KPMG Enterprise

The 5 Things You Need to Know About the Proposed Tax Changes

September 19, 2017

History of Rates

Prior to 2000

- Corporate tax rate on income <$200,000 was 21%
- Corporate tax rates were 46% on active income greater than $200,000

Where are we now in 2017?

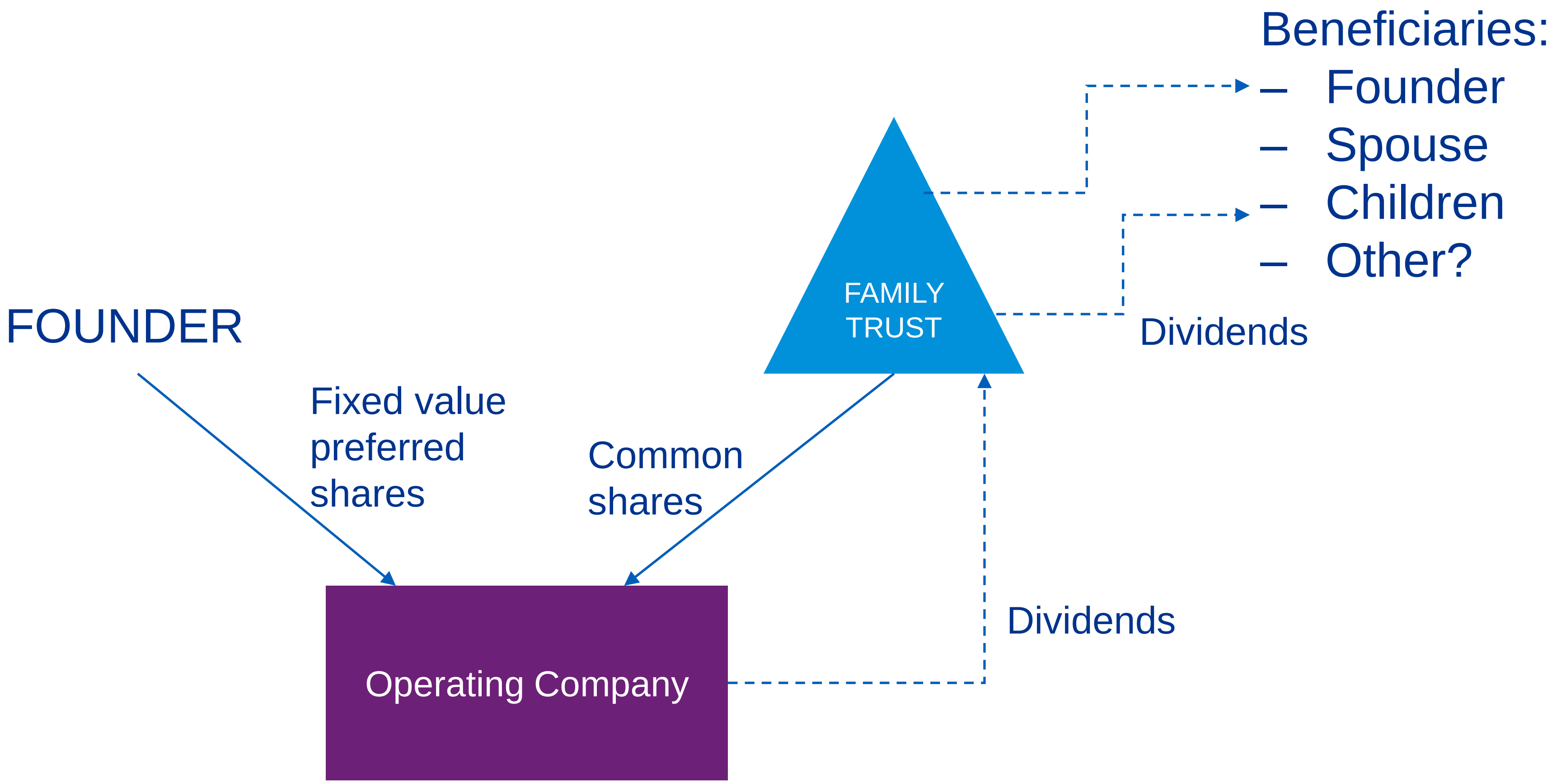
- Corporate tax rate on income <$500,000 is 12.5%
- Corporate tax rate on active income >$500,000 is 27%

History of Rates

What happened during this time?

- Significant accumulation of corporate profits being retained in “holding companies”
- More complicated corporate structures to increase access to the Small Business Deduction
- More incorporation of professionals

Typical Income Splitting Structure
(Dividends and Capital Gains Splitting)



March 2017 Federal Budget

- **Legislation changes that <u>limited</u> multiple access to the small business deduction**

And a statement:

> ***"We are reviewing a number of issues regarding tax planning strategies using private corporations, which can result in high income individuals gaining unfair tax advantages."***

Who is this?

July 18, 2017 Finance Release – Surprise!

New Legislation: comprehensive**,** complex, vague, circular

Three areas:

- Income and capital gains splitting
- Converting what would normally be dividends into capital gains
- Holding passive investment income in private corporations

1 | Most dividends to children ages 18 to 24 will be eliminated

Dividend Income Splitting

2017 is the last year of the "old rules"

- Share ownership entitles you to a dividend
- Do <u>not</u> have to contribute to the business to receive a dividend (established in *Neuman vs M.N.R*. in 1998 Supreme Court)
- The payment of wages always had a reasonableness test that had to be adhered to. Dividends didn't!

Dividend Income Splitting

Effective January 1, 2018, dividends to family members will be subject to a **"reasonableness test":**

- The new reasonableness test will consider the following:
  - Labour contribution
  - Capital contribution
  - Risk assumed by the individual, <u>and</u>
  - Prior remuneration

- Additional tests for children ages 18-24
  - Virtually eliminating most dividends to this age group
  - Requirement to be "actively engaged on a regular, continuous, and substantial basis"

<u>If unreasonable</u>, subject to highest personal tax rate, referred to as "tax on split income" (TOSI)

How may this impact you?

Beginning in 2018, taxpayers need to consider the following:

– Eliminates virtually all income splitting opportunities for those individuals **not actively involved** (labour or capital contributions) in the business

– Greater complexity and subjectivity in determining reasonableness of income paid to family members

– Who should be a shareholder when setting up a new company? e.g., a spouse

2 | Non-active shareholders will not be eligible for Lifetime Capital Gains Exemption

Capital Gain Splitting

Lifetime Capital Gains Exemption (LCGE)

Beginning January 1, 2019, **NO** LCGE available for:

- Minors (age under 18)
- Adults, not active in the business
- Adults, the portion of a capital gain that accrued while they were a minor
- Gains that accrued while shares were held by a family trust

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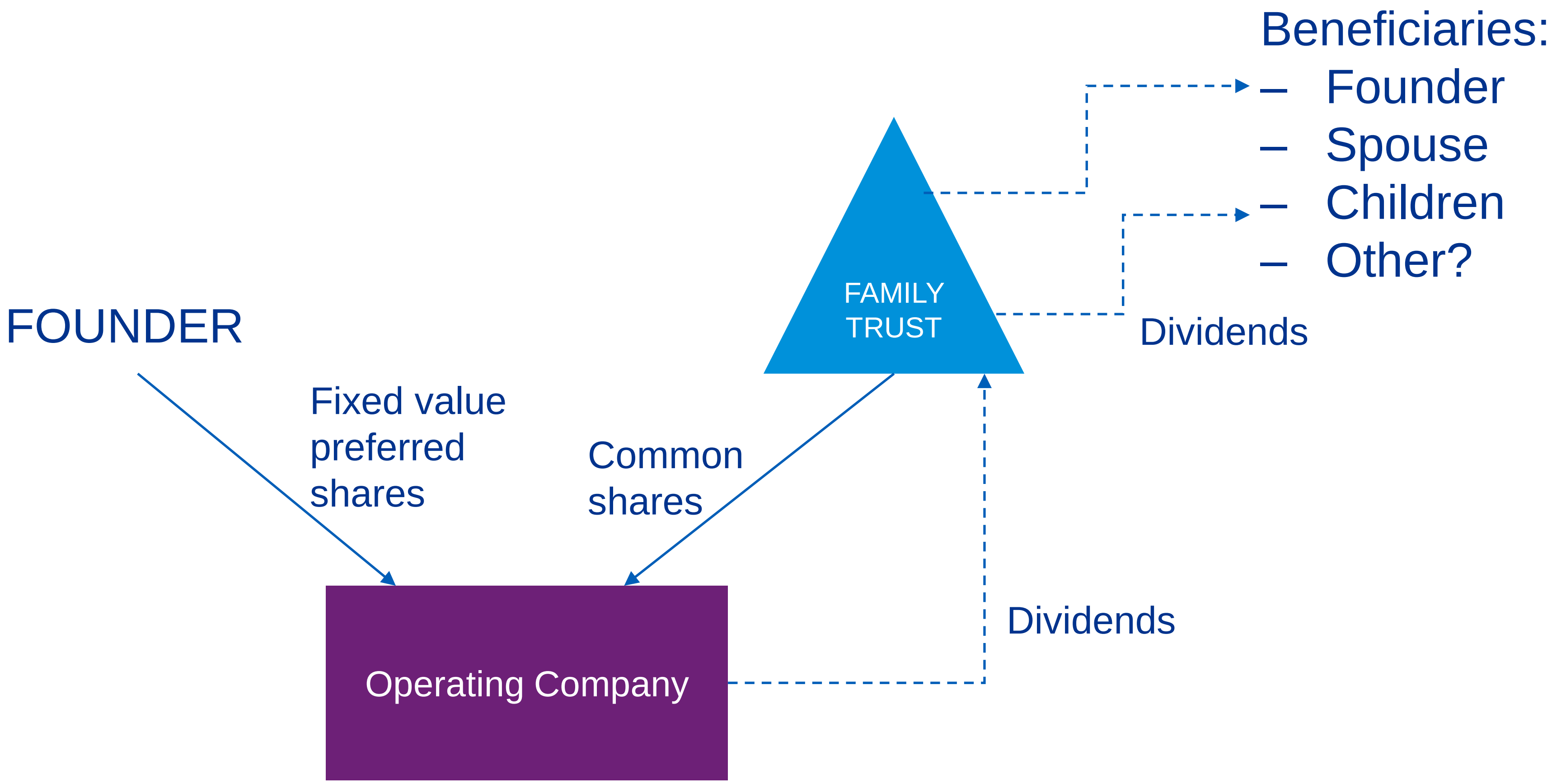


How may this impact you?

Taxpayers need to consider the following:

- What is the purpose of the family trust?
  - Income splitting?
  - Capital gains splitting?
  - Control?
  - Does it continue?

- Who should the shareholders be?
  - Are we more biased now? (non-active shareholders will not be eligible for the LCGE on their shares)

3 | 'Last chance' LCGE election may be available in 2018

2018 - Last Chance Election

Opportunity to use transitional rules to claim LCGE in 2018

- Elect to trigger a "**deemed**" capital gain to claim unused LCGE
  - At any point in 2018
  - Increased tax cost reduces tax on future sale
  - Cannot use to extract cash from corporate group
- Election can be made by:
  - **Adults** (18 or older in 2018)
  - **Family Trusts** (for beneficiaries at December 31, 2017 who will be 18 or older in 2018)

If a family trust is unable to make the election consider:

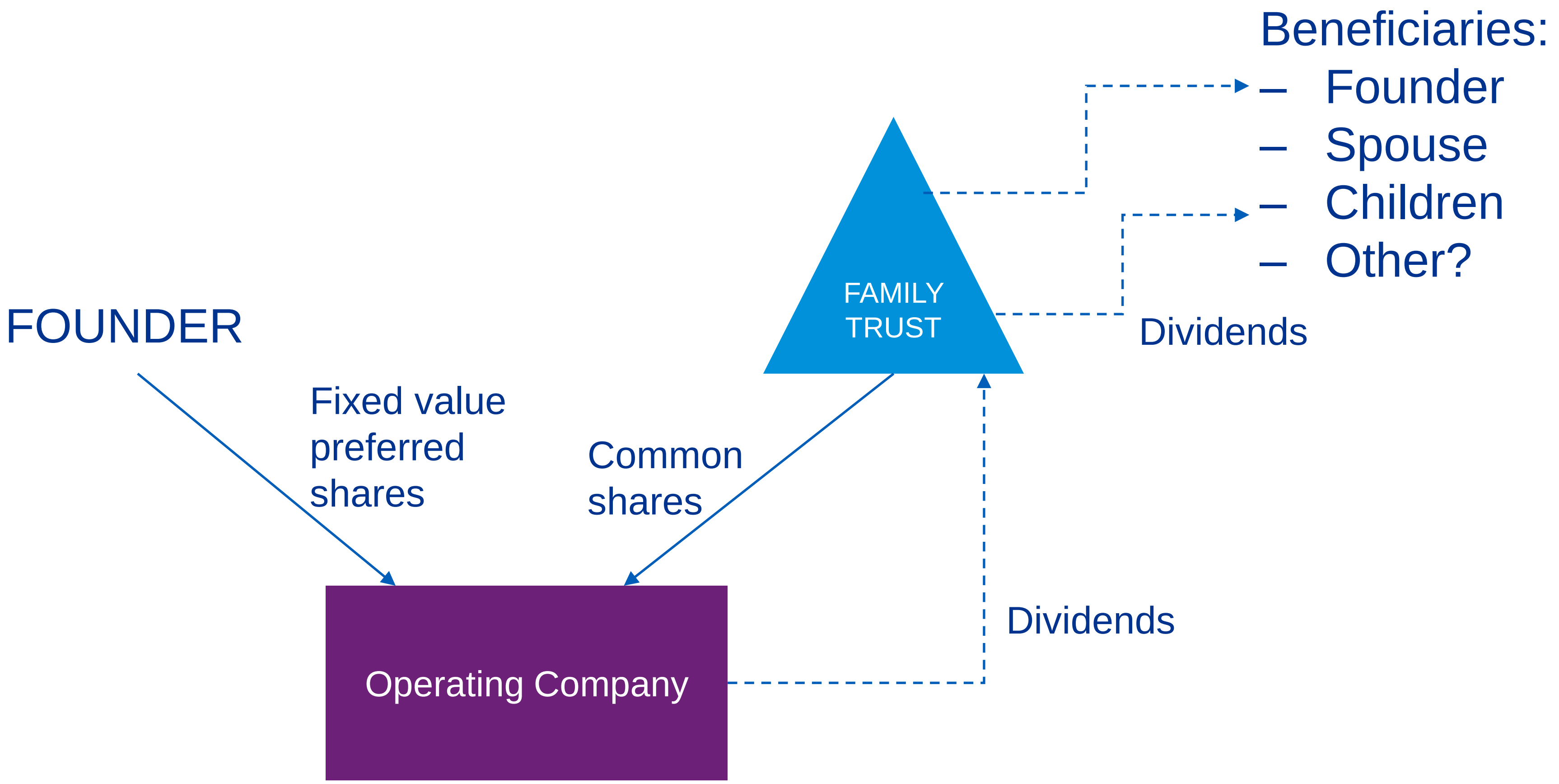
  - "crystallization" of trust gains in 2017
  - tax-deferred distribution in 2017 to allow adult to make election

How may this impact you?

Taxpayers need to consider the following:

- Do you / family trust elect in 2018?
- On what shares?
- What is their value?
- Does the Trust still continue to hold shares or do you roll them out?

Typical Income Splitting Structure
(Dividends and Capital Gains Splitting)



4 | There are exceptions to the transitional rules for minors

Transitional Rules - Minors

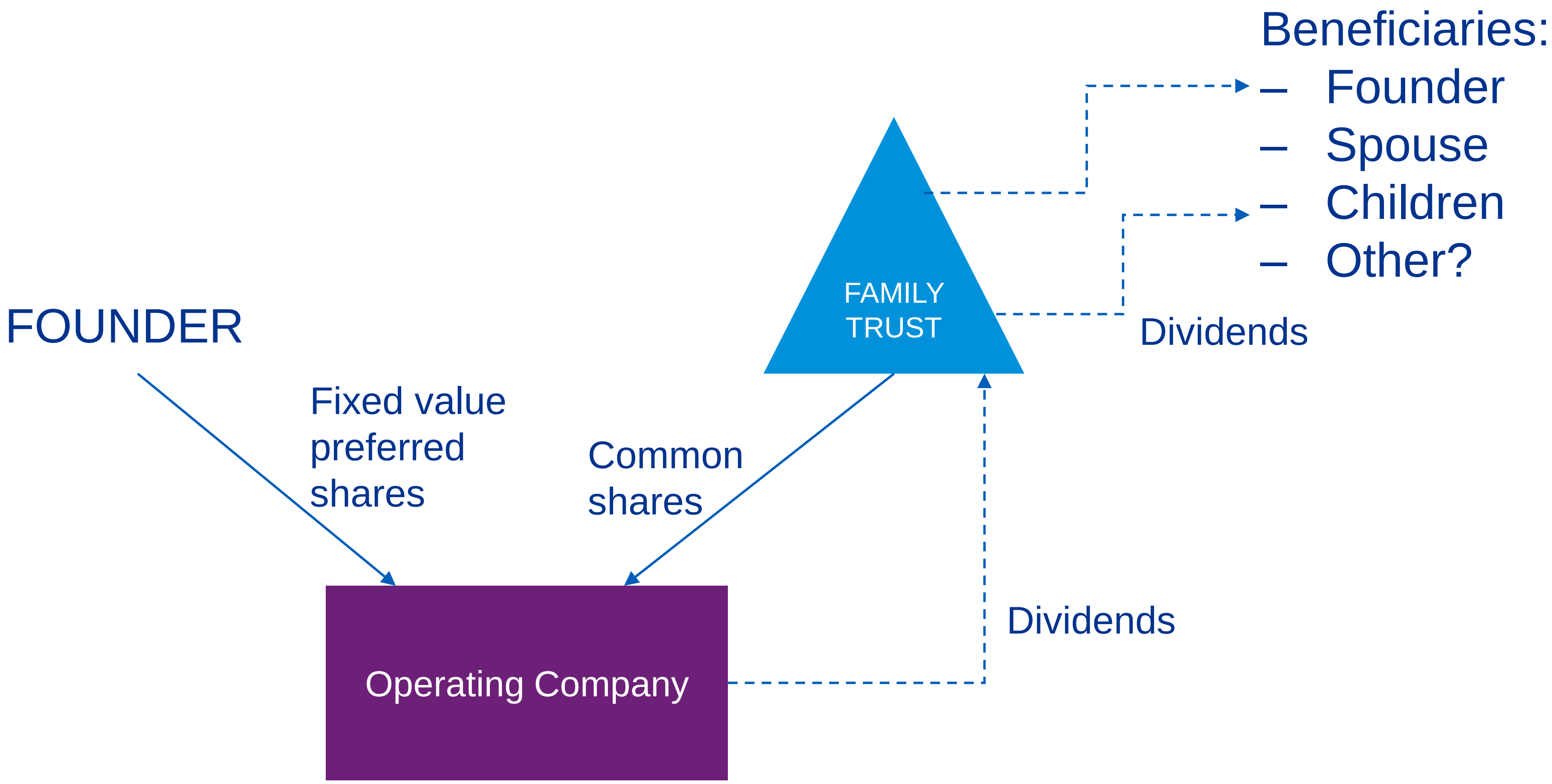
Can claim LCGE on dispositions of shares to an arm's length party in 2017 or 2018.

– Cannot trigger gains for a minor in a related party transaction

Election is available (similar to adults) on certain qualified farming or fishing property

– Farm land and partnership interests
– Not shares of a family farm or fishing corporation

Typical Income Splitting Structure
(Dividends and Capital Gains Splitting)



5 | Conversion of dividends to capital gains - effective July 18, 2017

Dividends or Capital Gains?

Individuals and family trusts owning private corporations

- Marginal tax rate on capital gains is lower than on dividends

2017 Rates	Non-eligible Dividends	Eligible Dividends	Capital Gains
Saskatchewan	40%	30%	24%

As capital gains are taxed at a lower rate than dividends, there was incentive to convert income that would otherwise be taxed as a dividend to a capital gain.

There are already rules in the Income Tax Act to stop this sort of planning, however, tax planning to achieve this still took place.

What's Changing?

The proposed legislation brings in new rules to curtail the ability to convert dividend income to capital gains (**effective July 18, 2017**).

However, the proposed rules are expanded to include the following as well:

- Capital gains realized on the death of a private company shareholder.
- Capital gains realized on the sale of private company shares to a related individual.
- Capital gains realized on the sale of capital assets (e.g., a rental property or portfolio shares) to a related company.

How may this impact you?

Future estate plans and post-mortem planning steps in process should be reviewed under proposals

Any divestitures in progress / upcoming to be reviewed under proposals

Any payments from capital dividend account (CDA) should be reviewed under proposals

Other reorganizations should be reviewed under proposals

*6 | Passive investments in a company - back to double tax?

Background - Active Income Integration

One of the key features of the current Canadian income tax system is the concept of income *integration*

- All types of income should ultimately attract the same level of tax whether earned through a corporation or by an individual

	Employee	Corporation*	Corporation*
Active income	$100	$100	$100
Less: income tax	(48)	(12)	(27)
	52	88	73
Less: dividend tax	-	(35)	(22)
After-tax income	$ 52	$ 53	$ 51

Income Integration:

Corporate tax + Dividend tax = Personal tax on income earned directly

*Income tax rate depends on availability of small business deduction

Background - Existing Passive Tax System

Refundable taxes (RDTOH)

Capital dividend account (CDA)

	Individual	Corporation
Investment income	$100	$100
Less: income tax	(48)	(51)
	52	49
Add: dividend refund	-	31
Less: dividend tax	-	(32)
After-tax income	$ 52	$ 48

Passive income is virtually integrated

How may this impact you?

	Individual	Corporation (existing rules)	Corporation (proposed rules)
Interest income	48%	52%	73%
Capital gains	24%	26%	57%
Public company dividends	30%	30%	64%

Income integration

No income integration

No longer integration for <u>passive</u> income.

Note: Prior to 2000 there was no integration.
2006 was the start of "perfect" integration.

Transitional Rules

Comments accepted until October 2, 2017
Draft legislation to follow

What they have said:

- New rules are to apply on a go-forward basis
- New rules are to have limited impact on existing passive investments
- Time will be provided before the new regime becomes effective
- Effective tax rates and dates uncertain

Next Steps

What does this mean for us?

- Minimal ability to income split in the future (2017 is the last year)
- Disincentive to accumulate further corporate investment assets
- Consider winding up trusts and/or restructuring
- Compensation plans will have to be revisited
- Estate plans will have to be revisited
- Divestiture plans will have to be revisited
- Retirement plans will have to be revisited
- Succession plans will have to be revisited

KPMG Impact Study

Review Current Situation

- Corporate structure
- Financial statements
- Tax returns
- Trust agreements

Answers the questions

- How will these changes impact me?
- What do I need to do now?
- What happens if I do nothing?
- What should I do with my trust?
- What should I do with my holding company?
- Should I pay out dividends in 2017?

Some Considerations

- **The proposed changes will eliminate many important incentives provided to small business owners.**
- **The changes, while effective after announcement date, will affect small business owners <u>retroactively</u>.**
- **Is this fair to the small business owner?**
  - Transitioning business has now been made more complex
  - There can be a higher tax cost to transferring to a family member
  - Employer versus employee risk
  - The Department of Finance has recently implemented other recent changes to the taxation of small business:
    - New inter-corporate dividend (safe income)
    - Changes to the ability to claim the small business deduction on certain types of income.
  - Pending CPP increases & minimum wage hikes

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