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Canadian Tax Alert

Finance proposals on “Tax Planning Using Private Corporations”: Capital gains implications

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On July 18, 2017, the Department of Finance issued broad sweeping proposals impacting private corporations and their owners. Our July 26, 2017 Canadian Tax Alert provided an overview of all the changes, and outlined typical scenarios that could be affected by the proposals.

This Canadian Tax Alert looks specifically at the proposed changes to capital gains, and is aimed at providing a more thorough analysis of those proposals, with examples of how the proposals could affect various transactions and structures.

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Framework

Under the general description of "capital gains", the Minister of Finance proposes to amend the application of one existing tax provision, while also introducing a second, both aimed at preventing "surplus stripping". In general, surplus stripping involves the extraction of corporate profits at a reduced rate of personal income tax, generally by accessing capital gains rates instead of dividend rates.

To attempt to address surplus stripping using private corporations, two particular changes to the Income Tax Act (the Act) have been proposed:

1) Restricting/reducing the adjusted cost basis (ACB) of private company shares as a result of some related party transactions; and
2) Recharacterizing tax-free capital dividends as taxable in some situations where they are paid to non-arm's length individuals.

Expanded section 84.1 of the Act – not all ACB is created-equal

Non-arm's length share sales

The first proposal is designed to prevent transactions that seek to extract surplus from a corporation through a series of transactions that ultimately results in the individual paying personal income tax on capital gains as opposed to dividends. This type of planning has become more popular in Canada as personal income tax rates on dividends have risen steadily over the past few years while rates on capital gains have not. The proposed legislation would curtail this planning by requiring a reduction in the ACB of shares acquired (for certain purposes), where those shares are acquired from a non-arm's length vendor.

For example, if Mr. A sold shares of Opco to his daughter, Ms. A, for $1,000 and realized a $900 gain that was not sheltered by the capital gains exemption, Ms. A would have paid $1,000 but would now have an ACB of only $100 for certain tax purposes. This reduced ACB would be relevant for a future sale or transfer of shares of Opco by Ms. A to a non-arm's length corporation. If proceeds of that sale or transfer include non-share consideration, say $1,000 in cash in this example, the amended section 84.1 would result in Ms. A paying tax on a deemed dividend of $900 on the disposition, even though Mr. A already paid tax on that amount as proceeds of disposition.

The reduction in ACB should not affect a sale by Ms. A to an arm's length purchaser; however, the expanded provisions do contemplate reductions to ACB by the amount of any gain previously realized on the share (or a substituted share) by any non-arm's length party. Consequently, if Mr. A sold to a third party and realized a gain in so doing, and Ms. A then acquired the shares from that third party in a subsequent transaction, her ACB would still be reduced in spite of the arm's length purchase. This has the potential effect of requiring multi-generational tracking and, by virtue of the application of the proposals to dispositions of shares that occur on or after July 18, 2017, may require the reduction of ACB to be computed for non-arm's length dispositions that occurred prior to that date.

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Below is a table that shows the variety of potential outcomes resulting from the new proposals, from what may initially appear to be very similar sets of circumstances:

	Scenario	Calculation	Outcome	Cause
1	John acquires shares from his mother for $1,000, on which she realized a gain of $900. John then sells the shares to his holding company for $1,000 in cash.	$1,000 out-of-pocket cost, less $900 gain realized by his mother, equals $100 ACB. $1,000 proceeds less $100 ACB results in a deemed dividend of $900	John is deemed to receive a taxable dividend of $900, even though his mother paid tax on the same $900 gain.	John's ACB, when considering transfers to non-arm's length corporations for non-share consideration, is reduced by the gain previously realized by his mother.
2	John acquires shares from a third party for $1,000, which he, in turn, sells to his holding company for $1,000 in cash.	$1,000 proceeds, less $1,000 ACB, equals $0 gain.	There is no taxable gain or taxable dividend to John.	The provisions should not reduce ACB when shares were acquired solely from a third party; but see scenario 5 below.
3	John sells $1,000 of shares, with ACB and paid-up capital of $100, to a corporation controlled by his brother for $1,000 in cash.	$1,000 proceeds, less "soft ACB" of $100, equals $900 deemed taxable dividend.	John is deemed to receive a taxable dividend of $900.	The sale of shares to a non-arm's length corporation results in a recharacterization from capital gain to taxable dividend.
4	John sells $1,000 of shares, with ACB and paid-up capital of $100, to a corporation controlled by an arm's length party for $1,000 in cash.	$1,000 proceeds, less ACB of $100, equals $900 capital gain.	John realizes a capital gain of $900.	Sales of shares to arm's length corporations should be unaffected by the proposed changes.
5	John acquires shares from a third party for $1,000. Those shares were previously sold to that third party in 1980 by his grandmother, who realized a $700 gain on that sale. John then sells the shares to his holding company for $1,000 in cash.	$1,000 out-of-pocket cost, less $700 gain previously realized by his grandmother, equals "soft ACB" of $300. $1,000 proceeds, less $300 ACB, equals $700 deemed dividend.	John is deemed to receive a taxable dividend of $700, even though his grandmother paid tax on the same $700.	The gain previously realized by any non-arm's length party reduces ACB in this situation, irrespective of ownership having been transferred for a period of time to an arm's length party.

Post-mortem tax planning

In addition to the potential impact on transactions similar to those noted above, the proposed amendment could have an adverse impact on common estate planning techniques used to avoid double taxation.

On the death of a taxpayer, a deemed disposition of assets at fair market value generally arises (barring select situations, such as the assets transferring to a spouse). This often results in a tax obligation. Where shares of a private corporation were owned, the disposition on death likely yields a capital gain, resulting in the first layer of post-mortem tax. Where those shares are received by a beneficiary of the estate, they should carry high ACB but will also generally have low paid-up capital, resulting in a second level of taxation in the form of a deemed dividend on a future redemption of those shares.

The planning technique previously used, often referred to as a "post-mortem pipeline", involved the sale of the shares by the estate to another corporation with a promissory note received as consideration. The estate, having high ACB under the previous wording of section 84.1, would not realize a gain and would then be able to receive repayments of the promissory note. This would leave only the estate with tax on the capital gain and no second layer of tax to the beneficiary.

The proposed amendment to section 84.1 would prevent this planning; therefore, to mitigate the potential double-taxation, some estates would look to have the shares of the corporation redeemed, causing a deemed dividend to the estate on which tax would be paid, but also triggering a capital loss. An existing provision allows that loss to be carried back by the estate to the terminal return of the deceased. This carryback provision is currently restricted in that the loss must be realized and carried back within one year of the death of the taxpayer. In light of the time that it can take to resolve an estate, it may not be practical or possible for many estates to rely on this approach. In addition, for those who passed away more than a year prior to July 18, 2017, but had not yet implemented the post-mortem pipeline strategy, the opportunity for a carryback would now be lost and double taxation would be assured under these new proposals.

The table below highlights some potential outcomes relating to estate planning as a consequence of the proposed amendments. In each scenario, our starting point is the passing of John, who owned $1,000 of shares of a private corporation that carried an ACB and paid-up capital of $100.

	Scenario	Current legislation	Proposed legislation	Outcome
1	John passed away when his shares were worth $1,000. He had an ACB and paid-up capital of $100.	Tax obligation on $900 capital gain.	No change. The gain on death remains the same.	Double taxation is expected to arise if the shares held by the estate (or a beneficiary of the estate) are redeemed, barring additional steps being taken.
2	The shares held by John's estate are redeemed within one year of John's death.	If an election under subsection 164(6) of the Act is filed, a $900 capital loss is carried back to offset the gain on John's death. John's estate receives a taxable dividend of $900.	No change. This election is still available.	Double taxation is eliminated, but tax is paid at dividend rates instead of capital gain rates.

3	John's estate initiated a pipeline transaction, whereby the shares owned by the estate were sold to a non-arm's length corporation in exchange for cash or a promissory note.	No additional tax, as proceeds and ACB on the sale are equal, leaving John's estate only with the original capital gain being realized.	Pipeline transaction would yield a deemed taxable dividend to the estate.	Double-taxation, in the form of a capital gain on death plus a deemed dividend on the subsequent sale, is expected to arise.
4	John passed away in January 2016. His estate had not redeemed the shares by January 2017 as a result of delays in administering the estate. A pipeline transaction was intended to be executed in October 2017.	John's estate would be left with $1,000 in cash (or promissory note), and no double-taxation would be expected.	The pipeline transaction would no longer be available. As a result of being more than a year since John's death, a subsection 164(6) carryback would no longer be available.	John (and his estate) is virtually assured of double-taxation, unless his estate sells the shares to a third party buyer.

For deceased taxpayers, the proposed amendments create a high likelihood of double-taxation without proper planning. Furthermore, for those who passed away more than a year ago, the opportunity to eliminate double taxation, either through a pipeline transaction or a subsection 164(6) carryback transaction, will be wiped out by the proposed legislation.

Capital dividends – maybe not tax-free after all

The second "capital gains" proposal is intended to recharacterize what would otherwise be tax-free capital dividends received by an individual to instead be taxable dividends in certain situations. Multiple criteria must be met in order for the provision to apply and the wording as proposed raises significant uncertainty with respect to the treatment of any capital dividend paid on or after July 18, 2017.

The criteria, all of which must be met in determining whether a dividend should be treated as taxable instead of capital, are:

1) The amount was received, directly or indirectly, by an individual resident in Canada;
2) The amount was received or receivable, directly or indirectly, from a person with whom the individual was not dealing at arm's length;
3) As part of the transaction or series of transactions, there is either a disposition of property or an increase or reduction of paid-up capital in the capital stock of the shares of a corporation; and
4) It can reasonably be considered that one of the purposes of the transaction or series was to effect a significant reduction of assets of a private corporation in a manner such that any part of tax otherwise payable by the individual is avoided.

It is important to note that the provision as proposed is not aimed solely at non-arm's length property dispositions or similar transactions that result in an increase to the capital dividend account (CDA). Instead, the relevant relationship is whether a dividend was received from a person with whom the individual was not dealing at arm's length. Consequently, this particular test may be automatically met by any individual who controls a corporation, or corporations that are controlled by a family, by virtue of other provisions that deem those groups to not be dealing at arm's length with the corporation. The nature of the test could mean that the same economic transaction undertaken could yield two materially different tax outcomes if the corporation was owned jointly by related or unrelated parties.

While some elements of these tests are reasonably straightforward, such as whether an individual is resident in Canada, others may be more difficult to determine with certainty. For example, whether there was a "significant" reduction in assets of a corporation is highly fact-dependent, as "significant" is not a defined term under the Act. Some cases may intuitively represent a significant reduction, such as the distribution of all property of a corporation to the individual shareholder(s) after the sale of a business to a third party. Other situations, such as distributing the CDA generated after a capital gain is realized on the sale of a building, may be less clear.

In addition to whether there is a "significant" reduction in assets, the fourth criterion under the proposed provision is that one of the purposes of the transaction was to avoid tax. It need not be the sole purpose or a primary purpose, but rather one of the purposes, which constitutes a lower standard. When we examine whether one of the purposes was to "avoid" tax, virtually any CDA payment appears to meet that interpretation. The explanatory notes that accompanied the proposed legislation noted the following:

> …an individual is to be considered to be avoiding any part of a tax… if the amount of tax is less than the amount of tax…had the corporation instead paid a taxable dividend…

This interpretation leads to a conclusion that any capital dividend payment, by virtue of capital dividends being tax-free as compared to taxable dividends, could be viewed as having avoided tax. The question therefore turns to whether one of the purposes of the transaction was to allow a capital dividend to be paid.

If all of the elements of the provision are met, the capital dividend received by the individual would instead be treated as a taxable dividend. However, a reduction to the CDA would still arise, thereby preventing that recharacterized capital dividend from ever being paid to another shareholder.

As noted, the provision applies to capital dividends paid on or after July 18, 2017. This means that any balance in the CDA that is unpaid at that date may require an assessment, creating a tedious and costly retroactive implication to the proposed provision.

The table below contrasts various scenarios and the potential application of the new provision:

	Scenario	Taxable dividend?	Reasons for treatment	Comments
1	Holdco sells some marketable securities and realizes a capital gain, with the objective of pulling cash out to the sole individual shareholder of the corporation via a capital dividend.	Potentially	There is a disposition of property, a payment of a capital dividend to a non-arm's length party, and one of the purposes appears to have been to avoid tax by way of receiving the capital dividend. If the amount is "significant", the provision could apply.	Even seemingly normal-course transactions could be affected by the new provision.

2	Holdco sells some marketable securities and realizes a capital gain, with objective of pulling cash out to each of three equal, unrelated individual shareholders via capital dividends.	Unlikely	Recipients of the dividend are not automatically deemed non-arm's length; however, if they are found to be factually not dealing at arm's length, the dividend may be treated as taxable.	The provision does not affect capital dividend payments to arm's length individuals.
3	Land was sold by Opco in 1990, and a capital gain was realized. CDA created on the gain was paid out on August 1, 2017 to the sole shareholder.	Potentially	If one of the purposes was to access CDA, thereby "avoiding" tax, the transaction could be caught.	The date that the CDA balance arose is not directly relevant to the potential recharacterization.
4	Opco sells a capital asset to Holdco on a taxable basis and realizes a gain. The main purpose is to isolate the asset from the operating activities of Opco. It does so on a taxable basis realizing that the CDA would be created as a result, allowing tax to be reduced at the shareholder level. Holdco pays the CDA to its sole individual shareholder.	Potentially	The 100% shareholder of Holdco is deemed non-arm's length, there was a disposition and one of the purposes may have been to allow the CDA to be paid, thereby reducing tax for the individual.	The main purpose of asset protection doesn't override that "one of the purposes" appears to have been to access the CDA.
5	An individual receives a capital dividend from a widely-held private corporation in which he has limited interaction and holds a 0.2% interest.	No	Barring a factual finding that the individual is not dealing at arm's length with the corporation, he should be arm's length and not affected by the provision.	Payments to arm's length individuals are not captured by the new provision.

As a consequence of the uncertainty related to this provision, significant caution should be exercised before paying any capital dividends to shareholders.

Actions to consider

The breadth of application of these provisions, and the inherent requirement to look back to transactions possibly undertaken decades ago, have the potential to create significant information gathering challenges. For example, the gain realized by a great-grandparent on the transfer of shares to a grandparent, where those shares have subsequently been transferred to the current generation of owners, may not be readily accessible or known. This will now create new uncertainty for the current generation as to whether certain transactions can be undertaken and what the tax implications of those transactions will be. Similarly, the potential need to assess all elements of the unpaid CDA against the proposed rules in section 246.1 of the Act could create comparable information access challenges. It is recommended that these attributes be examined and potentially summarized in a tracking document, in consultation with your Deloitte tax advisor.

The changes to section 84.1 of the Act appear to have implications for a variety of transactions undertaken, and may affect compensation models and reorganization transactions being used or contemplated, in addition to affecting estate planning. It is prudent and advisable to revisit these plans in light of the new provisions.

Finally, in advance of paying any capital dividend, a thorough assessment of the source of the balance as well as the purposes of the transactions that yielded increases to the CDA should be undertaken to fully understand the new risks that recipients of those dividends may face.

These are still proposals, not law…

The changes described herein are proposals only. They have not been enacted and do not yet represent law. Further, the consultation period associated with the proposals remains open and, as such, there may be changes to the proposals as originally presented. Deloitte will be providing a submission to the Minister of Finance as part of the consultation process, which closes on October 2, 2017.

Since the proposals are highly contentious and subject to change, we caution our readers against taking premature actions that may ultimately be unnecessary or counter-productive. We believe a thoughtful and patient approach, assessing both the risk and reward of alternative structures or transactions, remains prudent. Your Deloitte tax team remains available to support you through these uncertain times.

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