VIRTUS GROUP

Chartered Professional Accountants & Business Advisors LLP

Proposed Changes to Tax Planning Using Private Corporations –What Does This Mean for You and Your Client?

Laurie Hudema, CPA, CA

Clint Gifford, CPA, CA

Sept 26, 2017

value · worth · expertise

Overview of Major Changes Proposed

- "Income Sprinkling" with related parties
  - How the rules work now and what the proposed changes mean
- Use of the Capital Gains Exemption
  - Common planning situations now and proposed restrictions
- Avoiding Dividends with non-arm's length parties
  - Scenarios affected and what to watch for
- Passive investments in private corporations
  - Offsetting active business tax rates on inactive assets

Refresher - Marginal Tax Brackets

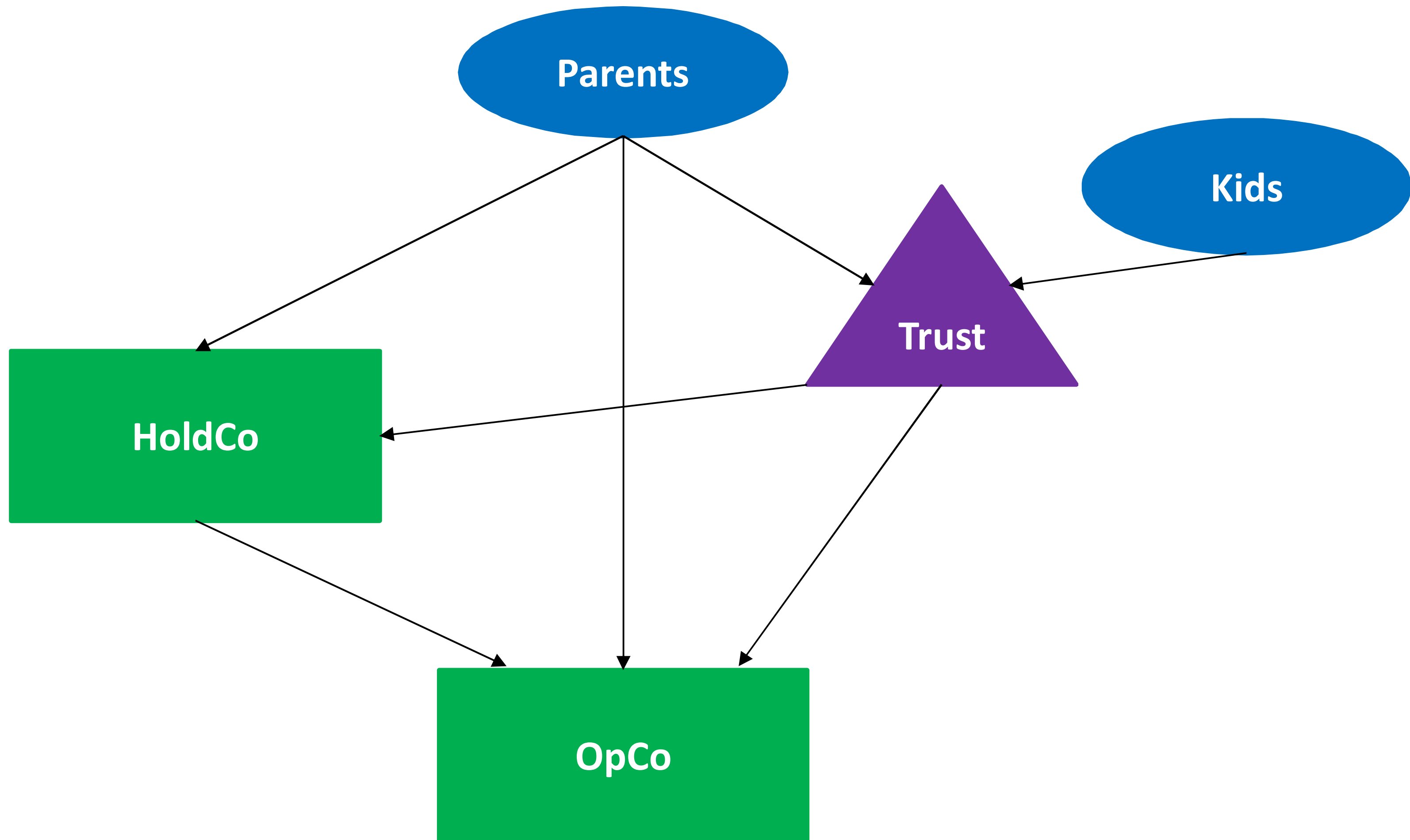
0%	Income up to about $12,000
26%	Income up to about $46,000
33.5%	Income up to about $92,000
39%	Income up to about $142,000
44%	Income up to about $203,000
47.75%	Income over $203,000

- Capital gains at 50% of regular income
- Dividends max at 30.33% (eligible), 39.62% (ineligible)

Income Sprinkling - The Advantage

- Medical professional earns $350,000 after expenses in Saskatchewan, spouse does not work and two kids in post-secondary education
  - Unincorporated – $137,400 in tax and CPP
  - Incorporated and sole shareholder - $133,187 (no CPP)
  - 2 Shareholders equally - $110,557
  - 4 Shareholders equally - $82,940
- $54,460 less tax, saves over 15%
- Average tax rate of 23.7%

Common Structure



The Current Rules

- S.120.4 of the Income Tax Act applies the highest marginal tax rate on “split income” earned by taxpayers
  - Currently non-listed corporate dividends and shareholder benefits, partnership income or trust income when earned from a related entity, capital gains on sales to related parties
  - Does not apply to wages, some interest, capital gains on sales to third parties and “second generation” income
  - Only applied to individuals under the age of 18
    - Informally known as the “kiddie tax”
  - Technically referred to as “Tax on Split Income” or TOSI

Proposed Changes – a Wider Net

- Removal of the age exclusion
- Expansion of definition of individuals that would be considered related
- Expansion of types of taxable income that would be considered "split income"
- Introduction of "reasonableness test" that would allow some amounts to be paid at marginal rates
- Particularly restrictive for individuals aged 18-24
- Effective after Dec 31, 2017

What does that mean?

- Virtually all amounts paid to extended family members from private corporations will potentially be subject to the highest marginal tax rates
  - Post-secondary students from 0% to 40% tax on dividend
- Only significant exemption is for "reasonable amounts"
  - Based on four factors:
    1. Labour contributions
    2. Asset contributions
    3. Business risks assumed
    4. Historical amounts paid

What does that mean? – Cont'd

- Individuals 18-24 have further restrictions on amounts considered reasonable
  - Asset contribution and risk return may be limited to 1%
- Capital gains from property will also be considered "split income" if income from the underlying property would have been considered as such

Restrictions on Capital Gains Exemption

- Current rules allow for non-"contributing" shareholders to claim their CGE on qualified corporations or partnership interests
  - Inactive spouses and family members, whether direct owners or through a family trust, can receive a tax-free capital gain on the sale
  - $835K for certain business corporations, $1M for qualified farm property

Restrictions on CGE Claims

- Proposed changes would eliminate ability to claim the CGE on:
  - Property disposed of by most trusts
  - Property that would have given rise to “split income”
  - Gains accrued while property was held by trust, even if not disposed of by trust
  - Gains accrued while the taxpayer realizing the gain was under 18 years old
- Election permitted to realize gain in 2018 under old rules
- Changes apply after Dec 31, 2017

2018 Elective Deemed Disposition

- Taxpayers can voluntarily elect to recognize accrued gains in 2018 to “crystalize” tax value that can be used to reduce taxes in the future
  - Must be careful, as use of the CGE can result in Alternative Minimum Tax owing in some situations
  - Election has potentially significant penalties if made late, or if valuation of asset elected on is too high
  - Holding period requirement has been reduced to 12 months from regular 24 month time frame

Corporate Distributions as Dividends

- Maximum tax rate on ineligible dividends is currently 39.62%
  - maximum tax rate on capital gains is 23.87%, eligible dividends is 30.33%, capital dividends and returns of capital are 0%
  - Strategies for reporting income that is not taxed as ineligible dividends have been attacked by CRA in the past
  - Sometimes referred to as “surplus stripping” and has been decided by the Supreme Court that it is not offensive to the scheme of the Income Tax Act
- Current rules convert tax cost from related party CGE claims to dividends

Expanded Deemed Dividends

- Proposed changes would expand the situations where tax cost on assets is converted to dividends
  - Any “non-arm’s length” capital gains realized in the past, whether the CGE was claimed or not, would potentially create a dividend
  - Fortunately only applies to shares of an individual being sold to a non-arm’s length corporation
  - Does not distinguish between “insider deals” (which are considered elsewhere in the ITA) and actual market value transactions
- New rules were effective on July 18, 2017 but existing tax cost base from prior transactions is also affected

Two Major Flaws

These changes will cause major trouble for:

1. Families attempting to pass incorporated businesses from one generation to the next
   - Family member purchasers will be at a disadvantage compared to others (public companies, foreign buyers) due to increased tax burden
   - Particularly troubling to farm corporations with long history of family involvement and sizable ability to reduce tax with CGE
   - Potentially some further consideration will be given to this issue to at least reduce the family disadvantage

Two Major Flaws

These changes will cause major trouble for:

2. Executors and beneficiaries of estates with shares of private corporations

   - Capital gains will be realized on the value of the shares at the time of death, plus dividend tax may be payable on same value when shares are distributed
   - Current rule has strict 12 month deadline to avoid this double tax but complex estates or arguing beneficiaries would often be unable to meet this deadline
   - Only applies to corporate shares, not other assets on death

General Surplus Stripping Rule

- An entirely new rule was also proposed that makes dividends the default method of extracting corporate funds
  - Assumed to be in response to Supreme Court decisions saying that this was not the express intent of the Income Tax Act
  - Very broadly worded, and potentially affects a wide variety of everyday business transactions including sale of assets to a corporation, borrowing funds from a corporation and declaring a capital dividend to shareholders
  - Many in the tax community believe this will be one area that will be adjusted as a result of the consultation period
- Related proposal could affect CDA accounts from prior periods

Income on Passive Investment

- The least defined but most disruptive of the proposed changes
- Based on the concept that the deferral of taxation in private corporations provides an unfair advantage for accumulating wealth
- Current corporate tax system
  - Active income – 12.5% on up to $500,000 per year
  - 27% on active income not eligible for the lower tax rate
  - Passive income – 50.67% up front with 30.67% refundable

Corporate Tax System (SK)

- Corporate tax on active income
  - 12.5% on up to $500,000 per year
  - 26.75% on active income not eligible for the lower tax rate (M&P income has a slightly reduced rate)
- Corporate tax on passive income
  - 50.67% up front with 30.67% refundable – interest, rent, foreign income or dividends
  - 25.33% up front with 15.33% refundable – capital gains
  - 38.33% up front with 38.33% refundable - Canadian dividends
- Refundable portion received when individuals report dividends

Suggested "Solutions"

- Option 1 – "the 1972 approach"
  - Additional tax would be paid on active business profits that were subsequently used to purchase passive assets so that total taxes paid were similar to personally earned income at highest rate
  - Income on earnings from passive investments still subject to current system with high initial tax rate and later refund after dividends paid
  - Initial tax on funds invested in passive assets would also be refundable if funds were later used for active business purposes
    - Appears to require change in use prior to refund being given, so cash flow would be a definite concern
  - Was introduced in 1972 and quickly repealed retroactively

Suggested "Solutions"

- Option 2 – "Deferred taxation"
  - Refundable portion of income tax on earnings from passive investments would be removed
  - Requires tracking of source of funds invested in passive investments to ensure only income previously taxed at lower active business income rates is subject to increased passive tax rate
    - Differentiate between lower and general active business rates
  - Also requires changes to "eligible" dividend rules so that only income earned on assets generated from higher initial tax rate income is available for lower personal tax rate
  - Non-taxable portion of capital gains would not be added to CDA

Deferred Taxation Option Issues

- Tracking the tax status of the source of funds used to purchase passive investments would be difficult
- Suggested options to simplify are:
  - Apportionment – the amount of the various sources of invested funds – low active rate taxed income, general active rate taxed income and full tax rate income – would be pro-rated to the total amount of passive income earned
    - Pro-rated income would create “pools” that could have dividends paid out to shareholders that would attract different levels of personal tax
  - Elective – companies would default to not generating any amounts for declaring eligible dividends but could elect out of that treatment
    - Would then be able to declare eligible dividends, but would not have access low active tax rate and would pay a higher tax rate on passive income with no refundability

Deferred Taxation Option Issues

- Passive corporation election – these corporations do not have any advantage under the current system unless income is taxed at the active rates
  - Additional funds received as dividends from active companies would be subject to additional refundable taxes to ensure no advantage

Other Considerations

- Huge amounts of capital are already held and invested in private corporations, any of these possible changes would be a massive change to current planning
  - Government has stated that they only intend to apply the rules on a go-forward basis – but it appears income on those existing investments would be caught
- No time frame has been suggested, but n period ends on October 2nd

What do we do now?

- Prior to January 1, 2018?
  - Maximize dividend sprinkling in 2017
  - Transfer shares out of trust to extent of not doing CGE election in 2018
  - If going to use the CGE election, planning to ensure shares qualify for CGE
  - Review status of estates with CCPC's to ensure can meet one year deadline for 164(6) loss carry-back
- Other?
  - Article amendments and share exchanges to give shareholders separate classes of shares for dividends
  - Continue to build up passive assets in corporations
  - Switch back to wages to family members
  - Wind-up of extra CCPC's in a corporate group originally set up for dividend sprinkling

Questions?

For more information contact us!

Laurie Hudema, CPA, CA
Tax Partner - Regina
lhudema@virtusgroup.ca

Clint Gifford, CPA, CA
Tax Partner - Saskatoon
cgifford@virtusgroup.ca

Saskatoon Phone: 306-653-6100
Regina Phone: 306-522-6500
www.virtusgroup.ca

Thank You!