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Update on Finance Proposals: Some Good, Some Bad

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During the summer, the Department of Finance issued sweeping tax proposals ("Proposals") targeted at private businesses. These Proposals received lots of criticisms and were analyzed at length by tax practitioners and advisors (please see Torkin Manes LLP's analysis of these Proposals delivered by webinar). After months of lobbying by various industry groups and tax advisors, the Department of Finance, at the 2017 Annual Tax Conference (November 21, 2017), clarified its position on these Proposals:

Multiplication of Capital Gains Exemption

The Department of Finance confirmed it will not proceed with the Proposals dealing a common tax planning strategy of multiplying the capital gains exemption among family members (Currently, each individual is entitled to $835,716 for 2017 (indexed annually with inflation)). It is a common strategy to have family trusts hold shares of a qualifying small business corporation. When the shares are sold to an arm's length purchaser, the capital gains realized may be allocated by the trustees to the beneficiaries. Each of the beneficiaries may apply his or her own unused capital gains exemption against such capital gains. Such beneficiaries may be minors.

Tax on Split Income

The Department of Finance confirmed that it will proceed with the Proposals on income splitting. Briefly, these Proposals will levy personal income tax at the highest personal marginal rate on dividends received by family members who are shareholders of the private corporation, if the amount of

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the dividend is not reasonable given the shareholder's labour contributions to the activities of the business, his/her assets contributed or risks assumed in respect of the business and his/her previous returns and remuneration paid to him or her. The Department of Finance stated that revised proposed legislation on income splitting (to address a few concerns raised during the consultation period) will be issued shortly. Dividends paid before January 1, 2018 will not be subject to this tax on split income. The Department of Finance clarified that the tax on split income will not apply to the multiplication of capital gains exemption strategy discussed above.

Surplus Stripping

The Proposals dealing with section 84.1 and the proposed section 246.1 of the *Income Tax Act* (Canada) will not be implemented. Therefore, post-mortem estate planning strategies, such as the "pipeline", are available and will not result in double taxation (as the Proposals intended). However, while the Department of Finance has backed off on pipeline transactions, the Canada Revenue Agency has issued a recent tax ruling on a pipeline transaction where it has stated that the amalgamation cannot occur sooner than 30 months after the sale of the shares of the existing corporation to a new corporation, and that thereafter the promissory note cannot be paid off faster than 15% per quarter (See Ruling 2016-0670871R3. A typical pipeline transaction involves the estate selling the shares of a company with a "business" of investing and trading in marketable securities to a Newco for consideration comprising mostly a promissory note, followed by an amalgamation of the two companies and the repayment by Amalco to the estate or beneficiaries of the note over time. Prior to this ruling, the Canada Revenue Agency takes the position that an amalgamation may occur after 12 months.).

As proposed section 246.1 is now abandoned, capital dividends may be paid and would not be recharacterized as taxable dividends. The Department of Finance noted that it will continue to review the tax issues arising on intergenerational transfers of family businesses.

Passive Investments held by Private Corporations

While no draft legislation was issued on the taxation of passive investments, the Proposals discuss the perceived unfairness of a private corporation using its retained earnings to invest in passive investments. The Department of Finance indicated that it will continue to study the submissions received from the public during the consultation period. Any proposals or update will be addressed in the 2018 Federal Budget.

CRA Roundtable

At the Annual Tax Conference, the Canada Revenue Agency ("CRA") addressed a few technical questions. Of note is the application of subsection 55(2) of the *Income Tax Act* (Canada) in the context of a purification reorganization. This provision is an anti-avoidance provision that can result in an intercorporate dividend (which is generally tax free) being recharacterized as either proceeds of disposition on the sale of shares or a capital gain. Generally, when shares are being sold and the shareholders would like to claim the capital gains exemption, the shares must be "shares of a qualified small business corporation". If at the time of the sale, not more than 90% of the assets of the corporation are used in an active business, the shares of such corporation will not qualified for the capital gains exemption. As

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such, many private corporations would undertake a "purification" reorganization prior to the share sale by removing redundant assets by way of dividends to a related corporation. If subsection 55(2) does not apply, that dividend would be a tax-free intercorporate dividend. CRA confirmed that, generally, a dividend paid for the purpose of purifying the corporation's assets should not trigger the application of subsection 55(2). However, if such dividend is a one-time "lumpy" dividend, subsection 55(2) could apply to recharacterize such dividend into capital gains. Therefore, in order to avoid the potential application of subsection 55(2), it is good practice for a private corporation to regularly purify its assets by paying regular intercorporate dividends. A corporate structure should be set up in advance of paying these regular dividends. We encourage you to discuss with one of the members of our Tax Group regarding the set-up of a structure appropriate for your business.

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