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Increasing the cost of intergenerational business transfers

Ross Cammalleri, CPA, CA, *is a partner in the Vaughan office of Collins Barrow*

The Canadian Federal Government introduced draft legislation on July 18, 2017 that will profoundly change the taxation of private corporations and their shareholders. The Government claims the changes are necessary to instil fairness into the tax system as it believes the current rules are being used for personal benefit and do not contribute to the economy as a whole.

The proposed legislation targets four strategies believed to be unfair:

1. Income splitting;
2. Multiplication of lifetime capital gains exemption;
3. Holding passive investments in a private corporation; and
4. Converting a corporation's after-tax income into capital gains.

The new rules will increase the overall tax cost to private corporations, shareholders and their family members if enacted as proposed.

This *Tax Alert* focuses on the new rules that attempt to curb strategies that convert corporate after-tax income into capital gains instead of dividends, and how the changes will increase the after-tax cost of financing intergenerational business transfers. This conversion of income into capital gains is commonly referred to as "surplus stripping."

Surplus stripping – converting corporate income into capital gains

The Government has proposed amendments to a leading anti-avoidance rule (section 84.1 of the *Income Tax Act*) that will put an end to tax planning that allows an individual shareholder to extract corporate surplus assets and obtain capital gains treatment rather than taxable dividend treatment. The amendments are applicable for dispositions that occur on or after July 18, 2017.

The old section 84.1 prevented the conversion of corporate income to capital gains that are tax-free to a taxpayer or a non-arm's-length seller where the taxpayer or seller uses their lifetime capital gains exemption (LCGE). However, it did not prevent a taxpayer from receiving a tax-free distribution of corporate cash where the taxpayer or a non-arm's-length seller realized a taxable capital gain as a result of a previous disposition of shares of the distributing corporation.

The following is a classic example of the type of surplus-stripping tax planning the proposed legislation seeks to prohibit:

> Mrs. A, a resident of Ontario, owns all the issued and outstanding shares of a private corporation, A Co. Mrs. A needs $50,000 from A Co to purchase a new car. A Co could pay her a $50,000 bonus or a taxable dividend. The tax to her on the bonus could be as high as $26,765 (tax rate of 53.53%). The tax on the taxable dividend could be as high as $22,650. However, the personal tax on the $50,000 could be reduced to a lower capital gains rate of 26.765%, or $13,382.50, by implementing the following transactions:
>
> 1. Mrs. A sells some shares of A Co with a value of $50,000 to her spouse, Mr. A, in exchange for a promissory note. Mrs. A would realize a capital gain of $50,000 and pay tax thereon of $13,382.50. She would not use any of her available LCGE to shelter the capital gain from tax. Mr. A's tax cost

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base of the shares purchased would be $50,000.

2. Mr. A would then sell the shares of A Co to a corporation that he owns, A-Holdco, for a $50,000 promissory note.
3. A-Holdco could then receive $50,000 of tax-free dividends from A Co that may be used to settle the promissory note owing to Mr. A. Alternatively, the $50,000 of A Co shares could be purchased for cancellation by A Co for $50,000.
4. Mr. A will then pay off the $50,000 promissory note owed to Mrs. A with the funds received from A-Holdco.

The plan effectively converts $50,000 of corporate surplus cash from what would normally be a bonus or a taxable dividend into a lower-taxed capital gain.

One can debate whether the conversion of corporate income into a capital gain should be permitted. Recent Canadian jurisprudence confirms that corporate surplus stripping is not, in general, an abuse or misuse of the scheme of the *Income Tax Act*. Nevertheless, the Government has decided to curb such planning by broadening the application of section 84.1.

Amended section 84.1 effectively disallows the use of the cost base to a taxpayer of shares of a corporation (or other shares substituted therefor) by any capital gains realized by the taxpayer or any individual who the taxpayer did not deal with at arm's length, to receive tax-free distributions from a corporation. It is the so-called "hard" cost base of the shares that may be recovered from a corporation without incurring additional tax at the personal level.

Where an individual transfers such shares of a particular corporation to another corporation with which they do not deal at arm's length, the cost base of such shares is now reduced by any capital gains realized by the taxpayer or any individual who the taxpayer did not deal with at arm's length. Thus, a lower amount of non-share consideration (i.e. cash or a promissory note) may be received by the taxpayer from the transferee corporation.

Applying the new section 84.1 to the example above would result in Mr. A realizing a taxable dividend of $50,000 on the transfer of the shares to A-Holdco in consideration for the $50,000 promissory note.

Intergenerational business transfers

One of the consequences of the amendments to section 84.1 will be an increase in a child's after-tax cost of financing an acquisition of shares of a corporation owned by a parent. The cost will surpass what an arm's-length purchaser would pay to purchase the same shares, thereby potentially putting the child and the acquired family business at a competitive disadvantage.

The old rules

Under the old rules, an arm's-length purchaser could incorporate a corporation and purchase the shares of an individual by having the corporation issue a promissory note and then settle such promissory note with after-tax corporate dollars. The cost to settle the promissory note is much less than using after-tax personal cash from the receipt of salaries or taxable dividends.

This concept is best illustrated with the following example:

An individual who is a resident of Ontario owns all the shares of a private corporation, Opco, that are valued at $1,000,000. If the individual were

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to sell the shares to an arm's-length corporation, Purchasco, for a $1,000,000 promissory note, they would realize a capital gain and pay tax at $267,650 (assuming they choose not to use their LCGE, or do not have any LCGE available).

Purchasco could then receive tax-free dividends from Opco's future corporate after-tax income to settle the promissory note. Thus, Opco would need to earn no more than $1,360,500 of net income (or $1,176,470 if Opco pays tax at the small business rate of 15%) so that $1,000,000 of corporate after-tax dollars may be used to settle the promissory note.

The old rules did not allow a child of a shareholder to use a corporation to purchase the shares of a parent directly for cash or a promissory note and have the parent realize a capital gain. Under this scenario, the capital gain would be re-characterized as deemed dividend and would thus be taxed at a higher rate (i.e. 39.34% or 45.30% vs. 26.77%). However, the old rules permitted a child to use the corporate after-tax income to fund the purchase price.

Under the example above, the child could personally purchase the shares of the parent for a $1,000,000 promissory note. The parent would realize a capital gain and pay tax at $267,650 (the plan calls for the parent not to use any available LCGE). The child could then sell the shares of Opco to a new corporation, Holdco, for a $1,000,000 promissory note. Holdco could then receive tax-free dividends from Opco's future corporate after-tax income and use the cash to settle the promissory note owed to the child. The child would then pay off the promissory note owed to the parent.

As with an arm's-length corporate purchaser, Opco would need to earn no more than $1,360,500 of income so that $1,000,000 of corporate after-tax dollars may be used to settle the promissory note owed to the parent.

This result seems fair, as such planning puts the child in the same position as an arm's-length corporate purchaser in terms of after-tax cost of financing of the purchase price paid for the shares previously owned by a parent. But, as is often the case, the Government introduced legislative amendments that are so broad, they negatively impact legitimate planning where there is no apparent abuse.

The new rules

Under the new rules, the child's cost base for the purposes of section 84.1 will be reduced by the capital gain realized by the parent. Thus, the child's cost base would be reduced to a nominal amount rather than the $1,000,000 purchase price paid to the parent. Consequently, no non-share consideration (i.e. the promissory note) may be received from Holdco without the child being deemed to receive a taxable dividend equal to the amount of non-share consideration received.

Opco could still pay tax-free dividends to Holdco; however, Holdco would have to pay either a salary or a taxable dividend to the child in order for the child to receive the necessary cash required to settle the $1,000,000 promissory note owed to the parent. Where a salary is paid, the child would need to earn a cumulative gross salary of $2,151,925. Opco would need to earn such income and pay it out as a bonus or additional salary.

Alternatively, Opco would need to earn an aggregate of $2,151,000 of corporate net income before tax so that the child could receive $1,828,350 in total taxable dividends. Those dividends would provide approximately $1,000,000 of after-tax cash needed to settle the promissory note owed to the parent. This strategy assumes that Opco pays the lower annual corporate income tax rate of 15% on active business income. Where Opco pays tax at the higher rate of 26.5%, it would need to earn an aggregate of $2,243,158 so that the child could receive taxable dividends of $1,648,721 in order to provide approximately $1,000,000 of

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after-tax dollars needed personally to settle the promissory note owed to the parent.

Whether it is $2,151,000 or $2,243,158 of corporate net income before tax that Opco must earn, or a salary of $2,151,925 that the child must receive from Opco so she can settle the purchase price owing to the parent, the cost to the child is far greater than the $1,360,650 that an arm's-length corporate purchaser would need Opco to earn to settle the purchase price.

Fairness?

The Government is promoting the proposed changes as a measure to restore fairness to the Canadian taxation system and ensure we all pay our "fair" share of taxes. Critics of the proposed changes ask how it is fair to impose a cost to a child that ranges between 58% to 65% higher than what an arm's-length corporate purchaser would pay to purchase the shares of a family business. This higher cost may simply make it unaffordable for a child to purchase shares of a family business that, in some cases, may have been previously passed down to more than one generation.

To the Government's credit, it has welcomed input from stakeholders on how to accomplish reducing abuse of the section 84.1 structure while better accommodating genuine intergenerational business transfers. We hope the final version of the amendments will have a narrower impact in order to put intergenerational business transfers on a more equal footing with arm's-length transfers.

We are entering a new and complex tax world with respect to private corporations, their shareholders and their family members. The July 2017 proposals, along with the recent changes to the access of the small business deduction and the taxation of intercorporate dividends, will increase the complexity of the income tax compliance obligations faced by owner-managers.

A Collins Barrow tax advisor can help you navigate the many changes and ensure effective and efficient compliance with the new rules.

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