LAMBTON FEDERATION OF AGRICULTURE

PRIVATE CORPORATION TAX PLANNING

BDO Canada LLP

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BACKGROUND

- In its 2017 budget, the federal government announced that it would be reviewing certain tax planning strategies that it believes result in “wealthy” individuals gaining unfair tax advantages over other Canadians
- In particular, the government stated it intended to primarily review three tax-saving strategies that involve the use of private corporations…
- On July 18th, Finance Minister Bill Morneau released the much anticipated consultation paper proposing changes to how private corporations are used to gain tax advantages…
- Trend toward complexity + uncertain of Interpretation + lack of clarity to thwart perceived “unfair” tax strategies

PROPOSED MEASURES

Proposals focused on three major areas of tax planning for private corporations:

1. Income sprinkling – dividends and capital gains deduction
   - Draft legislation provided effective January 1, 2018
2. Passive investments
   - No draft legislation provided
3. Surplus stripping
   - Draft legislation provided effective July 18, 2017 with retroactive application

INCOME SPLITTING

What areas are likely to be affected?

Draft legislation has been written and released to the public and it is the Department of Finance's intention these rules will be <u>in effect beginning January 1, 2018</u>

Income Splitting – <u>very common</u> tax-planning arrangements that allow for the redistribution of income among members

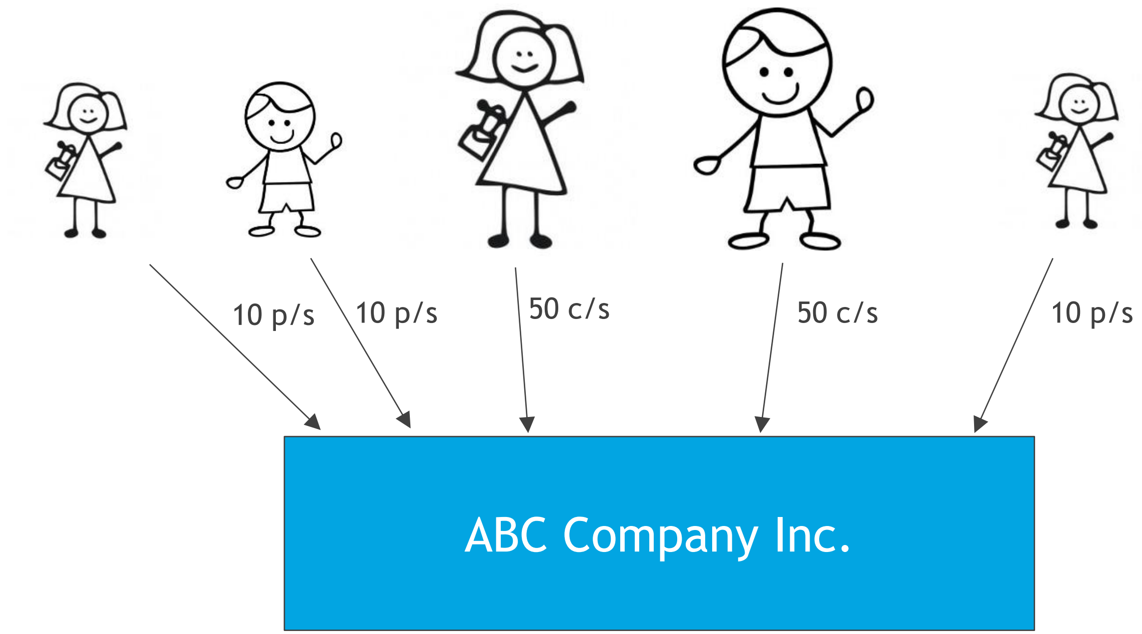
- **<u>Dividend Sprinkling</u>** to spouses or children taxed in lower tax brackets
  - Direct shareholdings
  - Family Trust

- **<u>Allocating Capital Gains</u>** resulting from the disposition of qualified small business shares or fishing/farming property to utilize multiple capital gains exemptions ("CGEs")

INCOME SPLITTING

Common tax planning strategies that will be ineffective under proposals

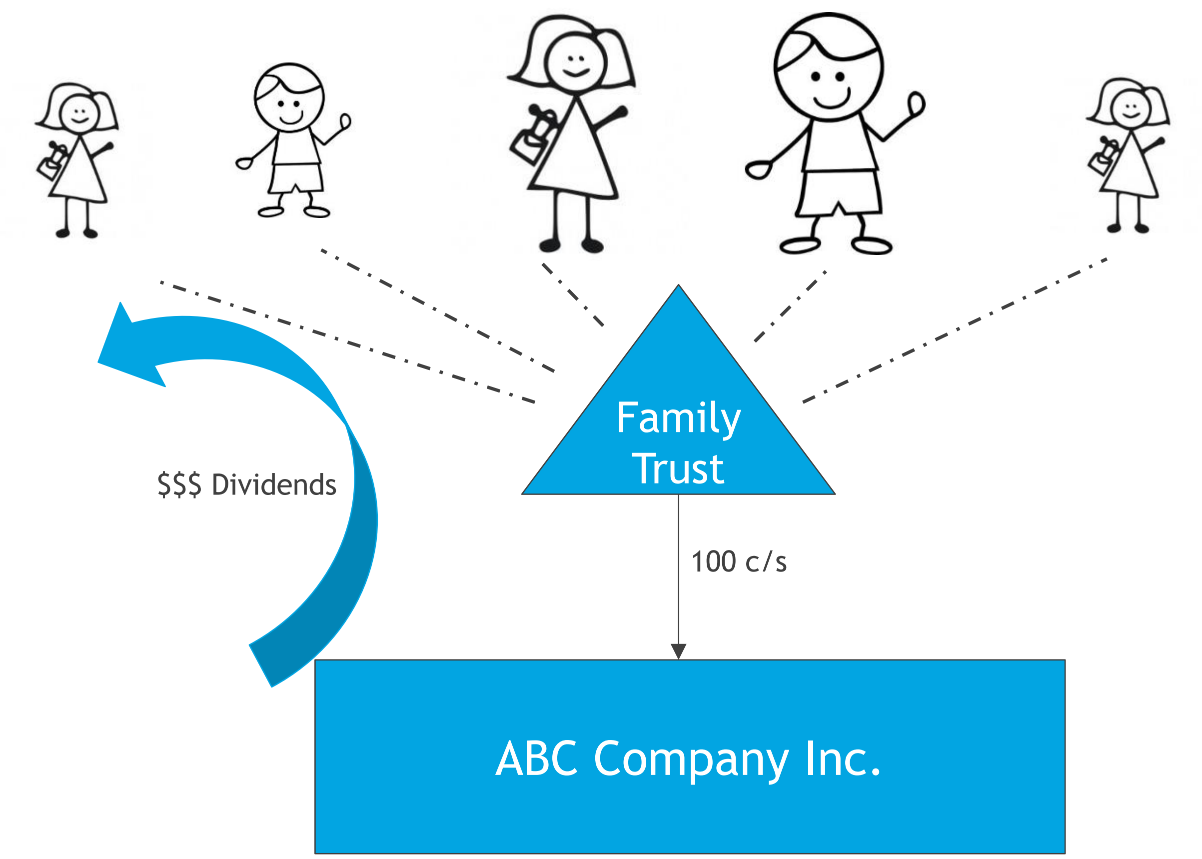
Dividend sprinkling with adult family members



INCOME SPLITTING

Common tax planning strategies that will be ineffective under proposals

Dividend sprinkling with adult family members



INCOME SPLITTING

Dividend Sprinkling - What does this mean for you?

- Private company dividends paid to adult family members subject to a "reasonableness test"

- Factors
  - Labour and capital contributions;
  - Risk assumed by shareholder (or trust beneficiary); and
  - Previous returns and remuneration

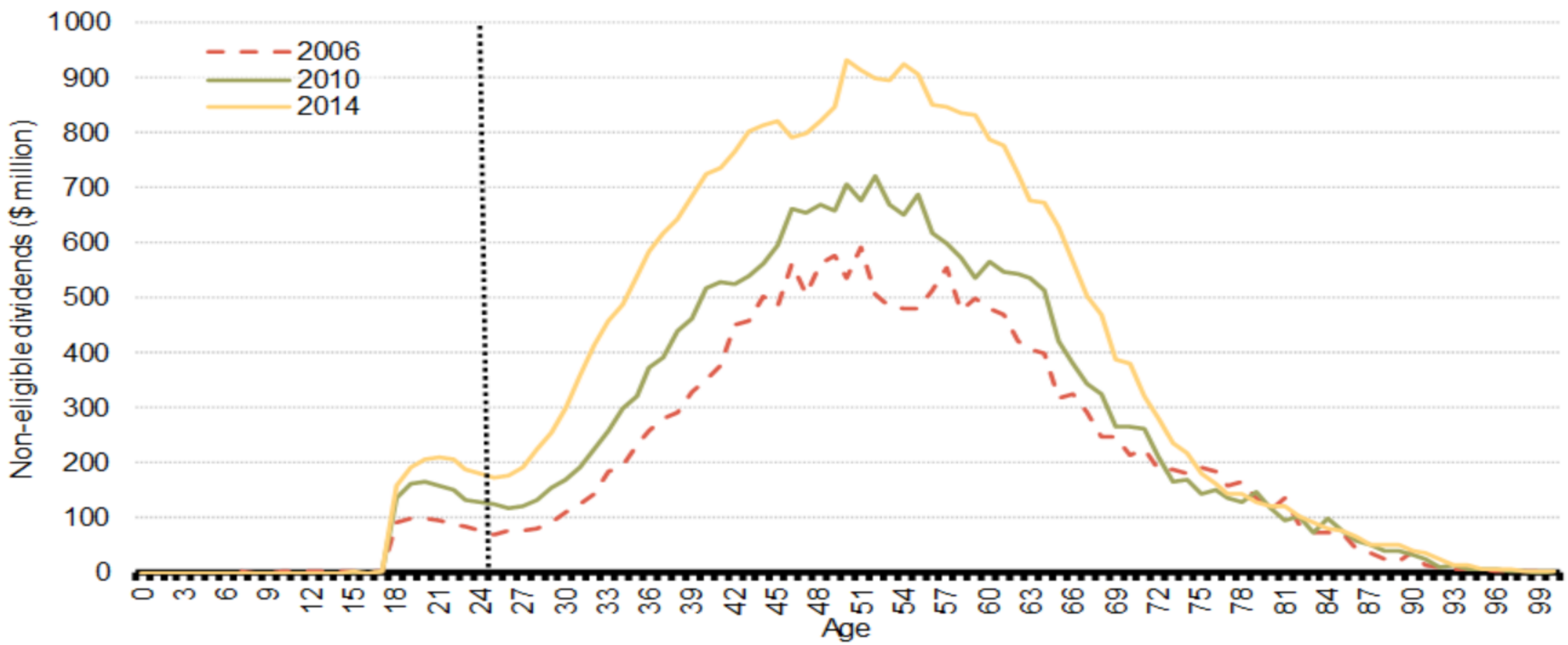
- If amount deemed "unreasonable," will be taxed at the <u>highest marginal rates</u> – **"split income"**

- More restrictive for children aged 18 – 24

INCOME SPLITTING

Dividend Sprinkling - What does this mean for you?

Chart 6
'Non-Eligible' Dividends Reported on T1 Returns, By Age of Filers ($million)



Text version

Source: T1 Universe datasets.
Note: No significant amount of actual 'non-eligible' dividends is received by individuals under age 18; these amounts are subject to personal income taxation at the top rate. The variable used is "actual amount of dividends, other than eligible," which is the net amount of dividends received, with no gross-up factor applied.

https://www.fin.gc.ca/activty/consult/tppc-pfsp-eng.asp#_Toc487531606

INCOME SPLITTING

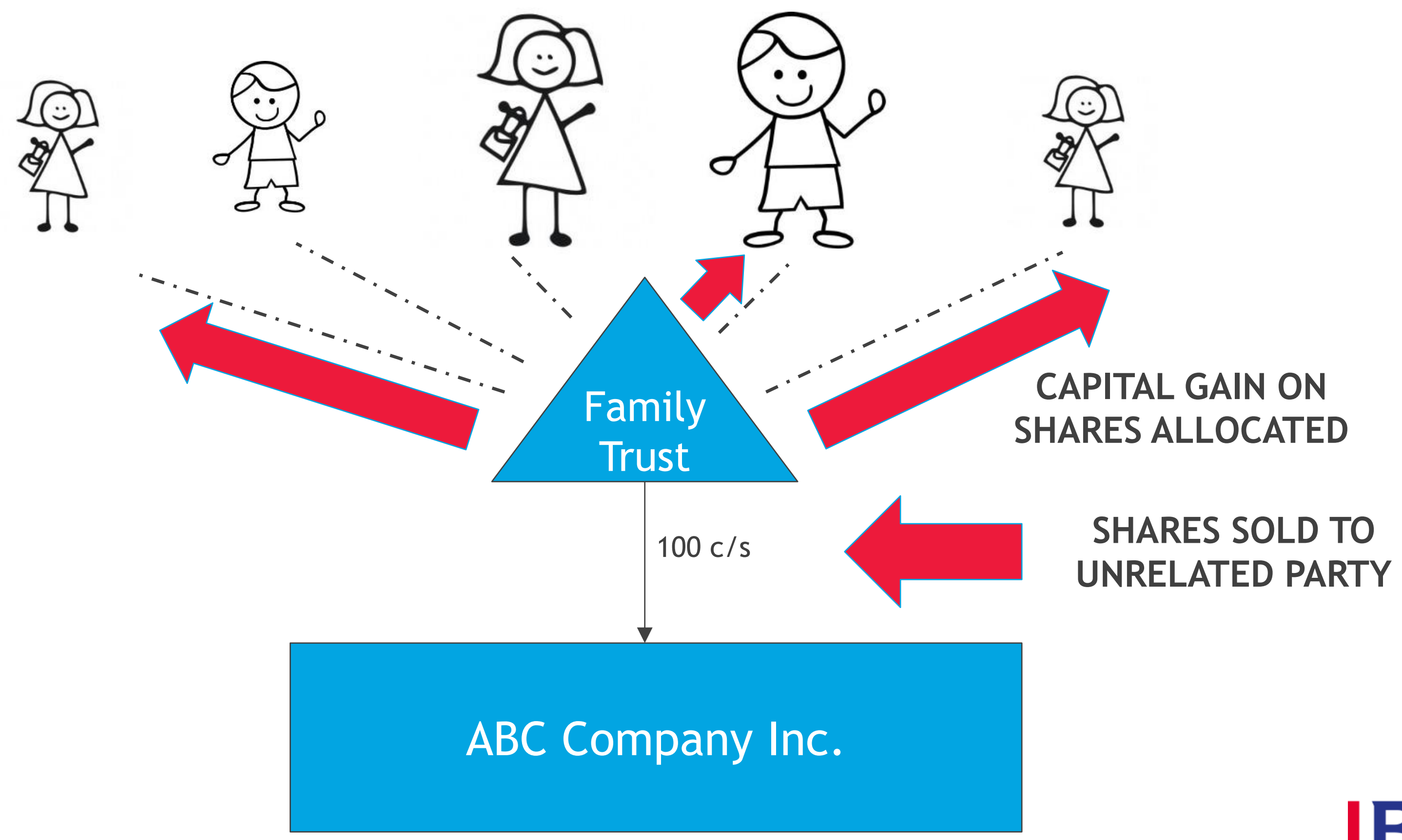
Dividend sprinkling - What does this mean for you?

- If enacted, effective January 1, 2018
- Not just dividends caught as “split income”
  - Taxable dividends from private company
  - Business income from partnership
  - Business income from trust
  - Income from indebtedness
  - Taxable capital gains & income from property dispositions
  - Benefit conferrals
  - Secondary, or re-invested split income (under age 25)

INCOME SPLITTING

Common tax planning strategies that will be ineffective under proposals

Allocating capital gains with family members



INCOME SPLITTING

Allocating Capital Gains - What does this mean for you?

Capital gains exemption restricted in three scenarios:

- Trusts: Gains that accrue on shares held by a trust generally not eligible for the capital gains exemption
- Age: Gains that accrue on property held *prior to an individual attaining age 18* will not be eligible for the capital gains exemption
- Reasonability: If the capital gain would be included in an individual's split income it will not be eligible for the capital gains exemption

INCOME SPLITTING

Allocating Capital Gains - What does this mean for you?

Capital gains exemption restricted in three scenarios:

Example: Age

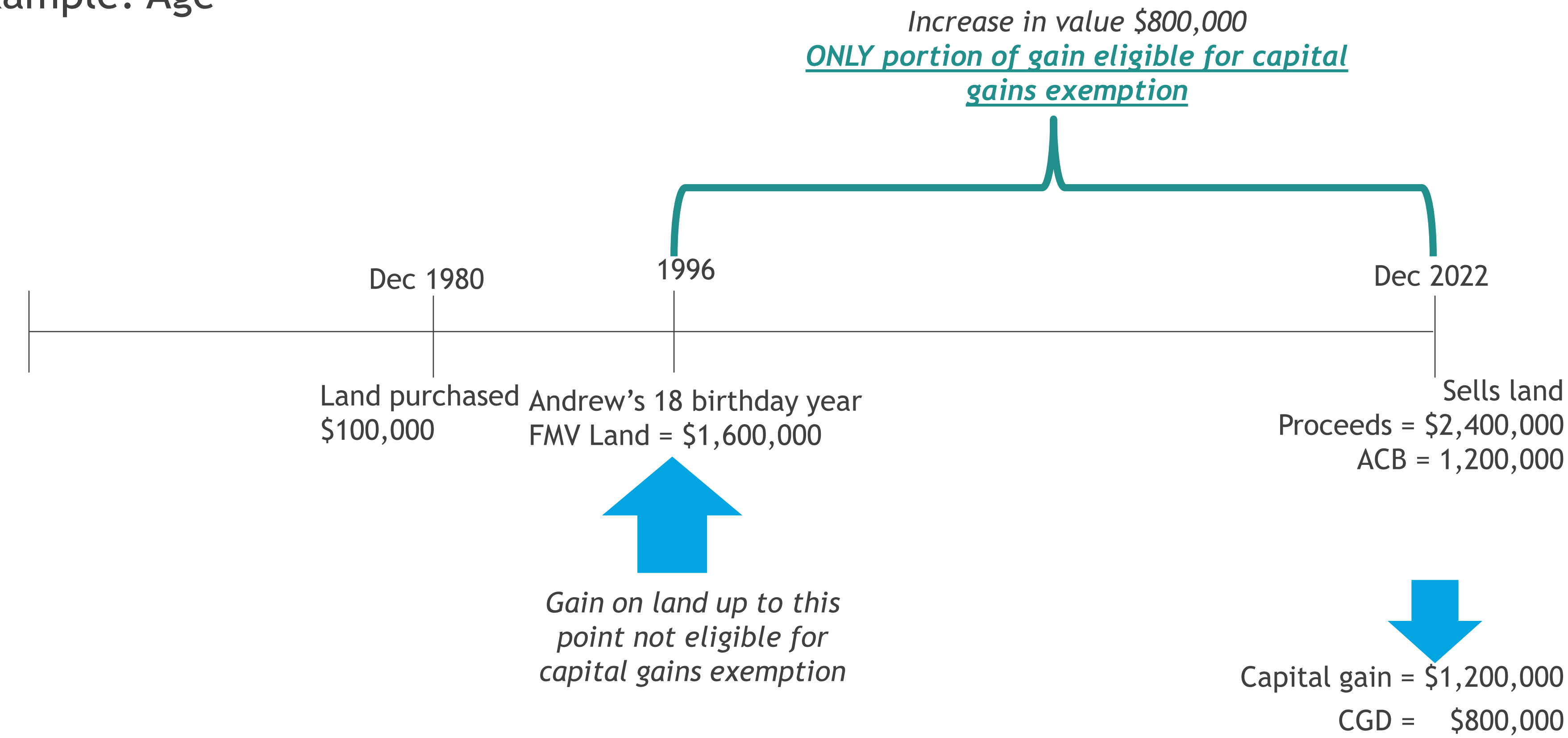
Andrew's family accessed the intergenerational rollover provisions to roll to him a piece of farmland with a FMV of $2,200,000. The elected amount was $1,200,000 to step up the cost by his father's capital gains deduction. Andrew sells the property in 2022 for $2,400,000. The land was originally purchased when Andrew was 2 years old for a FMV of $100,000.

INCOME SPLITTING

Allocating Capital Gains - What does this mean for you?

Capital gains exemption restricted in three scenarios:

Example: Age



INCOME SPLITTING

Allocating Capital Gains - What does this mean for you?

Capital gains transition rules

- Opportunity to elect to crystallize some capital gains exemption in 2018
- Holding period shortened to 12 months (vs. typically 24 months)
- Can increase cost base of property up to FMV
- Punitive penalty for electing at amount greater than 110% of FMV

WHY IS THE DEPARTMENT OF FINANCE DOING THIS?

Department of finance's target situation

- Jonah and Susan are neighbors living in Ontario. Both live with their spouses and children who have no significant sources of income
- Jonah and Susan both earn $220K annually – Jonah as a small business owner, Susan as an employee
- As an employee, Susan pays ~ $79K in tax
- Jonah has issued shares to his wife and children who receive dividends which are taxed at lower rates. As a result, Jonah's family tax (corporate tax, personal tax on salary + dividends) is ~ $44K
- The Department of Finance deems this arrangement unfair…

HOLDING PASSIVE INVESTMENT PORTFOLIOS INSIDE A PRIVATE CORPORATION

- Current Ontario tax rates:

– General corporate income	26.50%
– Small Business Deduction income	15.00%
– Highest personal rate (regular income)	53.53%
– Highest personal rate (eligible dividends)	39.34%
– Highest personal rate (ineligible dividends)	45.30%

- After paying tax in a corporation on $1 of business income, there is 73.5 / 85 cents remaining to invest
- If same income earned personally, there is 46.47 cents remaining
- Difference of 27.03 / 38.53 cents – tax deferral

HOLDING PASSIVE INVESTMENT PORTFOLIOS INSIDE A PRIVATE CORPORATION

- This is a deferral only – once funds removed from the company as a taxable dividend, total tax paid will be approximately 53%

- To the extent that the earnings are used to reinvest in the business – no issue

- Accumulated earnings could be used to purchase investment portfolios
  - Interest-free loan from government? **This is the perceived mischief!**

- Finance wants to eliminate this apparent advantage by introducing an alternative approach to taxation

HOLDING PASSIVE INVESTMENT PORTFOLIOS INSIDE A PRIVATE CORPORATION

- Removal of the refundable tax mechanism creates a corporate tax rate on passive income well in excess of the current personal top marginal rate of 53.53%
- Result of proposal is effective taxation at 100% of income earned on deferred corporate tax (“interest-free loan” portion) and regular tax on remainder
- Combined rate could be 70-73% on passive income
- Government has signalled willingness to “grandfather” existing investments
- Will require very complex calculations to determine which tax rates apply

HOLDING PASSIVE INVESTMENT PORTFOLIOS INSIDE A PRIVATE CORPORATION

What does this mean for you?

- A potential crushing compliance burden depending on the approach
  - More time will be required to track income pools and apply appropriate tax rates

- No advantage to earning active income through a business and investing
  - Decision to flow all income out to shareholders vs retain in corporation will be tax neutral

- <u>Severely undermines business owners' retirement and succession planning</u>
  - We should be encouraging retirement savings, not creating disincentives

HOLDING PASSIVE INVESTMENT PORTFOLIOS INSIDE A PRIVATE CORPORATION

What does this mean for you?

- Investment in technology does not happen every year
- Economic downturns can occur anytime – having cash reserves can help businesses overcome difficult times and maintain employment
- Having access to capital encourages entrepreneurialism

HOLDING PASSIVE INVESTMENT PORTFOLIOS INSIDE A PRIVATE CORPORATION

The good news?

- Draft legislation not yet written - Finance is seeking feedback with respect to the proposals
- No effective date has been set as of yet
- Intent for new rules to apply on a go-forward basis
- Should not apply to companies that reinvest their after-tax profits in their active business operations

SURPLUS STRIPPING

What is surplus stripping?

- Extracting funds from your corporation at either a zero tax or lower tax rate (capital gains rate) as opposed to extracting as a dividend or salary
- Canadian tax system designed so that a shareholder who earns income through a corporation and repatriates it to himself/herself as a dividend will pay approximately the same amount of tax as if they earned the income personally
- Surplus strips allegedly undermine this concept of "integration"

SURPLUS STRIPPING

"The way the proposed new tax rules are written, Gartner said, an older farmer who wants to sell a $4 million farm would pay $500,000 in tax if they sold the land to an aggregation company or a neighbour but would pay $1.64 million if they sold it to their children and the children used money generated by the farm to pay for the purchase."

- Financial Post

SURPLUS STRIPPING

A spokesperson for the Finance Minister said the department has heard … concerns from farmers worried the changes will prevent them from passing on their businesses.

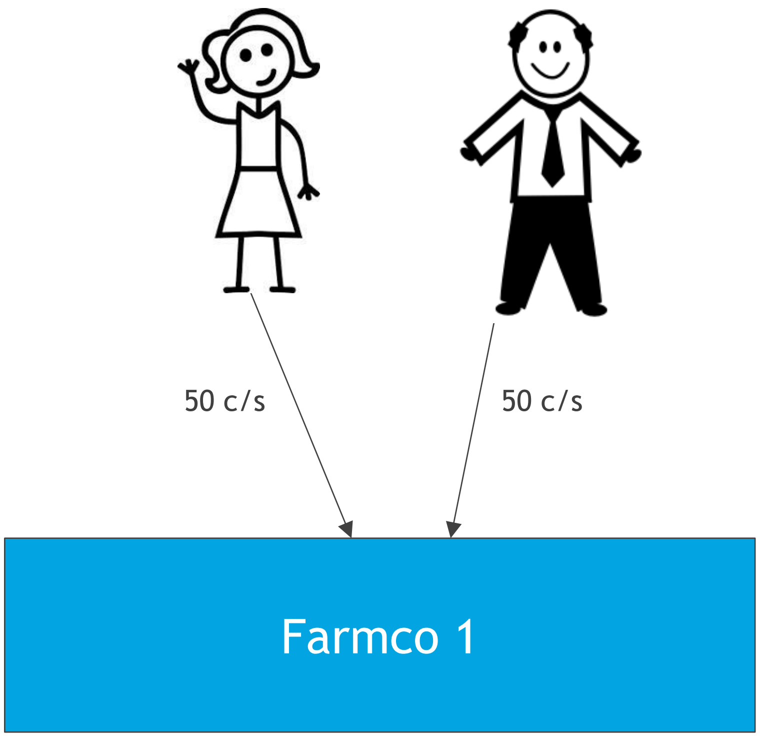
*"I can tell you that for hard-working, middle-class family farmers, **this simply isn't the case,"** said Mr. Morneau's director of communications Daniel Lauzon. "Our focus is on fixing a tax system that benefits the wealthy over the middle class."*

*He said the proposal looks to "prevent the use of complex transactions designed to circumvent existing rules restricting the conversion of dividends to capital gains. **These are sophisticated transactions, not simply about the transfer of family farms from one generation to the next.“***

- Globe and Mail

SURPLUS STRIPPING

Example 1: Farm Business Transition



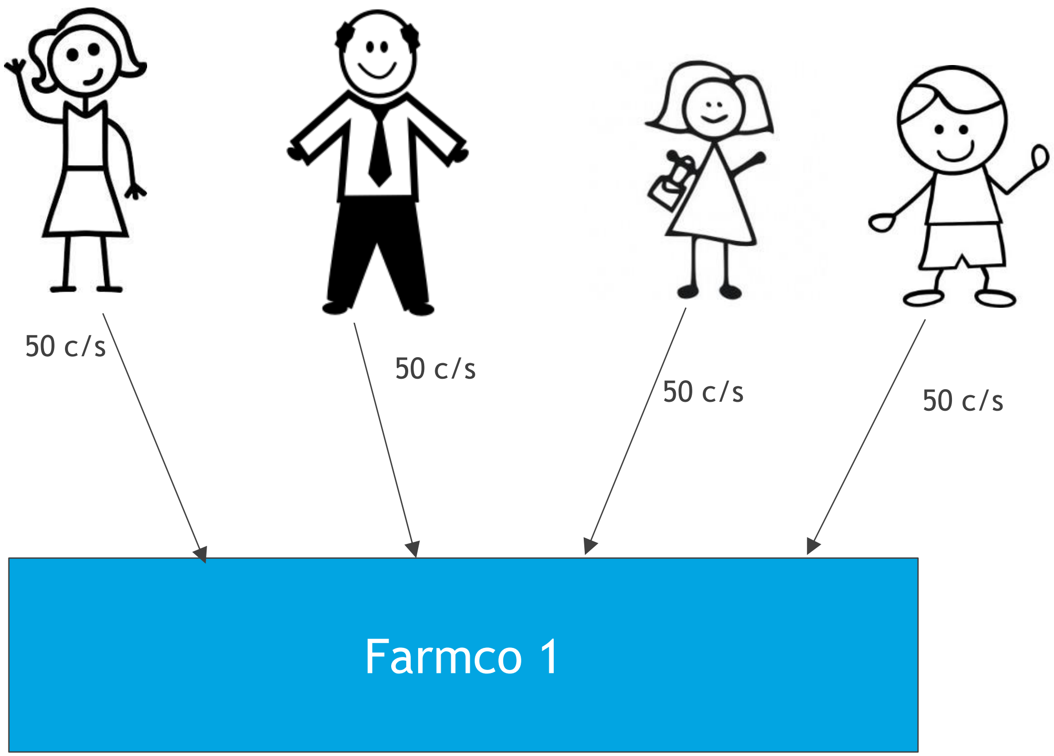
Fair market value = $4,000,000

Sale to THIRD PARTY

Proceeds =	$4,000,000
Less CGE	(2,000,000)
Gain	2,000,000
Tax @ 25%	(500,000)
After tax $	3,500,000

SURPLUS STRIPPING

Example 2: Personal debt

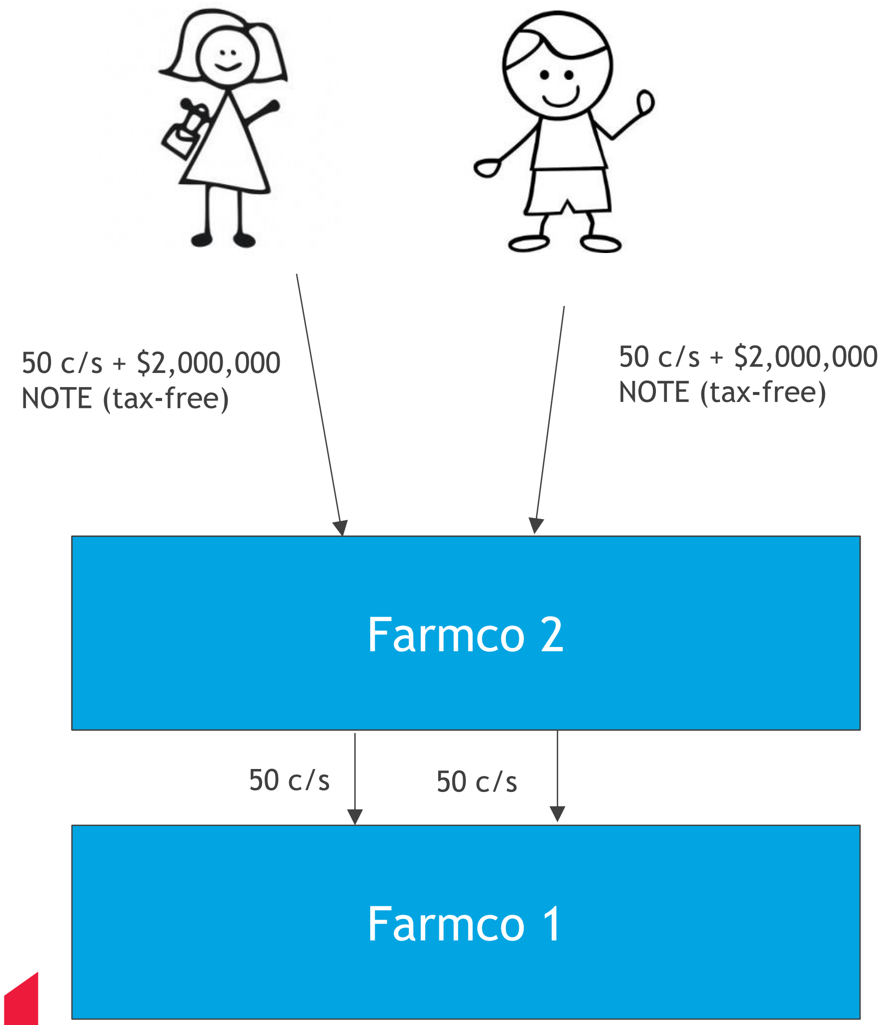


OLD RULES STEP ONE:

Proceeds =	$4,000,000
Gain	4,000,000
Tax @ 25%	(1,000,000)
After tax $	3,000,000

SURPLUS STRIPPING

Example 2: Personal debt

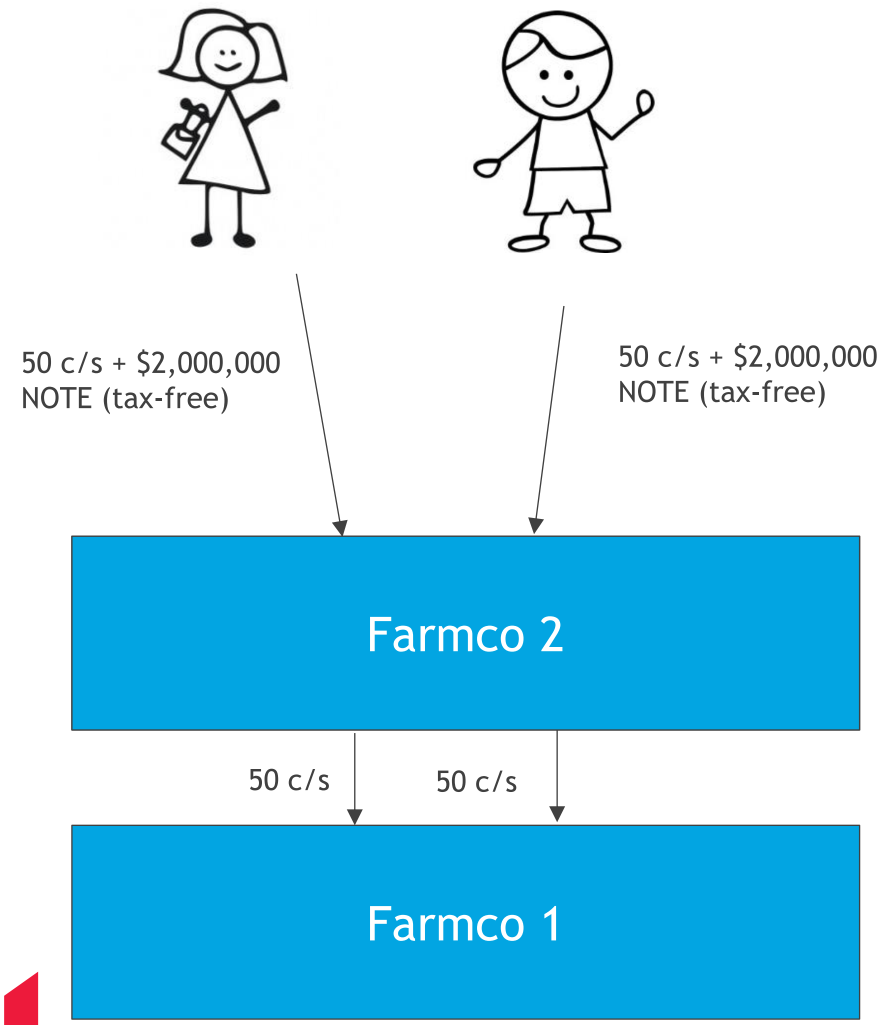


OLD RULES STEP TWO:

New corporation set-up and shares transferred in exchange for $4M of note payable, which can be withdrawn tax-free

SURPLUS STRIPPING

Example 2: Personal debt



NEW RULES STEP TWO:

If undertaken when **RELATED**
TAX = $4,000,000 x 43.5%
= 1,742,000

<u>If not related, no change vs. old rules</u>

COMPARISON OF TAX RESULT

INTERGENERATIONAL TRANSFERS

	3rd party OLD (#1)	3rd party NEW (#1)	Personal debt OLD (#2)	Personal debt NEW (#2)
Proceeds	$4,000,000	$4,000,000	$4,000,000	$4,000,000
Tax to seller	500,000	500,000	1,000,000	1,000,000
Net proceeds seller	3,500,000	3,500,00	3,000,000	3,000,000
Tax to purchaser*	NIL	NIL	NIL	1,742,000
Net funds extracted by purchaser	4,00,000	4,000,000	4,000,000	2,258,000
Total tax paid	500,000	500,000	1,000,000	2,742,000
Effective tax %	12.5%	12.5%	25%	68.55%

*on extraction of $4M paid for shares

SURPLUS STRIPPING
Estate Example

Mr. X passes away owning 100% of Xco with a fair market value of $1 million (made up of GICs). Mr. X leaves the shares in his will to his daughter Y.

Old Rules

- Estate of Mr. X pays tax of $267,650 on his final return
- Y transfers shares to new holding company Yco and receives promissory note for $1 million.
- Xco and Yco wound up – no additional tax because already taxed once
- Could have elected to pay tax at dividend rates (40-45%)
- Concept of “hard cost base” – already taxed

SURPLUS STRIPPING

Estate Example

<u>New Rules</u>

- No longer "hard cost base" on related party gain
- Estate of Mr. X pays tax of $267,650 on his final return
- Y transfers shares to new holding company Yco and receives promissory note for $1 million
- Xco and Yco wound up – now additional tax of $393,400 because Y does not get credit for tax paid by X and deemed to be a dividend
- Effective tax rate of 66.1%
- Could have elected to pay tax at dividend rates (40-45%) – will be only option

SURPLUS STRIPPING

What does this mean for you?

- Revisit any current or intended planning to ensure you are onside as the impact is severe (Section 84.1)

- New rules can have a significant impact on taxes paid on death (Section 84.1) so revisit estate planning

- Review any past planning where an amount may be receivable now resulting from a past transaction (Section 246.1)

SUMMARY OF CONCERNS

- Concern with Consultation process
  - Draft legislation included with Consultation paper
  - 75 day consultation period
  - Summer holidays
- Proposals ignore risks taken by the business owner
  - Ignores the Family units involvement in business + risk to Family Assets
  - Gov’t should be supporting business growth + innovation
- Proposals Ignore Timing
  - Assumes Inputs:
    - Time + Effort + Capital = Immediate Profit
- Complexity + subjective interpretation = lack of clarity + increased compliance costs

SUMMARY OF CONCERNS

- Complex Tracking of Passive investments
  - Discourages saving for future re-investment, economic slow down, expansion, retirement savings
- Proposals impair the concept of integration in some cases
- Proposals have retroactive effect in many circumstances
- Proposals do not affect only the “1%”
  - Affect the small business owner
- Proposals may negatively affect tax burden to estates
- Proposals may negatively affect market for business dispositions

WHAT CAN I DO?

- No drastic steps before consultation process plays out
- Consider larger dividends prior to 2018
- Consider “purification” before end of year for CGE if needed
  - Consider 2017 crystallization
  - 2018 CGE election
- Review past planning for impacts of surplus stripping changes
- Review estate planning
  - Impact of S84.1 changes

WHAT CAN I DO?

- Contact your MP to voice any concerns you may have with these proposed changes
- Discuss with your business colleagues to ensure they understand the impacts and encourage them to do the same in the event they have concerns
- Voice any concern you may have to any relevant professional associations as there is strength in collective representation
- Meet with your tax advisor (I can recommend a good one..) and discuss any planning strategies which may apply to you

QUESTIONS?