on their website. This is available at www.yaleandpartners.ca then select “blog” and see “Trudeau’s Proposed Tax Changes Devastating for Small Businesses: A letter to the Department of Finance.

Karen Stillwell at Connors Stilwell wrote a post on what questions a real consultation should include. It can be found at www.connorsstilwell.com then select “blog.”. The post in question was posted August 10, 2017.