Tax Planning Using Private Corporations

Chaggares & Bonhomme
CHARTERED PROFESSIONAL ACCOUNTANTS

Agenda

- Introduction
- Proposed Changes
  - Income Sprinkling
  - Holding Passive Investments Inside a Private Corporation
  - Converting Income into Capital Gains
- Examples
  - Department of Finance Example
  - Actual Example with Full Complexities
- Call To Action
- Questions

Chaggares & Bonhomme
CHARTERED PROFESSIONAL ACCOUNTANTS

Proposed Changes

- Proposal Released July 18th, 2017
- Tax "Fairness"
- Consultation Period – 75 days
- How it was drafted

Chaggares & Bonhomme
CHARTERED PROFESSIONAL ACCOUNTANTS

Income Sprinkling

- Tax on Split Income (TOSI)
  - Kiddie Tax – tax at highest marginal rate
  - Minor children under age of 18
- Expansion
  - Any individual, no matter what age, if they are not making a reasonable contribution to the business
  - Income received by an adult who is a specified individual will now be subject to a reasonableness test. Do you trust the CRA to determine what is reasonable?
  - Stricter rules governing the reasonableness of a return on shares or debt for a specified individual under age 25.
  - Related individuals include aunts, uncles, nieces, nephews and trusts deemed not dealing at arm's length.
  - Reasonableness test based upon either capital contribution or labour contributed

Chaggares & Bonhomme
CHARTERED PROFESSIONAL ACCOUNTANTS

Reasonableness Criteria 18 – 24 years

- ***Same reasonableness requirements as specified individuals 25 and over EXCEPT:***
- ***Labour***
    - No labour contribution deemed to have been performed except to the extent that the individual is actively engaged on a "regular, continuous and substantial basis in the activities of the source business"; and
- **Capital**
    - Any return in excess of the prescribed rate on the capital contributed by the specified individual is deemed to be unreasonable.

Capital Gains Sprinkling

- Any gains from the disposition of property, the income from which is split = SPLIT INCOME
  - Same rule applies as in income sprinkling
  - Specified Individual
  - Connected Individual
  - Reasonableness Test
- IF rules apply → SPLIT INCOME
- IF capital gain → INELIGIBLE DIVIDEND
  - Instead of a capital gain, being ½ taxable, it will now be a dividend, fully taxable at ordinary tax rates

C&B
Chaggares & Bonhomme
CHARTERED PROFESSIONAL ACCOUNTANTS

Lifetime Capital Gains Exemption

- TARGET: “Multiplication” Arrangements using Family Trusts to own shares of the active business
- Proposals intended to limit access to LCGE to persons actively involved in creating the gain.
- Huge issue for farm families

- No LCGE (as of January 1, 2018):
  - Gains included in split income of Taxpayer
  - Gains accrued or realized before the year in which the Taxpayer turned 18
  - Gains accrued on property **while held by Trust**
  - Exceptions for certain “special trusts” i.e. alter ego, joint spousal, employee share trusts
  - Standard tax plans using a discretionary family trust fall under this
  - Also affects trusts set up for succession planning having nothing to do with tax

Chaggares & Bonhomme
CHARTERED PROFESSIONAL ACCOUNTANTS

Lifetime Capital Gains Exemption

Transitional Rules

- One-time Election to Crystallize Gain in 2018 - Current rules apply
- If Taxpayer is <18 need actual disposition of shares
- For QSBC status, existing rules apply except 24 month eligibility period reduced to 12 months
  BUT, the election will trigger Alternate Minimum Tax (AMT), payable immediately
- Small business corporation shareholder with $50,000 year income triggering $836,000 of capital gain to make the election will trigger about $43,000 of AMT – where is the family going to come up with $43,000 per family member?

Chaggares & Bonhomme
CHARTERED PROFESSIONAL ACCOUNTANTS

Holding Passive Investments Inside a Private Corporation

- Aimed at discouraging corporate passive investments
- No draft legislation to date
- They want to tax a CCPC at top personal rates
- Changing the entire system of corporate taxation
- Many of the provisions will apply retroactively to tax you based on income already earned before these proposals
- **2 possible methods discussed, both complex and expensive**
- Proposals don't explain how to decide if holding funds is for investment purposes, or to fund future inventory, business downturns etc.

Chaggares & Bonhomme
CHARTERED PROFESSIONAL ACCOUNTANTS

Holding Passive Investments Inside a Private Corporation

- These proposals are horrendously complicated
- They penalize small companies that have accumulated savings
- They tax CCPCs on investment income at rates higher than public companies
- What will they do to successful companies that currently invest excess funds into new start-ups, especially in the high tech sector. If dividend returns from these investments will be taxed at a significantly higher rate, will these businesses still want to invest?

Chaggares & Bonhomme
CHARTERED PROFESSIONAL ACCOUNTANTS

Current Integration

		Capital Gains	Portfolio Dividends	Interest
Investment income	**$1,000**			
Corporate tax - federal and ON		$251	$383	$502
Refundable dividend tax on hand		153	383	307
Net corp. tax after taxable dividends		$98	$0	$195
Available to individual shareholder		$902	$1,000	$805
Capital dividend account		$500	n/a	n/a
To an individual:				
tax free CDA $500			-	-
if ineligible dividenc	45.3%	$182	$453	$365
Net to individual		**$720**	**$547**	**$440**
if eligible dividend	39.3%	$158	$393	$316
Net to individual		**$744**	**$607**	**$489**
If received personall	53.5%	**$733**	**same as above**	**$465**

C&B
Chaggares & Bonhomme
CHARTERED PROFESSIONAL ACCOUNTANTS

Effect of Proposals on Investment Income

Investment income	$1,000				
		Capital Gains		**Portfolio Dividends**	**Interest**
Corporate tax - federal and ON		$251		$383	$502
Refundable dividend tax on hand					
Net corp. tax after taxable dividends		$251		$383	$502
Available to individual shareholder		$749		$617	$498
Capital dividend account		$0		n/a	n/a
To an individual:					
tax free CDA nil				-	-
if ineligible dividenc	45.3%	$339		$280	$226
Net to individual		**$410**		**$337**	**$272**
		59.0%		**66.3%**	**72.8%**
if eligible dividend	39.3%	$294		$242	$196
Net to individual		**$455**		**$375**	**$302**
		54.5%		**62.5%**	**69.8%**
If received personall	53.5%	**$733**			**$465**
		27.0%	ineligible	**$547**	**53.5%**
				45.3%	
			eligible	**$607**	
				39.3%	

C&B
Chaggares & Bonhomme
CHARTERED PROFESSIONAL ACCOUNTANTS

Effect of Proposals on Investment Income

Tax on Interest Income following July 18th, 2017 Proposals			
	Public Corporation	Canadian Controlled Private Corporation	Relative Excess Tax
AB	27.00%	50.67%	87.67%
BC	26.00%	49.67%	91.04%
MB	27.00%	50.67%	87.67%
NB	29.00%	52.67%	81.62%
NL	30.00%	53.67%	78.90%
NS	31.00%	54.67%	76.35%
NT	26.50%	50.17%	89.32%
NU	27.00%	50.67%	87.67%
ON	26.50%	50.17%	89.32%
PE	31.00%	54.67%	76.35%
SK	26.75%	50.41%	88.45%
YT	28.49%	52.15%	83.05%

C&B
Chaggares & Bonhomme
CHARTERED PROFESSIONAL ACCOUNTANTS

Converting Income into Capital Gains

- Target – conversion of dividends into capital gains taxed at lower rates (Ontario 26.76 vs. 45.3% for non-eligible dividends or 39.34 for eligible dividends)

- Government proposal is to revise s.84.1 of the ITA and introduce a new anti-avoidance rule s246.1. It is unclear if these revisions will have a negative impact on the ability to pay capital dividends (tax free) as well.

- The current rules limit the ability to sale shares of a corporation to a non-arm's length party while utilizing the lifetime capital gains exemption ("LCGE"). In some circumstances the transferor can still get capital gains treatment but is denied the LCGE.

C&B
Chaggares & Bonhomme
CHARTERED PROFESSIONAL ACCOUNTANTS

Converting Income into Capital Gains cont'd

- This rule does not apply when shares are sold to a arm's length party making it more beneficial to sell to an outside party

- The proposed changes will also kill the "pipeline" strategy, which eliminates double or triple tax on the death of a taxpayer related to the disposition of their shares of a Canadian Controlled Private Corporation.

- The total tax paid by in the estate and by the heirs to get the money out of corporation can increase the total tax burden from 50% to over 93% as a result of the proposed changes.

C&B
Chaggares & Bonhomme
CHARTERED PROFESSIONAL ACCOUNTANTS

Department of Finance Example

- **Examples sprinkling income using a private corporation**
- *Jonah and Susan are neighbours living and working in Ontario. Jonah and Susan live with their spouses and children who have no significant sources of income, other than as described below. Although Jonah and Susan each earn $220,000 in 2017, Susan's household pays about $35,000 more tax than Jonah's household.*
- *This is because Susan earns $220,000 as an employee. As an individual with $220,000 in employment income, she pays about $79,000 in income tax for the year.*
- *Jonah has an incorporated consulting business that earns $220,000 before taxes and salary. Jonah provides the consulting services for the corporation. The corporation qualifies for the small business deduction in respect of its income from the business.*
- *Jonah owns the voting shares in the corporation. Jonah's spouse and two children, ages 19 and 21, also own shares in the corporation, for which they paid very little. The corporation pays Jonah $100,000 in salary, and pays its remaining after-tax profits in equal amounts to the spouse and children as dividends. The dividends are taxable income of the spouse and children.*
- *After accounting for corporate income tax, taxes on Jonah's salary, and dividend tax credits claimed by the spouse and children, about $44,000 in total tax is paid on the $220,000 earned in the year through the corporation and distributed to Jonah's family—$35,000 less than the amount of tax paid by their neighbour, Susan, on the $220,000 she earns to support her household.*
-
- ***Extracted from p.13 of July 18, 2017 "Tax Planning Using Private Corporations" from Department of Finance Canada's website***

Chaggares & Bonhomme
CHARTERED PROFESSIONAL ACCOUNTANTS

Why this is NOT a fair comparison

	Jonah (Incorporated consultant business $220K profit after expenses before salary)	Susan (Employee with $220K salary)
Business expenses like paying for an office, travel, assistants, computers, furnishings & fixtures, advertising & promotion	Cost: $100K-$200K per year	Free. Worth $100K to $200K per year
Indexed pension plan (taxpayer financed for federal govt employees and MPs)	No indexed pension plan	Worth $70K to 100K/year
Paid vacation	No	4 - 5 weeks
Unemployment Insurance Benefits	No, not allowed	Yes
Job security	Low, constant revenue worry	High
Severance	No	Yes
Parental leave	No	Yes
Cost related to corporate filings	$4K/ year	No cost
Cost to incorporated consultant for employer portion of levies on $100K salary to Jonah (Ontario)	CPP $2.5K/year	No cost

Chaggares & Bonhomme
CHARTERED PROFESSIONAL ACCOUNTANTS

Why this is NOT a fair comparison – cont'd

Risk of Entrepreneurship	**1. Unpaid time presenting to potential clients to attract new business**	**None**
	2. Invested capital (including debt)	**None**
	3. Risk of work related lawsuits you pay for	**None**
	4. Sudden drop in market for consultant's services	**No risk**
	5. Nonpayment of fees by client for any reason incl. bankruptcy of client	**No risk**
	6. Immediate firing by client	**No risk**
	7. Long irregular hours including weekends	**Home for dinner, kids & the game?**

Chaggares & Bonhomme
CHARTERED PROFESSIONAL ACCOUNTANTS

Why this is NOT a fair comparison – cont'd

- To take an example from the City of Ottawa employee collective agreement
  - **19.4 Extended Health Care**
  - (a) The Employer shall pay 100% of the premium cost for each employee and dependent coverage in the Extended Health Care Plan
  - **19.5 Dental Plan**
  - (a) The Employer shall provide a dental plan and shall pay 75% of the premium cost of this plan
- **19.6 Basic Life Insurance and Accidental Death and Dismemberment**
  - (a) The Group Life Insurance Plan shall provide coverage at the level of two (2) times regular salary with a minimum coverage of $100,000 per employee. The Employer shall pay 100% of the premium cost of this plan.
  - (b) The Basic Accidental Death and Dismemberment Insurance shall provide coverage at the level of two (2) times regular salary with a minimum coverage of $100,000 per employee. The Employer shall pay 100% of the premium cost of this plan.

C&B
Chaggares & Bonhomme
CHARTERED PROFESSIONAL ACCOUNTANTS

Why this is NOT a fair comparison – cont'd

- To take an example from the City of Ottawa employee collective agreement (cont'd)
  - **19.7 Long Term Disability Plan**
  - (a) The Employer agrees to pay 100% of the premium cost for a Long Term Disability Plan which provides the following:
  - (i) Benefits of 75% of the employee's salary or wage earned on the date of disability;
  - (iv) While the employee is in receipt of Long Term Disability Benefits, the Employer agrees to pay 100% of the premium cost of the following benefits:
    - (a) Extended Health Care including Vision Care, Paramedical package, and Semi-Private Coverage
    - (b) Group Life Insurance
    - (c) Dental Insurance
    - **Pension**
  - Under the Ontario Municipal Employees Retirement System, the City and the employee contribute equally to the employee's pension

Chaggares&Bonhomme
CHARTERED PROFESSIONAL ACCOUNTANTS

Example from Moody's Gartner Tax Law

- Tax Proposals Harm Middle Class

Examples from STEP Canada

- Society of Tax and Estate Practioners

Call to Action

- Email/write Finance Minister and Department of Finance and CC your Member of Parliament
- Email/write the Senate

- Templates Available on our website: http://cb-ca.ca/fair-tax-plan

- http://defendsmallbusiness.ca

Questions?

C&B

Chaggares & Bonhomme

CHARTERED PROFESSIONAL ACCOUNTANTS

4-355 Harry Walker Parkway North

Newmarket, ON L3Y 7B3

905-895-9922

http://cb-ca.ca/