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Tax Planning and Private Corporations

Summary of July 18, 2017 Finance Announcement

Thursday, October 12, 2017

AGENDA

- Overview of current regime
- Proposal addressing income splitting
- Proposal on access to the capital gains exemption
- Proposal on taxation of passive income
- Concluding thoughts
- Question period

CURRENT TAX RATES

Individuals (Ontario, 2017)

• Employment income	53.53%
• Capital gains	26.75%
• Eligible dividends	39.34%
• Ordinary dividends	45.30%

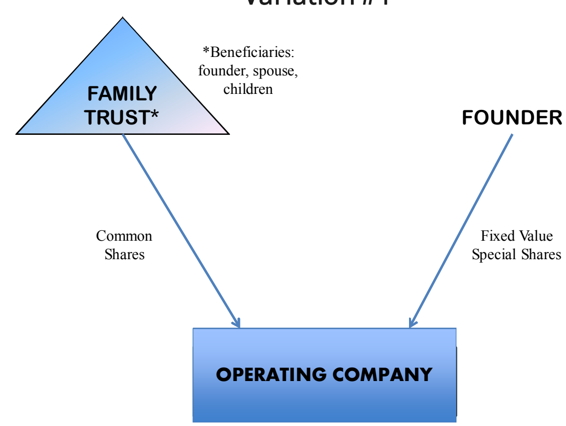
CURRENT TAX RATES

Corporations (Ontario, 2017)

• Active business income	
– With small business deduction	15.0%
– Without small business deduction	26.5%
– Manufacturing & processing	25.0%
• Investment income	50.17%
– Includes refundable rate of 30.67%	

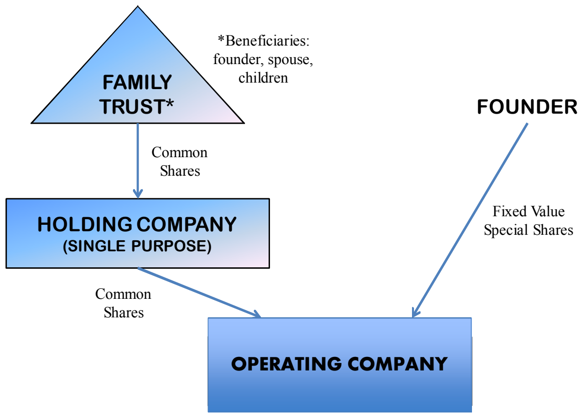
STANDARD "FREEZE" STRUCTURE

Variation #1



STANDARD "FREEZE" STRUCTURE

Variation #2



PROPOSAL FOCUS

Main targets of the July 18th proposal are:

1. Income splitting
2. Multiplication of the Lifetime Capital Gains Exemption (LCGE)
3. Holding of a passive investment portfolio inside a private corporation
4. Conversion of regular income into capital gains

The focus will be on the first three items

INCOME SPLITTING

Current

- The goal of income splitting is to shift income from a higher rate taxpayer to lower rate family member
- One spouse earning $200K after-tax is LESS than two spouses each earning $100K after-tax
  - On $200K of income:
    - If earned by one spouse? $71K in tax
    - If split between two spouses? <u>$50K in tax</u>

    Overall tax savings? <u>$21K</u>
- Current tax laws allow for income splitting with adult family members

INCOME SPLITTING

Current Rules

- Income splitting is appropriate if:
  - Recipient of split income is an adult; and
  - The nature of income being split is dividends
- If both conditions are met, then income splitting is deemed to be appropriate irrespective of nature or extent of shareholder's involvement in the business

INCOME SPLITTING

Current Rules

- Reasonability test with respect to deductible amounts
  - Usually applies to salary payments or management fees
  - No test of reasonability currently exists for dividends
- Tax on Split Income ("TOSI") AKA "Kiddie Tax"
  - Applies to individuals under the age of 18 who receive split income

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INCOME SPLITTING

Current Rules

- If income being split is dividend income and if it is split with persons > 18, then it is effectively done via:
  - Direct share ownership:
    - Non-active family member subscribes for shares of Company and earns dividend income on those shares
  - Use of a discretionary family trust:
    - The Trust subscribes for shares of the Company, earns dividend income on those shares and allocates income to the beneficiaries on a discretionary basis

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INCOME SPLITTING

When is income splitting used?

- To give income to spouses working inside the home
- Common planning strategy to fund post-secondary education:
  - A post-secondary-aged child holds non-voting shares in Mom's Co.;
  - Mom pays dividends to child which are taxed in child's hands at low rate; and
  - The child uses after tax dividend income to pay for his or her education
- Assuming dividend payment of $40,000 per year, tax saving is approximately $20,000

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INCOME SPLITTING

Current

- Allow for minimization of household tax by taking advantage of multiple sets of tax brackets and tax credits
- Tax benefit from income splitting increases with:
  - The difference in tax rates between the transferor and transferee;
  - The amount of income that can be sprinkled; and
  - The number of individuals who can receive the sprinkled income

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INCOME SPLITTING

Proposed

- Finance is aggressively targeting income splitting with family members either through direct ownership of shares or the use of a trust
- Introduce following two concepts:
  - **Connected** person
  - **Specified** person

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INCOME SPLITTING

Proposed – Connected Person

- Key individual of the corporation – i.e. the founder
- The individual who performs all or part of the services provided by the business or practice

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INCOME SPLITTING

Proposed – Specified Person

- Family members of the related person who receive "split income"
- Spouse, parents, siblings, aunts, uncles, grandparents or children
- **Concept of "kiddie tax" is expanded to include all specified individuals**
  - Individuals > 18; and
  - Applies on ALL income (including dividend income) received by specified individuals that is "above what is reasonable"

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INCOME SPLITTING

Proposed – Reasonableness Test

- How do we know what is "above reasonable"?
- Tests are complex and subjective
- Components of test include:
  - Labour contributions
  - Capital contributions
  - Risk assumption

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INCOME SPLITTING

Proposed – Reasonableness Test

- Test differs based on age group and applies to all types of income:
  - 18-24 year olds (stricter set of tests)
    - Regular and continuous employment
    - Rate of return limited to prescribed rate (currently 1%)
  - 25+ year olds
    - Involvement in business activities
    - Reasonable rate of return but not limited to prescribed rate

INCOME SPLITTING

Impact of the proposal, if enacted, will be the taxation of **all income** received by a **specified individual** that is above what is **reasonable** at the **highest marginal tax rates**.

- 45.3% for dividends; and
- 53.5% for regular income

INCOME SPLITTING

Proposed – Reasonableness Test

- How will the test be applied?

Proposed – Steps for 2017

- If able, pay dividends to family members in 2017

MULTIPLICATION OF THE LIFETIME CAPITAL GAINS EXEMPTION (LCGE)

Current

- Current tax laws allow Canadians to shelter capital gains on the disposition of “qualified small business corporation” shares from tax, up to a lifetime limit
- LCGE can be claimed on the sale of QSBC
- 2017 limit is approximately $835K
- Most active business companies with few idle assets would likely qualify

MULTIPLICATION OF THE LIFETIME CAPITAL GAINS EXEMPTION (LCGE)

Current

- Tax structures are often put in place to allow for the multiplication of LCGE
- How is this done?
  - Trust holds the shares of an operating company;
  - Trust realizes a capital gain on the disposition; and
  - Capital gain is allocated to the beneficiaries of the Trust.

MULTIPLICATION OF THE LIFETIME CAPITAL GAINS EXEMPTION

Current

- Would result in significant tax shelter
  - Suppose a four person family – two parents and two children
  - Sale of shares held by a trust with four family members as beneficiaries would result in 4X LCGE shelter or $3.3M
  - If it was only one person, shelter would be only $835K
- LCGE was not limited to children over 18; minors could claim it as well

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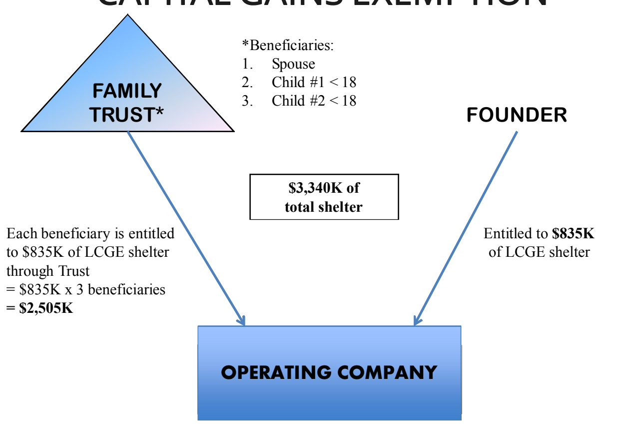
MULTIPLICATION OF THE LIFETIME CAPITAL GAINS EXEMPTION



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MULTIPLICATION OF THE LIFETIME CAPITAL GAINS EXEMPTION

Proposed

- LCGE can no longer be claimed on sale of shares by any specified individual
- LCGE can no longer be claimed on any capital gains accrued on shares held by a Trust
- LCGE cannot be claimed by any minors after 2017, even in the case of arm's length sales

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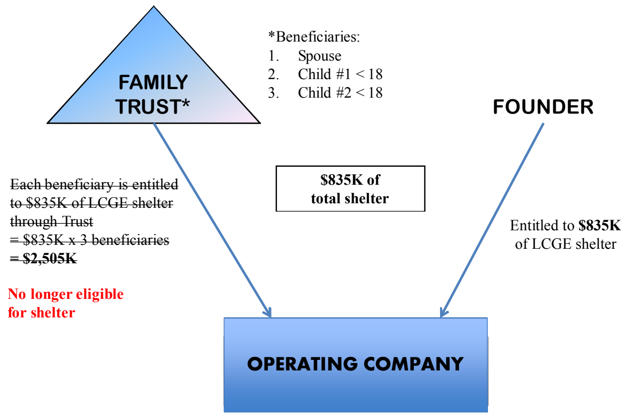
MULTIPLICATION OF THE LIFETIME CAPITAL GAINS EXEMPTION



MULTIPLICATION OF THE LIFETIME CAPITAL GAINS EXEMPTION

Special Election – Transitional Rules

- Opportunity to create a deemed disposition in 2018 to create a capital gain that would then be sheltered with the capital gains deduction (to the extent the shares qualify)
- Not available to minors
- Need to consider Alternative Minimum Tax ("AMT")
- Need appropriate valuations done

PASSIVE INVESTMENTS

Current

- Active business income earned through a corporation taxed at 15%
- Employment income earned by individual, assuming high rate, taxed at a rate of 53%
- Results in a 38% deferral of tax by keeping funds in a corporation
- Deferral eliminated once funds paid out as dividends

PASSIVE INVESTMENTS

Employment income at highest marginal tax rates:

	Incorporated	Unincorporated	Difference
Employment Income	$100,000	$100,000	$nil
Initial Tax	(15,000)	(53,530)	38,530
Rate	15%	53.53%	
Funds to Invest	85,000	46,470	38,530
			Tax Deferral
Future Tax	(38,505)	$nil	(38,505)
Rate	45.30%		
Final Cash on Hand	**$46,495**	**$46,470**	**$25**
			Tax Cost

In the end, integration works. However, the issue is the deferral benefit.

PASSIVE INVESTMENTS

Ineligible dividends at highest marginal tax rates:

	Incorporated	Unincorporated	Difference
Ineligible Dividend Income	$100,000	$100,000	$nil
Initial Tax	(38,333)	(45,300)	6,967
Rate	38.33%	45.30%	
Funds to Invest	61,667	54,700	6,967
			Tax Deferral
Dividend Refund	38,333	n/a	38,333
Future Tax	(45,300)	$nil	(45,300)
Rate	45.30%		
Final Cash on Hand	**$54,700**	**$54,700**	**$nil**

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PASSIVE INVESTMENTS

Eligible dividends at highest marginal tax rates:

	Incorporated	Unincorporated	Difference
Eligible Dividend Income	$100,000	$100,000	$nil
Initial Tax	(38,333)	(39,340)	1,007
Rate	38.33%	39.34%	
Funds to Invest	61,667	60,660	1,007
			Tax Deferral
Dividend Refund	38,333	n/a	38,333
Future Tax	(39,340)	$nil	(39,340)
Rate	39.34%		
Final Cash on Hand	**$60,660**	**$60,660**	**$nil**

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PASSIVE INVESTMENTS

Interest income at highest marginal tax rates:

	Incorporated	Unincorporated	Difference
Interest Income	$100,000	$100,000	$nil
Initial Tax	(50,170)	(53,530)	3,360
Rate	50.17%	53.53%	
Funds to Invest	49,830	46,470	3,360
			Tax Deferral
Dividend Refund	30,667	n/a	30,667
Future Tax	(36,465)	$nil	(109,400)
Rate	45.30%		
Final Cash on Hand	**$44,032**	**$46,470**	**2,438**
			Tax Cost

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PASSIVE INVESTMENTS

Capital gains at highest marginal tax rates:

	Incorporated	Unincorporated	Difference
Capital Gain	$100,000	$100,000	$nil
Initial Tax	(25,085)	(26,760)	1,675
Rate	25.08%	26.76%	
Funds to Invest	74,915	73,240	1,675
	**		***Tax Deferral***
Dividend Refund	15,333	n/a	15,333
Future Tax	(18,233)	$nil	(18,233)
Rate	45.30%		
Final Cash on Hand	**$72,015**	**$73,240**	**$1,225**
			Tax Cost

*** Can distribute from corporation $50,000 tax-free*

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PASSIVE INVESTMENTS

Proposed

- No set recommendation
- Looking for input from taxpayers as to how to address the deferral issue

PASSIVE INVESTMENTS

Some ideas:

- Replace current refundable tax system on passive income with a permanent tax
- Track different sources of capital
  - Retained Earnings from Small Business Income
  - Retained Earnings from General Rate Business Income
  - Shareholder Loans/Share Capital
  - Grandfathered Retained Earnings
- Track income based on source of capital and flow through – Apportionment Method

PASSIVE INVESTMENTS

MAC LLP advice:

Given the uncertainty, we recommend making no changes to the investment strategy until a proposal is made.

CONCLUSIONS

Although planning needs to be adjusted, corporations still make sense, as the fundamental building blocks are still in place

CONCLUSIONS

Questions to ask:

1. Are there non active shareholders in my corporate structure?
2. Are my shares worth more today than their costs?
3. Do I have passive investments?

Questions?

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