Private Company Income Splitting

Presented by: William Bernstein
September 14, 2017

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Topics to Review

1. Background to proposed changes
2. Current rules for income splitting with CCPC
3. Proposed changes for income splitting with CCPC
   - Expanding base of individuals
   - Expanding types of split income
   - Exemptions
4. Planning issues
   - What is no longer available or restricted
   - What is still available
   - To do prior to 2018
5. Take-aways

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Background to Proposed Tax Changes

- Federal budget 2017 warning about government concerns as to tax Issues for private corporations
- July 18, 2017 Department of Finance draft legislation, explanatory notes and consultation paper proposing to fundamentally overhaul system of taxation of private corporations, their shareholders and family members
- Very broad changes targeting Canadian-controlled private corporations ("CCPC") regardless of sector or industry

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Background to Proposed Tax Changes …cont'd

- Government projection of additional income tax revenue from income splitting changes is relatively minor so likely motivated largely by political issues for attacking high income earners to appeal to middle class
- Issues targeted are:
  - Income splitting/sprinkling
  - Lifetime capital gains exemption
  - Capital gains tax
  - Holding passive investments in a private corporation

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Background to Proposed Tax Changes ...cont'd

- Scope of proposals go beyond expectations of tax professionals
- Changes will affect all or most CCPCs
- I will be dealing with proposals for income splitting
- New rules to become effective 2018
- Much opposition to changes so question of what, if any, changes
- Ontario Medical Association particularly upset as Ontario government specifically allowed income splitting for professional corporations of physicians as part of settlement with OMA over fee schedule

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Current Rules as to Income Splitting with CCPCs

- Current restrictions to restrict income splitting with minors and spouses under various attribution rules and special rules that limit income splitting to minors (kiddie tax)
- Kiddie tax results in taxation at top marginal rate
- Maximum annual tax savings by dividend splitting approximately $25,000 to $35,000 per individual if no other income
- Savings decrease significantly if family member has other income

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Current Rules as to Income Splitting with CCPCs

Income Splitting by Dividends

- Current rules allow for income splitting by dividends to spouses and adult children if structured properly to avoid personal attribution rules and corporate attribution rules
- Common tax planning has spouse and adult children owning shares directly or through a family trust to allow dividends paid to various family members with flexibility
- CRA previously attacked income splitting by dividends to family members
- Courts determined that income splitting by dividend is legal if properly set up regardless of services provided or other contributions by the shareholder

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Current Rules as to Income Splitting with CCPCs

Income Splitting by Salary

- Alternative income splitting to family members by corporation pay a salary
- Always has been limited to what is reasonable relative to the services provided (arm's length test)
- Risk of double tax if deduction by corporation disallowed
- Commonly used and CRA not overly aggressive if salary not too aggressive
- Question if CRA will be more aggressive on proposed "reasonableness" test for dividends

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Proposed Changes for Income Splitting

Expanding Base of Individuals – Specified Individuals

- Significant changes to add significant restrictions and uncertainty to limiting income splitting among family members by CCPC
- The tax on split income (“TOSI”) (formerly limited to kiddie tax) will apply not only to minor children but to “specified individuals”
- Will apply to children over 18 and other related individuals, including spouses, common-law partners, aunts, uncles, nieces and nephews
- Limited to individuals resident of Canada

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Proposed Changes for Income Splitting

Expanding Types of Split Income

- Gains from property that would produce “split income” (i.e. shares of the CCPC)
- Related proposed change to deny capital gains exemption on such shares (to be dealt with by another speaker)
- Gain on such a share on non-arm’s length disposition is taxed as non-eligible dividend instead of capital gain

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Proposed Changes for Income Splitting

Expanding Types of Split Income …cont'd

- Income from loans to a corporation, partnership or trust in certain situations (i.e. interest on loan to a corporation)
- Income on previously split income if the individual is under age 25
- Amounts included in income because of benefit conferred by another person

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Proposed Changes for Income Splitting

Exemptions from TOSI

- For individuals age 25 or over exemption if the amount is reasonable relative to what would be paid to an arm's length person taking into consideration
  - Assets contributed to the business
  - Labour contributed to the business
  - Previous returns and remuneration

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Proposed Changes for Income Splitting

Exemptions from TOSI …cont'd

- Stricter tests for individuals age 18 to 24 years old
  - Consider labour only if acted on a regular and continuous basis
  - Only prescribe maximum return on assets contributed
- Practical problem to determine what is reasonable amount, which will depend in each situation, resulting in significant uncertainty

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Proposed Changes for Income Splitting

Exemptions from TOSI …cont'd

- Anti-avoidance provision if more than fifty percent of the income of a business is from property or its principal purpose is to derive income from property (e.g. a holding company) then individual deemed not to have performed any labour function in respect of the business

Planning Issues

What is No Longer Available or Restricted

- In context of an estate freeze there will be restrictions on dividends to family members based on reasonableness test (stricter if under age 25)
- In connection with setting up new corporation restrictions on dividends to family members based on reasonableness test (stricter if under age 25)
- Reinvestment of split income by child under age 25

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Planning Issues

Planning Still Available

- Salaries to the extent reasonable
- Dividends to a child aged 25 or over and spouse to extent reasonable relative to capital and labour provided taking into consideration previous returns and remuneration (? catch-up payments)
- Estate freeze still useful to freeze capital gains tax on death of freezor with family trust owning new growth shares to allow flexibility for future allocation of growth shares among family members

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Planning Issues

Planning Still Available …cont'd

- Dividends to individuals already subject to top tax rate
- Prescribed interest rate loans (currently 1%) reinvested by spouse and children, subject to payment of annual interest by January 30 each year
- Splitting eligible pension income between spouses
- Income earned on property received from a parent on death

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Planning Issues

Planning Prior to 2018

- Consider maximizing dividends to family members by December 31, 2017 before new restrictions apply

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Take-Aways

- If proposed income splitting changes become effective will impact all or most CCPCs
- Need to review all CCPCs and dividends paid
- Significant uncertainty as to what will be considered by CRA a reasonable amount of dividends in each situation
- Uncertainty as to how aggressive CRA will be in challenging dividends (past practice with salaries)
- Most of the tax savings occur at relatively low amounts of dividends
- Consider paying dividends by the end of 2017

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Questions?

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Lifetime Capital Gains Exemption and Converting Income Into Capital Gains

Presented by: Josh Harnett
September 14, 2017

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Lifetime Capital Gains Exemption

Current Rules

- Lifetime capital gains exemption (LCGE) applies to gains arising from dispositions of “qualified small business corporation shares” (QSBCS)
- LCGE shelters baseline amount of $800,000
    - Indexed to inflation
    - 2017: $835,716
- Can be claimed by an “individual” (other than a trust)

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Lifetime Capital Gains Exemption

Current Rules (cont'd)

- LCGE can be accessed through a trust
- With proper designations, character of capital gain is preserved when allocated to beneficiaries
- Beneficiaries then claim LCGE on their personal returns in respect of gain flowed to them
- Common planning technique to multiply access to LCGE

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Lifetime Capital Gains Exemption

Perceived “Evils”

- Government concerned with use of family trusts to “multiply” access to LCGE
- “Individuals have used these arrangements in a way that permits them to claim the exemption even though they may not have invested in, or otherwise contributed to, the business value reflected in the capital gains they realize on the disposition of property that is eligible for the exemption.”
  - Canada, Department of Finance, *Tax Planning Using Private Corporations* (Ottawa: Department of Finance, July 18, 2017), 28.

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Lifetime Capital Gains Exemption

New Measures

- Three different measures are being proposed o address LCGE multiplication

1. Age Limits
2. Reasonableness Test
3. Trusts

Lifetime Capital Gains Exemption

New Measures – Age Limits

- Under the proposed rules, individuals will not be eligible to claim the LCGE until the taxation year in which they attain the age of 18
- New paragraph 110.6(12)(a)
- Amount that is eligible for the LCGE is reduced by the entire amount of the capital gain where the individual has not attained the age of 17 years before the particular year

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Lifetime Capital Gains Exemption

New Measures – Age Limits (cont'd)

- New paragraphs 110.6(12)(c) and 110.6(12.1)(a)
- Where an individual holds property at the time the individual attains the age of 18 years, the portion of the gain that accrued prior to the individual attaining the age of 18 years is not eligible for the LCGE

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Lifetime Capital Gains Exemption

New Measures – Reasonableness Test

- Capital gains will be caught by expansion of tax on split income (TOSI) rules
- TOSI (formerly, "kiddie tax") will potentially apply to all individuals
  - No longer limited to those under 18
- A capital gain will be "split income" where it arises from a disposition of property the income from which would itself be "split income"
  - New paragraph (e) of definition of "split income"

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Lifetime Capital Gains Exemption

New Measures – Reasonableness Test (cont'd)

- New paragraph 110.6(12)(d)
- Amount that is eligible for the LCGE is reduced by twice the amount of the taxable capital gain where the individual has attained the age of 17 years before the particular year and the taxable capital gain would be included in the individual's split income

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Lifetime Capital Gains Exemption

New Measures – Reasonableness Test (cont'd)

- Reasonableness test that is part of the expanded TOSI rules directly impacts on ability to claim LCGE
- If individual did not make a "reasonable" capital contribution to the business that generated the capital gain, the capital gain will be "split income" and not eligible for LCGE

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Lifetime Capital Gains Exemption

New Measures – Trusts

- In broad terms, capital gains that accrue during a period in which a trust holds property will no longer be eligible for the LCGE
- New paragraphs 110.6(12)(e) and 110.6(12.1)(b)
- Where property is distributed from a trust to a beneficiary on a tax-deferred basis, the portion of the gain that arose while the property was held by the trust is not eligible for the LCGE
  - Must determine FMV as at date of distribution

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Lifetime Capital Gains Exemption

New Measures – Trusts (cont'd)

- Amendment to subsection 104(21.2)
- Flow-through of trust's capital gain on disposition of QSBCS so that beneficiaries can claim LCGE no longer available except in limited circumstances
- So, capital gain realized by trust can no longer be allocated to beneficiaries with LCGE then claimed by beneficiaries

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Lifetime Capital Gains Exemption

New Measures – Trusts – Exception

- “eligible LCGE trust” – two types of trusts are not caught by new rules

1. Life-interest trusts – alter ego trusts, spousal trusts, joint partner trusts
2. Trusts established to hold shares on behalf of employees under stock option rules in section 7

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Lifetime Capital Gains Exemption

2018 Election

- Some limited relief proposed for existing structures
- Election can be made in 2018 to “crystallize” LCGE
- Election can be made by individuals and certain trusts

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Lifetime Capital Gains Exemption

2018 Election (cont'd)

Conditions for election

1. Taxpayer must be an individual or a personal trust
2. Taxpayer must make prescribed election
3. Property must be "eligible property"
4. Where the taxpayer is an individual, must be reasonable to conclude that election will result in increase in amount deductible under LCGE rules
5. If taxpayer is under 18 years of age, the election cannot be made for a share of a corporation

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Lifetime Capital Gains Exemption

2018 Election (cont'd)

Conditions for election (cont'd)

6. Where the taxpayer is a trust
   a) Must be reasonable to conclude that any taxable capital gain will be deemed to be a taxable capital gain of a beneficiary that is an individual (other than a trust)
   b) Each beneficiary must be a beneficiary under the trust continuously from the end of 2017 to date on which the election takes effect
   c) If the beneficiary is under 18 years of age, the property is not a share of a corporation

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Lifetime Capital Gains Exemption

2018 Election (cont'd)

Meaning of "eligible property"

- Owned by the taxpayer continuously from the end of 2017
- Is capital property of the taxpayer
- In the case of a share, would be a QSBCS if the references in the definition of that term to "24 months" were read as references to "12 months"
    - This last point is intended to provide some relief where the shares currently do not qualify for the LCGE

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Lifetime Capital Gains Exemption

2018 Election (cont'd)

Effect of 2018 election

- Taxpayer deemed to dispose of property from proceeds equal to the greater of:
  - Amount designated in election; and
  - ACB of property
- Taxpayer deemed to reacquire property at cost equal to deemed proceeds
- New rules do not apply to prevent claiming LCGE

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Lifetime Capital Gains Exemption

2018 Election (cont'd)

- Election is "last chance" to claim LCGE for value that is accruing in a trust
- If planning rollout, must make sure rollout is complete by end of 2017 so that shares will be "eligible property"
- If making election in trust, must ensure that trustees can make deemed capital gain payable to beneficiaries

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Lifetime Capital Gains Exemption

Coming into Force

- The changes to the LCGE rules apply to the 2018 and subsequent taxation years

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Converting Income into Capital Gains

Current Rules

- Current section 84.1 prevents “surplus stripping” by limiting the amount that a taxpayer can extract in a non-arm’s length transaction to the greater of PUC or “hard” ACB
- Hard “ACB” does not include ACB that arose from claiming the LCGE
- Where section 84.1 applies, a taxpayer will be deemed to receive a dividend to the extent that surplus extracted from corporation exceeds the greater of PUC and “hard” ACB

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Converting Income into Capital Gains

Perceived "Evils"

- As section 84.1 is a specific anti-avoidance rule, government concerned that it does not go far enough in that it cannot prevent transactions that are specifically designed to avoid it
- Government also notes that courts have been siding with taxpayers in some cases

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Converting Income into Capital Gains

Amendment to Section 84.1

- Section 84.1 will be extended to apply to taxable transactions
- Section 84.1 will also apply to any share, and not only shares that were acquired in non-arm's length transactions
- If the ACB relates to previous transactions (whether taxable or not) involving the particular taxpayer or a non-arm's length person, that ACB will not prevent the application of section 84.1
- Effectively, only ACB from arm's length acquisitions or additional capital contributions will be taken into account

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Converting Income into Capital Gains

New Section 246.1

- For situations where the amendment to section 84.1 will not be enough to cause dividend taxation, the government is introducing new section 246.1
- Where section 84.1 is targeted at a particular type of transaction between an individual and a corporation, section 246.1 contains a broadly worded anti-surplus stripping rule

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Converting Income into Capital Gains

New Section 246.1 (cont'd)

Conditions for application:

1. Amount is received or receivable by an individual that is resident in Canada
2. Amount is received or receivable from a person with whom the individual was not dealing at arm's length
3. As part of the transaction or series of transactions, there was a disposition of property or an increase or reduction in PUC

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Converting Income into Capital Gains

New Section 246.1 (cont'd)

Conditions for application (cont'd):

4. It can reasonably be considered that one of the purposes of the transaction or series was to effect a significant reduction or disappearance of assets of a private corporation at any time in a manner such that any part of tax otherwise payable by the individual with respect to the portion, and in consequence of any distribution of property of the corporation, is avoided

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Converting Income into Capital Gains

New Subsection 246.1 (cont'd)

- Where the conditions for application are satisfied in respect of a particular amount, the individual will be deemed to have received a taxable dividend equal to such amount
- In interpreting the purpose test, an individual will be considered to be avoiding tax if the amount of tax actually payable by the individual is less that the tax that would be payable if the corporation has paid a taxable dividend

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Converting Income into Capital Gains

New Section 246.1 (cont'd)

- New subsection 246.1(3) contains a rule that will reduce a corporation's capital dividend account in respect of capital gains realized as part of a series of transactions that includes a distribution that is re-characterized as a dividend under subsection 246.1(1)
- The assumption appears to be that the capital gain realized as part of the series is not legitimate and so should not be included in the corporation's capital dividend account

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Converting Income into Capital Gains

Coming into Force

- The proposed amendments to section 84.1 and the introduction of section 246.1 are effective as of July 18, 2017

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Converting Income into Capital Gains

Scope of New Rules

- Consider a typical “pipeline” transaction
- Amendment to section 84.1 could apply where Estate transfers high ACB shares to new corporation
- Where assets are extracted from the corporation, either as loan repayment or return of capital, section 246.1 could apply to deem the otherwise tax-free payment to be a taxable dividend
- Potential scope of 246.1 is particularly concerning – can even apply to capital dividends

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Taxation of Investment Income; Voluntary Disclosure Program and Automatic Exchange of Tax Information

Presented by: Lorne Saltman
September 14, 2017

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Topics to Discuss

1. Introduction: Tax Reform in Canada and Internationally
2. Proposals to Modify the Taxation of Passive Investment Income of Private Corporations
3. Proposals to Amend the Voluntary Disclosure Programme
4. Proposals to Commit to the Common Reporting Standard and Provide Automatic Exchange of Tax Information to Foreign Tax Authorities

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Taxation of Passive Investment Income of a Private Corporation

- Policy Statement in Budget 2017
- *When private corporations earn income beyond what is needed to re-invest and grow the business, fairness and neutrality require that such corporations not be used as a personal savings vehicle for the purpose of gaining a tax advantage*
- *This use of a private corporation's lower tax rate to invest after-tax proceeds in passive investments results in a realization of returns that exceed what individual investors saving in a personal investment can achieve*

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Taxation of Passive Investment Income of a Private Corporation ...cont'd

- The objective of the "integration" rules for taxing investment income is to ensure that a dollar of such income earned through a corporation bears a tax burden, when corporate and personal taxes are combined, that is roughly similar to that of a dollar of such passive income earned directly by an individual

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Taxation of Passive Investment Income of a Private Corporation ...cont'd

Individual		Corporate Owner	
Salary	+$100	Business Income	+$100
Personal Income Tax	-$50	Corporate income tax	-$15
After-tax income	$50	Income after corporate tax	$85
		On distribution as dividend: Personal income tax - Dividend grossed up - PIT rates applied - Claim dividend tax credit	-$35
		Total tax paid	$50
		After-tax income	$50

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Taxation of Passive Investment Income of a Private Corporation ...cont'd

What is the alleged unfair advantage ?

- Suppose a private corporation earns active business income of $100,000 and pays corporate tax at a combined rate of 15%
- The entrepreneur has $85,000 after-tax proceeds with which to invest in passive investments
- In contrast, an employee earning $100,000 at the top rate will pay tax of 53.53% in Ontario, leaving only $46,407

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Taxation of Passive Investment Income of a Private Corporation ...cont'd

- *While the corporation's owner will have to pay personal tax upon dividend distributions, the strategy (?) will provide the owner with a significant tax deferral advantage compared to an employed Canadian- an unacceptable inequity in the government's goal to achieve social justice*
- *The fact that the private corporation is subject to immediate tax on this passive investment income of about 50%, which roughly equates with the tax an individual would pay on the same income, does not apparently remove the inequity*

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Taxation of Passive Investment Income of a Private Corporation …cont'd

Corporate owners invest surplus in a corporation because:

- They have no employer-provided pension or maternity leave
- They have no employer-provided health care or other insurance plan
- They have no safety net
- They need a capital reserve to cushion fluctuations in the business cycle
- To cover unforeseen expenses
- Act as security for better financing terms
- Capital for future business expansion/acquisitions

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Taxation of Passive Investment Income of a Private Corporation …cont'd

		Formula	Types of Passive Investment Income Interest Income/ Rental Income	Portfolio Dividends	Capital Gains
A	Passive investment income		100	100	100
B	Taxable passive investment income	A, or 50% of A for capital gains	100	100	50
C	Provincial corporate tax	B * 11.5% or 0 for dividends	11.50	0	5.75
D	Federal tax on interest, rental income and capital gains	B * 38⅔%	38.67	n/a	19.34
E	Federal tax on dividends	B * 38⅓%	n/a	38.33	n/a
	Refundable taxes and exempt amounts(1)				
F	Refundable portion of taxes on interest, rental income and capital gains	B * 30⅔%	30.67	n/a	15.34
G	Refundable portion of taxes paid on dividends	B * 38⅓%	n/a	38.33	n/a
H	Capital dividend account	A - B	n/a	n/a	50
	Distribution of income to individuals				
I	Taxable Dividends(2)	B – C – D + F or B – C – E + G	80.50	100	40.25
J	Capital dividends	H	0	0	50
K	Personal income tax(3)	I * 45.30% or 39.34%	36.47	39.34	18.23
L	After-tax income (Corporate owner)	(I + J – K)	44.03	60.66	72.02

Notes: (1) Refundable taxes represent the portion of federal taxes paid (D or E above) that will be refunded once the corporation distributes the income or capital gains to shareholders. (2) Dividends distributed to shareholders include the after-tax passive investment income, plus the refundable portion of federal taxes, which differ based on the type of income. (3) Effective dividend tax rate after dividend gross-up and dividend tax credit by a top-rate Ontario taxpayer. The effective dividend rate of 45.30 per cent applies to the distribution of corporate investment income such as interest or rental income, non-eligible portfolio dividends (defined later in this section), and the taxable portion of capital gains. In this example, the portfolio dividends are assumed to be eligible dividends received from a public corporation, and are subject to an effective dividend tax rate of 39.34 per cent.

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Taxation of Passive Investment Income of a Private Corporation …cont'd

- Currently, the payment of taxable dividends can trigger a corporate tax refund on passive investment income, irrespective if paid out of active or passive income
- To the extent that a corporation pays dividends from active business income, the payment of additional taxes on passive income and refund of these same taxes can happen in the same tax year, effectively nullifying the intended effect of the passive investment income taxes

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Taxation of Passive Investment Income of a Private Corporation ...cont'd

- *Preferential tax rates for corporations were never intended to facilitate passive wealth accumulation, such as through passive investments*
- Many businesses use the tax savings to expand their businesses, improve their technology and create more jobs, but in other cases the benefit of the lower tax rates is being used to confer a tax and financial advantage on what are, in essence, personal <u>savings (?)</u>
- Need to close this <u>loophole (?)</u>

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Taxation of Passive Investment Income of a Private Corporation …cont'd

- Possible Approaches - with the following objectives of the government:
  - Preserving the intent of the lower tax rates on active business income earned by corporations, which is to encourage growth and job creation, and
  - Eliminating the tax-assisted financial advantages of investing passively through a private corporation, and ensuring that no new avenues for avoidance are introduced

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Taxation of Passive Investment Income of a Private Corporation …cont'd

- **Possible Approaches**
  - Refundable tax on ineligible investments was originally part of the 1972 Carter Commission Tax Reform. But not actively being considered now, because of complexity, and liquidity issues for private corporations that may not be able to get the tax refund efficiently to meet legitimate business needs
  - Deferred Taxation
    - Currently the corporate tax on passive investment income is about 50%, of which about 30% is refunded when a taxable dividend is paid out
    - Propose to eliminate the refundability of corporate tax where earnings are used to fund passive investments that were taxed at low corporate rates
    - Must determine source of distributed income from passive investments funded by low corporate tax rate and not other sources, e.g. general rate

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Taxation of Passive Investment Income of a Private Corporation …cont'd

	Individual	Corporation	
		Current System	Proposed System
Source capital			
Income	100,000	100,000	100,000
Federal personal or corporate tax	33,000	10,500	10,500
Provincial personal or corporate tax	17,367	3,900	3,900
Starting portfolio	**49,633**	**85,600**	**85,600**
Return on investment in year 1*			
Interest (3 per cent)	1,489	2,568	2,568
Non-refundable personal or corporate tax	750	506	
Federal	*491*	*205*	
Provincial	*259*	*300*	
Non-refundable taxes (new system)			1,293
Refundable taxes (RDTOH)		788	
After-tax investment income (re-invested passively)	739	1,275	1,275
Portfolio value after 10 years	**57,539**	**99,235**	**99,235**
Refund of pre-paid tax (RDTOH)		8,424	
Distribution of taxable dividends		107,659	99,235
Personal income tax on dividends		45,235	41,696
Net worth	**57,539**	**62,424**	**57,539**

Notes: (*) This box illustrates the return on investment and its tax treatment in year 1 of the investment. It is assumed that passive investment income is earned for a period of 10 years, and the after-tax proceeds are reinvested passively each year. The returns in years 2 to 10 of the investment are not illustrated to simplify the presentation of the example.

This and the following examples in this section are based on simplified tax rate assumptions, chosen to remove small discrepancies that can arise due to imperfect integration of federal-provincial tax rates on dividends and differences between the top personal income tax rate that applies in each province and current tax rates on corporate passive investment income. The assumptions used are as follows:

•All investment income is assumed to be subject to the top personal income tax rate. For simplicity, the taxation of the income earned by the high-income individual that is used for consumption purposes is not illustrated in these tables. Rather, the examples only show how the additional funds used to undertake passive investments are taxed.
•Federal and provincial personal income tax rates of 33 per cent and 17.37 per cent, respectively.[14]
•Federal and provincial general corporate income tax rates of 15 per cent and 11.7 per cent, respectively.[15]
•Federal and provincial small business income tax rates of 10.5 per cent and 3.9 per cent, respectively.[16]
•Effective combined federal-provincial dividend tax rates of 32.29 per cent for eligible dividends, and 42.02 per cent for non-eligible dividends.[17]
•A federal non-refundable corporate passive investment tax rate of 8 per cent (0 percent for dividends)
•A federal refundable (or non-refundable under the new system) corporate passive investment tax rate of 30⅔ per cent (38⅓ per cent for dividends)

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Taxation of Passive Investment Income of a Private Corporation ...cont'd

- Deferred Taxation
  - All income generated by passive investments would be treated as "non-eligible dividends" upon distribution to shareholders
  - Accordingly, dividends from publicly-listed securities would no longer be treated as "eligible dividends", and
  - The non-taxable portion of capital gains from these passive investments would be not be credited to the capital dividend account
- If there is no refundable tax for passive investments, the corporation pays about 50% tax and then the shareholder pays about 45% on the non-eligible dividend so received for another 23%, or about <u>73% in total</u>

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Taxation of Passive Investment Income of a Private Corporation …cont'd

- Deferred Taxation
  - In order to attribute dividends to the correct source, the government is considering using an apportionment method
  - Corporate owner must maintain cumulative share of earnings taxed at the low corporate tax rate (non-eligible dividends), the general rate (eligible dividends), as well as capital contributed by shareholders out of personal after-tax income (tax-free)
  - Passive income earned in the current year would be apportioned to the three pools based on the previous year's undistributed income pools
  - Complex and costly to maintain and enforce

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Taxation of Passive Investment Income of a Private Corporation …cont'd

- Deferred Taxation
  - Alternatively, in order to attribute dividends to the correct source, the government is considering using an elective method
  - A private corporation would be subject to a default tax treatment, unless it elected otherwise
  - Under the default treatment, passive income earned in a CCPC would be subject to non-refundable taxes, and dividends distributed from these sources would be treated as "non-eligible dividends"
  - A CCPC could elect to retain refundable taxes and be able to pay out "eligible dividends", but it would foreclose its ability to be taxed at the low business rate

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Taxation of Passive Investment Income of a Private Corporation …cont'd

- Deferred Taxation
  - Complex and costly rules mean increased burden on small business for compliance;
  - Distinction between business income and passive investment income not as clear as Finance asserts;
  - Entrepreneurs may be driven by tax considerations to reinvest in new or current operations, which perversely may be uneconomic – the opposite of the government's stated intention
  - No grandfathering rules promulgated, although Finance states their intention is for there to be limited impact on existing passive investments, and apply the new rules prospectively

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Taxation of Passive Investment Income of a Private Corporation …cont'd

- Deferred Taxation
  - Accordingly, strategy may be to accelerate passive investments now (e.g. trigger capital gains to have some credit to CDA) before the new rules commence in 2019 (?)
  - Greater use of life insurance in CCPC
    - Apparently no intention of denying credit to CDA for proceeds on death, unlike denial of credit for capital gains from passive investments
    - Exempt life insurance policy can shelter investment income
  - Consider Individual Pension Plan
    - Corporate owner (generally best between ages 40 and 70) can establish key employee registered pension plan for himself/herself
    - Can contribute more than RRSP limits and income can accumulate tax-free

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Taxation of Passive Investment Income of a Private Corporation ...cont'd

- Deferred Taxation
  - Propose special election for Investcos that retains refundable taxes when only activity is passive investments
  - There does not appear to be need to restructure current tax & estate plan structures (e.g. estate freeze), although pure holding companies may now be subject to refundable taxes on dividends received from related operating companies, similar to dividends from portfolio investments
  - Questions for public consultation focus on implementation issues, not on fundamental policy issues

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What is the Voluntary Disclosure Programme?

Initiative of the Canada Revenue Agency to foster voluntary compliance

- Most generous amnesty programme among the developed countries
- If accepted, the taxpayer must pay past taxes owing plus interest (subject to some relief), but there is no prosecution and there are no penalties
- The VDP plays an important role in combatting tax evasion and achieving increased levels of tax compliance, by encouraging taxpayers to come forward voluntarily, correct their tax affairs, and pay their taxes. Not only does the VDP generate significant tax revenues that otherwise would go uncollected, but it also is a cost-effective way for the CRA to foster and achieve tax compliance

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Fundamental Requirements to Qualify for VDP

- The taxpayer directly, or through his/her/its representative, must initiate the disclosure on a voluntary basis, before any enforcement action is commenced by the tax authorities
- The disclosure must involve some past tax obligation that was missed resulting in potential penalties and interest
- The disclosure must be complete

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New VDP Proposals

- Following report from Offshore Compliance Advisory Committee in late 2016 to MNR
- June 9, 2017 news release from MNR announcing proposed changes, seeking consultation
- Changes to VDP apply to income tax and HST

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New VDP Proposals …cont'd

- Under the current VDP policy, a taxpayer is generally entitled to relief regardless of whether the failure was inadvertent. The underlying rationale for this approach has been that it is desirable, from a fiscal as well as social contract perspective, to encourage non-compliant taxpayers to reintegrate into the tax system, rather than rely solely on the threat of prosecution to discourage non-compliance

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New VDP Proposals …cont'd

- The proposed changes reflect a shift in this policy, by introducing a multi-tier system where eligibility for relief depends partly on the identity or characteristics of the taxpayer, and on whether the taxpayer is considered to have engaged in "major non-compliance"
- This new policy will create uncertainty and perversely discourage coming forward voluntarily , the exact opposite of what should be the government's goal of achieving more, not less, compliance

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Reduced Relief Under the Limited VDP Programme

The Limited Program provides limited relief for applications that disclose <u>major non-compliance</u>, including one or more of the following situations:

- active efforts to avoid detection through the use of offshore vehicles or other means,
- large dollar amounts,
- multiple years of non-compliance,
- a <u>sophisticated taxpayer</u>

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Reduced Relief Under the Limited VDP Programme …cont'd

Examples of major non-compliance include one or more of the following situations:

- the disclosure is made after an official CRA statement regarding its intended focus of compliance or following CRA correspondence or campaigns,
- any other circumstance in which a high degree of taxpayer culpability contributed to the failure to comply,
- for example, a taxpayer has been transferring undeclared business income earned in Canada to an offshore bank account since 2010

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Reduced Relief Under the Limited VDP Programme ...cont'd

- No relief for corporations with gross revenue in excess of $250 million in at least two of the last five taxation years – instead use normal filing process to amend their tax filings
    - This proposal to deny relief to large corporations should be reconsidered for fairness and equity
- Proposals to eliminate "no-name" method of disclosure and require full pre-payment of taxes owing
    - Reconsider maintaining the "no-name" disclosure and requiring taxes to be paid when correct amount determined, in order to maintain attractiveness of VDP
- If there has to be a multi-tier system, only exclude those taxpayers whose conduct was seriously culpable

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Common Reporting Standard

- The OECD has promulgated a process to combat tax secrecy and tax evasion, and to promote transparency through the automatic exchange of information known as the Common Reporting Standard ("CRS")
- Part XIX, Sections 270-281 have been added to the *Income Tax Act* to implement CRS in Canada
- Over 90 countries are committed to implementing CRS by 2018 (except for the U.S.A.) by signing the OECD'S *Convention on Mutual Administrative Assistance in Tax Matters*

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Common Reporting Standard …cont'd

- Canadian financial institutions must collect information about financial accounts owned by residents of other countries (*Reportable Persons*), and must report this information to the CRA
- In turn, the CRA will transmit this information to the taxation authority of the country of residence of the account holder
- The other countries that implement the CRS will likewise require their financial institutions to collect information about Canadians that will be transferred to the CRA

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Common Reporting Standard …cont'd

- *Reporting Financial Institution* covers what one would expect: depository institutions, investment entities and specified insurance companies
- *Reportable Accounts* include financial accounts held by individuals and entities, including a non-financial entity ("Passive NFE") that requires a high level of due diligence to determine if a Reportable Person is in control
  - In the case of a corporation, 25% share ownership is enough to constitute control
  - In the case of a trust, this could be the settlor, the trustee, a beneficiary, a protector, or any other person exercising effective control over the trust

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Country-by-Country Reporting

- Another OECD initiative to combat tax avoidance and tax evasion by multinational corporations and to promote transparency and ease of administration
- Canada has implemented CbC reporting in section 233.8 of the *Income Tax Act*
- An MNE with total consolidated group revenue of €750,000,000 or USD$838,500,000 must file CbC reports, disclosing for example if the Canadian entity is the ultimate parent entity, surrogate parent entity or constituent parent entity

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Country-by-Country Reporting

- A CbC report includes global allocation, by jurisdiction, of key variables for the group, including: revenue, profit, tax paid, stated capital, accumulated earnings, number of employees and tangible assets, as well as the main activities of each constituent entity
- Used to assess high level transfer pricing risk; to assess other BEPS-related risks; and for economic and statistical analysis
- CbC reports filed with the CRA will be automatically exchanged with other jurisdictions in which the MNE operates, and *vice versa*

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Questions?

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