Taxation of Investment Income; Voluntary Disclosure Program and Automatic Exchange of Tax Information

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September 14, 2017

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Topics to Discuss

1. Introduction: Tax Reform in Canada and Internationally
2. Proposals to Modify the Taxation of Passive Investment Income of Private Corporations
3. Proposals to Amend the Voluntary Disclosure Programme
4. Proposals to Commit to the Common Reporting Standard and Provide Automatic Exchange of Tax Information to Foreign Tax Authorities

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Taxation of Passive Investment Income of a Private Corporation

- Policy Statement in Budget 2017
- *When private corporations earn income beyond what is needed to re-invest and grow the business, fairness and neutrality require that such corporations not be used as a personal savings vehicle for the purpose of gaining a tax advantage*
- *This use of a private corporation's lower tax rate to invest after-tax proceeds in passive investments results in a realization of returns that exceed what individual investors saving in a personal investment can achieve*

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Taxation of Passive Investment Income of a Private Corporation ...cont'd

- The objective of the "integration" rules for taxing investment income is to ensure that a dollar of such income earned through a corporation bears a tax burden, when corporate and personal taxes are combined, that is roughly similar to that of a dollar of such passive income earned directly by an individual

Taxation of Passive Investment Income of a Private Corporation …cont'd

Individual		Corporate Owner	
Salary	+$100	Business Income	+$100
Personal Income Tax	-$50	Corporate income tax	-$15
After-tax income	$50	Income after corporate tax	$85
		On distribution as dividend: Personal income tax - Dividend grossed up - PIT rates applied - Claim dividend tax credit	-$35
		Total tax paid	$50
		After-tax income	$50

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Taxation of Passive Investment Income of a Private Corporation …cont'd

What is the alleged unfair advantage ?

- Suppose a private corporation earns active business income of $100,000 and pays corporate tax at a combined rate of 15%
- The entrepreneur has $85,000 after-tax proceeds with which to invest in passive investments
- In contrast, an employee earning $100,000 at the top rate will pay tax of 53.53% in Ontario, leaving only $46,407

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Taxation of Passive Investment Income of a Private Corporation ...cont'd

- *While the corporation's owner will have to pay personal tax upon dividend distributions, the strategy (?) will provide the owner with a significant tax deferral advantage compared to an employed Canadian- an unacceptable inequity in the government's goal to achieve social justice*
- *The fact that the private corporation is subject to immediate tax on this passive investment income of about 50%, which roughly equates with the tax an individual would pay on the same income, does not apparently remove the inequity*

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Taxation of Passive Investment Income of a Private Corporation …cont'd

Corporate owners invest surplus in a corporation because:

- They have no employer-provided pension or maternity leave
- They have no employer-provided health care or other insurance plan
- They have no safety net
- They need a capital reserve to cushion fluctuations in the business cycle
- To cover unforeseen expenses
- Act as security for better financing terms
- Capital for future business expansion/acquisitions

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Taxation of Passive Investment Income of a Private Corporation …cont'd

			Types of Passive Investment Income		
		Formula	Interest Income/ Rental Income	Portfolio Dividends	Capital Gains
A	Passive investment income		100	100	100
B	Taxable passive investment income	A, or 50% of A for capital gains	100	100	50
C	Provincial corporate tax	B * 11.5% or 0 for dividends	11.50	0	5.75
D	Federal tax on interest, rental income and capital gains	B * 38⅔%	38.67	n/a	19.34
E	Federal tax on dividends	B * 38⅓%	n/a	38.33	n/a
	Refundable taxes and exempt amounts(1)				
F	Refundable portion of taxes on interest, rental income and capital gains	B * 30⅔%	30.67	n/a	15.34
G	Refundable portion of taxes paid on dividends	B * 38⅓%	n/a	38.33	n/a
H	Capital dividend account	A - B	n/a	n/a	50
	Distribution of income to individuals				
I	Taxable Dividends(2)	B – C – D + F or B – C – E + G	80.50	100	40.25
J	Capital dividends	H	0	0	50
K	Personal income tax(3)	I * 45.30% or 39.34%	36.47	39.34	18.23
L	After-tax income (Corporate owner)	(I + J – K)	44.03	60.66	72.02

Notes: (1) Refundable taxes represent the portion of federal taxes paid (D or E above) that will be refunded once the corporation distributes the income or capital gains to shareholders. (2) Dividends distributed to shareholders include the after-tax passive investment income, plus the refundable portion of federal taxes, which differ based on the type of income. (3) Effective dividend tax rate after dividend gross-up and dividend tax credit by a top-rate Ontario taxpayer. The effective dividend rate of 45.30 per cent applies to the distribution of corporate investment income such as interest or rental income, non-eligible portfolio dividends (defined later in this section), and the taxable portion of capital gains. In this example, the portfolio dividends are assumed to be eligible dividends received from a public corporation, and are subject to an effective dividend tax rate of 39.34 per cent.

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Taxation of Passive Investment Income of a Private Corporation …cont'd

- Currently, the payment of taxable dividends can trigger a corporate tax refund on passive investment income, irrespective if paid out of active or passive income
- To the extent that a corporation pays dividends from active business income, the payment of additional taxes on passive income and refund of these same taxes can happen in the same tax year, effectively nullifying the intended effect of the passive investment income taxes

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Taxation of Passive Investment Income of a Private Corporation ...cont'd

- *Preferential tax rates for corporations were never intended to facilitate passive wealth accumulation, such as through passive investments*
- Many businesses use the tax savings to expand their businesses, improve their technology and create more jobs, but in other cases the benefit of the lower tax rates is being used to confer a tax and financial advantage on what are, in essence, personal <u>savings (?)</u>
- Need to close this <u>loophole (?)</u>

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Taxation of Passive Investment Income of a Private Corporation ...cont'd

- Possible Approaches - with the following objectives of the government:
  - Preserving the intent of the lower tax rates on active business income earned by corporations, which is to encourage growth and job creation, and
  - Eliminating the tax-assisted financial advantages of investing passively through a private corporation, and ensuring that no new avenues for avoidance are introduced

Taxation of Passive Investment Income of a Private Corporation …cont'd

- Possible Approaches
  - Refundable tax on ineligible investments was originally part of the 1972 Carter Commission Tax Reform. But not actively being considered now, because of complexity, and liquidity issues for private corporations that may not be able to get the tax refund efficiently to meet legitimate business needs
  - Deferred Taxation
    - Currently the corporate tax on passive investment income is about 50%, of which about 30% is refunded when a taxable dividend is paid out
    - Propose to eliminate the refundability of corporate tax where earnings are used to fund passive investments that were taxed at low corporate rates
    - Must determine source of distributed income from passive investments funded by low corporate tax rate and not other sources, e.g. general rate

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Taxation of Passive Investment Income of a Private Corporation …cont'd

	Individual		Corporation
		Current System	Proposed System
Source capital			
Income	100,000	100,000	100,000
Federal personal or corporate tax	33,000	10,500	10,500
Provincial personal or corporate tax	17,367	3,900	3,900
Starting portfolio	**49,633**	**85,600**	**85,600**
Return on investment in year 1*			
Interest (3 per cent)	1,489	2,568	2,568
Non-refundable personal or corporate tax	750	506	
Federal	*491*	*205*	
Provincial	*259*	*300*	
Non-refundable taxes (new system)			1,293
Refundable taxes (RDTOH)		788	
After-tax investment income (re-invested passively)	739	1,275	1,275
Portfolio value after 10 years	**57,539**	**99,235**	**99,235**
Refund of pre-paid tax (RDTOH)		8,424	
Distribution of taxable dividends		107,659	99,235
Personal income tax on dividends		45,235	41,696
Net worth	**57,539**	**62,424**	**57,539**

Notes: (*) This box illustrates the return on investment and its tax treatment in year 1 of the investment. It is assumed that passive investment income is earned for a period of 10 years, and the after-tax proceeds are reinvested passively each year. The returns in years 2 to 10 of the investment are not illustrated to simplify the presentation of the example.

This and the following examples in this section are based on simplified tax rate assumptions, chosen to remove small discrepancies that can arise due to imperfect integration of federal-provincial tax rates on dividends and differences between the top personal income tax rate that applies in each province and current tax rates on corporate passive investment income. The assumptions used are as follows:

- All investment income is assumed to be subject to the top personal income tax rate. For simplicity, the taxation of the income earned by the high-income individual that is used for consumption purposes is not illustrated in these tables. Rather, the examples only show how the additional funds used to undertake passive investments are taxed.
- Federal and provincial personal income tax rates of 33 per cent and 17.37 per cent, respectively.[14]
- Federal and provincial general corporate income tax rates of 15 per cent and 11.7 per cent, respectively.[15]
- Federal and provincial small business income tax rates of 10.5 per cent and 3.9 per cent, respectively.[16]
- Effective combined federal-provincial dividend tax rates of 32.29 per cent for eligible dividends, and 42.02 per cent for non-eligible dividends.[17]
- A federal non-refundable corporate passive investment tax rate of 8 per cent (0 percent for dividends)
- A federal refundable (or non-refundable under the new system) corporate passive investment tax rate of 30⅔ per cent (38⅓ per cent for dividends)

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Taxation of Passive Investment Income of a Private Corporation …cont'd

- Deferred Taxation
  - All income generated by passive investments would be treated as "non-eligible dividends" upon distribution to shareholders
  - Accordingly, dividends from publicly-listed securities would no longer be treated as "eligible dividends", and
  - The non-taxable portion of capital gains from these passive investments would be not be credited to the capital dividend account
- If there is no refundable tax for passive investments, the corporation pays about 50% tax and then the shareholder pays about 45% on the non-eligible dividend so received for another 23%, or about <u>73% in total</u>

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Taxation of Passive Investment Income of a Private Corporation ...cont'd

- Deferred Taxation
  - In order to attribute dividends to the correct source, the government is considering using an apportionment method
  - Corporate owner must maintain cumulative share of earnings taxed at the low corporate tax rate (non-eligible dividends), the general rate (eligible dividends), as well as capital contributed by shareholders out of personal after-tax income (tax-free)
  - Passive income earned in the current year would be apportioned to the three pools based on the previous year's undistributed income pools
  - Complex and costly to maintain and enforce

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Taxation of Passive Investment Income of a Private Corporation …cont'd

- Deferred Taxation
  - Alternatively, in order to attribute dividends to the correct source, the government is considering using an elective method
  - A private corporation would be subject to a default tax treatment, unless it elected otherwise
  - Under the default treatment, passive income earned in a CCPC would be subject to non-refundable taxes, and dividends distributed from these sources would be treated as "non-eligible dividends"
  - A CCPC could elect to retain refundable taxes and be able to pay out "eligible dividends", but it would foreclose its ability to be taxed at the low business rate

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Taxation of Passive Investment Income of a Private Corporation ...cont'd

- Deferred Taxation
  - Complex and costly rules mean increased burden on small business for compliance;
  - Distinction between business income and passive investment income not as clear as Finance asserts;
  - Entrepreneurs may be driven by tax considerations to reinvest in new or current operations, which perversely may be uneconomic – the opposite of the government's stated intention
  - No grandfathering rules promulgated, although Finance states their intention is for there to be limited impact on existing passive investments, and apply the new rules prospectively

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Taxation of Passive Investment Income of a Private Corporation ...cont'd

- Deferred Taxation
  - Accordingly, strategy may be to accelerate passive investments now (e.g. trigger capital gains to have some credit to CDA) before the new rules commence in 2019 (?)
  - Greater use of life insurance in CCPC
    - Apparently no intention of denying credit to CDA for proceeds on death, unlike denial of credit for capital gains from passive investments
    - Exempt life insurance policy can shelter investment income
  - Consider Individual Pension Plan
    - Corporate owner (generally best between ages 40 and 70) can establish key employee registered pension plan for himself/herself
    - Can contribute more than RRSP limits and income can accumulate tax-free

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Taxation of Passive Investment Income of a Private Corporation …cont'd

- Deferred Taxation
  - Propose special election for Investcos that retains refundable taxes when only activity is passive investments
  - There does not appear to be need to restructure current tax & estate plan structures (e.g. estate freeze), although pure holding companies may now be subject to refundable taxes on dividends received from related operating companies, similar to dividends from portfolio investments
  - Questions for public consultation focus on implementation issues, not on fundamental policy issues

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What is the Voluntary Disclosure Programme?

Initiative of the Canada Revenue Agency to foster voluntary compliance

- Most generous amnesty programme among the developed countries
- If accepted, the taxpayer must pay past taxes owing plus interest (subject to some relief), but there is no prosecution and there are no penalties
- The VDP plays an important role in combatting tax evasion and achieving increased levels of tax compliance, by encouraging taxpayers to come forward voluntarily, correct their tax affairs, and pay their taxes. Not only does the VDP generate significant tax revenues that otherwise would go uncollected, but it also is a cost-effective way for the CRA to foster and achieve tax compliance

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Fundamental Requirements to Qualify for VDP

- The taxpayer directly, or through his/her/its representative, must initiate the disclosure on a voluntary basis, before any enforcement action is commenced by the tax authorities
- The disclosure must involve some past tax obligation that was missed resulting in potential penalties and interest
- The disclosure must be complete

New VDP Proposals

- Following report from Offshore Compliance Advisory Committee in late 2016 to MNR
- June 9, 2017 news release from MNR announcing proposed changes, seeking consultation
- Changes to VDP apply to income tax and HST

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New VDP Proposals …cont'd

- Under the current VDP policy, a taxpayer is generally entitled to relief regardless of whether the failure was inadvertent. The underlying rationale for this approach has been that it is desirable, from a fiscal as well as social contract perspective, to encourage non-compliant taxpayers to reintegrate into the tax system, rather than rely solely on the threat of prosecution to discourage non-compliance

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New VDP Proposals …cont'd

- The proposed changes reflect a shift in this policy, by introducing a multi-tier system where eligibility for relief depends partly on the identity or characteristics of the taxpayer, and on whether the taxpayer is considered to have engaged in "major non-compliance"
- This new policy will create uncertainty and perversely discourage coming forward voluntarily , the exact opposite of what should be the government's goal of achieving more, not less, compliance

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Reduced Relief Under the Limited VDP Programme

The Limited Program provides limited relief for applications that disclose <u>major non-compliance</u>, including one or more of the following situations:

- active efforts to avoid detection through the use of offshore vehicles or other means,
- large dollar amounts,
- multiple years of non-compliance,
- a <u>sophisticated taxpayer</u>

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Reduced Relief Under the Limited VDP Programme …cont'd

Examples of major non-compliance include one or more of the following situations:

- the disclosure is made after an official CRA statement regarding its intended focus of compliance or following CRA correspondence or campaigns,
- any other circumstance in which a high degree of taxpayer culpability contributed to the failure to comply,
- for example, a taxpayer has been transferring undeclared business income earned in Canada to an offshore bank account since 2010

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Reduced Relief Under the Limited VDP Programme …cont'd

- No relief for corporations with gross revenue in excess of $250 million in at least two of the last five taxation years – instead use normal filing process to amend their tax filings
  - This proposal to deny relief to large corporations should be reconsidered for fairness and equity
- Proposals to eliminate "no-name" method of disclosure and require full pre-payment of taxes owing
  - Reconsider maintaining the "no-name" disclosure and requiring taxes to be paid when correct amount determined, in order to maintain attractiveness of VDP
- If there has to be a multi-tier system, only exclude those taxpayers whose conduct was seriously culpable

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Common Reporting Standard

- The OECD has promulgated a process to combat tax secrecy and tax evasion, and to promote transparency through the automatic exchange of information known as the Common Reporting Standard (“CRS”)
- Part XIX, Sections 270-281 have been added to the *Income Tax Act* to implement CRS in Canada
- Over 90 countries are committed to implementing CRS by 2018 (except for the U.S.A.) by signing the OECD’S *Convention on Mutual Administrative Assistance in Tax Matters*

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Common Reporting Standard …cont'd

- Canadian financial institutions must collect information about financial accounts owned by residents of other countries (*Reportable Persons*), and must report this information to the CRA
- In turn, the CRA will transmit this information to the taxation authority of the country of residence of the account holder
- The other countries that implement the CRS will likewise require their financial institutions to collect information about Canadians that will be transferred to the CRA

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Common Reporting Standard …cont'd

- *Reporting Financial Institution* covers what one would expect: depository institutions, investment entities and specified insurance companies
- *Reportable Accounts* include financial accounts held by individuals and entities, including a non-financial entity ("Passive NFE") that requires a high level of due diligence to determine if a Reportable Person is in control
  - In the case of a corporation, 25% share ownership is enough to constitute control
  - In the case of a trust, this could be the settlor, the trustee, a beneficiary, a protector, or any other person exercising effective control over the trust

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Country-by-Country Reporting

- Another OECD initiative to combat tax avoidance and tax evasion by multinational corporations and to promote transparency and ease of administration
- Canada has implemented CbC reporting in section 233.8 of the *Income Tax Act*
- An MNE with total consolidated group revenue of €750,000,000 or USD$838,500,000 must file CbC reports, disclosing for example if the Canadian entity is the ultimate parent entity, surrogate parent entity or constituent parent entity

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Country-by-Country Reporting

- A CbC report includes global allocation, by jurisdiction, of key variables for the group, including: revenue, profit, tax paid, stated capital, accumulated earnings, number of employees and tangible assets, as well as the main activities of each constituent entity
- Used to assess high level transfer pricing risk; to assess other BEPS-related risks; and for economic and statistical analysis
- CbC reports filed with the CRA will be automatically exchanged with other jurisdictions in which the MNE operates, and *vice versa*

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Questions?

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