

FEI Latest Private Company Developments

What are the latest developments affecting
private companies?

November 20, 2018



Welcome



Introduction



**Tax on Split
Income**



**2018 Federal
Budget
Highlights**



**US Tax
Reform**



**Wayfair:
The Case
and What it
Means**



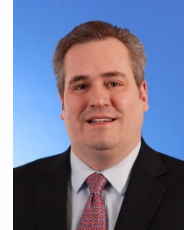
Q&A



Your Presenters for Today



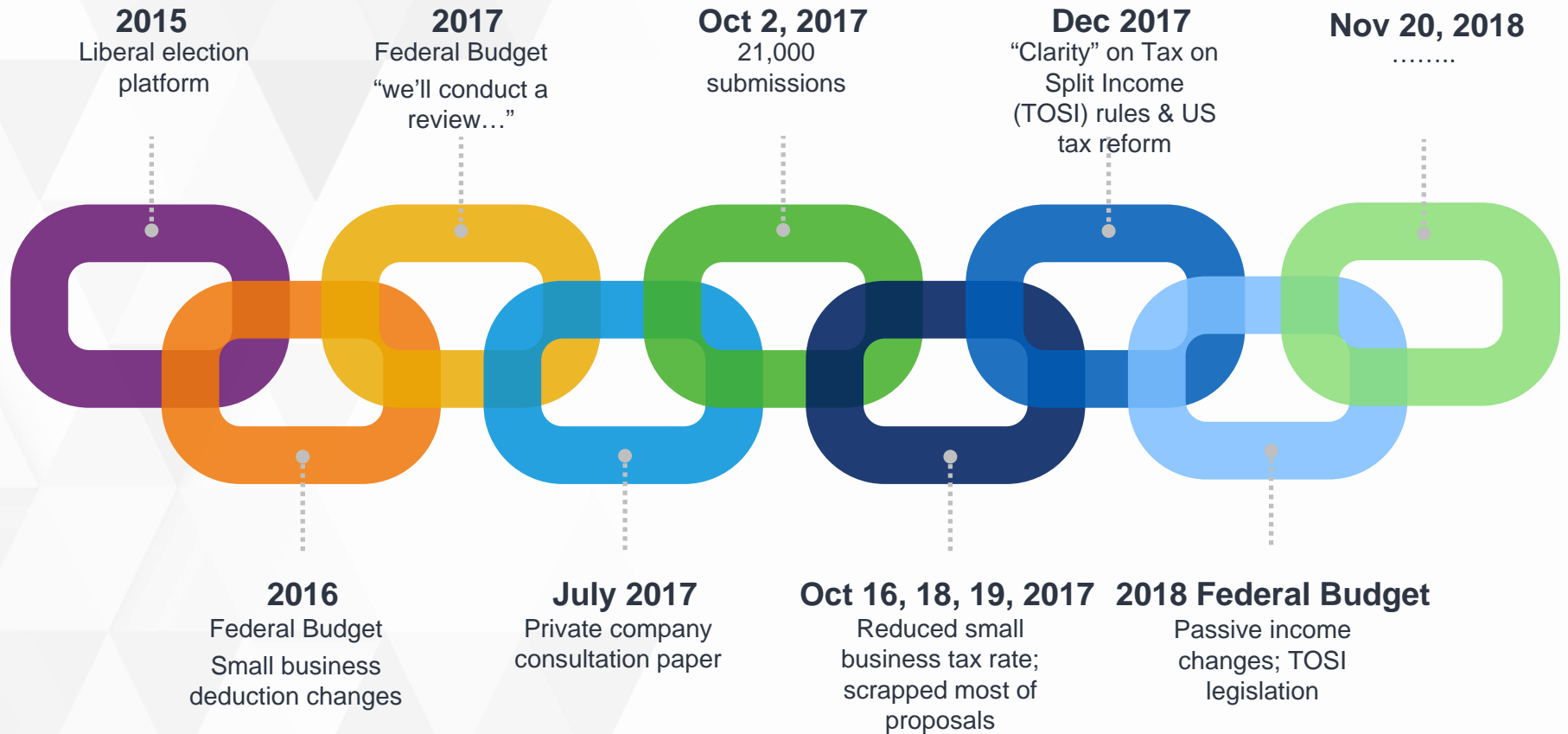
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It's been quite the journey....





Personal Taxes and Tax on Split Income (TOSI)

Payment of Dividends in 2018

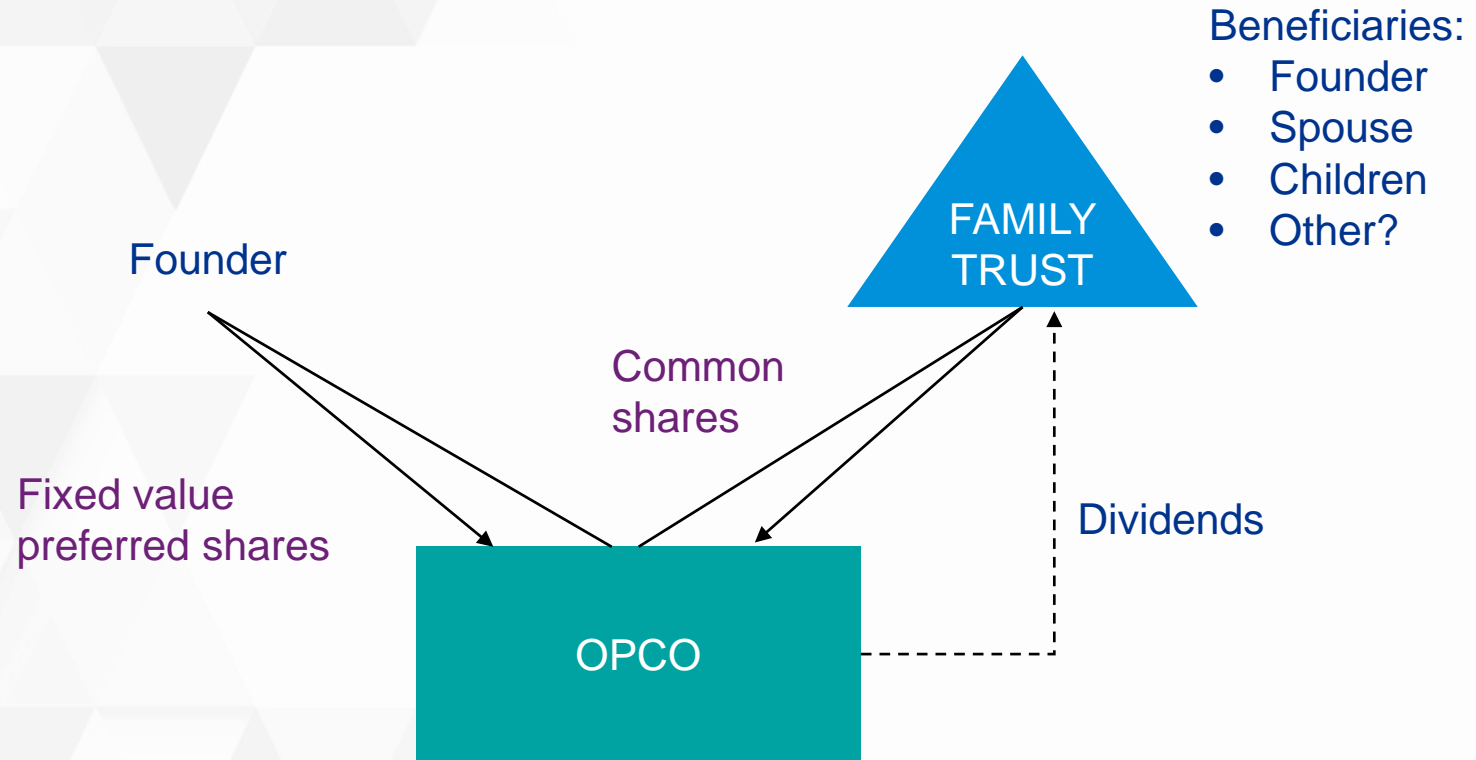
Actual amount of dividends that can be received tax-free in 2018

Alberta	Eligible Dividend	Non-Eligible Dividend
Actual amount of dividend	\$51,809	\$20,562

	Interest	Eligible Dividends	Ineligible Dividends
0 - \$46,605	23.36%	0	14.96%
\$46,606 - \$93,208	30.5%	7.56%	21.34%
\$93,209 - \$144,489	36%	15.15%	27.72%
\$144,490 - \$209,892	42%	23.43%	34.68%
> \$209,893	47-48%	30.33-31.71%	40.48-41.64%



Tax on Split Income (TOSI)



TOSI Decision Tree

1. Do you have a “specified individual”?

Yes

2. Does the specified individual earn any “split income”?

Yes

3. Is the split income an “excluded amount”? *It depends on the individual’s age.*

Excluded
for all
ages

Age 25+

24 or
younger

18 or
older, but
younger
than 25

Age 18+

Under
18

No

If an excluded amount

If not an excluded amount

Congratulations, no TOSI!

TOSI applies – higher tax bill.



TOSI Excluded Amount

Age	Excluded amount
Excluded for all ages (involves spouse or death)	<ul style="list-style-type: none"> Income from property acquired on breakdown of a marriage or common-law partnership Taxable capital gain arising on death Income where spouse is age 65+ and the income would not be TOSI to spouse Income where spouse is deceased and the income would not be TOSI immediately before death of spouse
Age 25+	<ul style="list-style-type: none"> <i>Income or gain <u>from excluded shares</u></i> <i>“Reasonable return” in respect of the individual’s contributions</i> – reasonability tests related to labour, capital, risk and other factors applied to “return” paid
24 or younger	<ul style="list-style-type: none"> Income from property acquired from deceased parent (if specified individual is a full-time student or claims disability tax credit, acquired from any deceased person)



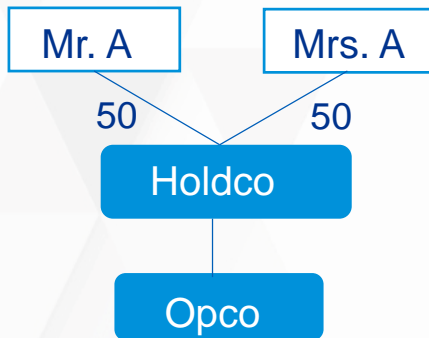
TOSI Excluded Amount

Age	Excluded amount
18 or older, but younger than 25	<ul style="list-style-type: none">• “Safe harbour capital return” – prescribed rate of return on capital contributions• “Reasonable return” on “arm’s length capital” contributions – arm’s length capital includes property earned (salary) or inherited; does not include loans or income from related business (other than salary)
Age 18+	<ul style="list-style-type: none">• <i><u>Not income from a related business</u></i>• <i><u>Income from an excluded business</u></i>• Taxable capital gain arising on sale of certain qualified property (personally or via trust)
Under 18	<ul style="list-style-type: none">• Taxable capital gain arising on sale of certain qualified property (personally or via trust) AND not a non-arm’s length disposition



What is Related Business?

- Generally, a business will be a “related business” if an individual who is related to the specified adult individual either:
 - is actively engaged on a regular basis in the business; or
 - owns a significant portion of the equity in the corporation that carries on the business (at least 10%)



Dividend received via Holdco is income from a related business for Mr. A because Mrs. A indirectly owns >10% of Opco; And for Mrs. A because Mr. A indirectly owns >10% of Opco.



TOSI - Excluded Business - Age 18+

Excluded Business

- Adults (18 and over)
- Engaged on a regular, continuous and substantial basis in the activities of the business
 - average of 20 hours per week
- During the taxation year or during any 5 previous years



TOSI - Excluded shares - Age 25+

Excluded Shares

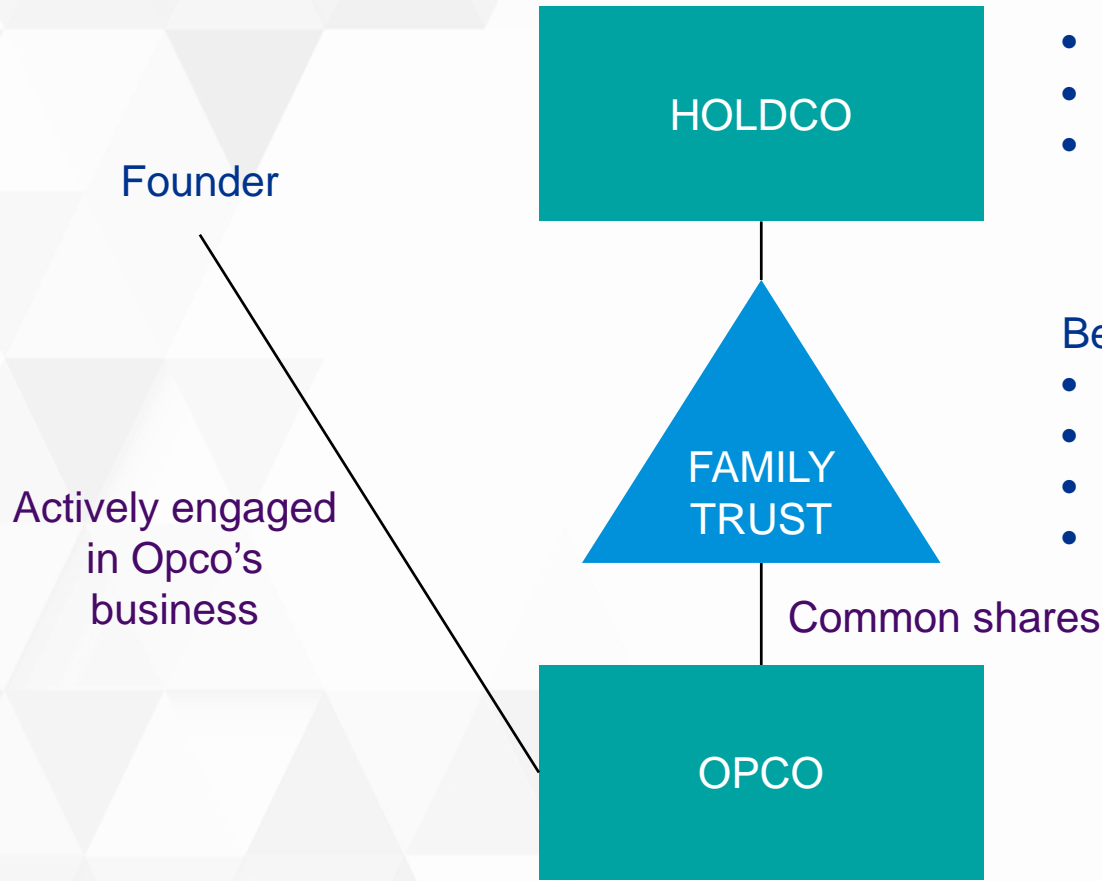
Adults 25 and over who own 10% or more of the votes and value of a corporation that:

- earns less than 90% of its income from provision of services,
- is not a professional corporation, and
- less than 10% of its income is derived, directly or indirectly, from a “related business”

Extended timeline to end of 2018 to meet definition.



Common Structure



Shareholders of Holdco:

- Founder
- Spouse
- Children
- Other?

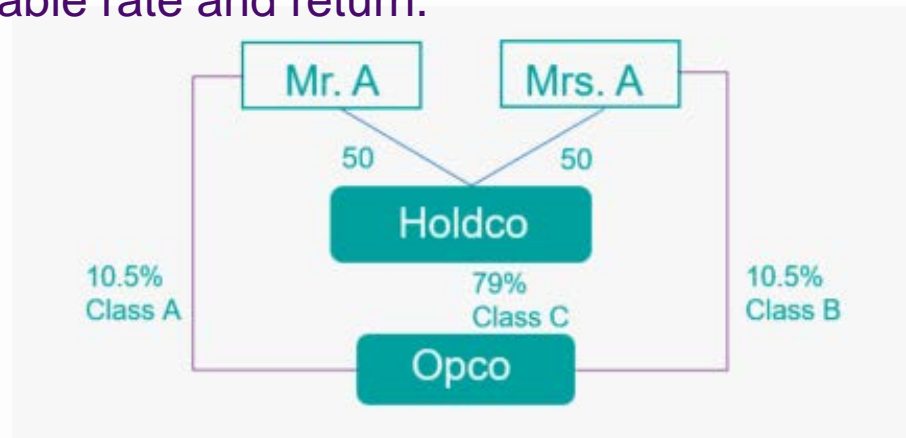
Beneficiaries of family trust:

- Founder
- Spouse
- Children
- Holdco



Solving TOSI

- Rely on Excluded Business?
 - Document support
 - Any reorganization needed if multiple lines of business?
- Rely on Excluded Shares?
 - Do we need to transfer shares out of a trust?
 - Do we need a share exchange to meet V and V?
 - Do we need to reorganize service components separate?
 - Do we need to collapse Holdco structure?
- Restructure affairs to meet reasonable rate and return.



Benefits of Family Trust

What is the future of family trusts?

- Revisit structure and the merits of the Family Trust
- Merits of the family trust:
 - estate planning
 - capital gains exception or split capital gains
 - flexibility
 - other legal benefits
 - can split income if meet TOSI exemption





2018 Federal Budget Highlights

2018 Corporate Tax Rates

Canadian-Controlled Private Corporation

	Active Business Income up to \$500,000	Active Business Income over \$500,000	Investment Income
Federal	10.0%*	15.0%	38.7%
Alberta	2.0%	12.0%	12.0%
TOTAL	12.0%	27.0%	50.7%

* Federal small business tax rate will decrease to 9% on January 1, 2019.



Passive Investment Income Rules Update

- Private Company tax consultation paper released in July 2017
- Federal Budget 2018, 2 new measures
 - Limit access to **small business income tax rate**
 - Limit access to **dividend refunds** when paying eligible dividends
- Applies to taxation years beginning after 2018
 - Subject to certain anti-avoidance rules



Limiting Access to Small Business Tax Rate

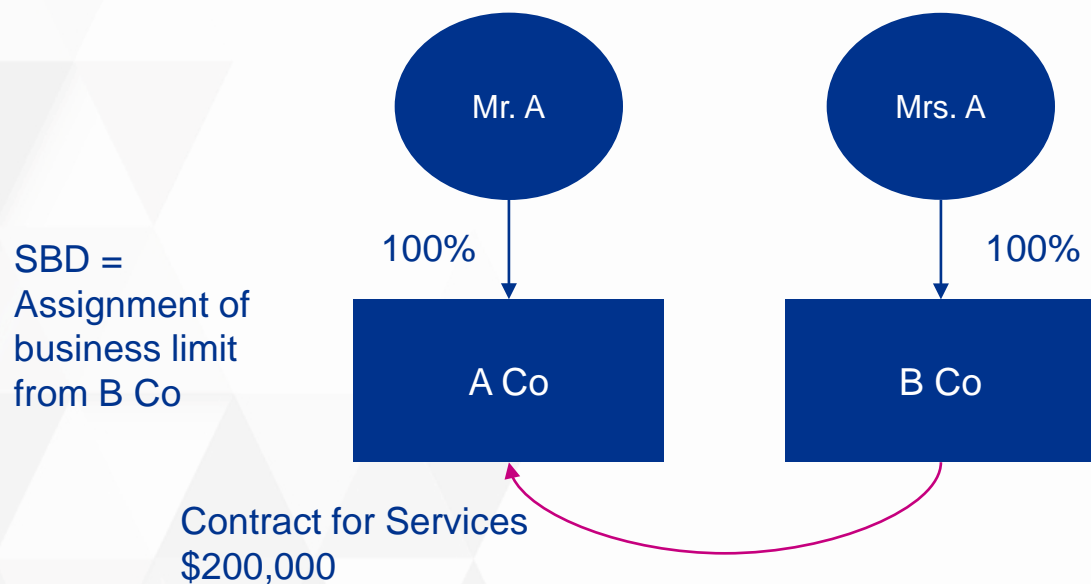
Investment income (new rule)	\$50,000	→	\$150,000
Taxable capital (existing rule)	\$10,000,000	→	\$15,000,000
Income eligible for small business tax rate	\$500,000	→	\$0
Corporate tax rate (Federal and Alberta combined)	12%	→	27%



Small Business Deduction - Don't Forget 2016 Changes!

2016 Federal Budget Changes to Limit Multiplication of SBD

- Specified Partnership Income
- Specified Corporate Income
 - Income earned from non-arm's length private corporations



Limiting Access to Dividend Refunds

	Individual	Corporation (existing rules)		Corporation (new rules)
		Non-eligible dividend	Eligible dividend	
Interest income	\$100	\$100	\$100	\$100
Less: income tax	(48)	(51)	(51)	(51)
	52	49	49	49
Add: dividend refund	-	31	31	31
Less: personal tax on non-eligible dividend	-	(33)	-	(33)
Less: personal tax on eligible dividend	-	-	(25)	-
After-tax income	\$ <u>52</u>	\$ <u>47</u>	\$ <u>55</u>	\$ <u>47</u>
Effective tax rates	<u>48%</u>	<u>53%</u>	<u>45%</u>	<u>53%</u>



Limiting Access to Dividend Refunds

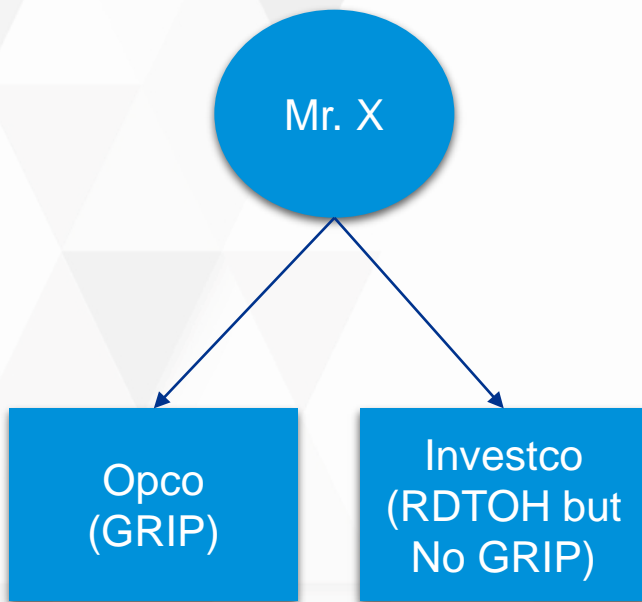
RDTOH	Eligible dividends	Non-eligible dividends
38.33%	(31.71%)	(41.64%)



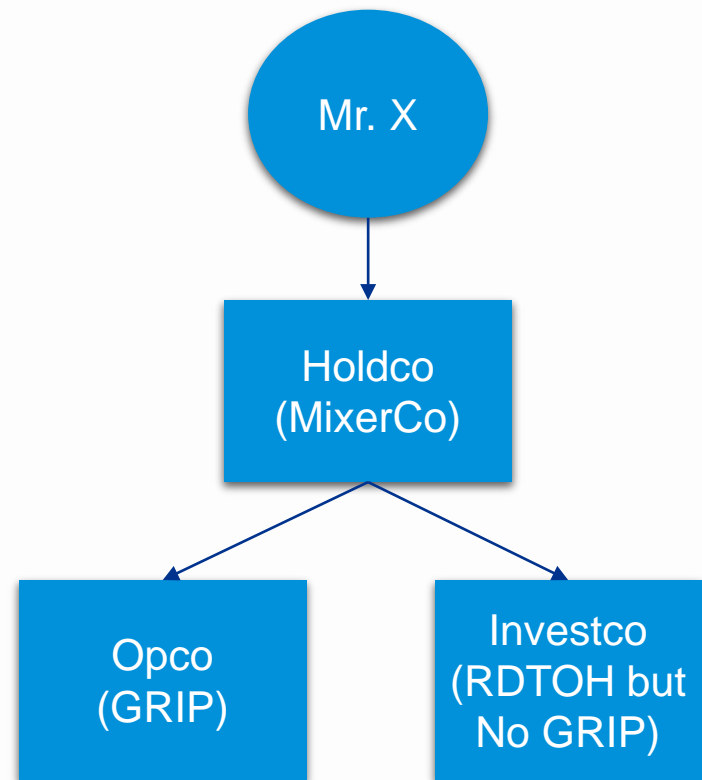
Planning Considerations

Eligible Dividend Planning – GRIP Mixer – Need to Act in 2018!

Before







After










US Tax Reform

US Business Tax Measures

Provision	Summary	Expected Impact to After-Tax Cash
US federal corporate tax rate	Change to a flat 21% corporate tax rate, effective for taxable years beginning after Dec 31, 2017	
Tax depreciation	100% expensing for certain depreciable asset additions acquired after Sept 27, 2017 and before Jan 1, 2023	
Interest expense limitations	<p>Net business interest deductions generally limited to 30% of EBITDA (30% of EBIT starting in 2022)</p> <p>Exceptions for small businesses and taxpayers in certain industries</p>	
Net operating losses (NOLs)	Limited to 80% of taxable income (for losses arising in tax years beginning after 2017); generally no carrybacks; indefinite carry-forward	



US International Tax Measures

Provision	Summary	Expected Impact to After-Tax Cash
Limited participation exemption	100% exemption for dividends received by US corporations from 10% owned Canadian (or other non-US) subsidiaries (similar to existing Canadian system)	
Mandatory repatriation tax	One-time tax on certain US shareholders, including individuals, of earnings accumulated in Canadian (or other non-US) corporations (to the extent of unrepatriated earnings and profits)	
Current tax on certain foreign income	Minimum tax on “high return” income earned in low tax jurisdictions by Canadian (or other non-US) subsidiaries (intended to discourage “offshoring” intellectual property)	
Foreign derived intangible income (FDII)	Preferential tax rates on certain “high return” income of a US corporation deemed derived from intangibles (intended to encourage developing and retaining intellectual property in the US)	
Related-party transaction base erosion measures	Discourage cross-border payments through a “base erosion anti-abuse tax” that generally targets non-COGS deductible payments made by large US groups to Canadian (or other non-US) related parties.	



Flow-through Tax Rates

	Pre-Tax Reform (blended rate of 40%)	Post-Tax Reform (blended rate of 25%)
US Taxable Income	\$100	\$100
Blended US Federal and State Rate	(\$40)	(\$25)
Net Income	\$60	\$75
FDAP Withholding Tax or Branch Profits Tax (at 5%)	(\$3.0)	(\$3.8)
Net Payment to Canadian Parent Corporation	<u>\$57</u>	<u>\$71</u>
Canadian Taxable Income	\$0	\$0
Tax in Canadian Parent Corporation (assume 27% Federal and AB rate)	\$0	\$0
Net Payment to Canadian Individual before Tax	<u>\$57</u>	<u>\$71</u>
Personal Income Tax (assume 31.71% Federal and AB rate)	(\$18)	(\$23)
Net Payment to Canadian Individual	<u>\$39</u>	<u>\$48</u>
Effective Tax Rate	61%	52%



Capital asset expensing and NOL modeling

	Regular Depreciation		
	Year 1	Year 2	Year 3
Operating Income	\$200	\$200	\$200
Depreciation	(\$200)	(\$320)	(\$192)
Taxable Income (loss) before NOLs	-	(\$120)	\$8
NOL Deduction (80% limit)	-	-	(\$6)
Taxable Income (loss)	-	(\$120)	\$2
Cash Tax	\$0	\$0	\$0.42

	Full Expensing		
	Year 1	Year 2	Year 3
Operating Income	\$200	\$200	\$200
Depreciation	(\$1000)	-	-
Taxable Income (loss) before NOLs	(\$800)	\$200	\$200
NOL Deduction (80% limit)	-	(\$160)	(\$160)
Taxable Income (loss)	(\$800)	\$40	\$40
Cash Tax		\$8.40	\$8.40



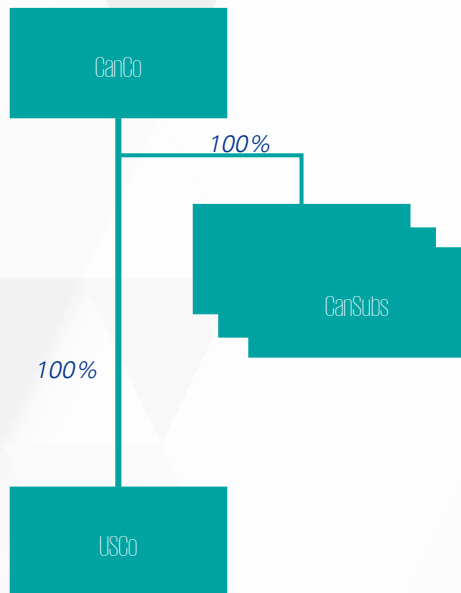
“Downward Attribution” Issue

- The Act repealed a provision (IRC section 958(b)(4)) that previously blocked certain constructive ownership rules (the “downward attribution” rules under IRC section 318(a)(3) for purposes of determining whether a US Person is a US Shareholder and whether a foreign corporation is a CFC.
- Effective for the last tax year of a foreign corporation beginning before January 1, 2018 and all subsequent tax years, a “downward attribution” rule applies to attribute stock ownership to a corporation from its shareholders, but only with respect to shareholders that own, directly or indirectly, 50% or more of the value of the corporation’s stock.
- Intended to capture post-inversion “de-CFC” planning transactions.
- Causes certain foreign corporations with US subsidiaries, that were not previously treated as CFCs, to be treated as CFCs.

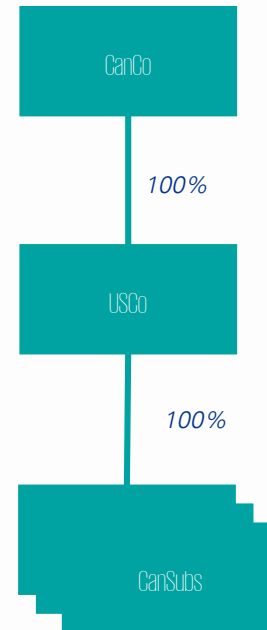


Illustrative Example of "Downward Attribution"

Actual Ownership Structure



958(b) Fiction after Applying 318(a)(3)(C)



5471 Reporting

- Form 5471, “Information Return of US Persons With Respect to Certain Foreign Corporations” is a US foreign reporting form used by certain direct, indirect, and constructive US shareholders to report the activities of the foreign corporation and, if required, their share of the earnings and profits of the foreign corporation.
- Current Form 5471 instructions state that a **Category 5** filer includes a 10% or more direct, indirect, or constructive US shareholder with respect to a foreign corporation that is a CFC.
- IRS intends to amend the instructions for Form 5471 to provide a filing exception if:
 - 1) No US Shareholder owns, directly or indirectly without applying “downward attribution” rules, stock of the CFC; **and**
 - 2) The foreign corporation is only treated as a CFC because of the “downward attribution” rules.





Wayfair: The Case and What it Means

Quill – and how we got here

In *Quill v. North Dakota* (1992), the US Supreme Court ruled that a state cannot require a business to collect use tax from in-state customers if the business has no physical presence in the state

- In the 26 years since *Quill* was decided, states have been increasingly aggressive in their efforts to narrow *Quill*'s effect and expand what constitutes a physical presence
 - Initial efforts focused on representational nexus – states asserting that the physical presence of a third-party or an affiliate in the state created nexus for the out-of-state seller
 - This required a showing that the in-state person was engaging in activities that were “significantly associated with the seller’s ability to establish and maintain a market for sales”
- Most recently, several states have adopted “economic nexus” standards that require sellers with no physical presence to collect sales and use tax if they exceed certain bright-line sales or transaction thresholds
 - Many of these state statutes specifically acknowledged that the economic nexus standards and thresholds conflicted with the Court’s holding in *Quill*



South Dakota v. Wayfair

Background

- In 2016, South Dakota passed Senate Bill 106, which adopted an economic nexus standard for sales and use tax purposes
 - Under the revised law, any seller with sales exceeding an annual threshold of \$100,000 or 200 separate transactions in South Dakota was required to collect and remit effective May 1, 2016
 - The law was quickly challenged; as was expected
- On September 14, 2017, the South Dakota Supreme Court held that the state is bound to follow established US Supreme Court precedent
 - A law imposing economic nexus standards on remote retailers could not be enforced in light of *Quill*

On January 12, 2018, the US Supreme Court granted certiorari and oral arguments were held April 17, 2018



South Dakota v. Wayfair

On June 21, 2018, the Court ruled in a 5-4 decision in favor of South Dakota

- The Court concluded that the physical presence rule set forth in *Quill* is overruled as it is “unsound and incorrect”
- The physical presence rule “has been the target of criticism over many years from many quarters”
 - “*Quill* is flawed on its own terms. First, the physical presence rule is not a necessary interpretation of the requirement that a state tax must be applied to an activity with a substantial nexus with the taxing state. Second, *Quill* creates rather than resolves market distortions. Third, *Quill* imposes the sort of arbitrary, formalistic distinction that the Court’s modern Commerce Clause precedents disavow”
- While multistate business may be faced with significant compliance costs, the Court suggested that other aspects of constitutional analysis, can “better and more accurately address any potential burdens on interstate commerce”
- The four dissenters followed varied lines of reasoning, including decrying the lack of a record and that the issue was better left to Congress; none defended the physical presence rule



What are the implications for sellers?

The physical presence rule has been overturned, but it is not clear how the Court's holding will be applied in every other state

- It's important to keep in mind that the Court did not hold that South Dakota's law would be permissible under every circumstance in every state
 - The Court held that the taxpayers at issue had the requisite virtual and economic contacts with South Dakota to meet the “substantial nexus” requirement
 - There might be a different result for different sellers in other states
- Also, under the Court's rationale, the laws, as applied to the sellers, **cannot discriminate or place undue burdens on interstate commerce**
 - The South Dakota statute, in the Court's view, appeared to do neither
 - The South Dakota law included a safe harbor for those sellers who transacted only limited business in South Dakota; ensured that no obligation to remit the sales tax may be applied retroactively; and, South Dakota is one of more than 20 States that have adopted the Streamlined Sales and Use Tax Agreement



What are the implications for sellers?

Considerations

- Over half the states that impose sales and use taxes have laws or provisions similar or substantially similar to South Dakota's
 - Most of these laws or regulations are currently effective; more will become effective in the weeks and months to come
 - No state has attempted to enforce their laws pre-*Wayfair* (even in the states that had provisions in place and effective prior to the decision)
- There are other states that have no economic nexus rules – at least currently – but their doing business statutes may be sufficiently broad so as to encompass remote selling and/or they do not specifically require a physical presence
 - Sellers will need to carefully track state responses and act accordingly
 - Also, keep in mind that two states, Massachusetts and Ohio, had economic nexus plus software-related presence standards and these states will enforce pre-*Wayfair*
 - These are not “pure” economic nexus standards and therefore, in the state’s view, can be enforced prior to *Quill* being overturned



Reactions to Wayfair - 11/19/2018

A. Economic nexus with effective date

AL – 10/1/2018	IA – 1/1/2019	MS – 9/1/2018	SD – 11/1/2018
CO – 12/1/2018	LA – 1/1/2019	NE – 1/1/2019	UT – 1/1/2019
CT – 12/1/2018 (lower threshold pre-12/1/2018)	KY – 10/1/2018	NJ – 11/1/2018	VT – 7/1/2018
HI – 7/1/2018	ME – 7/1/2018	NC – 11/1/2018	WA – 10/1/2018
IL – 10/1/2018	MD – 10/1/2018	ND – 10/1/2018	WI – 10/1/2018
IN – 10/1/2018	MI – 10/1/2018	NV – 10/1/2018*	WV – 01/01/2019
	MN – 10/1/2018	SC – 11/1/2018	WY – 02/01/2019

B. Economic nexus with no specific date

NY (no guidance)	TN (enjoined; needs legislative approval)
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C. Broad doing business statute¹

AZ	CA	FL	KS	NM	VA
AR	DC	ID	MO	TX	

D. Other

GA (collect-or-report)	OH (software nexus)	PA (collect-or-report)	RI (collect-or-report)
MA (software nexus)	OK (collect-or-report)	PR (report)	

* Must collect starting the 1st day of the 1st month that starts 30 days after threshold is met, including if met 10/1.

¹ Statute likely broad enough so as not to require physical presence, but no official notice/action taken requiring collection by remote sellers



Economic nexus

As of November 19, 2018

State	Threshold	Effective Date
Alabama	\$250,000	October 1, 2018
Colorado	\$100,000 or 200 transactions	December 1, 2018
Connecticut	Regular or systematic solicitation of sales, plus \$250,000 <u>and</u> 200 transactions	December 1, 2018 (previous standard in effect until December 1, 2018)
Hawaii	\$100,000 or 200 transactions	July 1, 2018
Illinois	\$100,000 or 200 transactions	October 1, 2018
Indiana	\$100,000 or 200 transactions	October 1, 2018
Iowa	\$100,000 or 200 transactions	January 1, 2019
Kentucky	\$100,000 or 200 transactions	October 1, 2018
Louisiana	\$100,000 or 200 transactions	DoR aiming for January 1, 2019
Maine	\$100,000 or 200 transactions	July 1, 2018



Economic nexus, continued

As of November 19, 2018

State	Threshold	Effective Date
Maryland	\$100,000 or 200 transactions	October 1, 2018 (effective date of emergency regulation)
Michigan	\$100,000 or 200 transactions	October 1, 2018
Minnesota	Regular or systematic solicitation of sales, plus either 100 transactions or 10 or more transactions totaling over \$100,000	October 1, 2018
Mississippi	\$250,000 plus purposeful or systematic exploitation of the Mississippi market	September 1, 2018
Nebraska	\$100,000 or 200 transactions + meet “doing business” definition	January 1, 2019
Nevada	\$100,000 or 200 transactions	October 1, 2018 (must collect starting the 1 st day of the 1 st month that starts 30 days after threshold is met, including if met 10/1)
New Jersey	\$100,000 or 200 transactions	November 1, 2018
New York	\$300,000 and 100 transactions	TBD
North Carolina	\$100,000 or 200 transactions	November 1, 2018



Economic nexus, continued

As of November 19, 2018

State	Threshold	Effective Date
North Dakota	\$100,000 or 200 transactions	October 1, 2018
South Carolina	\$100,000	November 1, 2018
South Dakota	\$100,000 or 200 transactions	November 1, 2018
Tennessee	\$500,000 and regular or systematic solicitation	TBD (pending resolution of state litigation regarding state economic nexus rule and approval by General Assembly)
Utah	\$100,000 or 200 transactions	January 1, 2019
Vermont	Regular, systematic, or seasonal solicitation of sales, plus either \$100,000 or 200 transactions	July 1, 2018
Washington	\$100,000 or 200 transactions	October 1, 2018
West Virginia	\$100,000 or 200 transactions	January 1, 2019
Wisconsin	\$100,000 or 200 transactions	October 1, 2018
Wyoming	\$100,000 or 200 transactions	February 1, 2019



Economic threshold + software-related presence

As of November 19, 2018

State	Threshold	Effective Date
Massachusetts	\$500,000 and 100 transactions for retailers with software in state (apps, cookies, etc.)	October 1, 2017
Ohio	\$500,000 for retailers with software or content distribution networks in state	January 1, 2018



Issues - remote sellers generally

Besides having to register and collect in new states, what are the other issues?

- Determining taxability of goods in new states where the seller has a collection obligation
 - Not always easy- even when selling tangible personal property
 - A number of states have exemptions for clothing, farm equipment, durable medical equipment, etc.
 - Determining what does and does not fall within the scope of an exemption may not be simple and will be subject to audit
 - Does the state have sales tax holidays that need to be addressed for online sales?
 - Does the seller have a process for collecting and storing exemption certificates for sales to exempt organizations?
- Determining the tax base upon which sales tax is charged
 - Are delivery/shipping costs subject to sales tax in each state?
 - Are there ancillary services being provided as part of the sale that would be taxable under a true-object analysis?



Issues - foreign sellers

Wayfair does not provide different rules or carve-out foreign sellers making sales to customers in the US

- No states limit the scope of their economic nexus laws to US - based sellers.
 - Under plain reading, foreign sellers are required to collect and remit on sales made to in-state customers if they meet the state's economic threshold
- Note that economic nexus thresholds in many states apply to gross sales, not just taxable sales

State laws that impose burdens on interstate commerce that are clearly excessive in relation to local benefits may be unconstitutional

- Under Foreign Commerce Clause jurisprudence, a heightened standard applies to foreign commerce and there may be arguments that as applied to foreign sellers, state economic nexus laws discriminate or are unduly burdensome
 - Would be a facts and circumstances analysis



Issues - foreign sellers and enforcement

The Revenue Rule

- A general legal principle that the courts of one country will not enforce the tax laws of another country
- US courts generally do not enforce foreign tax judgments against US companies
 - The US Supreme Court has held that US courts are prohibited from enforcing a foreign court's tax judgment, unless otherwise permissible under US statutes or treaties
 - The 2006 US Model Income Tax Convention does not allow the enforcement of foreign tax judgments US courts (and doesn't apply to state taxes in any event)
 - Of the newer US-foreign tax treaties that have some enforcement reciprocity, none apply to state taxes
 - State statutes generally reflect the federal approach to foreign tax judgments
 - 31 states have adopted a model law that excludes tax judgments from enforceable foreign judgments
- Therefore, it is unlikely that any foreign court will enforce state sales tax judgments against foreign sellers



Issues - foreign sellers and enforcement

General procedure for enforcing sales tax collection

- If a seller fails to collect and remit tax or fails to reply to audit notices, the state can issue a jeopardy assessment and seek a tax judgment against the seller in the state's court
- If the seller is based in another state, per the US constitution's full faith and credit clause, the other state must enforce this judgment from a "sister state"

Foreign sellers

- If a foreign seller has in-state property, a state court may order it seized to satisfy the judgment
- If not, the state would have to rely on the courts in the seller's home jurisdiction to enforce the judgment. Per the "revenue rule," foreign courts are not likely to enforce the judgment

Alternative enforcement tools (as identified by the Multistate Tax Commission)

- Impose collection obligations on marketplace facilitators who provide a platform for foreign sellers
- Obtain purchase data from US Customs and deduct unpaid use tax from state income tax refunds
- Pursue non-tax civil actions against sellers that collect but do not remit (i.e. tort of conversion)
- Impose reporting requirements on sellers that do not collect and remit, with penalties for failure to comply (presumably the revenue rule will not apply to collection of penalties)
- Impose collection obligations on US-based entities that provide credit card and payment processing services
- CAVEAT: States cannot discriminate against foreign commerce (constitutional issue)



Questions?



How KPMG Enterprise can help you and your business

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PLANNING

ESTATE PLANNING

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DISPUTE
ADVISORY

WEALTH PRESERVATION

PERSONAL TAX

PRIVATE COMPANIES

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AUDIT SERVICES GOING
PUBLIC

FAMILY BUSINESSES

SUCCESSION PLANNING VALUATIONS

CORPORATE RESTRUCTURING INDIRECT TAX

RISK MANAGEMENT

FAST GROWING ENTERPRISES





Thank You

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