Agenda

• Donations Involving Private Corporation Shares or Real Estate
• December 2015 Personal Tax Rate Changes
• Review of Attribution Rules
• Income Splitting Strategies for Spouses and Minor Children
• Income Splitting Strategies for Adult Children
New Donation Rules

- Legislative proposals released on July 31, 2015 to give effect to 2015 Budget promise
- Consider: Ms. Z is selling her corporation and wants to donate all or a portion of the proceeds to charity
- Ms. Z will be taxable on the capital gain realized on the disposition
- Ms. Z then receives a donation credit for the cash gift to the qualified donee
New Donation Rules

• New rules will deem a Ms. Z’s capital gain to be zero where sale proceeds are gifted to a qualified donee within 30 days after the disposition

• Rules apply where property disposed of is:
  • Share of the capital stock of a private corporation; or
  • Real property situated in Canada

• Rules are proposed to apply to dispositions that occur after 2016
New Donation Rules

• Reduction to capital gain is pro rated to the extent that sale proceeds are gifted
  • Also reduced to the extent that the donor receives a “benefit” from the donee

• Proposals contain a series of anti-avoidance provisions to prevent abuse
  • Includes transactions between affiliated persons and transactions where property is reacquired
New Donation Rules

- Planning opportunity for charitably minded clients
- New rules provide a benefit similar to existing rules for donation of public company shares
- Must be cognizant of 30 day limitation
  - Can be problematic where sale transaction includes a holdback or earn-out
Personal Tax Rates

• Liberal “Robin Hood” campaign promise to increase taxes on the “One Percent” while cutting taxes for the “Middle Class”

• Draft legislation released on December 7, 2015
  • Bill C-2 has received First Reading and is on its way to becoming law

• Changes to tax brackets and marginal tax rates
Personal Tax Rates

- Upper limits of first, second and third tax brackets increased, with third tax bracket now capped at $200,000
- Tax rate for second bracket reduced from 22% to 20.5% (“Middle Class” tax break)
- New fourth bracket created for taxable income in excess of $200,000
- Tax rate for new fourth bracket is 33% (tax on the “One Percent”)
Combined Rates

Top combined marginal rates in Ontario for 2016

- Interest: 53.53%
- Capital Gains: 26.76%
- Eligible Dividends: 39.34%
- Non-eligible Dividends: 45.3%

Note: Slightly lower rates apply to income under $220,000
What to do?

- With personal tax rates exceeding 50% (!!!), clients are looking for ways to reduce total tax burden
- Income splitting with low income family members is an attractive opportunity
- But consider attribution rules
Attribution Rules

• Sections 74.1 through 74.5 of the Income Tax Act
• Various rules to attribute income back to transferor in certain situations
• Rules are generally designed to prevent income splitting with family members, but useful exceptions exist
Income Attribution

• Where property (including cash) transferred directly or indirectly to spouse, income from that property (or property substituted for that property) is attributed back to the transferor-spouse and taxed in his/her hands
  • This would apply to property transferred under the spousal rollover rule
Income Attribution

• Income attribution also applies to property transferred to minor children

• The application of this rule is not limited to the transferor’s children but extends to any minor children with which the transferor does not deal at arm’s length (such as grandchildren) and to a niece or nephew of the transferor
Attribution Rules

Capital Gains Attribution

- Capital gains arising from property transferred to a spouse (or substituted property) is attributed back to the transferor-spouse and taxed in his/her hands.
- Attribution does not apply to capital gains arising from property transferred to minors.
  - Planning opportunity.
Attribution Rules

Trust Attribution

• Special rule applies where property is transferred to a trust for the benefit of a spouse or minor children

• Income attributed will be either the actual amount received or proportionate share of trust income
Attribution Rules

Corporate Attribution

• Deemed interest income imputed to transferor where property transferred to a corporation where one of the main purposes is to reduce the transferor’s income and benefit a spouse or minor child

• Exception where corporation is a “small business corporation”
Kiddie Tax

- Not an “attribution rule”
- So-called kiddie tax will apply to income earned by children prior to the year that they turn 18 on interests in private entities
- Any such income will be taxed in the hands of the minor at the highest marginal rate
- Cannot split income with minors using dividends on private corporation shares
- Does not apply to publicly listed shares
Exceptions

• Fair market value transactions
  • Not practical in most cases
  • If transaction is between spouses, must be sure to elect out of the automatic spousal rollover

• Loans for value – attribution does not apply where property is loaned to, or for the benefit of, a spouse or minor child and interest is paid at a rate at least equal to the prescribed rate
  • Current prescribed rate is only 1%
Prescribed Rate Loans

• Mr. X is in top tax bracket from regular income sources
• Mr. X has an investment portfolio that is generating income which is being taxed at the top marginal rate
• Mr. X has a spouse and minor children that have little or no income
Prescribed Rate Loans

• Mr. X can loan funds to spouse or children to be invested by them
• So long as interest is charged at the prescribed rate (1%), attribution will not apply
• Mr. X is taxable on the interest received; but compare to income generated by portfolio that is now being taxed at lower rates in the hands of Mr. X’s spouse and children
Prescribed Rate Loans

- What if Mr. X does not want to put property directly into the hands of his spouse or minor children?
- What if Mr. X also wants to maintain some degree of control over the investment portfolio?
Prescribed Rate Loans

- Family trust can be established for benefit of Mr. X’s spouse and minor children
  - If structured properly, Mr. X could also be among the class of discretionary beneficiaries
- Mr. X makes a loan to the trust with interest at the prescribed rate
- Income generated by the trust can be allocated among spouse and children to maximize tax efficiency
Prescribed Rate Loans

- Income does not actually have to be paid to minor children, but can be made “payable” to them by trust issuing a demand promissory note
  - This will be sufficient for the income to be taxed in the hands of the minors and for the trust to be able to deduct these amounts
- Alternative to promissory note is “Age 40” trust
- Mr. X can be one of the trustees of the trust so as to be active in the investment strategy
Prescribed Rate Loans

- **Important**: Interest on prescribed rate loan must be paid no later than January 30\textsuperscript{th} of each year.
- If interest payment is late even once, the exception from attribution will be lost and entire strategy is nullified.
- Interest payment should be verifiable through cancelled cheque and bank records.
Adult Children

- Attribution does not apply where children are 18 years or older
- Income splitting with adult children can be efficient way of funding expenses, such as education expenses
- As attribution does not apply, no need to charge interest on loan to, of for benefit of, adult children
- Adult children can also receive dividends on private company shares without kiddie tax
  - Dividends will be taxed at marginal rates
Adult Children

- Establishing and funding a TFSA for an adult child
- Growth and income in TFSA are entirely tax sheltered
- TFSA funded with after-tax money, but so is loan to adult child
- Additional $5,500 per year of family wealth that can grow tax free
- Adult child can withdraw if needed without penalty
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Update on Recent Trust Tax Changes and Planning Opportunities

Toolbox Seminar

March 3, 2016

Presented by:
Lorne Saltman
Topics to Discuss

- Changes to Subsection 75(2) for resident and non-resident trusts
- Demise of the 5-year immigration trust
- Testamentary trusts and graduated rate estate
- Life interest trusts
- Philanthropic planning with trusts
- Residence of trusts – recent cases
- Rectification and trusts
Non-Resident Trusts and ss. 75(2)
after Sommerer v. The Queen, 2012 DTC 5126 (FCA)

• Despite long-standing CRA policy that ss. 75(2) applied not only a to gift but also a sale at FMV by a person to a family trust, Federal Court of Appeal held in Sommerer that 75(2) does not apply to a sale at FMV

• 75(2) amended in 2013 to be limited to a trust that is resident in Canada
Non-Resident Trusts and ss. 75(2)
after Sommerer v. The Queen, 2012 DTC 5126 (FCA)
…cont’d

- 94(8.1) uses familiar “reversionary” wording of old 75(2) to trigger application of NRT rules under 94(3) to deem a non-resident trust to be resident in Canada for certain purposes under the Income Tax Act
Demise of 5-Year Immigration Trust

• Consider remaining opportunity
• NRT tax rate going up from current 42.92% (as compared with top tax rate for Ontario resident individual at 49.53%) to 46.92% (as compared with 53.53%)
Testamentary Trusts and Graduated Rate Estate

- The Federal government views as abusive the use of multiple testamentary trusts to split income among family member trusts, and introduced rules starting in 2016 to tax testamentary trusts at the highest personal rate in the same way as are inter vivos trusts. i.e. 53.53% in Ontario.
There are two important exceptions to the new rules:

- A **Graduated Rate Estate**, one that arose on, and as a consequence of, an individual’s death, that can utilize the graduated marginal rates for the first 36 months after death; and

- A **Qualified Disability Trust**, a testamentary trust in respect of which the beneficiary who is disabled and qualifies for the Federal disability tax credit, jointly elects with the trustee to have the trust qualify to be taxed at the graduated marginal rates.

Given that a deceased can now have only one GRE for income tax purposes, current estates with testamentary insurance trusts, spousal trusts or other family trusts should be reviewed and updated.
Life Interest Trusts

- The new rules starting in 2016 are applicable to spousal trusts, *alter ego* trusts, joint spousal trusts and joint common-law partner trusts ("life interest trusts").
- When the individual with the life interest dies (such as the spouse in a spousal trust), the trust is liable for the tax on death.
- The testamentary spousal trust will not qualify for marginal rate treatment.
Charitable donations can be made in a Will, so that the personal tax credit can be claimed to offset tax payable by the individual deceased or the resulting estate.

New rules deem the gift to be made by the estate when the property is actually transferred to the charity—valuation must be done at that time, even though the deemed disposition of the deceased’s assets occurred at death.
• For gifts made by a GRE, the donation may be claimed in any of (a) the taxation year of the estate in which the donation is made, (b) an earlier taxation year of the estate, (c) any of the following five taxation years of the estate, or (d) the last two taxation years of the deceased.
If the estate is a GRE at the time the gifted property is transferred to a qualified donee (generally, a registered Canadian charity) and the gift comprises publicly-listed securities, an ecological gift or a cultural gift, the deceased will realize a capital gain of nil on the deemed disposition of the property on death, and the estate will realize a capital gain of nil on the actual disposition of the property to the donee.
In the last several years, it has been common for trusts to be established in Alberta by individuals in the high-rate provinces, in order to shift income and capital gains to take advantage of the lower provincial tax rate in Alberta.

“As with corporations, residence of a trust should be determined by the principle that a trust resides for purposes of the Act where ‘its real business is carried on’ … which is where the central management and control of the trust actually takes place.” (Garron case)
The Minister of National Revenue has lately been auditing many trusts and challenging their entitlement to the lower tax rate, on the basis of the test for “residence”, in order to protect the tax base of the higher-rate provinces.
• In *Discovery Trust*, the taxpayer was successful in demonstrating that the trust was resident in Alberta and not in Newfoundland

• In *Boettger*, the Minister of National Revenue was successful in demonstrating that the trust was resident in Québec and not in Alberta
While it is difficult to reconcile these two cases, there are some lessons to be gleaned from the reports.

• **First**, the substance of who exercises central management and control of the trust must follow the customary procedures and commercial practises in favour of the trustee acting with independence.
Second, the settlor of a trust must recognize the trade-off between giving up control and benefitting from the conferral of sufficient independent powers on the trustee to defeat an argument that the settlor has, in fact, never given up control.

Finally, the documents and correspondence reflecting the planning and implementation of a trust arrangement should be carefully crafted to be consistent with the usual non-tax purposes (such as estate planning) as well as the tax purposes for establishing the trust.
Rectification and Trusts

- When a tax-related error is made in relation to a trust, it may be possible to apply for an order from the civil courts to rectify the relevant documents to be consistent with the original intention of using the trust, and thus avoid the adverse tax consequences.
Rectification and Trusts

*Canada (Attorney General) v. Brogan Family Trust* 2104 ONSC 6354 (OSCJ)

- The CRA and the Department of Justice have expressed dissatisfaction and concern with the result in this case.
- The Ontario Superior Court of Justice held that CRA need not be served with notice of a rectification application to add minor beneficiaries inadvertently omitted from a family trust deed. Subsequently, tax on the capital gain on the sale of trust property was allocated to the added minor beneficiaries:
  - “the CRA is only required to be given notice of a proposed rectification proceeding when the CRA’s legal interests might be directly affected by the outcome of the rectification proceeding, such as where the CRA is a creditor and the rectification would affect its rights…” (paragraph 22)
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Update on Recent Corporate Tax Changes and Planning Opportunities

Toolbox Seminar

March 3, 2016

Presented by:
William Bernstein, LL.M. (Taxation) TEP
Overview of Issues Reviewed

- Significant Changes to Section 55 for Inter-corporate Dividends
- Review of Post-Mortem Tax Planning to avoid Double Tax on Shares of Private Corporations
  - Pipeline Planning
  - Section 164(6) Election to Carry-Back Loss
- Recent Changes to Corporate Tax Rates
- Key Takeaway Points
Changes to Section 55 Relating to Inter-Corporate Dividends

Purpose of Section 55

• Subsection 55(2) is an anti-avoidance rule to prevent “capital gains striping”, by which a tax-free inter-corporate dividends is used to reduce capital gains that would otherwise occur on a sale of shares.

• The scheme of the Act intends to have a capital gain equal to unrealized and untaxed appreciation in the corporation’s assets.
Changes to Section 55 Relating to Inter-Corporate Dividends …cont’d

- When 55(2) applies, the dividend is deemed to be proceeds of disposition of a share or a capital gain.
- It is a common error for clients and some practitioners to assume that all inter-corporate dividends between private corporations are tax-free by failing to take into account 55(2).
Exemptions to 55(2)

There have been a number of exemptions to 55(2) including the following:

1. **Related Party Exemption:**
   - A key exemption has been 55(3)(a), which is available if as part of the series of transactions that includes the dividend, there is no increase in an interest in the corporate payor of an unrelated person
   - This exemption has often been sufficient to avoid 55(2) in many situations
   - The availability of this exemption has been significantly reduced
2. **Purpose Test Exemption:**

- In connection with the payment of a regular dividend (rather than deemed dividend on redemption) 55(2) does not apply unless one of the purposes is to result in a significant reduction to a capital gain that would otherwise occur.

- Risky to rely on this exemption as CRA may have a different interpretation of the purposes.

- This exemption will be significantly narrowed by adding to offensive purposes.
3. **Safe Income on Hand Exemption:**
   - 55(2) does not apply if the amount of the dividend on a share does not exceed the safe income on hand ("SIOH") allocated to the share
   - The calculation of SIOH can be very complicated and subject to various uncertainties because the Act does not provide any type of comprehensive rules for calculation but is largely dependent upon various administrative positions from CRA over the years
Exemptions to 55(2) …cont’d

- The tax courts have often disagreed with CRA’s position
- “Safe Income” in a very general way is the post-1971 tax-paid retained earnings of the corporation, subject to various adjustments
- In the past it was often unnecessary to rely on SIOH because of being able to rely on another exemption
- Because of significant narrowing to other exemptions, it will be more common to have to rely on the SIOH exemption
Exemptions to 55(2) ...cont’d

4. **Part IV Tax Exemption:**
   - 55(2) does not apply if a dividend is subject to Part IV tax that is not refunded as a consequence of a dividend to a corporation
   - This exemption available if dividend refund arose from payment of a dividend by a corporate shareholder to an individual shareholder
   - This exemption will also be significantly narrowed
5. **Butterfly Exemption:**
   - 55(3)(b) provides an exemption from 55(2) for certain divisive reorganizations that have a complicated set of rules that require a pro rata distribution at different types of assets among the corporate shareholders
   - This exemption is usually not available and is not being significantly changed
Changes to Section 55

- Very significant changes are proposed to section 55 arising from the April 21, 2015 federal budget
- Draft legislation released on July 31, 2015
- Legislation will be retroactive to dividends received after April 20, 2015
- Explanatory notes from Department of Finance describe certain perceived abuses being targeted but as is often the case, the changes will apply to many situations beyond the perceived abuse
Changes to Section 55 …cont’d

- These changes will significantly increase the risk of 55(2) applying to many common transactions, including the payment of regular, periodic dividends between related corporations, inter-corporate dividends paid in connection with common asset protection/creditor proofing transactions and dividends paid in connection with purifications to access the capital gains exemption.
1. **Changes to Related Party Exemption:**
   - The exemption in 55(3)(a) will no longer be available for the payment of regular dividends but will be available only for deemed dividends arising on the redemption of shares.
   - This is a significant adverse change that will affect the payment of most dividends between related corporations, especially in light of the narrowing of the Purpose Test Exemption.
Changes to Section 55 …cont’d

- For example, 55(2) may apply to the simple situation of payment of dividends from Opco to Holdco where Opco is wholly-owned by Holdco and Holdco is wholly-owned by Father.

- Much more need to rely on the SIOH exemption which will require the calculation of SIOH in many more situations.
Changes to Section 55 …cont’d

• As a planning point, it will likely be desirable to structure transactions to have deemed dividends arising from redemptions rather than regular dividends

• This may require reorganizing the shares of a corporation prior to the inter-corporate payments
2. **Changes to Purpose Test Exemption:**
   - Availability of Purpose Test Exemption will be narrowed since there will be two additional offensive purpose tests.
   - Exemption will be available only if one of the purposes is not only to reduce significantly capital gain but also to significantly reduce the fair market value of a share or significantly increase the cost of property owned by the dividend recipient.
Changes to Section 55 …cont’d

• In the case of a deemed dividend arising from a redemption, the above tests are applied based on the “results” rather than on the “purpose” so will provide even a narrower exemption

• Problem that significant uncertainty as to what CRA will regard as one of the purposes of a series of transactions
Changes to Section 55 …cont’d

• Risky to rely only on this exemption without more administrative comfort over time from CRA as to transactions it regards as acceptable

• Initial comments by CRA relating to common creditor proofing transactions indicate significant narrowing of this exemption

• From a planning point of view, it will be more important to document the purpose of particular transactions
3. **SIOH Exemption:**
   - The SIOH exemption is narrowed since it will be available only to the extent the SIOH contributes to a capital gain on the share.
   - There are many circumstances in which a share may have SIOH allocable to it in excess of the unrealizable gain on the share.
   - Despite the somewhat narrowing of this exemption, SIOH will become more important to rely on because of narrowing of other exemptions.
Changes to Section 55 …cont’d

- From a planning point of view, it will be prudent for a corporation to calculate and track its SIOH on an annual basis as it will more than likely be relied upon.
- The difficulty will be in doing the initial SIOH calculation from the date of incorporation, assuming that has not been done.
4. **Part IV Tax Exemption:**
   - This exemption is narrowed as it is no longer available if as part of the series of transactions there is a dividend refund as a result of a dividend from a corporate shareholder to an individual shareholder

5. **Special Stock Dividend Rule:**
   - Ability to avoid 55(2) by payment of a high-low stock dividend is eliminated
Changes to Section 55 …cont’d

• Amount of a dividend in connection with a stock dividend is the paid up capital of the shares issued so it could be kept artificially low

• Before the changes, it was possible to avoid 55(2) by issuing a stock dividend with a high fair market value but low paid up capital

• Now for purposes of 55(2) the amount of the stock dividend will be the greater of the paid up capital and the fair market value of the shares issued
Changes to Section 55 …cont’d

- NET RESULT

- The exemptions from 55(2) will be significantly narrowed such that 55(2) will apply to many more common inter-corporate dividends with relief dependent upon the SIOH exemption
Comments from CRA at Canadian Tax Foundation Roundtable – November 24, 2015

• CRA has recently provided comments on various aspects of the proposed changes to 55(2)
• Much uncertainty as to various issues arising

Expanded Purpose Test
• Significant uncertainty as to how CRA will apply
• Risky to rely only on the purpose test exemption
• Little comfort that CRA can provide as dependent on the facts of each situation
• Bad initial indication as per creditor-proofing below
Comments from Roundtable ...cont’d

**Ordinary course dividends**

- CRA provided limited comfort on whether the purpose test exemption would be available for ordinary course dividends
- Comfort limited to situations where dividends are paid as part of a well-established dividend policy to the extent the dividends represent a reasonable rate of return
- Difficult standard as most corporations do not have a consistent policy of paying certain dividends each year
Large Dividends Paid for Creditor-Proofing

- Common in related party situations for a wholly-owned Opco to pay large dividends from retained earnings to Holdco with all or most of the dividends loaned back on a secured basis for creditor protection.

- In past could rely on related party exemption but that exemption will no longer be available for payment of regular dividends (but still available for deemed dividends on redemption).
• CRA indicated that payment of such dividends likely not protected by purpose test exemption even though the main reason for the dividends is a non-tax reason because one of the purposes is to try to reduce the value of Opco

• More need to rely on SIOH exemption or structure the payment as redemption of shares and rely on related party exemption
Dividends on Skinny Dividend Shares

• There is often a class of shares with nominal entitlement on liquidation and redemption with the discretionary right to unlimited dividends

• In the past, dividends were protected by related party exemption but no longer

• CRA confirmed that no SIOH will be allocated to such shares so cannot rely on that exemption

• Only possible protection is the purpose test exemption but risky
Loss Consolidation Arrangements

• One positive item that CRA indicated that it would generally not apply 55(2) for dividends paid in connection with a loss consolidation arrangement between related or affiliated parties based upon the purpose test exemption.
Comments from Roundtable ...cont’d

**Intended use of 55(2)**

- Another positive item is that CRA will generally not apply GAAR if a taxpayer deliberately triggers 55(2) without a corresponding separate dividend designation under 55(5)(f) to allow distributions at capital gains tax rates.
Comments from Roundtable ...cont’d

- Since capital gains tax rates are generally significantly lower than dividend tax rates, the overall tax costs of distributing money from a corporation to individual shareholders is often less if inter-corporate payments are taxed as capital gains, rather than as tax-free dividends and the individual shareholder can use the capital dividend account.
- This is a planning opportunity.
- Risk that CRA has expressed concern to the Department of Finance so there may be amendments to close this opportunity.
Whether 55(2) Application Limited to Excess Over SIOH

- 55(2) technically applies on an all or nothing basis.
- For example, if there is a dividend of $200,000 and CRA determines the SIOH for those shares was $190,000, 55(2) technically applies to all of the $200,000 rather than only the $10,000 excess unless the corporation filed a designation under 55(5)(f) to designate separate dividends at $190,000 and $10,000.
• Some uncertainty as to whether late-filed designation will be allowed despite support by a tax case
• CRA has indicated in several technical interpretations that it administratively would apply 55(2) only to the excess amount (i.e. $10,000 excess) even if a designation is not filed
• Generally preferable not to file a designation since it is a red flag for CRA review
• If taxpayer wants 55(2) to apply only to the excess, some uncertainty to rely on this administrative position
Comments from Roundtable ...cont’d

• If taxpayer wants 55(2) to apply to the whole dividend, the recent comments from CRA at the roundtable seem to indicate CRA would allow the taxpayer to self-assess on that basis

• From planning point of view, if taxpayer wants 55(2) to apply only to the excess, prudent to still use a series of separate dividends and not file a 55(5)(f) designation
Use of Redemptions to Rely on Related Party Exemption

• Since the related party exemption is available only for deemed dividends arising from redemptions (versus regular dividends), it may be desirable to reorganize the shares of a corporation to allow for payments from Opco to Holdco on the redemption of shares rather than payment of regular dividends.
• CRA has provided some comfort that it would not apply GAAR to such arrangements so long as they do not result in artificial generation or manipulation of costs
Take Away Points re: 55(2)

• Much more exposure to 55(2) problems with inter-corporate dividends, including many common transactions

• Significant narrowing of various exemptions

• More need to rely on SIOH so consider tracking

• If relying on purpose test exemption, refer to purpose of transactions in the documents
Changes to Section 55 …cont’d

• In order to rely on related party exemption, need a redemption rather than regular dividends so it may be necessary to reorganize the shares prior to the inter-corporate payments

• Care needs to be taken with common creditor-proofing transactions

• Consider intentionally triggering 55(2) if capital gains treatment is preferred to dividends treatment
Post-Mortem Tax Planning to Avoid Double Tax

• When individual dies owning shares in a private corporation, potential for double tax

• First tax is a capital gain on the shares based upon the deemed disposition at FMV immediately prior to death under 70(5) unless shares transferred to a spouse or QST

• Additional potential incident of tax to shareholder when corporation distributes assets to the estate
Post-Mortem Tax Planning ...cont’d

Two Alternatives to Avoid or Minimize Double Tax

164(6) Approach:

• Effect to replace a capital gain with a deemed dividend

• Redemption of shares from estate with high ACB (bumped on death) and low PUC within first year of estate

• Results in deemed dividend and capital loss
• Estate elects 164(6) to carry back estate’s loss to terminal return

• Off-sets capital gain of deceased in terminal return

• Tax rates on dividends higher than capital gains so this approach may not be tax efficient

• Efficiency depends on various tax attributes relating to the corporation
Post-Mortem Tax Planning ...cont’d

• Capital dividend account ("CDA") allows all or part of the dividend to be received tax-free

• Restrictions on the amount of loss if capital dividend used per 112(3.2)

• May not be tax efficient to make full use of capital dividend in order to avoid erosion of capital loss

• CDA may be created by life insurance owned by corporation
Post-Mortem Tax Planning ...cont’d

- CDA arising from older grandfathered life insurance policies not subject to capital loss restriction
- Ideal situation of grandfathered life insurance policy with sufficient CDA to cover full deemed dividend with result that no tax payable by the deceased or by the estate on distribution
• GRIP allows for deemed dividend to be designated as eligible dividend

• If corporation has RDTOH, deemed dividend will result in dividend refund

• Under new tax rules for testamentary trusts the 164(6) election is available only if the estate is a graduated rate estate
Pipeline Approach:

• Results in net tax being a capital gain to the deceased in terminal return with tax-free distribution from corporation to estate

• If corporation does not have favourable tax accounts, pipeline approach may be more tax efficient

• Estate sells shares of the corporation to Newco for a promissory note up to ACB of shares (i.e. bumped up to FMV at death)
Post-Mortem Tax Planning ...cont’d

• Newco amalgamates with the corporation resulting in Amalco

• Amalco repays the promissory note to the estate

• Allows the estate to receive tax-free payment (referred to as the pipeline to receive corporate assets)
Attack by CRA

• CRA attacked the pipeline approach in 2011
• Argument that section 84(2) re distribution in connection with a winding-up of the corporation, applied to treat the payment of the promissory note as a deemed dividend if the payment to the estate occurred shortly after the death and the corporation’s assets were mainly cash
• Other potential attacks by CRA under section 84.1 and GAAR
Post-Mortem Tax Planning ...cont’d

• CRA has issued number of advance rulings since 2011 (including very recent rulings) that indicate pipeline approach not attacked if following conditions met:

  1. Corporation’s business continues for at least one year after shares of the corporation transferred to Newco. Sufficient if corporation’s assets were investment assets rather than an active business
2. The corporation and Newco not amalgamated for at least one year

3. The corporation’s assets not distributed to the estate for at least one year followed by a progressive distribution of the corporation’s assets over an additional period of time

• Pipeline approach not work under 84.1 if shares of the deceased have significant ACB based upon V-DAY value or use of capital gains exemption
Post-Mortem Tax Planning ...cont’d

- Planning point: While arguably pipeline approach should work without satisfying CRA administrative requirements, it is prudent to implement pipeline approach satisfying CRA’s requirements.

- If the corporation owns non-depreciable capital property, it is possible to have added tax efficiency by bumping up the ACB as part of the pipeline approach.
Post-Mortem Tax Planning ...cont’d

Planning Point

• Whether 164(6) approach or pipeline approach is most tax efficient will depend on the specifics in each particular situation

• It may be more tax efficient to use a hybrid approach combining the two approaches
Post-Mortem Tax Planning ...cont’d

Take-away Points for Post-Mortem Planning

• Whenever an individual dies owning shares of a private corporation, consider steps to avoid and minimize double tax

• Consider if use 164(6) approach, pipeline approach or combination depending on various factors including if corporation has CDA, if there is grandfathered life insurance, GRIP and RDTOH
• If use pipeline approach, follow CRA administrative requirements

• Limited time for planning as 164(6) election must be filed within one year of death

• Wills should contain provisions that allow for post-mortem planning
Recent Corporate Tax Rate Changes

- Federal budget April 21, 2015
- Bill C-2 December 9, 2015 First Reading

Changes Relating to Active Business Income ("ABI")

- Income Tax Act ("ITA") provides reduced small business tax rate ("SBTR") for ABI earned by Canadian-controlled private corporation up to $500,000 per year for an associated group of corporations by way of allowing a deduction from regular corporate tax rate, being the small business deduction ("SBD")
Recent Corporate Tax Rate Changes
...cont’d

• Reduced tax rate is a combination of federal and provincial SBD

• Political issues involved in providing financial incentives to small business

• Separate federal and provincial political issues can apply re amount and targeting of the financial incentive (e.g. proposed Quebec changes)
Recent Corporate Tax Rate Changes
...cont’d

- SBD phased out starting with taxable capital in Canada of more than $10,000,000 for associated group and eliminated at $50,000,000
- SBD provides significant deferral for ABI that is left in the corporation
Recent Corporate Tax Rate Changes
...cont’d

Changes to SBTR

• Federal SBTR is being reduced from 11% down to 9% for 2019
• Phased in rates are 10.5% for 2016, 10% for 2017, 9.5% for 2018 and 9% for 2019
• Corporations with tax years that straddle calendar year have pro rating
• Combined federal and Ontario SBTR is 15% for 2016 and 14.5% for 2017
• Planning point: Decrease to SBTR and increase to personal rates creates more deferral incentive to leave after-tax profit in corporation
Changes to Dividend Tax Credit (“DTC”)

- General intention of tax system that combined income tax paid by a corporation and shareholder on distributed dividends to be same as if income earned directly by the shareholder
- Rarely, if ever, perfect integration
- As a result of changes to SBTR there will be a phase-in of changes to DTC from 11% to 9% and the gross-up from 18% to 15% by 2019
Recent Corporate Tax Rate Changes
...cont’d

- DTC and gross-up applies not only for dividends paid from ABI but also dividends paid from investment income (other than eligible dividends)

- Unfair result that these changes further erode concept of integration as more overall tax paid if income earned through a corporation versus directly
Other Tax Changes Relating to Investment Income Earned by Corporation

• In addition to changes to DTC and gross-up, the following changes impact on investment earned by a CCPC for tax years ending after December 31, 2015

• Proration for tax years that straddle calendar year

**Investment Income Surtax**

• In order to avoid deferral of payment of tax on investment income there is a surtax payable by corporations on investment income that is refundable when the corporation pays taxable dividends

• Refundable tax is increased from 6 2/3% to 10 2/3%
Changes Relating to Investment Income ... cont’d

Part IV Tax

• Similarly, refundable Part IV tax is payable on portfolio dividends received by a corporation and refunded when taxable dividends paid to a shareholder

• Part IV tax rate is increased from 33 1/3% to 38 1/3%
Changes Relating to Investment Income ... cont’d

Dividend Refund Rate

• As part of the integration system it is intended to have the total tax paid on investment income earned by a corporation and distributed as dividends to shareholders as if the investment income earned directly by the individual

• As a result of the above tax rate increases, the dividend refund rate is increased from 33 1/3% to 38 1/3%
Use of Investment Holding Company

- Integration generally does not work perfectly

- Changes make it less tax efficient to earn investment income through a CCPC versus earned directly by an individual

- In Ontario there is still some deferral of tax for a CCPC receiving portfolio dividends, capital gains and interest income so long as the money is left in the corporation but less than previously
Changes Relating to Investment Income ... cont’d

- Once the corporation pays after-tax investment amount to a shareholder as dividends, total tax paid by the corporation and the shareholder is generally more than if the investment income is earned directly by individual, except neutral for portfolio dividends.

- As a planning point, it is not worthwhile to set up an investment Holdco for the primary purpose to save tax on investment income but there are often other reasons why it is worthwhile to set up as part of family estate planning.
Changes Relating to Investment Income ... cont’d

- Combined federal and provincial corporate tax rate in Ontario for 2016 on investment income is 50.2%

Risk of Restricting Access to SBTR

- In federal election campaign some comments that SBTR should not be available to certain corporations, such as professional corporations

- Quebec recently narrowed the provincial SBD for ABI so not allowed if not more than 3 employees starting in 2017
Changes Relating to Investment Income ... cont’d

- Manufacturing companies may be excluded from this change so change appears targeted to services and construction sectors

**Take-Away Points from Corporate Tax Rates Changes**

- Decrease to small business tax rate results in more deferral of tax if leave after-tax money in the corporation

- Changes make it somewhat less tax efficient to earn investment income in a corporation, but still some deferral (while after-tax money left in a corporation)

- Other reasons to use investment holding companies
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