STEP Canada

ADVISING FAMILIES ACROSS GENERATIONS

A word of explanation

In August, STEP Canada organized a special symposium to consider the recent private corporation tax proposals released on July 18, 2017. In this symposium, six examples were presented for analysis by the speakers and for comment from the over 70 people attending, many of them very experienced tax professionals.

Since then, we have reviewed the examples carefully, refined them, and we now offer them for your consideration. They demonstrate how the proposals lead to punitive levels of taxation, double taxation, and produce unfair results. The examples show common situations which are frequently encountered in the real world, and will, if these rules become law, pose a major problem for business owners and their families, as well as the professionals who advise them. They apply to every day Canadian families and not only to the wealthy or super wealthy (however that may be defined). In addition, the examples do not involve exploiting loopholes employed in exotic tax planning arrangements used only by those with the most sophisticated professional advice. They describe everyday situations. Many of the adverse results which these examples clearly show cannot be easily mitigated through different structures or tax planning techniques. To this extent, perhaps it can be said that that the proposals meet their objectives. However, the results are harsh, and in some cases, blatantly unfair.

STEP Canada did not present these examples to the Department of Finance in advance, and has not received confirmation that our analysis and interpretation of the rules is correct. We welcome any corrections or insights which anyone may wish to offer, including officials of the Department of Finance, and corrections will be made and the examples reissued if there is reason to do so. Many of the proposals are difficult to interpret, and as a result, we have exercised our judgment in interpreting them in certain instances.

The examples contain a degree of rhetoric, which is intentional, and designed to mimic the tone of the examples contained in the government's consultation paper accompanying the proposals. We make no apologies for this. It is, however, our view that the rhetoric found in the consultation paper was excessive and uncalled for. Consequently, we feel it appropriate to take a similar approach.

Questions, comments, and input concerning the examples may be directed in the first instance to Janis Armstrong, jarmstrong@step.ca , who will see that it is routed to the appropriate person.

Lastly, STEP Canada stands ready to engage in constructive discussion with the Department of Finance on these matters. However, as has been pointed out by many commentators, the 75-day consultation period (commencing in the heart of the summer) is completely inadequate for engaging in any meaningful process of dialogue. Accordingly, the first action which is required is a significant extension of the consultation period.

45 Sheppard Avenue East, Suite 510, Toronto, ON M2N 5W9
TEL 416.491.4949 www.step.ca FAX 416.491.9499

STEP Canada
ADVISING FAMILIES ACROSS GENERATIONS

Example 1

Living Side by Side / Tax Comparison

Adam and Brenda live at #2 Any Road, Sometown, Saskatchewan. Clive and Donna live at #4.

Adam and Brenda are employees each earning $75,000 per year. They have two young children. Adam's mother looks after the children during the day.

Clive and Donna are doctors who incorporated a professional corporation (PC) and own the shares equally. Donna works in the local hospital in the emergency trauma unit. Her job requires that she work evenings and weekends as the need arises .Clive stays home with their two young children.

PC makes $150,000 per year, pays tax at 12.5%, and pays out the remainder as dividends annually of $131,250, $65,625 to each of Clive and Donna.

How does the taxes paid by the two families compare under the current and proposed rules?

Outcome

Adam and Brenda each pay about $21,500 in tax; $43,000 in total.

Clive and Donna pay tax of $40,457 including the corporate tax paid by PC.

Clive and Donna pay less tax, about $2,543 and have a small advantage (produced by the Saskatchewan corporate tax being 12.5%, not 15% which is the benchmark rate upon which the system was designed and a provincial matter).

Under the proposed rules Adam and Brenda have no change.

Clive and Donna pay $55,604 combined under the proposals, about $15,000 more than before and $12,600 more than Adam and Brenda. Clive is taxed at the top tax rate on dividends. Donna has no change to her tax as she is active. If all the income went to Donna she would still not be at the top tax bracket.

Is it a fair result that Clive pays tax at a higher rate than if all the income went to Donna?

Example 2

Eugenio's Bakery / Start-up Capital

Eugenio is a baker and works as an employee at Crusty Loaf Bakery in Nova Scotia. He has always dreamed of having his own bakery, like his father before him. But his dream to set up Eugenio's Bakery faces a major hurdle which is start up capital. A friend tells him that the first place to look for capital, when starting a small business, is to go to your family. So Eugenio goes to visit his mother Francesca to ask her for $120,000 as a loan.

Francesca lives on very modest income from Canada Pension Plan, Old Age Security, and a small RRSP annuity which became hers when her husband died a few years ago. Her income is so modest that she does not pay any income tax. Her children also support her financially .

Francesca's main asset is her modest house, which is debt free. However, to help her son out, and enable him to fulfill his dream, she is prepared to take out a mortgage to raise the money. Eugenio and Francesca go to visit their accountant to ask for assistance and advice.

The accountant explains to Eugenio and Francesca that the mortgage interest will be tax deductible to Francesca, although she does not really have enough income to use the deduction effectively, but the principal of the mortgage, when it is paid back, will not be deductible. Money will have to be raised to pay back this principal, which normally comes from corporate earnings. Francesca can loan the money to the new corporation and it can be repaid tax-free.

Eugenio is prepared to grant 50% of the shares in his new bakery business to Francesca in exchange for the capital contribution, and a plan evolves where he will take only a modest salary and dividends will be paid to himself and to Francesca equally. If the business is successful, Francesca will do well financially, and this could become a fund for her in her old age. She will then not have to rely on her children.

The accountant explains that this would work very well if an unrelated and arm's length person made the investment (such as a friend or a private equity fund, or even the next-door neighbour). However, because the investment is made by a related person (in this case, mother), other rules may now come into play from 2018. Under these rules, Francesca's dividends are split income, taxed at the top tax rate, unless the amount can be justified to Francesca on the basis of her efforts, assumption of risk in the business, and/or capital contributed.

Outcome

Francesca understands that everyone must pay their fair share of tax, but why should she be paying tax at the top tax rate when she does not have that level of income? Why should be the tax treatment be different to her versus that of an outsider who makes the investment? Eugenio's

.../2

Example 2 (continued)

income will not be large. He will not be in the top tax bracket. Why should she pay more tax than him?

The accountant informs her that some amount of the dividend may be taxable in the normal way, and probably she will pay very little tax on part of the dividend. The amount can be increased if she is actively involved in working in the bakery or if she guarantees certain things, like the lease on the premises and the equipment lease for the ovens. At her age she is not prepared or able to work in the business, nor is it advisable for her to guarantee anything for the business. If the business fails, she could lose her house. Why would the government encourage her to take a risk like this? In addition, nobody really knows how much of the dividend would be considered "reasonable" as an appropriate return for her investment. It would be difficult to determine how much of the dividend will be taxable in the normal way (i.e. at low rates) and how much would be taxed at the top tax bracket. The accountant recommends that an economic study be done on market rates of return. But she will only invest $50 in the shares. Does the loan count as capital contributed? Nobody knows.

Francesca cannot understand how a mother who mortgages her home to invest in her son's business can be treated worse than an outsider in the same circumstances and also worse than her son. She wonders how many other families might be affected and what impact this will have on start up capital.

STEP Canada
ADVISING FAMILIES ACROSS GENERATIONS

Example 3

Restaurant Linen Supplies / Business Succession

Many years ago George established Restaurant Linen Supplies Ltd. in Ontario. It is an industrial laundry which supplies local restaurants with services to pick up, wash, press, and delivery back tablecloths and napkins. He has developed the business into a substantial enterprise, servicing approximately 100 restaurants. He has two children, Henry and Iris who are both actively involved in the business. However, they are not shareholders.

George will soon be 70 years old, and he wants to pass on the business to his children. This will be his retirement fund. The shares of the business have been valued at $4 million, and he would like to work out an arrangement where Henry and Iris can purchase the business and pay him over time from the earnings of the business. He knows from previous conversations with his professional advisors that any amount which he claims under the capital gains exemption cannot be paid out from the business in this way, but that is only about $830,000 of the total of $4 million. He is prepared to forego claiming the capital gains exemption.

He is now at the point where he wishes to go ahead with a succession plan and he seeks professional advice on how to structure this.

The original plan was to sell the shares to Henry and Iris for notes to be paid over 10 years. They would transfer the shares to holding companies (HCo and ICo) for notes. These holding companies would receive dividends from Restaurant Linen Supplies Ltd. and then pay Henry and Iris and then George. He would recognize a capital gain of $4 million. Income would be earned each year by Restaurant Linen Supplies Ltd., corporate tax would be paid, and the remainder would go to dividends to HCo and ICo and ultimately to George. He anticipates that he will pay tax on the capital gain at about 27%, which he is prepared to do. In addition, the gain will be taxed over 10 years, helping to match the tax to what he will receive. This 10 year period is a special incentive to help transition a family business to children. Normally tax would be paid on the gain over 5 years.

Outcome

George is advised that under proposed rules, this will be a problem.

The proceeds received will now be treated as a dividend, not a capital gain either to him or to his children (the latter with the way the plan was conceived). Tax of around 45% can be expected, all payable in the first year.

The plan to transition the business to his children has risk associated with it. If the business fails, George's retirement fund is in jeopardy.

.../2

Example 3 (continued)

George becomes aware that the adverse tax result is because on the new proposed rules and how they apply where the business is being sold to family members. On the other hand, if he sells the business to Mega Laundry Corp, a U.S. conglomerate and a public company with operations in Canada, he will not only be able to realize a capital gain as he originally planned, but will also be able to claim the capital gains exemption on $830,000 of the capital gain. Also he takes no risk.

The tax paid on a transfer to children is estimated at $1,800,000 (45% of $4 million).

The tax paid on a sale to Mega Laundry is $856,000, which is less than half. This is because the capital gains exemption of $830,000 can be used and the remaining $3,170,000 is taxed as a capital gain at 27% ($3,170,000 x 27% = $856,000).

George is also told that if he proceeds with the plan as he originally intended, there could be double tax; once on the capital gain to him on sale of the business, and once on the withdrawal of funds from the business used to pay him. That would bring the total tax rate to about 72%.

With such a strong tax bias and a risk free alternative, why would George not proceed with a sale to Mega Laundry?

How is it fair that a sale to family members should be subject to over double the tax compared to a sale to an outsider? Surely the tax rules should encourage, not penalize, succession of the family business to children.

Example 4

Spilt Income and Excess Tax

John and Kathy founded Grade A Eggs Inc. 40 years ago. It is an egg processing business in Manitoba. John is active, Kathy used to be active but not anymore.

The shares of Grade A Eggs Inc. are to be sold for $4,000,000 to an arm's length purchaser, and John and Kathy will each realize a capital gain of about $2,000,000. John and Kathy have not used up any of their respective capital gains exemptions.

Kathy has taxable income of $198,000 from retirement and investment income. John's income is similar.

What is Kathy's tax treatment of the capital gain?

If she withdrew an additional $10,000 from her RRIF what would the treatment be?

Outcome

1) Kathy is a specified individual because she is related to John who is a specified shareholder (as well as a connected individual) of Grade A Eggs Inc.. The capital gain of $2 million would be considered to be a split portion to Kathy because of two reasons: 1) She fails the reasonableness tests found in the definition of split portion; and 2) Had she received this capital gain as a dividend it would be considered to be split income to Kathy. This income would be split income to Kathy because it is not an excluded amount by virtue of being a split portion (for reasons discussed previously). The entire $2,000,000 taxable capital gain would be taxed at the highest marginal rate of 25.2% for Manitoba despite the fact that Kathy is not in the top bracket. None of the capital gain would be eligible for the capital gains exemption for Kathy because it is split income for Kathy. Her capital gain will attract taxes of approximately $504,000.

2) The only change in facts for part ii of this question is that Kathy pulls an extra $10,000 from her RRIF in the year of sale of her Grade A Eggs Inc. shares. She is now in the top bracket with taxable income of $208,000. The RRIF income attracts taxes of $4,848 ($4,800 at 46.4% and the remainder at 50.4%).

Notwithstanding that Kathy's capital gain is not an excluded amount because it is a split portion, her split income is deemed to be nil because she is subject to income tax at the highest marginal rate from non-split income sources (RRIF and retirement and investment income).Kathy would still be subject to the highest marginal rate on her capital gain. However, Kathy would now be eligible for the capital gains exemption since none of her capital gain is split income.

.../2

Example 4 (continued)

The point of this example is to show the absurdity of the rules in that if Kathy prepaid less than $5,000 of personal tax on cashing out her RRIF's earlier, she would be eligible for the capital gains exemption of approximately $835,000 which would save her approximately $210,000 of personal tax (over 40% of the tax otherwise payable on the gain).

Of course, a lower income taxpayer would have to accelerate much more income, if they even have the resources to push their income to the highest tax bracket and access the CGE, while a higher income person would automatically be entitled to the CGE. This seems inconsistent with the repeated statements that these provisions target wealthy Canadians, not the middle class.

STEP Canada

ADVISING FAMILIES ACROSS GENERATIONS

Example 5

AAA Trucking / Business Succession on Death

Nora was widowed in 2016 after her husband died of cancer following a long illness. She lives in Sometown, Newfoundland. Her husband had a small trucking business, AAA Trucking Ltd. delivering milk, and her son Oscar is actively involved in that business and holds 10% of the shares. Nora is now the owner of 90%.

Oscar has funds to buy the remaining shares of AAA Trucking Ltd. for the anticipated $800,000 that the shares are worth, having been the beneficiary of a life insurance policy on the life of his father. He is prepared to buy the shares from Nora. Assume it is now 2019 and Oscar and Nora wish to complete the arrangement.

Nora has never been involved in the business, and never contributed any funds to the business. Her husband established the business many years ago with share capital of $100 and ceased to be active when he became ill.

Nora anticipates that she will be able to claim her capital gains exemption on the sale, because Oscar will purchase the shares personally, and not through a holding company.

Outcome

Under the proposed rules Nora may be able to enjoy the attributes of active involvement in the business because her deceased husband was active. But this is unclear because of his long illness. Even if she can, then one needs to determine how much of the gain might be protected. There is considerable uncertainty.

If no level of activity is imputed to Nora, she will have an $800,000 dividend. Rather than pay no tax, she will pay $344,000.

Nora could have elected to claim the capital gains exemption in 2018 had she known of this. She might be able to salvage this by making a late election if she pays a penalty. But the theory seems suspect, even if the situation can be fixed for Nora and Oscar by a transition rule.

Example 6

Fort Far North Welding / Inheritance and double tax

Paul was a welder by trade. He operated a welding business from Fort Far North, Alberta (Fort Far North Welding Ltd.). The business serviced communities in Northern Canada and specialized in gas pipelines. He also operated an apprentice program and trained local people in this trade.

Over the years, Paul accumulated a significant amount of cash in his corporation.

Paul died recently and the welding business will be discontinued, and the funds in the company will be paid to his heirs, which are his two children.

The shares are not eligible for the capital gains exemption, so Paul recognized a capital gain on death.

Owing to potential issues of legal liability, the executors of Paul's estate firmly decided not to make any distributions for two years, the statute of limitations for civil litigation, based on legal advice received. Once clear of that, they plan to distribute the funds in the company equally to the two children.

Because the funds will not be distributed for two years, a special election to create a capital loss and a deemed dividend (under subsection 164(6)) is not available in this circumstance. Instead, the plan is to transfer the shares to a holding company in exchange for a promissory note and to gradually pay off this promissory note. This is called a "pipeline" arrangement (coincidentally being what Paul's business was directed to servicing). In any event, over one year has now passed by July 18, 2017 So the capital loss plan is not available.

Outcome

Paul has a capital gain subject to tax at up to 24%.

When the funds are withdrawn from the corporation, they are taxed as a dividend even though Paul already paid tax on this value via his capital gain. The tax on the dividend is up to 41%.

The total tax paid reaches a marginal rate of 65%.

Clearly the same value is being taxed twice here, once as a capital gain and once as a dividend.

Taxing the same value twice cannot be viewed as fair by any measure.