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# Canadian Federal Tax Reform
# How Will It Affect Your Business?

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Audit.Tax.Consulting.Financial Advisory.

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# Agenda

- Background - How did we get here?;
- July 18, 2017 – original proposals;
- Overview of perceived "abuse" proposed measures were meant to target;
- Overview of surplus stripping proposals that were retracted;
- Proposals to deal with "income sprinkling";
- Proposals to deal with passive income earned in a Canadian Controlled Private Corporation;
- Reduced small business tax rate to 9% Federally, and 3.5% in Ontario;
- Next steps; and
- Questions.

# How Did We Get Here

- Budget 2017 – Government indicated that it intended to release a paper setting out the nature of various tax issues it identified in its review of federal tax expenditures, and its proposed policy responses;
- Specifically they were concerned with “sprinkling income using private corporations”, holding of passive investments in a private corporation, and the conversion of a private corporation’s regular income into capital gains.

# July 18, 2017 – Original Proposals

- On July 18, 2017 Government released a “consultation paper” and invited submissions up until October 2nd (76 days);
- There was quite a bit of rhetoric – terms such as “loopholes”, “fair share of taxes”, etc.;
- The “consultation paper” included very detailed draft legislation for two of the topics introduced – income sprinkling and conversion of dividends to capital gains.
- The only piece that appeared to be a true consultation paper was the request for input and alternatives to deal with passive income being earned in a CCPC (with the assumption that there was an issue to begin with);
- What followed was an unprecedented response resulting in over 21,000 submissions

# What Were the Perceived Abuses?

- “Income sprinkling” – expansion of the Tax on Split Income Rules (“TOSI”) i.e. “Kiddie Tax”;
- “Multiplication” of the Capital Gains Exemption (“CGE”);
- Conversion of regular income into capital gains – “surplus stripping”; and
- Earning investment income through a private corporation;
- They have since abandoned the proposed legislation relating to the CGE and surplus stripping, but have we heard the last on this? I doubt it – most likely more to come;
- They have since “loosened” the proposed rules on income sprinkling and earning investment income through a private corporation, but have they done enough? Should they abandon these proposals altogether and seek a proper consultation on the tax system as a whole – i.e. Carter Commission 2.0?

# Surplus Stripping – More to Come?

- During the “Santa Clause” week of press releases from October 16th through the 20th it was announced that the surplus stripping proposals were abandoned;

- Most likely to be revisited – there’s an even larger variance between dividend rates and capital gains rates providing an even greater incentive to strip surplus at more favorable tax rates

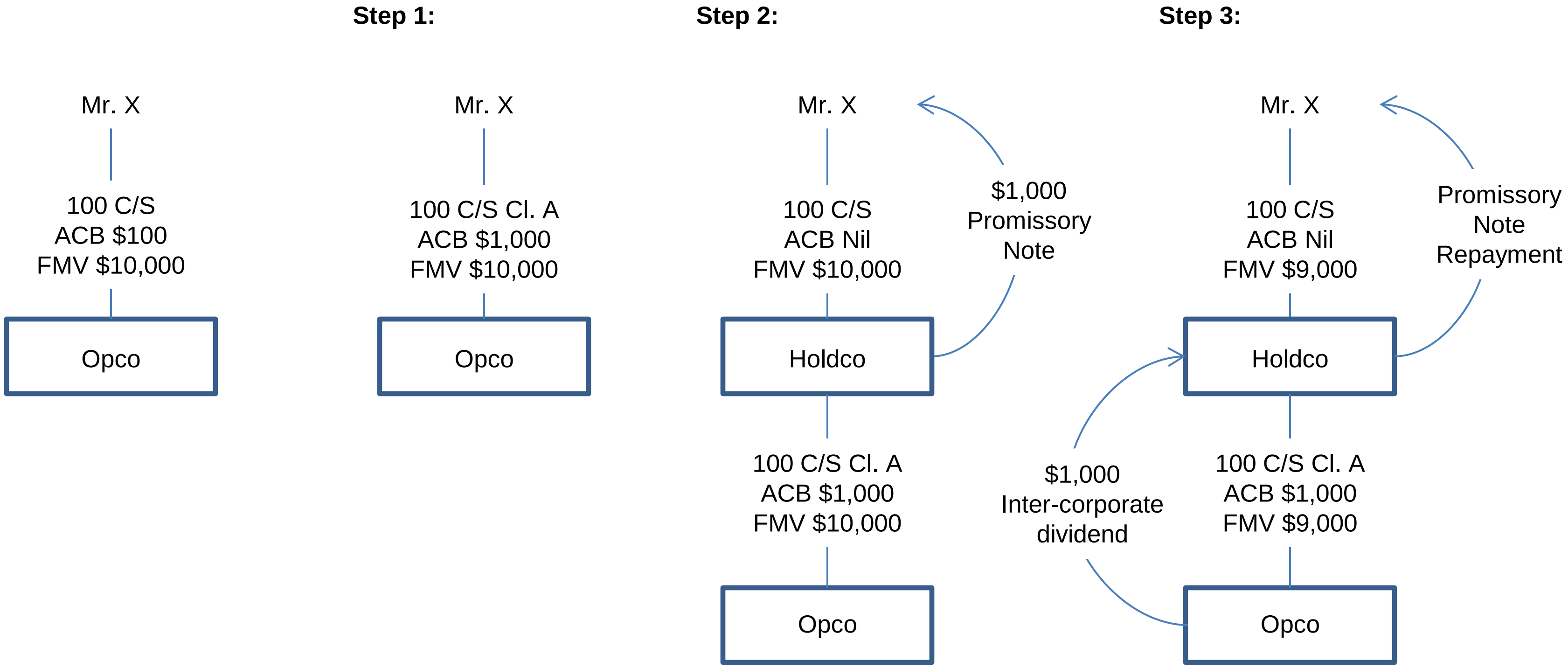
# Surplus Stripping – Mischief Example #1

- Finance was trying to catch individuals that were extracting surplus at capital gains rates effectively converting dividends into capital gains;

- This was accomplished as follows:
  - Taxpayer owns shares of a corporation (“Opco”) and exchanges those shares for a different class of shares and elects to trigger a capital gain on the exchange pursuant to Section 85 of the Act;
  - Taxpayer then sells the exchanged shares to a Holdco for a promissory note;
  - Opco pays a tax free inter-corporate dividend to Holdco and Holdco uses the funds to repay the note;
  - Resulting in the retained earnings (i.e. surplus) of Opco being extracted at capital gains rates.

- Previously CRA had commented that this type of transaction could have been subject to GAAR;
- To deal with this Finance had introduced changes to Section 84.1 of the Act;
- Again, proposed changes were abandoned as they were too far reaching and impacted other legitimate tax planning and also inter-generational transfers.

# Surplus Stripping – Mischief Example #1

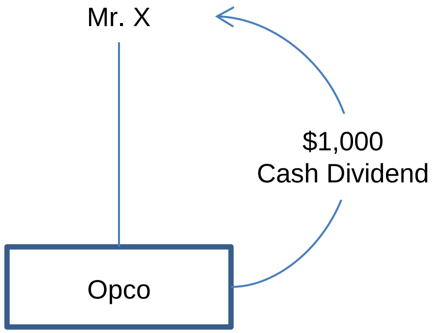

Step 1:
Step 2:
Step 3:
Mr. X
100 C/S
ACB $100
FMV $10,000
Opco
Mr. X
100 C/S Cl. A
ACB $1,000
FMV $10,000
Opco
Mr. X
100 C/S
ACB Nil
FMV $10,000
$1,000
Promissory
Note
Holdco
100 C/S Cl. A
ACB $1,000
FMV $10,000
Opco
Mr. X
Promissory
Note
Repayment
100 C/S
ACB Nil
FMV $9,000
Holdco
$1,000
Inter-corporate
dividend
100 C/S Cl. A
ACB $1,000
FMV $9,000
Opco

# Surplus Stripping – Mischief Example #2

- Finance also introduced a new anti-surplus stripping rule under proposed Section 246.1 of the Act that was meant to prevent the conversion of a private corporation's surplus into capital gains;
- It deemed an amount received or receivable, whether directly or indirectly, by an individual to be a taxable dividend received in the year;
- If a portion of the amount received came out as a capital dividend, the provision also ground the corporation's CDA

# Surplus Stripping – Mischief Example #2

**Scenario #1:**



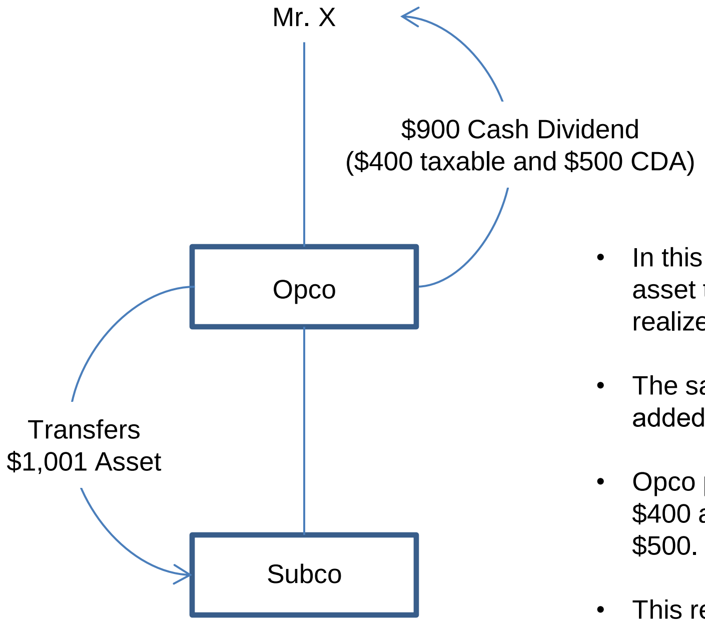
Mr. X

$1,000
Cash Dividend

Opco

- Assume Opco has $1,000 of cash and also has a capital asset with a FMV of $1,001 and an ACB of $1
- Under this scenario, the cash dividend would result in approx. $450 of tax at top rates in Ontario
- Mr. X is left with $550 of after tax cash.

**Scenario #2:**



Mr. X

$900 Cash Dividend
($400 taxable and $500 CDA)

Opco

Transfers
$1,001 Asset

Subco

- In this scenario Opco sells its asset to Subco for $1,001 and realizes a $1,000 capital gain
- The sale results in $500 being added to Opco’s CDA.
- Opco pays a taxable dividend of $400 and a capital dividend of $500.
- This results in approximately $180 of personal tax and $100 of non-refundable corporate tax, or total taxes payable of $280 versus $450 in scenario #1
- Mr. X is left with $720 of after tax cash

# Surplus Stripping – More to Come?

- There were other variations of the previously noted plans; however, the main concept was to strip surplus at capital gains rates as opposed to much higher dividend tax rates;
- The proposed draft legislation introduced in the summer went too far and created too many unintended consequences;
- After much push back the proposed legislation was abandoned, at least for now;
- In my opinion this will be short lived and we will hear more in this area. The hope is that they engage with the tax community at large to come up with the right approach to deal with the more aggressive, perhaps offensive planning, while leaving legitimate planning intact.

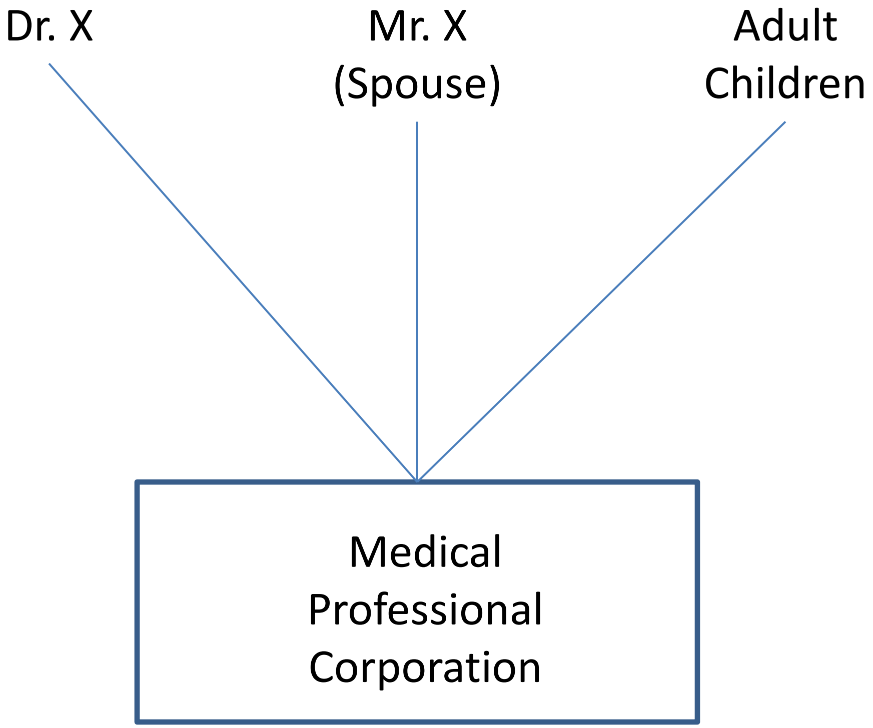
# “Income Sprinkling” – Expansion of the TOSI Rules

- The current TOSI rules are more commonly known as the “Kiddie Tax” rules. As it currently stands, the Kiddie Tax applies to a “specified individual” which is currently defined as a minor (i.e. < 18 years of age) with a Canadian resident parent;
- Kiddie tax currently applies to “split income”, which essentially includes, among other things, dividends from private corporations;
- Under the proposed rules, the definition of “specified individual” will be expanded to include adults;
- In addition, the definition of “split income” will also be expanded to include debt, capital gains, and reinvested split income;
- There are also new definitions being introduced such as “connected individual”, “related source”, and “split portion”.

# “Income Sprinkling”: Expanded Definition - Specified Individual

- A Canadian resident individual related to another Canadian resident individual (not a trust) where three preconditions are met:
  - The first individual's income includes income from property, Section 15 or 246 benefits (i.e. appropriation of property from a corporation), or a taxable capital gain from the disposition of property;
  - It can reasonably be considered that the income or gain is derived from a business; and
  - The business is carried on by: (i) the other individual; (ii) a corporation in which the other individual is a specified shareholder or a **“connected individual”;** (iii) a partnership or trust if the other individual is engaged in the business; or (iv) a partnership in which the other individual has an interest.

# Expanded Definition - Specified Individual Illustrated


Dr. X
Mr. X (Spouse)
Adult Children
Medical Professional Corporation

In this scenario, everyone is a specified individual!

# TOSI – New Terms: Connected Individual

- Extends the concept of a specified shareholder to an individual who:
  - Has de facto control or is a member of a related group that has de facto control;
  - Owns 10% of the equity of the corporation (including options or other property deriving its value from shares of the corporation);
  - Owns any level of shares of a services business if:
    - The services are primarily carried on by the individual or the income is primarily generated by the individual; or
    - If the service business requires statutory authorization (i.e. a professional corporation), the individual performs any of the services;
    - Owns 10% of the equity of the corporation (including options or other property deriving its value from shares of the corporation);
  - Owns any level of shares or property that derives its value from such shares and the individual has funded 10% of the underlying business through shares, debt or transfers of property at less than FMV.

# TOSI – Split Income – As it Currently Stands

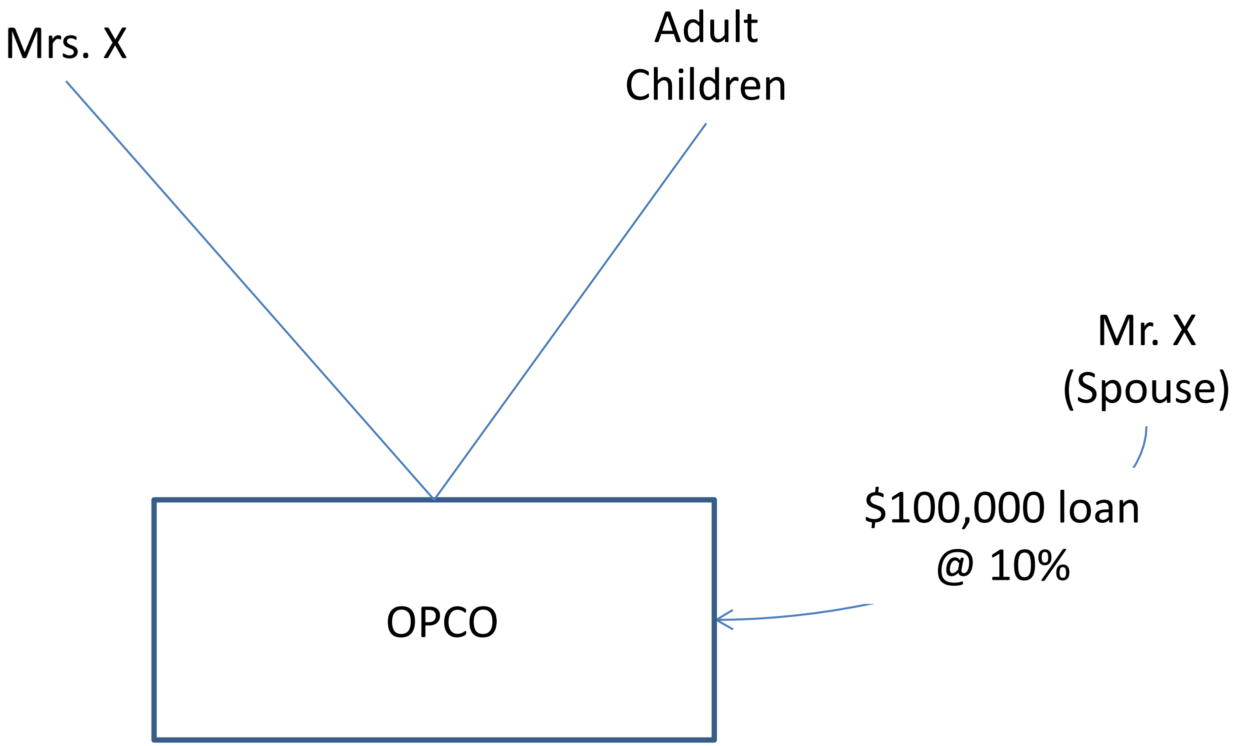
- Under the current TOSI rules split income includes:
  - Dividends and Section 15 income inclusions (i.e. shareholder benefits) from private corporations;
  - Partnership income derived from a related source and trust allocations of trust income in the form of dividends, Section 15 benefits and income allocations from a related source;
  - Income from a business of, or the rental of a property by, a partnership or trust if a related person is actively engaged on a regular basis in the activities of the partnership or trust; and
  - Capital gains from the transfer of private company shares to a non-arm’s length person, whereby the capital gain is treated as a ineligible dividend and taxed as such at the top marginal rate

# TOSI – Split Income – Expanded Definition

- Split income continues to include all of the items previously listed and is expanded to also include:
  - Income from a debt obligation of effectively a private corporation, if it is derived from a related source or paid from a corporation with a related specified shareholder or connected individual;
  - Taxable capital gains from: (i) the sale of private company shares, or (ii) an interest in a partnership, a trust, or a debt obligation if an amount has been included in split income in respect of that share/interest, or if the FMV of the property is derived from shares of a private corporation – will this claw back access to the CGE?;
  - Section 246 benefits (i.e. benefits conferred on a person);
  - Reinvested split income which is income of an individual under the age of 25 that is derived from split income, attributed income and capital dividends.

# Split Income – Debt Obligation of a Corporation

The interest from Mr. X's loan will be considered split income



Mrs. X

Adult Children

Mr. X (Spouse)

$100,000 loan @ 10%

OPCO

# TOSI – Excluded Amount – Expanded Definition

- Split income does not include an “excluded amount”;
- Excluded amount for minors has not changed and generally means income from, or the taxable capital gain realized on the disposition of, a property acquired as a consequence of the death of a parent of the minor;
- For anyone else over the age of 18 the excluded amount is any amount that is not a “split portion” – another newly defined term.

# TOSI – New Term – Split Portion

- Split portion includes all reinvested split income
- For all other amounts you must consider a three part test (which may change under new proposals) which looks at:
  - Relationship between the payor and the recipient of the income;
  - The nature of the underlying business; and
  - Whether or not the payment is “reasonable” (again, this may change).

# TOSI – Final Thoughts

- Revised legislation is expected to be released later this fall (perhaps toward the end of November);
- Comments had been made by Finance during the "Santa Clause" week that the TOSI proposals would be amended but there is still much uncertainty. It's not clear if there will still be a reasonableness test as there was mention of a test relating to a significant contribution;
- What would be more useful and would simplify the rules would be a bright line test as opposed to a subjective test as initially announced. Finance has said it will look at using a bright line application to the rules;
- Many have suggested to scrap the July 18th proposals on TOSI and simply introduce similar rules to that of the US, which uses a bright line application for adult children up to the age of 24;
- If not amended will the new TOSI rules claw back access to the CGE notwithstanding that Finance abandoned its proposed legislation on CGE?

# Passive Income Earned Through a Private Corporation

- Finance has argued that entrepreneurs that carry on their business through a corporation have an unfair advantage over a salaried employee as the incorporated entrepreneur is able to accumulate a greater amount of savings over time given that they enjoy the benefit of a tax deferral due to low corporate tax rates;
- For example, Ontario's top marginal tax rate for individuals is 53.53% while the small business corporate tax rate is currently15% and the general rate is 26.5%;
- Therefore, a salaried individual is only able to invest $46.47 of after tax income whereas a small business owner is able to invest between $73.50 to $85.00;
- Finance argues that the tax deferral conferred on private corporations “was never intended to be used to realize higher personal savings”;
- There have been many arguments made against this assertion, most recently the Owens MacFayden Group prepared a very comprehensive analysis comparing a business owner to a salaried worker over their lifetimes to disprove claims made by Finance

# Example Provided by Finance

| | Salaried Individual | Corporation |
|---|---|---|
| **Source of Capital** | | |
| Income | $ 100,000.00 | $ 100,000.00 |
| Federal tax | $ 33,000.00 | $ 15,000.00 |
| Provincial tax | $ 17,367.00 | $ 11,700.00 |
| **Net funds remaining:** | $ 49,633.00 | $ 73,300.00 |
| | | |
| **Return on Investment in Yr 1** | | |
| Interest @ 3% | $ 1,489.00 | $ 2,199.00 |
| Non-refundable tax | $ 750.00 | $ 433.00 |
| Federal tax | $ 491.00 | $ 176.00 |
| Provincial tax | $ 259.00 | $ 257.00 |
| Non-refundable tax (New system) | $ - | $ - |
| Refundable taxes (RDTOH) | $ - | $ 674.00 |
| **After-tax investment proceeds reinvested:** | $ 739.00 | $ 1,092.00 |
| | | |
| **Portfolio value after 10 years** | $ 57,539.00 | $ 84,975.00 |
| Refund of pre-paid tax (RDTOH) | $ - | $ 7,214.00 |
| Eligible dividend paid | $ - | $ 73,300.00 |
| Ineligible dividends paid | $ - | $ 18,889.00 |
| Personal tax on dividends paid | $ - | $ 31,603.00 |
| **Net remaining capital** | **$ 57,539.00** | **$ 60,586.00** |

# Passive Income Earned Through a Private Corporation

- Finance’s example was meant to illustrate the perceived advantages of operating through a corporation under the current rules;
- Unfortunately there were many points excluded from their analysis – i.e. the provincial rates used were not actual provincial rates. Many provinces are under-integrated on passive income being earned through a corporation (i.e. there’s a tax cost) – in Ontario that tax cost is currently 2% and will be increasing to 4% by 2020;
- At what point does the deferral advantage offset the under-integration?;
- What assumptions were made? What other factors were considered?

# Passive Income Earned Through a Private Corporation

- Various alternatives were put forward by Finance to deal with this perceived advantage, specifically the Deferred Taxation Approach which uses two methods:
  - Apportionment method
  - Elective method
- In all cases the intention is to essentially remove the refundable tax mechanism on passive income earned from active business earnings that were previously taxed at low corporate rates;
- Moreover, dividends from public companies would no longer be added to GRIP, non-taxable portion of capital gains would no longer be added to CDA;
- Under apportionment method would have to align tax treatment of passive income distributed as dividends with earnings used to fund the investments

# Apportionment Method

- Under this method the corporation will need to track three separate pools and would have to apportion annual passive income earned to the three pools;
- Three potential treatments for dividends:
  - Pool #1: Small Business Income Pool – ineligible dividends
  - Pool #2: General Rate Income Pool – eligible dividends
  - Pools # 3: Shareholders' Contribution Pool – tax-free capital dividends

# Apportionment Method - Example

| | SBIP | GRIP | SCP | Total |
|---|---|---|---|---|
| Paid-up capital | | | $ 100,000.00 | $ 100,000.00 |
| Net after-tax income year 1 | $ 425,000.00 | $ 73,500.00 | $ - | $ 498,500.00 |
| Balances @ end of year 1 | $425,000.00 | $ 73,500.00 | $100,000.00 | $ 598,500.00 |
| | 71.01% | 12.28% | 16.71% | 100.00% |
| | | | | |
| Investment income year 2 | | | | $ 8,000.00 |
| Tax @ 50.17% | | | | $ 4,013.60 |
| Net passive income allocated prorata | $ 2,830.78 | $ 489.56 | $ 666.07 | $ 3,986.40 |
| Net after-tax income year 2 | $ 425,000.00 | $ 73,500.00 | | $ 498,500.00 |
| Balances year 2 | $ 852,830.78 | $ 147,489.56 | $ 100,666.07 | $ 1,100,986.40 |
| | | | | |
| **Distributions:** | | | | |
| Return of capital | | | $ 100,000.00 | $ 100,000.00 |
| Capital dividend | | | $ 666.67 | $ 666.67 |
| Ineligible dividend | $ 852,830.78 | | | $ 852,830.78 |
| Eligible dividend | | $ 147,489.56 | | $ 147,489.56 |
| | | | | |
| | | | | |

# Elective Method

- Under this method the corporation would be subject to a default tax treatment unless it elects otherwise – i.e. assumes that all corporate earned passive income is derived from retained earnings subject to the small business rate, therefore all dividends are ineligible;
- Corporation would be able to elect to have all dividends paid out as eligible dividends, but will lose access to the small business rate;
- There would be a further election for investment holding corporations such that all income is taxed as passive investment income, and where shareholders are not individuals, amounts transferred inter-corporately would be subject to an additional refundable tax (to bridge the gap between corporate tax rates and personal tax rates)

# Passive Income – Final Thoughts

- Finance has pushed this out to the 2018 budget, probably sometime in March, 2018 so expect new legislation to be introduced then;
- During the “Santa Clause” week Finance said it will consider submissions that were made and will include a one size fits all $50,000 annual passive income exemption. Finance also indicated that it would “grandfather” all existing retained earnings and any passive income earned on those existing retained earnings, and lastly, there will be concessions for “Angel Investors”;
- There is still much uncertainty around these rules – i.e. what will be included in passive income? Capital gains on the disposition of a subsidiary’s shares? Gains on the disposition of real estate?;
- How many pools will be needed to be created under the new legislation? By some counts upward to 13 separate pools – i.e. the three pools introduced earlier, pre-2018 capital, post 2017 income from pre-2018 reinvested capital and many more;
- The proposed rules are extremely complex not only to legislate but more importantly to administer in practice.

# Reduction to the Small Business Tax Rate

- During the "Santa Clause" week Finance revealed that it was going to lower the small business tax rate from 10.5% currently to 10% on January 1st, 2018 and then to 9% on January 1st, 2019;
- More recently, Ontario also introduced a reduction to the Ontario small business tax rate from the current 4.5% down to 3.5% effective January 1, 2018;
- As previously noted, this will ultimately increase the top marginal tax rate on ineligible dividends from the current rate of 45.31% up to over 47.5%, resulting in a full flow through tax rate on passive income earned through a corporation of over 57.8% versus 55.4% currently;
- This is arguably bad policy as it exasperates the very problems Finance is currently concerned with

# Next Steps

- There is still a lot of uncertainty surrounding these rules. We hope to at least have greater clarity on the TOSI rules later this fall;
- We have not heard the last on surplus stripping. The spread between the tax rate on dividends and capital gains has increased. More incentive for more aggressive planning? Will Finance look to change the inclusion rate of capital gains from 50% to 75%?
- For 2017 it may make sense to maximize dividend sprinkling to take advantage of the tax savings perhaps one last time. We are told that the new TOSI rules will not come into effect until January 1, 2018;
- In terms of paying dividends one should also consider unused RRSP room as RRSP deduction is not available against TOSI income;
- May want to consider crystallizing capital gains exemptions in 2017 where possible. Notwithstanding that Finance abandoned the CGE proposals, there could still be a claw back of CGE where TOSI applies;
- Accelerate recognition of income where possible – Finance has said that all historical retained earnings will be grandfathered as will any income earned on those retained earnings. Is there a competing interest with paying dividends versus keeping retained earnings? Perhaps tax savings outweighs the deferral.

# Questions?

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