Private corporation tax proposals unquestionably harm “middle-class” business owners

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On July 18, 2017, the Liberal Government announced a significant set of tax proposals purported to close “*tax loopholes*” and “*strategies that can result in high-income individuals gaining tax advantages that are not available to most Canadians.*” We have previously written on the misguided rhetoric contained in these proposals and the integrity of the purported “consultation” period. As we have stated many times, these proposals are clearly an attack on all entrepreneurs – large and small. Regardless, the government continues to state that these proposals will not increase small business taxation. Accordingly, this blog uses a typical “middle-class” family business in Canada to illustrate that these proposals harm them just as much, if not more, than “high-income individuals.”

Lesley and Jackie are a married couple who make a living operating Icy Ice-Cream, a local confectionary store in Alberta. Back in 2014, they incorporated a private corporation, IcyCo, in which they each put in $25,000 for 50% of the common shares. The funds were then used to start the business.

Both Lesley and Jackie worked hard: Jackie churns the cream in the back while Lesley works the front counter. Both of them signed personal guarantees with the bank in order to secure IcyCo’s line of credit. With their efforts, Icy was well-run and profitable, generating $100,000 of profits a year. As a Canadian-controlled private corporation that earns active business income in Canada, IcyCo is subject to the small business tax rate of 12.5% so it pays $12,500 of corporate tax every year. Rather than paying out all of its $87,500 of retained earnings each year as dividends, Lesley and Jackie decide to leave $17,500 inside IcyCo each year to cushion against up and down business cycles, fund the opening of a second Icy store in the future and build up a bit of a nest egg. Therefore, each receives $35,000 of dividends per year, putting them solidly into the Canadian “middle class” family category with $70,000 of personal family income. Thanks to each of their personal tax credits and dividend tax credits, Jackie and Lesley’s combined personal tax each year on the $70,000 of total dividends is approximately $2,200. Combined with corporate income tax of $12,500, their global tax burden for the year is $14,700; which is similar to where corporate earnings had been paid to them as salaries, since the Canadian tax system has been designed to achieve integration.[1]

In 2016, Jackie decided to stay home to raise their children. Although Lesley has to work harder at the store to cover the front and back operations, Lesley was able to do so because Jackie was taking care of their family as well as the bookkeeping for IcyCo. The couple came to the conclusion that Jackie’s contribution to the family success was just as important as Lesley’s, so in 2016 and 2017, IcyCo continues to pay equal dividends of $35,000 to each of Lesley and Jackie (note that it is not even possible – unless IcyCo’s corporate share structure was changed – to pay different amounts of dividends between the two of them since they both own the same class of shares).

During 2018, the couple was shocked to learn the news about the anti-income splitting measures that had come into effect and that these rules may apply to them. After one look at the 28 pages of legislative amendments that just deal with income and capital gain splitting, Jackie decided that they need to visit a qualified tax lawyer/accountant, who, after receiving a hefty retainer, tried to summarize the following

legislative principles that were applicable to the couple's simple holding structure:

Under new section 120.4 of the Income Tax Act, a Canadian resident adult could be a "*specified individual"* if the person is related to another individual who is a "*specified shareholder*" or a "*connected individual*" in respect of the corporation. A "*specified shareholder*" is generally someone who, together with non-arm's length persons, owns 10% or more of a corporation, and the definition of a "*connected individual*" is a complicated series of tests to determine if someone has sufficient '*strategic influence,* ' '*equity influence,*' '*earnings influence*' or '*investment influence*' in a corporation[2]. A specified individual who earns "*split income*" is subject to the top personal marginal rate and loses entitlement to the personal tax credit. A dividend from, or capital gain from the disposition of, a private corporation is amongst the many types of income caught under the new "*split income*" definition. However, as long as an income amount is an "*excluded amount,*" it would be exempted from the definition of "*split income.*" For an adult, an income amount is an "*excluded amount*" to the extent it is not "*split portion.*" With respect to a private corporation dividend, a portion could be considered to be "*split portion*" if (i) the dividend payor is a corporation in which a related person is a "*connected individual*" and (ii) the portion represents the excess of what would be paid by the corporation to an arm's length person, having regard to (a) the functions performed in the corporation's business, (b) the assets contributed in support of the business, (c) the risk assumed in respect of the business, and (d) all other amounts already paid to the person in the past in respect of the business. Furthermore, in determining the reasonableness test, assets contributed to a business is disregarded if that asset was acquired in connection with any financial assistance provided by a related person (and new section 120.4 also included a special interpretation rule that for purpose of the section, related persons are expanded to include uncle, aunts, niece and nephews).

Both Jackie and Lesley are considered "*specified individuals.*" Whether each of them has "*split income*" will depend on whether any of the $35,000 dividend each received is an "excluded amount," which would only be possible if no portion of the dividend is a "*split portion.*" Jackie and Lesley have to determine what the "reasonable" amount of dividends is having regards to the functions performed, assets contributed, risks assumed by each of them and the amounts paid to them in the past. This is easier said than done, even for their simple situation.

Since 2016, most of the functions relating to the business was performed by Lesley, yet the determination must factor in the fact that Jackie prepared the bookkeeping and during the initial years of the business, worked in the business just as much as Lesley did. Both contributed $25,000 initially to IcyCo, but each of them have to examine closely whether the money was originally acquired in connection with any financial assistance from any family member, in which case the contribution would be disregarded. At the same time, both signed personal guarantees with the bank to support IcyCo's line of credit. Even after this explanation, Jackie and Lesley are still puzzled as to how they can accurately determine what is "reasonable" based on these myriad of factors. They also cannot believe the amount of power and discretion that the CRA will wield under these new rules; should the CRA raise the issue that it is not reasonable for Jackie to earn the same amount of dividends as Lesley, they will have the burden of proving the CRA wrong. What kind of documentation can they offer up, a number of years after the fact, to substantiate each spouse's contribution to the business? And what is the cost of failing to provide sufficient support to prove reasonableness? If Jackie's entire $35,000 turns out to be "*split portion,*" their family personal tax burden rises from $2,200 to $10,500, an almost five-fold increase, plus arrears interest and potential penalties – a significant cashflow issue for this family. From a combined corporate and personal tax burden perspective, this would increase the combined tax

burden from $14,700 to $23,000. This is blatantly unfair.

Should the family wish to be prudent in tackling the new rules, they will need to make a proper determination of reasonableness each time a dividend is paid, based on the function, risk, and contribution tests, and fully document the analysis in case of a future CRA challenge. This is not dissimilar to the transfer pricing documentation that large multi-nationals prepare for cross-border transactions, albeit at a much smaller scale. As previously mentioned, since Jackie and Lesley hold the same class of shares in IcyCo, it is legally impossible for IcyCo to pay them different amount of dividends. Therefore, they will need to undertake a share reorganization to obtain separate classes of shares to avoid falling afoul of the new rules. Such a reorganization will add thousands of dollars to professional fees, and yet they will still have no certainty that they have determined the correct "reasonable" amount in the eyes of the CRA.

Let's add to the example. Jackie's uncle is a pensioner in the lowest income tax bracket, but has some savings he wants to invest into IcyCo for an equity position. The new proposals will add significant complexity to this objective since Jackie's uncle is unwilling to assume the risk and complexity of these new rules whereby he may, by investing in IcyCo, be subject to the top marginal tax rate on any future dividends and capital gain he earns.

This is just the start of the headaches and complexity. IcyCo has been investing the $17,500 of surplus cash retained in the corporation each year in GICs, as well as a small 10% investment in Butcher Inc, a small butcher shop started by their neighbor. Under the proposals, IcyCo's income from these investments will be subject to a flat permanent corporate tax of over 50.7%[3] – a shockingly high tax rate to Jackie and Lesley compared to IcyCo's normal corporate rates and their personal tax bracket. Additionally, when the passive income is eventually distributed to them personally, they will pay another layer of personal tax on the distribution. Furthermore, it turns out that both Jackie and Lesley are "*connected individuals*" to Butcher Inc., because they indirectly own a share of Butcher Inc, and 10% or more of Butcher Inc's property is attributable to property transferred or loaned by IcyCo for shares or debt consideration. As a result of this, any future return received by Lesley and Jackie relating indirectly to Butcher Inc. will likely be considered "*split portion*" income and will be subject to the top personal marginal tax rate of 48%. All in, their total tax burden on any return on the Butcher Inc investment will approximately 70%.

The new rules, if enacted, will also require complex tracking systems in order to properly account for the new passive income rules. Under this new system, IcyCo's corporate tax return has three different pools that need to be tracked: a pool tracking retained earnings subject to the small business tax rate, a pool tracking retained earnings subject to general corporate tax rate ("general rate income pool"), and a final pool tracking shareholders' contribution previously subject to personal tax (paid-up capital or shareholder loans). The after-tax passive income will need to be allocated to these three pools each year, from which different types of dividends can be paid.

After learning about the high tax rate and complexity associated with IcyCo's investment of its modest portfolio, Jackie and Lesley decided there is no way any after-tax return from these investments (and goodwill from their butcher neighbour) justifies the associated risk and complexity and their best course of action is to liquidate IcyCo's investments and pull all excess funds out of IcyCo, through a mixture of return of capital and dividends. Jackie and Lesley are also well aware of the fact that this move will leave IcyCo with a much smaller "war-chest" for business cycles and expansion, putting IcyCo in a significant disadvantage against eateries owned by public companies which are unaffected by these new rules.

Jackie and Lesley wish to withdraw some of the original funds – the combined $50,000 – that they

invested in IcyCo. They would like to pay down their mortgage. Do the new proposals add complication to such a withdrawal? Well, adding insult to injury, it turns out even returning of after-tax capital is now a challenge under the new measures. Prior to July 18, 2017, pulling out one's paid-up capital from a corporation could always be done on a tax-free manner. Post July 18, a return of capital (in fact, any amount received or receivable) from a non-arm's length corporation can be converted into a taxable dividend under new section 246.1 if it can reasonably be considered that one of the purposes of the transaction, event of series of transactions or events is to effect a significant reduction or disappearance of corporate assets, in a manner that any part of tax otherwise payable under the Act by the individual in regards to the distribution of property is avoided. Could this provision apply? Hard to say for certain without investing further professional fees of a tax specialist.

On top of all this, their advisor then tells them that IcyCo will need to obtain a formal business valuation and perform "purification" transactions before the end of 2018 if Jackie and Lesley desire to use their lifetime capital gain exemption to increase their tax basis in the shares of IcyCo (without having to worry about whether a portion of the capital gain could be re-characterized as a taxable dividend to the extent it turns out to be "split portion") under a narrow transitional window offered by the new measures. By this time, Jackie and Leslie have completely tuned out, wondering if they had made the wrong decision to start a business in the first place.

The example of Jackie and Lesley is simplistic and does not scratch the surface of the other obstacles and complexity that the proposals will present in terms of family succession and estate planning – which future blog postings will discuss – but it demonstrates the blunt instruments contained in the proposals that clobber middle-class family businesses, in some ways even more than the so-called "1%."

Whereas large established businesses often have access to third party financing, small businesses and start-ups often rely on financing from family, which will likely become punitive and unworkable under the proposed regime. Many small businesses simply cannot afford tax specialists to navigate these complex rules (keep in mind that this is just the latest of extremely complicated rules impacting private businesses: consider the small business deduction rules introduced in 2016 and the subsection 55(2) rules introduced in 2015). Finally, the penalty for inadvertently falling into these rules is disproportionately harsh for a "middle-class" family, as the consequence may be over 50% rate of taxation when the income would otherwise have been subject to a much lower personal tax rate bracket.

Many business organizations across Canada have started waking up to the destructive nature of the proposals, and the disingenuous nature of the consultation process: 75 days in the middle of summer with the Minister of Finance using social media to defend the proposals. We hope the Government will listen to the issues that are being raised about these very misguided and inappropriate proposals.

[1] If IcyCo had paid $40,000 of salary to each of Lesley and Jackie (assuming such salaries are reasonable which would be debatable), it would have $20,000 of net income on which the corporate income tax would have been $2,500, leaving the same $17,500 of corporate savings. The $40,000 of salary to each of Lesley and Jackie would result in total personal tax of $11,500 for the family. Combined, the corporate and personal tax burden would equal $14,000 – slightly less than the $14,700 where earnings are paid out as dividends.

[2] These are terms used by the Department of Finance in its explanatory notes to summarizes the four tests contained in the definition of "connected individual".

[3] This 50.7% corporate tax on investment income applies under the existing rules as well, but 30.7% of this upfront corporate tax is refundable upon the payment of a taxable dividend by the corporation. Under the proposal, the upfront corporate tax is no longer refundable.