Private Company Consultation Paper - How Potential Tax Policy Changes May Impact You

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Welcome

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Introduction

Private Company Consultation Paper – How Potential Tax Policy Changes May Impact You and Your Business

Q&A

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History

2015 – Election platform "ensure that Canadian controlled private corporation ("CCPC") status would not be used to reduce the income tax obligations of high-income earners"

2016 Budget – certain measures to limit multiplication of the small business deduction for CCPCs.

2017 Budget – announced that it would conduct a review of tax planning strategies and introduce a paper

July 18, 2017 – Draft legislation – Income Splitting and certain Capital Gains measures

- Consultation paper – Passive income

October 2, 2017 – Consultation closes

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What's Happened?

July 18, 2017 Consultation on Tax Planning Using Private Corporations

http://www.fin.gc.ca/n17/17-066-eng.asp

Addresses three key issues:

- Income splitting amongst family members;
- Converting capital gains into dividends; and
- Holding a passive investment portfolio inside a private corporation

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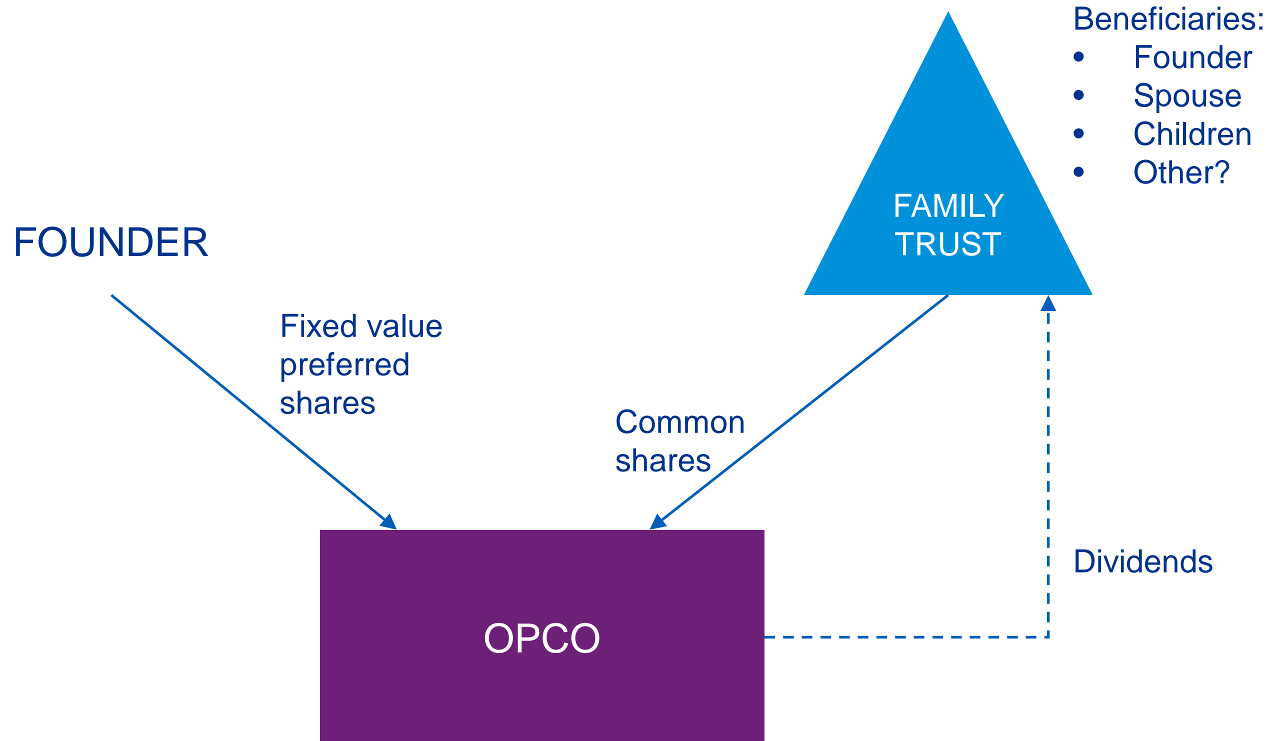
INCOME SPRINKLING:
Tax on Split Income

Typical Income Splitting Structure



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What's Happened?

Effective after 2017, the rules pertaining to income tax on split income ("kiddie tax") are being expanded in the following ways:

- More types of income will be subject to tax;
- Any Canadian resident (regardless of age) with a connection to a private company; and
- A new reasonableness test based on labour and capital contribution, including previous returns/remuneration paid

Proposed rules would eliminate the potential tax savings on existing income splitting plans

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How this May Impact You?

Beginning in 2018, taxpayers need to consider the following:

- Eliminates virtually all income splitting opportunities for those individuals not actively involved (labour or capital contributions) in the business
- Loss of tax saving opportunities to adult family members due to TOSI proposals up to $30,000 to $37,000 per person (depending on province of residence)
- Greater complexity and subjectivity in determining reasonableness of income paid to specified individuals
  - A portion of the income may be reasonable (and a portion not reasonable)
- TOSI will now impact whether the individual would qualify for certain income-tested benefits

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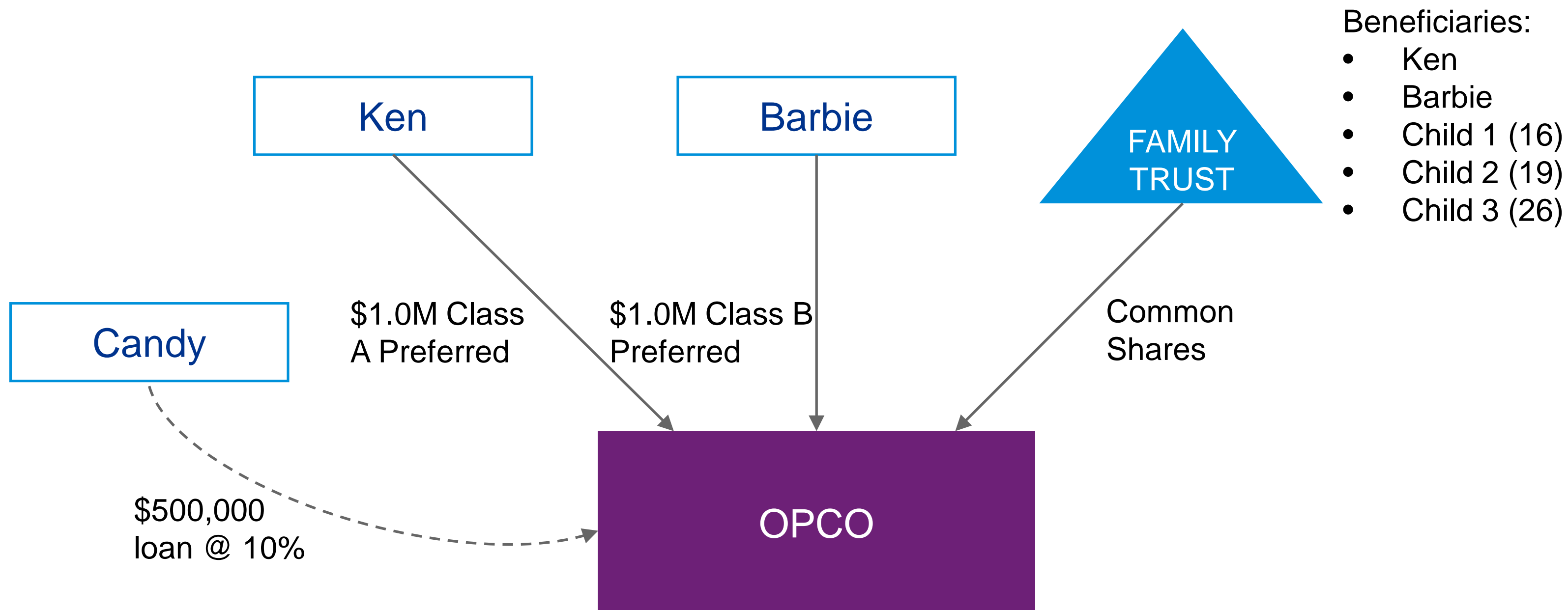
Case Review



Ken	-	employed full-time @ $100,000 annual salary
Barbie	-	not employed, receives $40,000 non-eligible dividends on Class B shares
Candy	-	not employed, receives $50,000 annual interest income
Child 2	-	in university full time, employed summer salary $10,000
Child 3	-	employed full time @ $50,000 annual salary
Income Splitting	-	$80,000 non-eligible dividend paid to Family Trust; $40,000 each to Child 2 / 3
Note:		Assume dividends do not meet reasonableness test

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Tax Impact

	2017	2018
Ken – Wages-$100,000	26,000	26,000
Barbie – Dividend-$40,000	2,300	16,000
Child 1	--	--
Child 2 • Wages-$10,000 • Dividends-$40,000	 NIL 2,300	 NIL 16,000
Child 3 • Wages-$50,000 • Dividends-$40,000	 8,900 9,500	 8,900 16,000
Candy • Interest-$50,000 • Personal Tax	 9,900	 23,900
Total	58,900	106,800

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What Now?

Beginning in 2018, taxpayers need to consider the following:

- Eliminates virtually all income splitting opportunities for those individuals not actively involved (labour or capital contributions) in the business
- Loss of tax saving opportunities
- Greater complexity and subjectivity in determining reasonableness of income paid to specified individuals
- TOSI will now impact whether the individual would qualify for certain income-tested benefits

Consider:

- Final large income splitting plan for 2017
- If family member is, or can be, employed in business, pay reasonable salary
- Develop procedures to document past, current and future labour and capital contributions from family members to support future “reasonability” tests
- Potential reorganization of ownership of business entities

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Curbing the Lifetime Capital Gains Exemption (“LCGE”)

What Is Changing?

Beginning January 1, 2019, no LCGE available for:

- Minors (age under 18).
- Adults, the portion of a capital gain on a sale of property that accrued while shareholder was a minor.
- Adults, where capital gain is subject to TOSI
- Gains that accrue while shares held by a family trust.

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Typical example

Sale proceed of $800,000 each, Saskatchewan tax rates

Family member	Sale proceeds	“Reasonable remuneration”	Tax under Old Rules	Tax under New rules
Founder	$800,000	$800,000	$nil	$nil
Spouse	$800,000	$400,000	$nil	$158,400
Child 1 – active	$800,000	$400,000	$nil	$158,400
Child 2 – not active	$800,000	$nil	$nil	$316,800
Total	$3,200,000		$nil	$633,600

*Note that Alternative Minimum Tax (AMT) may apply

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Transitional Measures- Adults

Opportunity to use transitional rules to claim LCGE in 2018

- Elect to trigger a "deemed" capital gain to claim unused LCGE
    - At any point in 2018
    - Increased tax cost reduces tax on future sale
    - Cannot use to extract cash from corporate group
- Election can be made by:
    - Adults (18 or older in 2018)
    - Family trusts (for beneficiaries at December 31, 2017 who will be 18 or older in 2018)

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Transitional Rules - Minors

Can claim LCGE on dispositions of shares to an arm's length party of shares in 2017 or 2018.

Election is available (similar to adults) on certain qualified farming or fishing property

- Farm land, fishing vessels and partnership interests in either
- Not shares of a family farm or fishing corporation

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Conclusion

Starting in 2019, only those involved in family business will be able to claim in LCGE.

Therefore consider taking steps before December 31, 2017 to access LCGE.

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Conversion of Dividends to Capital Gains and Surplus Stripping

Dividends or Capital Gains?

- Individuals and family trusts owning private corporations
  - Marginal tax rate on capital gains is lower than on dividends

2017 Rates	Non-eligible Dividends	Eligible Dividends	Capital Gains
British Columbia	40.95%	31.30%	23.85%
Alberta	41.29%	31.71%	24.00%
Saskatchewan	39.62%	30.33%	23.88%
Manitoba	45.74%	37.79%	25.20%
Ontario	45.30%	39.34%	26.76%
Quebec	43.84%	39.83%	26.65%

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Conversion of Capital Gains to Dividends

- There are rules exist to convert capital gains into dividends already. However, the proposed rules are expanded to include
  - Capital gains realized on the death of a private company shareholder.
  - Capital gains realized on the sale of private company shares to a related individual.
  - Capital gains realized of sale of capital assets (i.e a rental property or portfolio shares) to a related company.
  - Capital gains subject to TOSI.

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Capital gains on death

- Assumes Saskatchewan tax rates

	Value of shares in estate	Tax under Old Rules	Tax under New rules, no planning	Tax under New rules, with planning
Shares	$1,000,000	$240,000	$636,000	$396,000
Rate		24%	63.6%	39.6%

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Capital gains on sale to a child

- Assumes Saskatchewan tax rates

	Gain on shares	Tax under Old Rules	Tax under New rules	Tax on sale to Third party
Total	$1,000,000	$240,000	$396,000	$36,000
Rate		24%	39.6%	3.6%

*Note that Alternative Minimum Tax (AMT) may apply

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Other "Internal" Capital gains

- Consider the following:
- George has a company that owns a rental property with an accrued gain of $1M. For creditor reasons, he decides to sell it to a sister corporation and realize a gain.
- Previously, as only 50% of capital gains are taxed, 50% could be distributed to a shareholder as a tax free capital dividend.
- New rules provides no capital dividend available to pay as a result of this transaction.
- The result, this would result in an increase in tax by about $200,000 (20%). Punitive to trigger any internal gain.

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Next Steps - Surplus Stripping Amendments

- Future estate plans and post-mortem planning steps in process should be reviewed under proposals
- Any divestitures in progress / upcoming to be reviewed under proposals
- Any payments from capital dividend account (CDA) should be reviewed under proposals
- Other reorganizations should be reviewed under proposals

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Holding Passive Investments

In Private Corporations

What's Happened

- Finance Objectives:
  - Fairness
  - Neutrality
  - In substance: Shareholders and employees end up with the same after-tax savings in their personal bank accounts regardless of the source of the capital

- White paper issued July 18, 2017
- Comments accepted until October 2, 2017
- Draft legislation to follow?
- Effective dates uncertain

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Background - Income Integration

- One of the key features of the Canadian income tax system is the concept of income *integration*
- All types of income should ultimately attract the same level of tax whether earned through a corporation or by an individual
- Corporations that do not distribute their after-tax earnings as dividends or reinvest those funds in their businesses can invest more in passive investments than employees

	Employee	Corporation*	Corporation*
Active income	$100	$100	$100
Less: income tax	(48)	(13)	(27)
	52	87	73
Less: dividend tax	-	(35)	(22)
After-tax income	$ 52	$ 52	$ 51

Income Integration:

Corporate tax + Dividend tax = Personal tax on income earned directly

*Income tax rate depends on availability of small business deduction

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Background - Existing Passive Tax System

- Refundable taxes (RDTOH)
- Capital dividend account (CDA)

	Individual	Corporation
Investment income	$100	$100
Less: income tax	(48)	(51)
	52	49
Add: dividend refund	-	31
Less: dividend tax	-	(32)
After-tax income	$ 52	$ 48

Cost of about 3.9% of earning passive income in a corporation

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How To Eliminate the Benefit of Deferral?

A number of options, but generally, through the elimination of two key components of integration:

- Refundable taxes
- Capital dividends

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Alternative Approaches

1. Apportionment method
2. Elective method
   - Default treatment
   - Elective treatment
3. Corporation focused on passive investments

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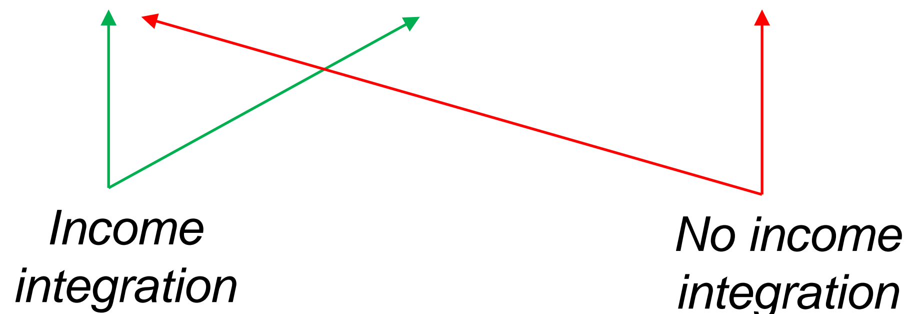
Alternative Approaches - Effective Tax Rates

	Individual	Corporation (existing rules)	Corporation (proposed rules)
Interest income	48%	52%	70%
Capital gains	24%	26%	55%
Public company dividends	30%	30%	63%



No longer integration for passive income

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Corporations Focused on Passive Investments

- Additional election possible for both methods
- All income generated by the corporation taxed as passive investment income
- Existing refundable tax system applies
- Additional refundable tax may apply to inter-corporate dividends received
- Unclear whether existing CDA rules to continue to apply to capital gains realized by the corporation

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Transitional Rules

- According to the Department of Finance:
  - New rules are to apply on a go-forward basis
  - New rules are to have limited impact on existing passive investments
  - Time will be provided before the new regime becomes effective
  - Avenues for tax avoidance to be considered and addressed
  - New rules are not intended to impact taxes payable by corporations with no passive investment income

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Transitional Rules - Unknowns

- Unanswered questions remain how Finance plans to ensure limited impact on existing passive investments, for example:
  - How will income on those investments be taxed?
  - How will unrealized accrued gains on those investments be taxed?
  - How will distributions of the capital used to fund those investments be taxed?
  - Will capital assets used in an active business that are sold be subject to the new tax regime?

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Next Steps

What does this mean for us?

- Minimal ability to income split in the future (2017 is the last year)
- Disincentive to accumulate corporate investment assets
- Consider winding up trusts and/or restructuring
- Compensation plans will have to be revisited
- Estate plans will have to be revisited
- Divestiture plans will have to be revisited
- Retirement plans will have to be revisited
- Succession plans will have to be revisited

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Providing Feedback

- Talk to your MP
- Participate in the consultation:

http://www.fin.gc.ca/activty/consult/tppc-pfsp-eng.asp

Written comments should be sent to: fin.consultation.fin@canada.ca

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