

Owner Manager Remuneration – Current Trends, Strategies and Challenges

Kim G C Moody FCA, TEP¹

A. INTRODUCTION

Remuneration planning for owner-managers (abbreviated as OM throughout this paper) is a “meat and potatoes” area of practice for tax professionals across Canada. Simply put, the three objectives of OM remuneration planning are:

1. determining the amount of the remuneration;
2. determining the form of the remuneration; and
3. determining when to pay the remuneration.

The tax landscape has changed dramatically since the beginning of the millennium. Notable changes include the wholesale reduction of federal and provincial tax rates, introduction of the eligible dividend regime and the “kiddie tax”. Rules in the Act governing popular remuneration vehicles such as retirement compensation arrangements (RCA’s), employees profit sharing plans (EPSP’s), health and welfare trusts (HWT’s) and personal service businesses (PSB’s) have also been tightened.² The goal for this paper is not to duplicate the efforts of previous papers which have already covered each of these changes in-depth but to take a collective step back and examine how this new landscape demands a complete re-think in the area of OM remuneration planning.

Our paper focuses on the income tax aspect of OM remuneration planning but a remuneration plan may also impact matters such as alternative minimum tax, cumulative net investment loss balances, contribution room for registered retirement saving plans, excise tax, contributions and entitlement to the Canada Pension Plan (CPP) and Employment Insurance (EI) among others. Discussion on these topics are beyond the scope of this paper but should be considered in connection with any OM remuneration planning.

B. QUICK REVIEW OF INCOME TAX RATES

The lowering of tax rates is one of the most visceral types of tax reform a government could undertake. In Canada, we have seen a dramatic decrease in federal and provincial corporate tax rates over the last ten years. This reform in corporate tax rates was kick-started by Parliament in 2007 when it passed a bold tax reduction plan which ushered in a series of federal corporate tax rate reductions and

¹ The author would like to acknowledge and thank his colleague, Kenneth Keung CA, CPA (CO, USA), CFP, MTax, LLB, for his substantial contributions to the preparation of this paper. Special thanks also to Michael Cadesky, FCA of Cadesky and Associates LLP...some of the material/examples contained in this paper has been previously presented by Michael at various presentations that the author has attended or participated in with Michael. Mr. Moody is a partner at Moodys Tax Advisors.

² All references are to the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), as amended.

encouraged the provinces and territories to collaborate towards the goal of a 25-per-cent combined federal-provincial/territorial corporate income tax rate.³

The following two tables illustrate the combined federal and provincial/territorial general corporate tax rates and rates for income below the small business limit from 2011 to 2014.⁴ The rates shown are based on December 31st taxation year-ends and include rate changes proposed in provincial budgets to date.

Combined Federal and Provincial General Corporate Rate – Based on Calendar Year End

	2011	2012	2013	2014
Alberta	26.50%	25.00%	25.00%	25.00%
BC	26.50%	25.00%	25.75%	26.00%
Saskatchewan	28.50%	27.00%	27.00%	27.00%
Manitoba	28.50%	27.00%	27.00%	27.00%
Ontario	28.30%	26.50%	26.50%	26.50%
Quebec	28.40%	26.90%	26.90%	26.90%
New Brunswick	27.00%	25.00%	26.00%	27.00%
Nova Scotia	32.50%	31.00%	31.00%	31.00%
PEI	32.50%	31.00%	31.00%	31.00%
Newfoundland and Labrador	30.50%	29.00%	29.00%	29.00%
NWT	28.00%	26.50%	26.50%	26.50%
Nunavut	28.50%	27.00%	27.00%	27.00%
Yukon	31.50%	30.00%	30.00%	30.00%

³ Department of Finance, Economic Statement “Strong Leadership. A Better Canada”, October 30, 2007.

⁴ The tax rates in this paper are for informational purposes only. Caution must be exercised with respect to the use of the information due to possible misinterpretation or misapplication of the tax rates.

Combined Federal and Provincial Small Business Rate – Based on Calendar Year End

	2011	2012	2013	2014	<i>Small Business</i>	
					<i>Limit</i>	
Alberta	14.00%	14.00%	14.00%	14.00%	\$	500,000
BC	13.50%	13.50%	13.50%	13.50%	\$	500,000
Saskatchewan	14.25%	13.00%	13.00%	13.00%	\$	500,000
Manitoba	11.00%	11.00%	11.00%	11.00%	\$	400,000
Ontario	15.50%	15.50%	15.50%	15.50%	\$	500,000
Quebec	19.00%	19.00%	19.00%	19.00%	\$	500,000
New Brunswick	16.00%	15.50%	15.50%	15.50%	\$	500,000
Nova Scotia	15.50%	15.00%	14.50%	14.50%	\$	400,000
PEI	12.00%	12.00%	14.64%	15.50%	\$	500,000
Newfoundland and Labradc	15.00%	15.00%	15.00%	15.00%	\$	500,000
NWT	15.00%	15.00%	15.00%	15.00%	\$	500,000
Nunavut	15.00%	15.00%	15.00%	15.00%	\$	500,000
Yukon	15.00%	15.00%	15.00%	15.00%	\$	500,000

As of 2013, the general corporate tax rates in more than half of the provinces/territories are 27 percent or below which is a substantial change from the pre-2006 years when most provinces/territories had rates in the 35-plus percentage range. The corporate tax rates in these lower-rate provinces, particularly Alberta at 25 percent, are internationally competitive and are in some instances substantially lower than other Western countries (for example, the top combined federal and state corporate rates in certain U.S. states are in the 40-plus percentage range). Lately, some provinces have seen a slight reversion of the slide of corporate tax rates. For instance: the freezing of the Ontario general corporate income tax rate at 11.5 percent after previously scheduled to reduce to 10 percent by 2013, and the proposed increase of the British Columbia general corporate tax rate from 10 to 11 percent effective April 1, 2013. Also worthy of note is that the prairies and Western provinces generally have the lowest small business tax rates in Canada (although Manitoba is the only remaining province where the small business limit is lower than the federal threshold of \$500,000 but that is compensated by the province claiming the lowest combined small business rate in Canada of 11 percent).

We will now review the combined federal and provincial/territorial top marginal personal rates for ordinary income, eligible dividends and non-eligible dividends from 2011 to 2014.⁵ We did not include the rates applicable for capital gains, but they would be one-half of the rates on ordinary income.

⁵ The highest marginal personal tax rate is the rate of tax that will be assessed on income over the highest tax brackets, as provided in the tables below.

Top Marginal Combined Federal and Provincial Personal Income Tax Rates on Ordinary Income

	2011	2012	2013	2014	Highest tax bracket (2013)
Alberta	39.00%	39.00%	39.00%	39.00%	\$ 135,055
BC	43.70%	43.70%	43.70%	45.80%	\$ 104,755
Saskatchewan	44.00%	44.00%	44.00%	44.00%	\$ 122,590
Manitoba	46.40%	46.40%	46.40%	46.40%	\$ 67,001
Ontario	46.41%	47.97%	49.53%	49.53%	\$ 500,000
Quebec	48.22%	48.22%	49.97%	49.97%	\$ 100,001
New Brunswick	43.30%	43.30%	43.30%	43.30%	\$ 126,663
Nova Scotia	50.00%	50.00%	50.00%	50.00%	\$ 150,001
PEI	47.37%	47.37%	43.37%	47.37%	\$ 63,970
Newfoundland and Labrador	42.30%	42.30%	42.30%	42.30%	\$ 67,497
NWT	43.05%	43.05%	43.05%	43.05%	\$ 128,287
Nunavut	40.50%	40.50%	40.50%	40.50%	\$ 135,055
Yukon	42.40%	42.40%	42.40%	42.40%	\$ 135,055

Top Marginal Combined Federal and Provincial Personal Income Tax Rates on Eligible Dividends

	2011	2012	2013	2014	Highest tax bracket (2013)
Alberta	17.72%	19.29%	19.29%	19.29%	\$ 135,055
BC	23.91%	26.11%	25.78%	28.68%	\$ 104,755
Saskatchewan	23.36%	24.81%	24.81%	24.81%	\$ 122,590
Manitoba	26.74%	32.27%	32.27%	32.27%	\$ 67,001
Ontario	28.19%	31.69%	33.85%	33.85%	\$ 500,000
Quebec	31.85%	32.81%	35.22%	32.81%	\$ 100,001
New Brunswick	20.96%	22.47%	22.47%	22.47%	\$ 126,663
Nova Scotia	34.85%	36.06%	36.06%	36.06%	\$ 150,001
PEI	27.33%	28.70%	28.70%	28.70%	\$ 63,970
Newfoundland and Labrador	20.96%	22.47%	22.47%	22.47%	\$ 67,497
NWT	21.31%	22.81%	22.81%	22.81%	\$ 128,287
Nunavut	25.72%	27.56%	27.56%	27.56%	\$ 135,055
Yukon	17.72%	19.29%	15.93%	15.93%	\$ 135,055

Top Marginal Combined Federal and Provincial Personal Income Tax Rates on Non-Eligible Dividends

	2011	2012	2013	2014	Highest tax bracket (2012)
Alberta	27.71%	27.71%	27.71%	28.89%	\$ 135,055
BC	33.71%	33.71%	33.71%	36.33%	\$ 104,755
Saskatchewan	32.08%	33.33%	33.33%	34.20%	\$ 122,590
Manitoba	39.15%	39.15%	39.15%	39.69%	\$ 67,001
Ontario	32.57%	34.52%	36.47%	40.14%	\$ 500,000
Quebec	36.35%	36.35%	38.54%	36.52%	\$ 100,001
New Brunswick	30.83%	30.83%	30.83%	31.84%	\$ 126,663
Nova Scotia	36.20%	36.20%	36.20%	36.91%	\$ 150,001
PEI	41.17%	41.17%	41.17%	41.72%	\$ 63,970
Newfoundland and Labrador	29.96%	29.96%	29.96%	31.01%	\$ 67,497
NWT	29.65%	29.65%	29.65%	30.72%	\$ 128,287
Nunavut	28.96%	28.96%	28.96%	30.07%	\$ 135,055
Yukon	30.41%	30.41%	30.41%	31.71%	\$ 135,055

For non-eligible dividends paid after December 31, 2013, the 2013 federal budget proposes to adjust the gross up factor for non-eligible dividends from 25 to 18 percent, and the corresponding dividend tax credit from 2/3 of the gross up amount to 13/18. As a result, the effective rate of the dividend tax credit will be 11 percent of the grossed-up amount of a non-eligible dividend.

Ontario has recently joined the ranks of Quebec and Nova Scotia for having a 50 percent (after rounding) top bracket. In an amendment to its 2012 budget, Ontario introduced the temporary “Deficit-Fighting High-Income Tax Bracket”, which applies to an Ontario individual taxpayer’s taxable income in excess of \$500,000. The previous top marginal rate of 46.41 percent will continue to apply to taxable income between \$78,044 and \$500,000. The new combined top tax bracket of 49.53 percent will apply once taxable income exceeds \$500,000. The Ontario government has indicated that it will eliminate this temporary bracket once Ontario's budget is balanced. Another province that has proposed a similar temporary tax bracket is British Columbia. In its 2013 budget, the province proposed a temporary two-year increase in the personal income tax rate for individuals earning more than \$150,000. Under the proposal, the British Columbia provincial rate for this new top bracket will increase by 2.1 percentage points to 16.8 percent starting January 1, 2014.

Also, Manitoba, in its 2012 budget, retroactively decreased the dividend tax credit on eligible dividends received after December 31, 2011, effectively increasing the combined federal and provincial rate on eligible dividends to 32.27 percent (26.74 percent in 2011).

In contrast to the trend amongst provincial corporate rates towards convergence, personal rates still differ significantly between the provinces (for example, compare the personal rates for Alberta versus

the personal rates applicable in Ontario and Quebec). Therefore, inter-provincial tax planning for individuals and trusts to take advantage of these differentials continue to be popular. Such type of inter-provincial planning is covered in detail by my colleague Gregory J Gartner in his paper for this conference.⁶

C. OM REMUNERATION PLANNING – A QUICK HISTORICAL REVIEW

In the following section, we will review several OM remuneration plans frequently relied on by practitioners historically, and how these plans have been impacted by the recent changes in the Canadian tax landscape.

1. The “Bonus-down” Strategy

Historically, high general corporate tax rates provided a strong incentive for OMs to “bonus-down” to the small business income limit. Prior to 2006, the combined federal and provincial general corporate rates were usually in the 35-plus percentage range. As there was no concept of eligible versus non-eligible dividends prior to 2006 (the eligible dividend regime will be discussed in further detail later in the paper), personal tax rates on taxable dividends were usually in the 30-plus percentage range. Consequently, corporately earned income that was subject to the general corporate rate and repatriated as dividends usually had an overall effective tax rate that exceeded 50 percent. In comparison, the top marginal combined federal and provincial personal tax rates on employment income were usually in the 40-plus percentage range. For illustration, the table below shows the combined 2005 federal and provincial rates for British Columbia, Alberta, Saskatchewan and Manitoba:

2005 Combined Federal and Provincial Tax Rates:

	<i>General corporate rate on business income</i>	<i>Top personal rate on taxable dividend</i>	<i>Top personal rate on ordinary income</i>
British Columbia	34.1%	31.6%	43.7%
Alberta	33.6%	24.1%	39.0%
Saskatchewan	39.1%	28.3%	44.0%
Manitoba	37.1%	35.1%	46.4%

The lack of integration for corporately-earned income in excess of the small business limit essentially subjected such income to double-taxation, hence the best-practice was for corporations to pay or accrue a bonus to the OM sufficient to reduce corporate income to the small business limit. To illustrate this numerically, assume that Mr. Apple owns all of the issued shares of Opco, an operating company that is a Canadian-controlled private corporation (CCPC),⁷ and both Mr. Apple and Opco are residents of

⁶ Gregory J. Gartner, “Residence of Individuals”, 2013 CTF Prairie Provinces Tax Conference.

⁷ Canadian-controlled private corporation is defined in subsection 125(7).

Saskatchewan. If Opco earned \$1,000,000 of active business income in 2005, Mr. Apple's net-after tax remuneration would be \$86,343 higher if Opco used the "bonus-down" strategy to reduce corporate income to \$300,000 (the federal and Saskatchewan small business limit for 2005) instead of repatriating the \$1,000,000 corporate earnings solely through dividends:

	2005	
	Bonus	No Bonus
Opco's taxable income before bonus	\$ 1,000,000	\$ 1,000,000
Bonus	\$ (700,000)	\$ -
Taxable income after bonus	\$ 300,000	\$ 1,000,000
On first \$300,000 of income - 18.1% (combined federal and Saskatchewan rate on small business income)	\$ 54,300	\$ 54,300
On remaining \$700,000 of income - 39.1%	\$ -	\$ 273,700
Total corporate income tax	\$ 54,300	\$ 328,000
Remaining cash to be paid as taxable dividend to Mr. Apple:	\$ 245,700	\$ 672,000
<i>Personal income tax</i>		
On salary - 44%	\$ 308,000	\$ -
On taxable dividend - 28.3%	\$ 69,533	\$ 190,176
Total personal income tax	\$ 377,533	\$ 190,176
Net after-tax proceeds to Mr. Apple		
Dividend	\$ 245,700	\$ 672,000
Bonus	\$ 700,000	\$ -
Personal taxes	\$ (377,533)	\$ (190,176)
Net after-tax proceeds	\$ 568,167	\$ 481,824
<i>Effective tax rate</i>	43.2%	51.8%
Additional net-after tax proceeds by bonusing-down		\$ 86,343

As illustrated, the bonus-down strategy was an effective strategy for avoiding the double-taxation element of corporate ownership that, for Mr. Apple's fact pattern, resulted in an absolute tax decrease of close to 9 percent. Therefore, it was almost always an automatic practice for OMs and their advisors to bonus-down, unless the corporation had a significant refundable dividend tax on hand (RDTOH) balance and it otherwise did not have sufficient retained earnings to declare a taxable dividend to obtain a dividend refund – RDTOH and related planning will be discussed in further detail later in the paper.

The primary hurdles imposed by the Act in connection with the bonus-down strategy are section 67 and paragraph 18(1)(a), which prohibit deductions in respect of an outlay or expense except to the extent that it is reasonable in the circumstances and incurred for the purpose of earning income from business or property. Also, if the bonus is accrued, subsection 78(4) requires that it must be paid within 179 days

after the end of the taxation year in order for the amount to be deductible (accordingly, it is very important such bonuses be paid on a timely basis).

The leading jurisprudence on the test of reasonableness for salary is the *Gabco* decision by Cattanach J in the Exchequer Court, where it was established that the determination of a reasonable salary is not based on the judgment of the Canada's tax administrator, but rather a reasonable salary is one that a reasonable business person might have contracted to pay having only business consideration in mind.⁸ Nevertheless, the long standing administrative position of the CRA is that the reasonableness of salaries and bonuses paid to a principal shareholder/manager of a corporation will not be challenged when

- the general practice of the corporation is to distribute the profits of the company to its shareholder/manager in the form of bonuses or additional salaries; or
- the company has adopted a policy of declaring bonuses to the shareholders to remunerate them for the profits the company has earned that are attributable to special know-how, connections or entrepreneurial skills of the shareholders.⁹

The CRA, in Income Tax Technical News (ITTN) no. 22, emphasized that its administrative position only applies in the context of CCPC's and active shareholder/managers who are resident in Canada.¹⁰ In the same ITTN, the CRA also indicated that it will apply its administrative position where the salaries and bonuses are paid out of non-active business income or where they are paid directly or indirectly through a holding company, provided that the Canadian resident recipients are active in the operating business of the CCPC and contribute to the income-producing activities from which the remuneration is paid.¹¹

Where a bonus-down strategy usually typically falls flat is when the remuneration plan does not fit neatly into the CRA's administrative position. For example, an OM may attempt to income split with a family member who is not a shareholder or is not active in the business, in which case, the CRA will not apply its position and the remuneration to the family member will be subject to the reasonability requirement under section 67.¹² A frequent mistake made by an OM is assuming that the CRA's administrative position will be extended to inter-corporate "management fees", while ITTN-22 clearly states that the CRA will challenge the reasonableness of inter-corporate management fees (we will discuss management fees as a planning tool in more detail in a later section of the paper).¹³

⁸ *Gabco Limited v. MNR*, 68 DTC 5210 (Ex. Ct.).

⁹ "Revenue Canada Round Table" in Report of Proceedings of the Thirty-Third Tax Conference, 1981 Conference Report (Toronto: Canadian Tax Foundation, 1982), 726-66, question 42, at 757-58; Income Tax Technical News no. 22, January 11, 2002, question 6 under the heading "Shareholder/Manager Remuneration".

¹⁰ ITTN-22, January 11, 2002, question 2 under the heading "Shareholder/Manager Remuneration".

¹¹ *Ibid*, question 3 and 7.

¹² *Ibid*, question 5: the CRA will not challenge the reasonability of salaries and bonuses paid to a family member who is an active shareholder/manager.

¹³ *Ibid*, question 6.

The double taxation element that is the impetus of the bonus-down strategy has been largely legislated away after the enactment of the eligible dividend regime. As we will elaborate further below, bonusing-down is no longer a rule of thumb that practitioners can rely on for OM remuneration planning.

2. Income Splitting with Minors

Splitting income with family members that are in lower tax brackets in order to take advantage of their marginal personal tax rates and personal credits is a staple of OM remuneration planning. Similar to the bonus-down planning, the first hurdle is the reasonableness requirement of section 67 and the business purpose requirement under paragraph 18(1)(a). In its simplest form, income splitting can be accomplished by employing family members and paying them salary and/or a bonus based on the fair market value of the services they rendered.¹⁴ For this strategy to work, the OM must be able to substantiate that the family member has actually offered services that are commensurate with his or her remuneration, which may be difficult when the family member in question is a minor. Therefore, tax practitioners and creative OMs had come up with multitude of creative planning techniques that allowed income-splitting with minors without the need for the minor to provide services in return. Many of these plans use trusts as the income splitting vehicle since trusts have the advantage of being flexible and providing the OM control over the assets being transferred. In most cases, these strategies may no longer be used to split income with minors due to the introduction of the “kiddie tax” regime in year 2000 (to be discussed in further detail below). As an illustration, below are three common planning tools often used for splitting income with minors prior to year 2000:

1. Dividend sprinkling: in a typical dividend sprinkling plan, a family trust would hold a separate class of shares in an operating company (Opco). The trust would usually be a discretionary trust with the OM and/or his spouse as the trustee, and the beneficiaries would include their children. It would have been necessary to ensure that the reversionary trust rules in subsection 75(2) did not apply to the trust, otherwise all income or gain from the trust property would have been attributed back to the settlor and the trust would generally lose the ability to roll assets out to most beneficiaries on a tax-deferred basis.¹⁵ Each year, Opco would declare a dividend on the shares held by the trust and the trust would allocate the dividend to the children.¹⁶ This provided for the dividend income to be taxed at the children's marginal rates and take advantage of their personal credits. It was also a popular technique to pay an amount of dividends each year (usually around \$30,000) that would just be sufficient to fully utilize a child's personal and dividend tax credits to offset any tax on the dividend. This plan also had the added benefit that future gains on the Opco shares held by the trust could be allocated to the children

¹⁴ For a recent example, contrast *Noel v R*, 2012 DTC 1013, where the taxpayer's wife worked as an office manager in his law practice and her remuneration was found to be reasonable despite being paid on a sporadic basis as cash flow permitted, with *Bitzanis v R*, 2010 DTC 1254, where the taxpayer paid management fees to his sons but those fees were found not to be deductible because there was no evidence that the sons did any work.

¹⁵ Subsection 107(4.1).

¹⁶ Trust's income that became payable to a beneficiary is included in the beneficiary's income by virtue of subsection 104(13) and is deductible by the trust pursuant to paragraph 104(6)(b).

and potentially be sheltered by their lifetime capital gains exemption.¹⁷

2. Management services: another common strategy was to have a family trust enter into a management service contract with a related operating company (Opco). Pursuant to the contract, the trust would carry on the business of providing management services to Opco and Opco would pay a reasonable management fee to it. Opco would then allocate the fee income to minor beneficiaries to be taxed at their marginal rates. A similar plan to this was used successfully by the taxpayer in *Ferrel*.¹⁸ In *Ferrel*, the father was the sole trustee and employee of a business trust and the trust provided management services to the family holding company. The income earned by the trust was allocated to the beneficiaries who were minor children of the father. The Tax Court of Canada (TCC) concluded that subsection 56(2) could not apply because it could not be established that absent the agreements, the father would have earned the income. The court also stated that in the absence of a sham, there is nothing in law to prevent an individual from agreeing to provide professional or management services to a client through the medium of a corporation or some other entity, such as a trust. The Federal Court of Appeal (FCA), citing the Supreme Court of Canada (SCC)'s decision in *Neuman*,¹⁹ upheld the decision noting that structures, including business trusts, can be created solely to avoid the payment of tax.
3. Subsection 15(2): subsection 15(2) taxes shareholders or connected persons²⁰ with respect to borrowings from their corporations (certain borrowings are excepted from the rule, such as a loan that is repaid within one year after the end of the taxation year of the lender in which the loan was made other than as a series of loans and repayments a detailed discussion on subsection 15(2) is contained in a later section of this paper). An operating company could loan funds to a child of the shareholder with the intention that the loan would never be repaid. Since the child was connected with the shareholder, subsection 15(2) would apply to deem the amount of the borrowing as income to the child. As a result, the family permanently extracted corporate surplus that otherwise would have been taxed in the OM's hands as a dividend or salary, while paying minimal (or no) taxes due to the deemed income under subsection 15(2) being subject to the low marginal rates and personal credits of the child.

The rampant use of plans (such as the above) to split income with minors led to Parliament's enactment of section 120.4, commonly referred to as the "kiddie tax", which came into effect in year 2000. Under section 120.4, any income received by a child that is considered "split income" is

¹⁷ Under subsections 104(21) and (21.2), a trust may designate its taxable capital gain to an beneficiary and the beneficiary may use his or her capital gains exemption to shelter the gain if the property disposed of meets the requirements under section 110.6 (i.e. qualified small business corporation shares, qualified farm property, or qualified fishing property).

¹⁸ 97 D.T.C 1565 (TCC); aff'd. 99 D.T.C 5111 (FCA)

¹⁹ 98 D.T.C 6297 (SCC)

²⁰ The meaning of "connected" for purpose of 15(2) is contained in subsection 15(2.1), and it includes persons not dealing at arm's length with the shareholder. Arm's length relationships are defined in subsection 251(1) to include related persons, which in turn is defined in subsection 251(2) to include individuals connected by blood relationship.

subject to tax at the highest marginal tax rate of 29 percent.²¹ For the purpose of these rules, split income is defined in subsection 120.4(1) to include the following:²²

- a) taxable dividends and income arising from section 15 from a corporation (other than one whose shares are listed on a designated stock exchange or a mutual fund corporation) received directly or indirectly through a trust or partnership; and
- b) income from a partnership or trust where the income can reasonably be considered to be derived by the partnership or trust from the business of providing property or services to,²³ or in support of, a business carried on by
 - i) a person who is related to the child at any time in the year;²⁴
 - ii) a corporation of which a related person is a specified shareholder at any time in the year;²⁵ or
 - iii) a professional corporation of which a related person is a shareholder at any time in the year.

Section 120.4 dismantled the majority of tax plans involving income-splitting with minors, including the types of plans described above. Dividends sprinkled to minors from a private corporation, either directly or via a trust, would constitute split income and be subject to the top marginal tax rates. Similarly, income from management services provided by a family trust to the parent's operating company, or deemed income under subsection 15(2), would be caught under the definition of split income.

The introduction of section 120.4 was significant, but it was also drafted to apply specifically to certain types of income. A notable exception from the original version of section 120.4 was capital gains realized by the child. Naturally, numerous planning structures were developed to exploit this omission. As a response, Parliament enacted subsections 120.4(4) and (5) effective for dispositions occurring after March 21, 2011. Generally speaking, subsections 120.4(4) and (5) operate to deem a minor who has received certain taxable capital gains, either directly or through a trust, to have received twice the amount as a non-eligible taxable dividend if the gain arises from disposition of shares of a corporation

²¹ Section 120.4 applies to a "specified individual", which is defined in that section to be a Canadian resident individual who had not attained the age of 17 years before the year and has a Canadian resident parent.

²² Income or taxable capital gains on property acquired as a consequence of death is generally excluded from split income— see definition of "excluded amount" in subsection 120.4(1).

²³ The currently enacted definition refers to provision of "goods or services"; a proposed amendment to the definition will change the phrase to refer to "property or services" to ensure that the split income rules will apply to income from property, such as rental income. The proposed change is effective for taxation years that begin after December 20, 2002.

²⁴ The rules for whether persons are related to each other are contained in subsection 251(2).

²⁵ A "specified shareholder" of a corporation is defined in subsection 248(1) to mean a taxpayer who owns, directly or indirectly, at any time in the year, not less than 10 percent of the issued shares of any class of the corporation or of any other related corporation.

(other than a publicly listed corporation or a mutual fund corporation) to a person with whom the minor does not deal at arm's length.²⁶ A good illustration of the perceived abuse that subsections 120.4(4) and (5) were intended to target is the series of transactions undertaken by the taxpayers and their parents in *Gwartz v Queen*,²⁷ which took place prior to the enactment of those provisions. The *Gwartz* case is also worthwhile to examine in detail for its well-reasoned and up-to-date analysis of the general anti-avoidance rule (GAAR) as it relates to income-splitting and surplus stripping.²⁸

In *Gwartz*, the taxpayers, who were minors at the time, were beneficiaries of a family trust. The trust held all the common shares of a management corporation for the taxpayers' father's dental practice. During 2003 and 2005, the management corporation declared stock dividends of high-low preferred shares (high redemption value and low paid-up capital) to the trust.²⁹ The stock dividend declaration resulted in only nominal income inclusion for the trust but shifted substantially all of the value of the common shares to these high-low preferred shares.³⁰ Throughout 2003 to 2005, the trust sold the high-low preferred shares to the father at fair market value (i.e. the redemption value of the shares) for promissory notes. Since the trust had nominal adjusted cost base (ACB) in the high-low preferred shares, the trust reported capital gains on these dispositions and allocated them to the taxpayers. Subsequently, the father sold the high-low preferred shares to a corporation wholly owned by his spouse at fair market value for promissory notes. No gains were triggered by the father on the transfer since his ACB in the shares equaled fair market value. The shares were then redeemed by the management company. The spouse's corporation reported a deemed dividend in respect of the redemption pursuant to subsection 84(3) but claimed a fully offsetting deduction under subsection 112(1). The redemption proceeds were used to repay both sets of promissory notes, effectively resulting in an extraction of funds equal to the aggregate redemption value from the management company to the trust, which presumably were subsequently distributed to the beneficiaries as tax-free capital allocations.

The CRA reassessed the taxpayers under the GAAR on the basis that,³¹ by effecting the realization of capital gains and their allocation to the beneficiaries rather than the distribution of taxable dividends, the series of transactions had abusively circumvented section 120.4 of the Act. The TCC performed a comprehensive GAAR analysis and concluded that the avoidance transaction giving rise to the tax benefit was not abusive under subsection 245(4) and accordingly the Minister cannot rely on the GAAR

²⁶ Arm's length relationship – supra, note [20].

²⁷ 2013 TCC 86.

²⁸ The GAAR is contained in subsection 245(2), but the criteria for applying GAAR is mostly established by a series of SCC decisions such as *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54, and *Cophthorne Holdings Ltd. v. Canada*, 2011 SCC 63.

²⁹ "Paid up capital" is defined in subsection 89(1).

³⁰ With a stock dividend, the amount included in a recipient's income is the corresponding increase in the paid-up capital in the shares of the corporation. This is by reason of the definition of an "amount" in subsection 248(1).

³¹ Supra, note [28].

to re-characterize the capital gains as dividend income subject to the pre- 120.4(4)/(5) kiddie tax regime. In coming to its conclusion, the TCC cited reasons such as the following:

- Citing the SCC's decisions in *Canada Trustco* and *Copthorne Holdings* as well as the FCA's decision in *Lehigh Cement Limited*,³² the TCC stated that tax planning is not inherently abusive, and that it is inappropriate, where the transactions do not otherwise conflict with the object, spirit and purpose of the Act, to apply the GAAR to deny a tax benefit resulting from a taxpayer's reliance on a previously unnoticed legislative gap;
- After examining the judgements in *Collins & Aikman*, *Copthorne Holdings*, and *Neuman*,³³ the TCC concluded that there is no broad statement of policy in the Act against surplus stripping or income splitting;
- In determining the significance of subsequent amendments as an indicator of the policy underlying previous versions of a provision, the court compared the FCA's judgement in *Water's Edge* with that court's later decisions in each of *Triad Gestco* and *1207192 Ontario Limited*.³⁴ In *Water's Edge*, the court decided that a subsequent amendment to subsection 96(8) was indicative of the provision's object and spirit. Whereas, in each of *Triad Gestco* and *1207192 Ontario Limited*, the FCA ruled that subsequent amendment to the definition of "affiliated persons" in section 251.1 as it applies to the stop-loss rule in subparagraph 40(2)(g)(i) cannot be relied on to infer a policy of the Act before the amendment. Using that comparison, the TCC held that a subsequent amendment does not in itself indicate whether or not transactions undertaken prior to the amendment were abusive. The TCC therefore went on to examine the historical context and the Department of Finance's budget materials in connection with section 120.4, and concluded that Parliament intended section 120.4 to be a narrow and targeted provision, and not a broad provision dealing with all types of income splitting with minors. As such, the 2011 amendment for certain capital gains was intended by Parliament to be an extension of section 120.4, rather than a closing of a loophole as described in *Water's Edge*;
- Finally, the facts of this case were distinguished from the earlier GAAR cases of *Triad Gestco* and *1207192 Ontario Limited* because capital gains were recognized by the taxpayers, whereas the taxpayers in those two prior cases created artificial capital losses to shelter true economic capital gains.

As noted above, the planning strategy used in *Gwartz* is no longer effective after March 21, 2011 because of the application of subsections 120.4(4) and (5), but the judgment contained in *Gwartz* that the kiddie tax provision is intended as a narrow and targeted measure and its reminder that the Act has no general policy against income-splitting or surplus stripping will no doubt continue to encourage creative tax practitioners to incorporate income-splitting and surplus stripping in structuring their clients' affairs to the extent possible.

³² *Canada Trustco* and *Copthorne Holdings*: supra, note [28]; *Lehigh Cement Limited v Canada*, 2010 FCA 124.

³³ *Collins & Aikman Prodcuts Co. et al v Queen*, 2009 TCC 299, aff'd 2010 FCA 251; *Copthorne Holdings*, supra, note [28]; *Neuman*, supra, note [19].

³⁴ *Water's Edge Village Estates (Phase II) Ltd v Canada*, 2002 FCA 291; *Triad Gestco Ltd. V Queen*, 2012 FCA 258, aff'g. 2011 TCC 259; *1207192 Ontario Limited v Queen*, 2012 FCA 259, aff'g. 2011 TCC 383.

3. Retirement Compensation Arrangements

Another common tool in OM remuneration planning has been the RCA.³⁵ In general, an RCA permits an employer to make contributions to a custodian who holds the funds in trust with the intention that they will eventually be distributed to an employee on, after, or in contemplation of any substantial change in the services rendered by the employee, his retirement or loss of employment. The establishment of an RCA generally requires the creation of an *inter-vivos* trust (i.e. a RCA trust³⁶) and compensation agreements. RCA plans enable an employer to make a deductible contribution in respect of select employees with no immediate tax consequences to the employees.³⁷ Contributions to a RCA must be reasonable pursuant to section 67 in order for the employer to take advantage of the deduction.³⁸

In order to prevent inappropriate tax deferral involving employee contributions to self-funded plans, Part XI.3 requires that when a contribution is made to a RCA, the RCA must remit a 50 percent refundable tax to the CRA.³⁹ Income or capital gains earned in the RCA are also subject to the 50 percent refundable tax.⁴⁰ The CRA refunds the tax proportionately as distributions are made from the RCA,⁴¹ and all distributions are taxable as income to the recipient.⁴²

Due to the 50 percent refundable tax mechanism, a RCA does not *prima facie* appear to be an effective means of tax deferral or reduction. However, over the years, OMs have used “RCA loan-back” strategies as an effective tax planning tool. An illustration of this strategy is depicted below:

³⁵ A RCA is defined under subsection 248(1).

³⁶ “RCA trust” as defined in subsection 207.5(1).

³⁷ Paragraph 20(1)(r) provides the employer a deduction for contributions under a RCA, while employee can exclude benefits received under an RCA from taxable benefit pursuant to paragraph 6(1)(a). When the employee receives payments from the RCA, the employee will include the amount in income under paragraph 56(1)(x).

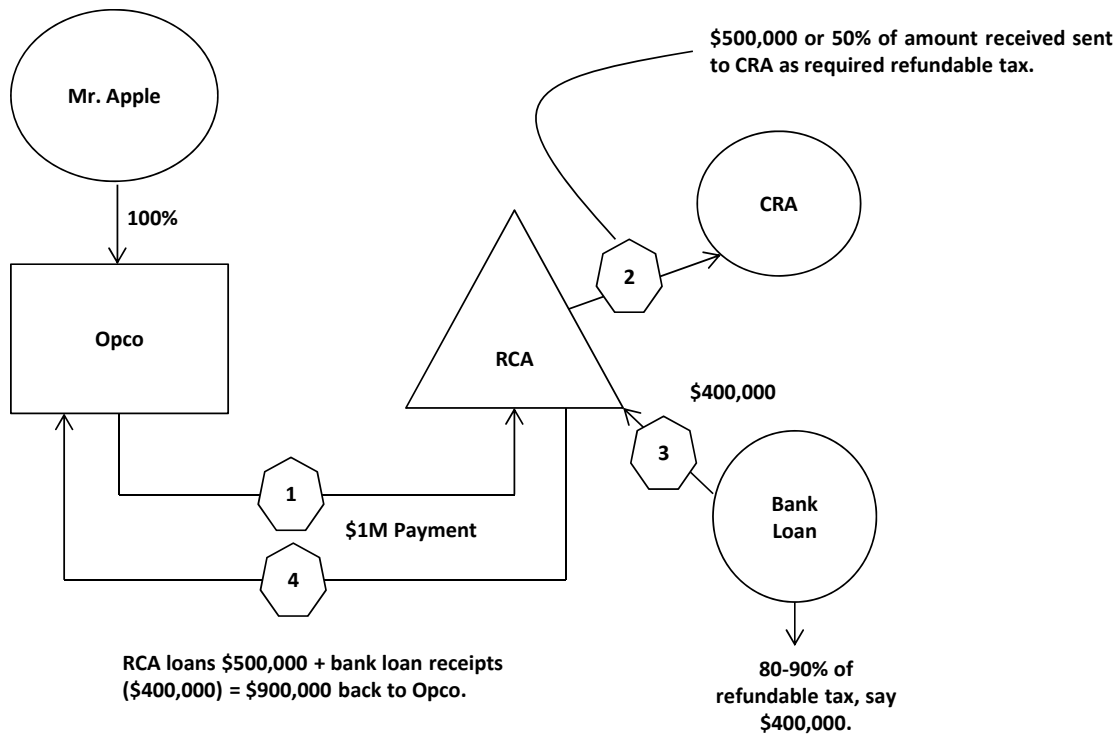
³⁸ 1997 Deferred Income Arrangements Conference, Q&A, CRA Response; CRA Technical Interpretation no. 2005-0149321E5.

³⁹ Subsection 207.7(1) and the definition of “refundable tax” contained in subsection 207.5(1).

⁴⁰ *Ibid.*

⁴¹ Subsection 207.7(2) and the definition of “refundable tax” contained in subsection 207.5(1).

⁴² Paragraphs 56(1)(x)-(z).



Here, Mr. Apple owned all of the issued shares of an operating company (Opco). Opco made a \$1 million contribution to a RCA that has Mr. Apple as its sole beneficiary, and claimed a deduction for the amount. As required under Part XI.3, the custodian remitted 50 percent of the contribution, or \$500,000, to the CRA as refundable tax. In conjunction with the contribution, the RCA took out a loan from an arm's length bank equal to approximately 80 to 90 percent of the refundable tax, say \$400,000 in this case, using the refundable tax as collateral. The RCA then loaned all its funds, consisting of i) \$500,000 which was the contribution less the refundable taxes remitted and ii) \$400,000 bank loan receipt, back to Opco (or alternatively to another related corporation). As a result, Opco had access to nearly the full amount that was contributed to the RCA but it benefited from the tax savings generated from full deduction of the \$1 million contribution.

Presumably, the government was not happy with the loan-back arrangement, and obviously had questions about whether the RCA was created for the purpose of funding employee retirement. In addition, RCAs were allowed a wide range of investment choices and, as illustrated in the above example, the government did not appear to like some of those choices. Therefore, in the 2012 federal budget, the government proposed to add to the RCA provisions prohibited investment and advantage rules, modeled closely on similar rules applicable to tax-free savings accounts (TFSA) and registered retirement savings plans (RRSPs), to prevent RCA's from being involved in non-arm's length transactions.

Therefore, effective March 29, 2012, where a RCA trust holds a prohibited investment which includes, among other things, debts of a corporation that the beneficiary of the RCA has a "significant interest" in (generally more than 10 percent ownership), the custodian of the RCA will be subject to an additional 50

percent tax on the fair market value of the prohibited investment.⁴³ The tax on prohibited investments is refundable when the RCA trust disposes of the prohibited investment, unless it is reasonable to consider that the custodian or the beneficiary knew or ought to have known at the time the property was acquired that it was or would become a prohibited investment.⁴⁴ Also, the custodian will be subject to 100 percent tax on the value of any “advantage” where an advantage is extended to, or is received or receivable by, an RCA trust, a specified beneficiary or any person not dealing at arm’s length with the beneficiary.⁴⁵ Further, the ability of the RCA to obtain a refund of the Part XI.3 refundable taxes is restricted if a decline in value of property held in trust is reasonably attributable to a prohibited investment or an advantage.⁴⁶

This change in the legislation has rendered the RCA loan-back plan such as the one illustrated above obsolete. The \$900,000 loaned by the RCA to Opco would constitute a prohibited investment, and the RCA custodian would be liable to a \$450,000 tax liability (50 percent of the \$900,000) which would not be refundable if the custodian or Mr. Apple knew or ought to have known at the time the loan occurred that it would be a prohibited investment.

4. Employees Profit Sharing Plan

An employees profit sharing plan (“EPSP”) is an *inter vivos* trust arrangement that allows employers to share profits with all, or a selected group of, employees.⁴⁷ Generally speaking, the conditions for a valid EPSP are: i) there must be payments computed by reference to the employer’s profits, ii) the amount must be paid to the trustee of an arrangement for the benefit of the employees, and iii) all amounts received by the trustee and all income and capital gains of the EPSP for the year must be allocated to the employees either contingently or absolutely.⁴⁸ Normally, any income realized by an *inter vivos* trust would be subject to the highest rate of tax.⁴⁹ However, no tax is payable by a trust on its taxable income for a taxation year throughout which the trust is governed by an EPSP.⁵⁰

⁴³ Subsections 207.61(1) and (2) impose the 50% tax on a prohibited investment, which is defined in subsection 207.5(1) to include a debt of a corporation in which a “specified beneficiary” has a “significant interest”. A specified beneficiary is defined in subsection 207.5(1) to mean an individual beneficiary who has or had a significant interest in the employer or former employer, and significant interest is defined in subsection 207.01(4) to mean a “specified shareholder” in the case of a corporate employer. Specified shareholder is defined in subsection 248(1) to generally mean a taxpayer who owns more than 10% of a corporation.

⁴⁴ Subsection 207.61(3).

⁴⁵ Subsections 207.62(1) and (2).

⁴⁶ Paragraph 207.5(3).

⁴⁷ EPSP is defined in subsection 144(1).

⁴⁸ These conditions are pursuant to the definition of EPSP in subsection 144(1).

⁴⁹ Subsection 122(1).

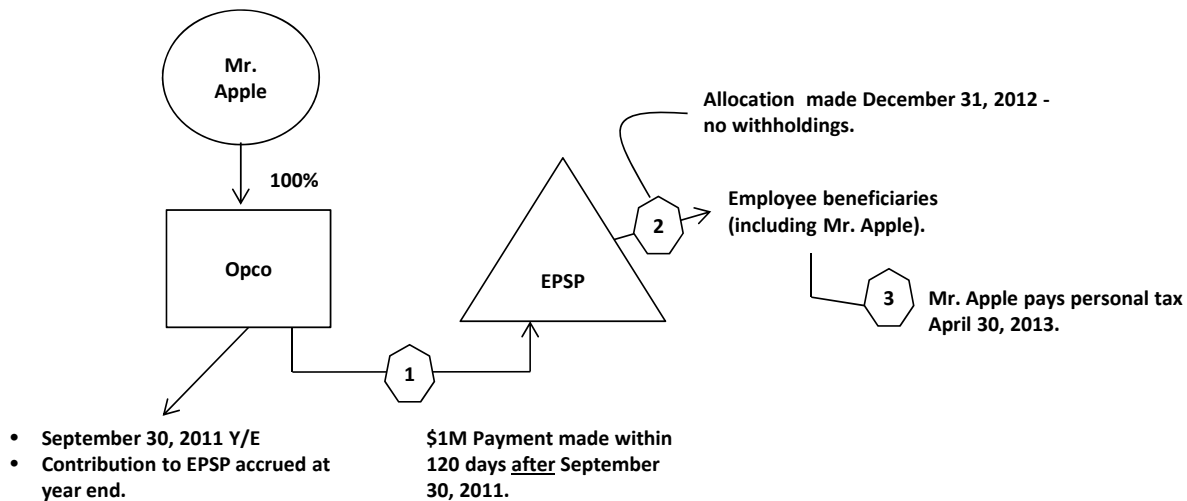
⁵⁰ Subsection 144(2).

An employer can deduct a contribution to an EPSP trustee made during a taxation year or within 120 days thereafter.⁵¹ Also, the contributions to the EPSP will not be subject to source deductions requirements (since such contributions are not listed under subsection 153(1)). The employees are required to include in their income amounts allocated to them contingently or absolutely under the EPSP,⁵² but are not taxed again when funds are later received from the plan.⁵³

The CRA has commented in numerous Technical Interpretations that an employer's contribution to an EPSP is subject to the reasonableness provisions of section 67.⁵⁴ However, a technical argument can potentially be made that section 67 does not apply to allocations by the trustee to the employee beneficiaries, hence providing a potential avenue for income-splitting.

EPSP's were commonly used by OM's to allocate income to an employee group that includes members of the OM's family. It was a relatively simple tool that allowed OM's to income split with family members, avoid source withholding (including CPP and EI amounts⁵⁵), and defer tax by taking advantage of the potential 120-day delay between a corporation's year-end and the payment to the trustee, and the requirement for the EPSP to allocate when amounts were received.

An example of how EPSPs have been used historically in OM remuneration planning is depicted below:



In this situation, Mr. Apple was the sole shareholder of an operating company (Opco) which had a September 30th year-end date and he was also an employee of Opco. Opco had established an EPSP for

⁵¹ Subsection 144(5).

⁵² Subsection 144(3) and paragraph 6(1)(d).

⁵³ Subsection 144(6).

⁵⁴ See for example CRA Technical Interpretation no. 9709575.

⁵⁵ An EPSP allocation is not included in "insurable earnings" for EI purposes or in "contributory salary and wages" for CPP purposes.

its employees including Mr. Apple. For its September 30, 2011 taxation year, Opco accrued a \$1 million expense in respect of contribution to the EPSP, and made the contribution payment in 2012 but within 120 days after September 30, 2011. Since the EPSP received the amount in 2012, it allocated the \$1 million to Mr. Apple in 2012. The tax result is that Opco claimed a \$1 million deduction for its September 30, 2011 taxation year, avoided income tax/CPP/EI payroll withholding on the amount, and the arrangement achieved a tax deferral of 19-months since Mr. Apple reported the amount in his 2012 income on which he was liable for income tax on April 30, 2013 (or June 15, 2013 if he carried on business outside of employment with Opco). If members of Mr. Apple's family were also employees of Opco, the beneficiaries of the EPSP could include those family members and there may be opportunity to split income as well if they were in a lower tax bracket.

Due to the popularity of such strategies, the 2012 federal budget proposed that a special tax of 29 percent, the highest personal marginal rate, to be applied to any "excess EPSP amounts" paid to a "specified employee". These rules were enacted in new Part XI.4, or section 207.8, effective for EPSP contributions on or after March 29, 2012. "Excess EPSP amount" is defined in subsection 207.8(1) as the portion of the employer's EPSP contribution allocated to a "specified employee" in excess of 20 percent of the employee's annual salary. A "specified employee" is defined in subsection 248(1) as an employee who is a "specified shareholder" of the employer corporation (which generally means ownership of at least 10 percent of any class of shares)⁵⁶ or who does not deal at arm's length with the employer.⁵⁷ Since the excess EPSP amount is already taxed at 29 percent under Part XI.4, it should not be subject again to regular tax so paragraph 8(1)(i.2) provides a deduction of the amount to the employee.

Part XI.4 tax should severely limit EPSPs as a tool to split income with family members that have low marginal tax rates. Also, it should deter OM's from paying themselves a nominal amount of salary and receiving the balance of their compensation as EPSP for the purpose of avoiding payroll withholding requirements, since the Part XI.4 rules will effectively cause the whole EPSP allocation to be taxed at the highest marginal rate. Bottom line, it would appear that much of the mischief involving EPSPs and OM remuneration planning will end and many EPSPs will now likely need to be wound down. Also, the section 8 deduction mechanism that helps the employee avoids double taxation on the excess EPSP amount will have the side effect of reducing RRSP earned income limits and other income-sensitive amounts such as charitable donation limits.

5. Health and Welfare Trust

A Health and Welfare Trust ("HWT") is an *inter vivos* trust structure used by employer to fund health and other benefits for employees. The concept of a HWT is not defined in the Act, but is recognized by the CRA administratively as an employee health and welfare benefit program provided it qualifies as one or a combination of a) a group sick or accident insurance plan, a private health services plan, or a group

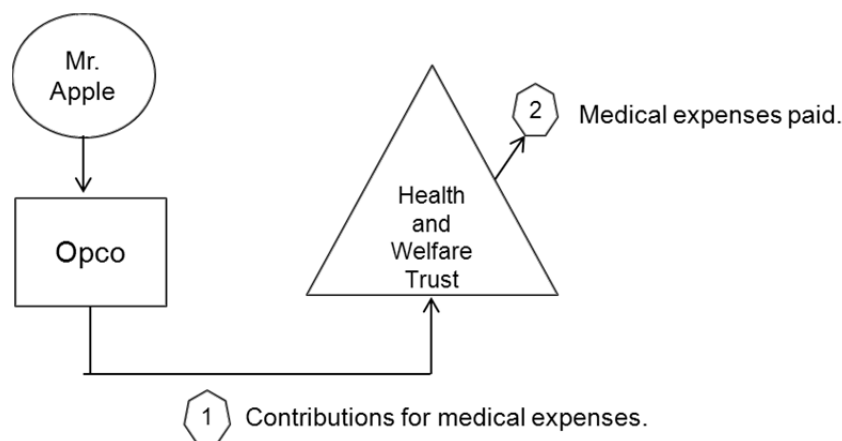
⁵⁶ "Specified shareholder" is also defined in subsection 248(1).

⁵⁷ Persons not dealing at arm's length with the employer corporation can include family members of the specified shareholder of the corporation. This is because persons not dealing at arm's length includes related persons. A corporation and any person related to a person who controls the corporation are related pursuant to subparagraph 251(2)(b)(iii).

term life insurance policy.⁵⁸ There are also other requirements such as that the funds of the trust cannot revert to the employer or be used for any purpose other than providing health and welfare benefits for which the contributions are made. To the extent contributions to the trust are reasonable and laid out to earn income from business or property, they should be deductible to the employer.⁵⁹ From the employees' perspective, any benefits derived from group sick or accident insurance plans, private health services plans, and group term life insurance policies are exempted from income inclusion by virtue of subparagraph 6(1)(a)(i).

Parliament enacted section 144.1 in 2010 which provided for a new type of employee benefit trust – “Employee life and health trust” (ELHT). However, the CRA has indicated it will not withdraw its administrative practice regarding HWTs (even though the ELHT rules, to a large extent, codify these administrative practices) and that a trust should maintain evidence to support its intention as to which regime (ELHT or HWT) is intended to apply.⁶⁰

In recent years, HWTs have been significantly commoditized, mainly by financial advisors and the insurance industry. Below is an illustration of a typical HWT setup for a private company:



Here, Mr. Apple was the sole shareholder of an operating company (Opco) and was employed by Opco. Opco established a HWT for the purpose of providing health benefits for Mr. Apple, and the HWT was set up in a manner that met the definition of a private health services plan – namely that it was a plan in the nature of insurance and followed the guideline set out by the CRA in its Interpretation Bulletin.⁶¹ As a result, Opco deducted contributions to the HWT as a business expense on an accrual basis, but those contributions did not give rise to a taxable employment benefit to Mr. Apple. Effectively, this plan

⁵⁸ CRA Interpretation Bulletin IT-85R2 - Health and Welfare Trusts for Employees.

⁵⁹ Expenses incurred to earn business or property income are deductible pursuant to section 9 and paragraph 18(1)(a), provided they meet the reasonableness requirement set out in section 67.

⁶⁰ CRA Views Document no. 2011-0398371C6.

⁶¹ “Private health services plan” is defined in subsection 248(1), and the CRA set out administrative guidelines for such plans in CRA Interpretation Bulletin IT-339R2 – “Meaning of “Private Health Services Plan”.

allowed Mr. Apple to have his health costs paid for by Opco's pre-tax dollars, rather than having them paid for by personal tax-paid funds (derived from salaries or dividends from Opco).

From our practice, we have come across many such HWT plans and we found that OM's or their advisors often overlook the risk associated with the shareholder benefit provisions found in subsection 15(1). Under subsection 15(1), if a shareholder receives a benefit in his/her capacity as a shareholder, in other words "qua shareholder", the shareholder will be required to include the value of the benefit in income while the corporation will not be entitled to any corresponding deduction. Whether the benefit in connection with a private health plan or policy is received qua shareholder or qua employee is addressed in the case of *Spicy Sports Inc.*⁶² In that case, the taxpayer was the president and majority shareholder of a corporation. The corporation paid \$38,327 through a "cost plus" insurance policy to cover the taxpayer's cost of a knee operation. The TCC stated that whether the taxpayer received the benefit qua shareholder or employee is dependent on whether the corporation would have entered into such a contract with an arms' length key employee as an employee and not a shareholder. Accordingly, the court found the taxpayer to have received a benefit by virtue of his shareholdings pursuant to subsection 15(1).

In another case, *O'Flynn*,⁶³ a dental plan was available to all employees of a corporation, and the TCC in that case found that the dental benefits received by the controlling shareholders were by virtue of their employment and not shareholding. Accordingly, those benefits were excluded from income under subparagraph 6(1)(a)(i).

Therefore, caution must be taken in using HWTs as a planning mechanism for OMs. Using the example above, it would be difficult to argue that the benefit conferred on Mr. Apple was qua employee particularly if no other employees benefit from the HWT or if a significant amount of health costs were reimbursed through the HWT. The potential exposure would be an income inclusion for Mr. Apple under subsection 15(1) while Opco is denied its deduction under paragraph 18(1)(a) since the contribution would not be for purposes of earning income from a business.

6. Personal Services Business

A personal services business ("PSB") exists where an individual who is a specified shareholder (or is related to the specified shareholder)⁶⁴ provides services on behalf of a corporation to a client, where, if the corporation did not exist, the nature of the relationship between the individual and the client would be that of employee–employer.⁶⁵

⁶² *Spicy Sports Inc v Queen*, (2004) 5 CTC 2090 (TCC).

⁶³ *O'Flynn v. The Queen*, 2005 DTC 556 (TCC)

⁶⁴ *Supra*, note [56].

⁶⁵ Subsection 125(7) "personal services business".

A number of restrictions apply to PSB's. A corporation carrying on a PSB is limited by paragraph 18(1)(p) in terms of the deductions it could claim in computing taxable income, and cannot claim the small business deduction under subsection 125(7).⁶⁶ However, prior to draft legislation proposed on October 31, 2011, a PSB arrangement was still an attractive option for executives and high salaried employees because it provided the ability to retain income taxed at the corporate rate (25 to 31 percent depending on the province of residence) in the corporation, thereby deferring personal tax until funds are needed for personal use (contrast with immediate taxation on employment income at the highest personal marginal rate of 39 to 50 percent depending on province of residence). Further, it is generally accepted industry practice, especially in the resource and construction sector, for field employees to be incorporated contractors even though all other facts and circumstances support a long term employer-employee relationship.

However, as a result of the proposed amendment to the definition of "full rate taxable income" contained in section 123.4, the general rate reduction is no longer applicable to income from a PSB effective for taxation years that begin after October 31, 2011. Therefore, the federal tax rate applicable on PSB income is now 28 percent, or between 38 and 44 percent when combined with provincial tax depending on the province of residence. This significantly reduces the tax deferral opportunity, and causes a PSB's corporate and shareholder tax to no longer be integrated: the combined corporate and personal 2013 tax on PSB income paid via an eligible dividend to an individual taxed at the top marginal rate is now 49.96 percent in Alberta or 54.74 percent in British Columbia.⁶⁷ These rates are significantly higher than the top marginal personal rate that would have been applicable for employment income in those provinces. The proposed amendment has effectively chastised any PSB that does not flow out all of its profits to its shareholders as salaries.

D. ELIGIBLE DIVIDEND TAXATION REGIME AND IMPACT ON OM PLANNING

Earlier in the paper, we mentioned that the primary tax problem the bonus-down strategy was designed to address, being the double-tax of corporately earned income subject to the general corporate rate, has been largely legislated away after the enactment of the eligible dividend regime. We will now discuss this in further detail, as well as how the eligible dividend regime completely threw out old "rule of thumbs" in the area of OM remuneration.

1. History and General Principles of the Eligible Dividend Regime

On November 23, 2005, the Department of Finance announced a new regime for the taxation of dividends. The measures were intended to make the total taxes paid by individuals on dividends from large corporations comparable to the flow-through tax results of income trust distributions. These new

⁶⁶ The definition of "active business" in subsection 248(1) excludes a PSB.

⁶⁷ Computation uses 2013 combined corporate rate of 38% for Alberta and 38.75% for British Columbia, and 2013 combined top marginal personal rate on eligible dividend of 19.29% for Alberta and 26.11% for British Columbia.

measures were mostly enacted within section 89 and became law effective for 2006 and subsequent tax years.

Under the new measures, a corporation may designate dividends it pays as an “eligible dividend”.⁶⁸ Public companies and other non-CCPCs can generally pay eligible dividends unless they have a low rate income pool (LRIP).⁶⁹ In general, an LRIP balance exists if the non-CCPC receives dividends that are not eligible dividends (usually a dividend other than an eligible dividend received from a CCPC) or have accumulated retained earnings from certain tax preferred amounts. With respect to CCPC’s, they can pay eligible dividends to the extent of their general rate income pool (GRIP). Generally speaking, a CCPC’s GRIP represents the after-tax amount of business income that has been subject to the federal general corporate tax rate (usually the CCPC’s business income that exceeds its \$500,000 small business limit) plus any eligible dividends and dividends from foreign affiliates received by the CCPC, less any eligible dividends the CCPC paid to its shareholders in preceding years.⁷⁰ If eligible dividends are paid in excess of applicable limits, the corporation is subject to a penalty tax of 20 percent under Part III.1.⁷¹ Transitional rules were enacted for the calculation of a CCPC’s opening 2006 GRIP balance, and those transitional rules were subject to a lot of controversy and technical interpretations.⁷²

The difference in treatment between an eligible dividend and a dividend other than an eligible dividend (herein referred to as a “non-eligible dividend”) to the individual recipient is attained through the dividend gross-up and dividend tax credit mechanisms. The dividend gross-up applicable to an eligible dividend received by an individual after 2011 is 38 percent of the dividend, and the associated dividend tax credit is 6/11ths of the gross-up amount.⁷³ For non-eligible dividends, the gross-up factor is 25 percent and the dividend tax credit is 2/3 of the gross-up amount. In the 2013 federal budget, the government proposed to increase the net tax rate on non-eligible dividends paid after 2013 by adjusting the gross-up factor and the dividend tax credit calculation. Refer to the tables and accompanying discussions earlier in the paper for the net top marginal personal rates on non-eligible and eligible dividends for each province from 2011 to 2014.

⁶⁸ “Eligible dividend” is defined in subsection 89(1), and the designation is provided for in subsection 89(14).

⁶⁹ LRIP is defined in subsection 89(1).

⁷⁰ GRIP is defined in subsection 89(1). It is a formulaic driven amount, and it applies a “general rate factor” to the CCPC’s income as a proxy of income after federal and provincial taxes. For taxation years after 2011, the general rate factor is defined in subsection 89(1) as 0.72.

⁷¹ Subsection 185.1(1).

⁷² For example, see Steven Carreiro and Ian Crosbie, “Update on GRIP and LRIP Calculations: Anomalies in and Problems with the Rules,” Report of Proceedings of Sixty-First Tax Conference, 2009 Tax Conference (Toronto: Canadian Tax foundation, 2010, 12:1-34).

⁷³ The gross-up factor for eligible and non-eligible dividends are provided by subparagraph 82(1)(b)(i) and (ii) respectively, and the dividend tax credit for eligible and non-eligible dividends are pursuant to paragraphs 121(a) and (b) respectively. The gross-up factor and dividend tax credit calculation for eligible dividends has changed throughout 2009 to 2012 in order to maintain integration with the decreasing general corporate tax rates.

Given the increase in net tax rates on non-eligible dividends paid after 2013, OM's of private corporations should consider paying non-eligible dividends in 2013 to the extent it is congruent with other remuneration objectives.

2. Impact to OM Remuneration Planning (Old/new rule of thumbs)

a) Bonus down versus no bonus down

The introduction of the eligible dividend rules has had a significant impact regarding whether to bonus-down to the small business limit. As discussed earlier, the long standing rule-of-thumb was that bonusing-down results in a significant absolute tax savings for income that would otherwise be subject to the general corporate tax rate. Under the new regime, a CCPC's business income that is subject to the general corporate tax rate creates GRIP balance at the general rate factor of 0.72, from which the CCPC may pay out eligible dividends to its shareholders. To illustrate, we will use the same example as earlier of the Saskatchewan-resident Mr. Apple and his wholly owned CCPC (Opco), but this time, Opco earns \$1,000,000 of active business income in 2013 and Mr. Apple is deciding whether to bonus down to the \$500,000 federal and Saskatchewan small business limit for 2013 (again assuming top marginal federal and Saskatchewan personal rates):

	2013	
	Bonus	No Bonus
Opco's taxable income before bonus	\$ 1,000,000	\$ 1,000,000
Bonus	\$ (500,000)	\$ -
Taxable income after bonus	\$ 500,000	\$ 1,000,000
On first \$500,000 of income - 13% (combined federal and Saskatchewan rate on small business income)	\$ 65,000	\$ 65,000
On remaining \$500,000 of income - 27%	\$ -	\$ 135,000
Total corporate income tax	\$ 65,000	\$ 200,000
Remaining cash to be paid as dividend to Mr. Apple:		
Non-eligible dividend	\$ 435,000	\$ 440,000
Eligible dividend (from GRIP balance - 0.72 of income subject to general corporate rate)	\$ -	\$ 360,000
<i>Total dividend</i>	<i>\$ 435,000</i>	<i>\$ 800,000</i>
<i>Personal income tax</i>		
On salary - 44%	\$ 220,000	\$ -
On eligible dividend - 24.81%	\$ -	\$ 89,316
On non-eligible dividend - 33.33%	\$ 144,986	\$ 146,652
Total personal income tax	\$ 364,986	\$ 235,968
Net after-tax proceeds to Mr. Apple		
Dividend	\$ 435,000	\$ 800,000
Bonus	\$ 500,000	\$ -
Personal taxes	\$ (364,986)	\$ (235,968)
Net after-tax proceeds	\$ 570,015	\$ 564,032
<i>Effective tax rate</i>	<i>43.0%</i>	<i>43.6%</i>

Due to the lower personal tax rates on eligible dividends, there is almost no difference between not bonusing-down and bonusing-down in terms of net after-tax proceeds once the income is repatriated to the hands of Mr. Apple. This is consistent with the policy intent of integration and tax neutrality behind the eligible dividend regime. Therefore, bonusing-down to the small business limit is no longer the default strategy today and the form of remuneration now depends largely on the OM's personal needs. To the extent the OM does not require funds for personal consumption, it would generally be preferable to retain income in the corporation to achieve a deferral of personal tax (corporate general rate at 27 percent, versus 44 percent if salaried to Mr. Apple). Obviously practitioners in each province should model out their own tax calculations for different remuneration strategies as tax rates differ between each province.

Old rule of thumb: bonus income to small business limit for active CCPC.

New rule of thumb: retain income in corporation except as needed personally.

b) Selling Shares versus Selling Assets

Prior to 2006, practitioners across Canada typically advised their OM clients who were looking to divest from their business to sell shares and not corporately-owned assets. The tax reasons were primarily that

- i) the seller may benefit from the lifetime capital gain exemption if the shares were “qualified small business corporation shares” (QSBC shares);⁷⁴
- ii) selling shares that were capital property triggers a capital gain that is includable in the OM’s income at one-half, which allowed for a better tax result than if the corporation realized gains on goodwill and the proceeds were repatriated to the OM as a combination of capital and taxable dividends;⁷⁵ and
- iii) there was no opportunity to defer tax on capital gains earned by a CCPC because of the RDTOH rules.⁷⁶

Since the purchaser would lose the benefit of the depreciation or tax shield on an asset purchase, the purchaser would generally offer a lower price for a purchase of shares. The vendor OM would then have to weigh all the tax and non-tax factors to conclude on an acceptable structure for the sale.

Today, when advising an OM on a sale of business, practitioners must consider the impact of the eligible dividend regime. For a CCPC and ignoring the application of small business rates, gain on a sale of eligible capital property (ECP) such as goodwill results in income taxed at the regular corporate rate,⁷⁷ which generates GRIP at the general rate factor (0.72 for taxation years after 2011) from which eligible dividends can be paid. Combined with a private corporation’s ability to pay capital dividends, selling goodwill assets at the corporate level has become substantially more attractive under the eligible

⁷⁴ Subsection 110.6(2.1) provides for a capital gains deduction up to a lifetime limit of \$375,000 against taxable capital gains arising from disposition of QSBC shares. The 2013 federal budget proposes to increase the deduction to \$400,000 for the 2014 taxation year and index this amount to inflation for subsequent taxation years. The requirements for shares to qualify as QSBC shares are contained in the definition of a QSBC share in subsection 110.6(1).

⁷⁵ Subsection 83(2) permits a private corporation to elect to pay tax-free capital dividend to the extent of its “capital dividend account” (CDA) – defined in subsection 89(1). A corporation’s CDA keeps track of various tax-free surpluses which includes, but are not limited to, the non-taxable portion of a capital gain (less the non-deductible portion of capital losses), the non-taxable portion of the disposition of “eligible capital property” (defined in subsection 14(5) and includes intangible goodwill), the receipt of capital dividends from another corporation, and the net proceeds of a life insurance policy.

⁷⁶ At a high level, the RDTOH regime can be described as follows: “aggregate investment income”, which is defined in subsection 129(4) to include income from property and taxable capital gains, that is earned by a CCPC is not entitled to the general rate reductions provided by subsection 123.4(2) and is subject to an additional refundable tax of 6.67% under section 123.3; however, 26.67% of the aggregate investment income is included in RDTOH – see definition of RDTOH in subsection 129(3) – which is refundable to the CCPC pursuant to subsection 129(1) at a rate of 1/3 of taxable dividends paid by the CCPC. In essence, the RDTOH regime causes a refundable tax to be paid by a CCPC on property income and capital gain in the year it earned the income or gain thereby eliminating any tax deferral that is usually possible when business income is retained in a corporation.

⁷⁷ Where a taxpayer disposes of an ECP, subsection 14(1) will generally provide that one-half of the gain on the eligible capital property be included in the taxpayer’s income from business. ECP is defined in subsection 14(5), and Canadian courts have generally accepted that goodwill is ECP.

dividend/GRIP regime. Where the inherent gain to each shareholder is below or does not significantly exceed \$750,000, the best option often continues to be a share sale since the taxable capital gain arising on the sale will be fully or substantially sheltered by each shareholder's lifetime capital gain exemption (unless the discount on the negotiated purchase price on a share sale is greater than the tax savings). Where the old rule of thumb to sell shares may not ultimately provide the best decision for the OM vendor is when the gain in question significantly exceeds the capital gain exemption limit or if the vendor is not entitled to the capital gain exemption.

To illustrate, we will compare an asset sale and a share sale in Alberta under the old rules in 2005 and under the current rules as they apply in 2013. Assume an Alberta-resident individual vendor (Mr. Orange) who is at the highest personal marginal tax rates and has no lifetime capital gains exemption available. Mr. Orange owns all of the issued shares of an Alberta-resident CCPC (Opco). The business of Opco has done well and Mr. Orange estimates that it has appreciated \$100,000 in value. To simplify the calculations, we will assume that the entire value of the business is attributable to internally-generated goodwill and that Opco has other income in the year that fully utilizes any small business deduction.

	<u>2005</u>	<u>2013</u>
<u>Share sale</u>		
Mr. Orange's capital gain	\$ 100,000	100,000
Personal tax - 39% on the \$50,000 taxable portion	\$ 19,500	\$ 19,500
Net after-tax proceeds to Mr. Orange	\$ 80,500	\$ 80,500
<u>Asset sale (goodwill)</u>		
<u>Opc's level</u>		
Proceeds on sale of goodwill	\$ 100,000	\$ 100,000
2005 corporate tax - 33.6% on the \$50,000 taxable portion	\$ 16,810	
2013 corporate tax - 25% on the \$50,000 taxable portion		\$ 12,500
Proceeds available for repatriation to Mr. Orange		
Capital dividend (from CDA - non-taxable portion of sale)	\$ 50,000	\$ 50,000
Pre-2006 taxable dividend/Non-eligible dividend	\$ 33,190	\$ 1,500
Eligible dividend (from GRIP balance - 0.72 of income from goodwill sale subject to general corporate rate)		\$ 36,000
<i>Total dividend</i>	\$ 83,190	\$ 87,500
<u>Mr. Orange's level</u>		
2005 personal tax on taxable dividend - 24.1%	\$ 7,999	
2013 personal tax on non-eligible dividend - 27.71%		\$ 416
2013 personal tax on eligible dividend - 19.29%		\$ 6,944
Total personal taxes	\$ 7,999	\$ 7,360
<u>Net after-tax proceeds to Mr. Orange</u>		
Dividend	\$ 83,190	\$ 87,500
Personal taxes	\$ (7,999)	\$ (7,360)
Net after-tax proceeds to Mr. Orange	\$ 75,191	\$ 80,140
Difference in net after-tax proceeds	\$ 5,309	\$ 360

Under the old regime, Mr. Orange was able to increase his net after-tax proceeds by \$5,309 by selling shares instead of selling the corporately-owned goodwill at Opc's level. Today, the difference in tax cost between the two alternatives is close to nil. Again, practitioners should run the numbers as applicable to their province and their clients' specific facts (e.g. existing tax attributes, recapture on depreciable property, etc), but the overall result should be similar. In that light, given that a purchaser is usually willing to offer a higher price for an asset purchase due to tax shield consideration and the fact that it does not have to inherit potential hidden liabilities of the seller's corporation, the new rule of thumb now is to sell assets and not shares unless the gain is substantially sheltered by the vendor's lifetime capital gains exemption.

Another related consideration is how the eligible dividend regime may impact purification strategies in respect of a share sale. As discussed previously, the eligible dividend rules encourage corporations to maintain corporate earnings to maximize deferral opportunities. Therefore, corporations are more likely to accumulate excess cash which may, over time, cause the corporation to be off-side of the small business corporation test and the 24-month period asset test that are required to be met for the shares to be considered QSBC shares.⁷⁸ Therefore, if utilizing the capital gains exemption is an objective on an eventual sale, it is more important that purification strategies be considered well ahead of the sale.

Old rule of thumb: sell shares not assets.

New rule of thumb: sell assets not shares, if beyond capital gains exemption limits.

c) Selling Tangible Assets versus Selling Intangible Assets

Prior to 2006, it was a general rule-of-thumb that on a sale of corporately-owned assets, the vendor should allocate as much proceeds as possible to capital properties (which gives rise to capital gains) rather than to goodwill (which is an ECP, a gain on which gives rise subsection 14(1) income inclusion).⁷⁹ The reason was that the RDTOH regime provided a better net tax result than corporately-earned subsection 14(1) income.

To illustrate, we will refer to the preceding numeric illustration for Mr. Orange. If the \$100,000 gain related entirely to Opco's capital property rather than goodwill and Mr. Orange opted for an asset sale at Opco's level, the net after-tax proceeds to Mr. Orange would have been \$80,132 if the sale took place in 2005 (compare to \$75,191 if Opco had sold goodwill asset). This resulted in Mr. Orange being \$4,941 ahead than if Opco sold goodwill asset.

Today, ignoring the application of small business rates, a CCPC's income under subsection 14(1) – i.e. gain on goodwill – generates GRIP at the general rate factor (0.72 for taxation years after 2011) from which the CCPC may pay eligible dividends. As a result, the net tax cost of a sale of ECP at the corporate level is substantially similar to the net tax cost of a sale of capital property at the corporate level. If the sale took place in 2013 and Opco sold capital property for a \$100,000 gain, the net after-tax proceeds to Mr. Orange would be \$79,639, which is substantially similar to \$80,140 when the proceeds were allocated to gain on goodwill (results will vary slightly across the provinces, but the overall result should be similar). Since there is no longer any absolute tax savings by allocating proceeds to capital gains, the bias now should be towards allocating proceeds to gain on ECP's such as goodwill to the extent possible. This is because by avoiding the RDTOH regime, subsection 14(1) income provides the opportunity for tax deferral if the OM is willing to retain the cash in the corporation. That said, any allocation of proceeds must be reasonable or it could be challenged by the CRA under section 68.

⁷⁸ The definition of QSBC shares in subsection 110.6(1) requires that the shares meet three tests: i) the share must be a "small business corporation" share – defined in subsection 248(1); ii) the share must meet a 24-month holding period requirement test; and iii) throughout a 24-month period, more than 50% of the fair market value of the underlying assets must be used principally in an active business carried on primarily in Canada. These tests are complex and a detailed discussion is beyond the scope of this paper.

⁷⁹ Supra, note [77].

When advising on a sale of ECP, practitioners should be aware of the timing of CDA inclusion. Since subsection 14(1) refers to an excess amount included in income at the end of the taxation year, the addition of the non-taxable portion to the corporation's CDA does not occur until the end of the year of the sale. Consequently, the CDA cannot be paid out as capital dividend until the first day of the following taxation year. In order to accelerate the addition to CDA, an election under subsection 14(1.01) may be possible to deem the corporation to have realized a capital gain on the date of sale.

Old rule of thumb: on a sale of assets, allocate as much as possible to capital gain.

New rule of thumb: on a sale of assets, allocate as much as possible to goodwill.

d) Investment Income Earned Personally (or Through a CCPC) versus Investment Income Earned Through non-CCPC

Prior to the eligible dividend regime, the rules-of-thumb for tax practitioners in respect of investment income were:

- 1) for most individuals, there were no tax advantage to establishing a CCPC solely for the purpose of earning investment income since the RDTOH regime prevents tax deferral and achieves integration so that the net tax result is very close to personally-earned investment income; and
- 2) on the flip side, for a CCPC that was earning income beyond the small business limit and could not, or did not wish to, bonus-down to the small business limit, there is a strong preference for it to earn investment income to achieve integration through the RDTOH regime, as opposed to earning business income subject to the general corporate rate and then repatriating the cash as taxable dividends (which, as we discussed earlier, results in an absolute tax cost significantly higher than for income that was personally earned).

Today, the first rule still rings true as investment income does not add to a CCPC's GRIP balance and therefore the eligible dividend regime does not apply to such income. The second rule, however, is no longer sound, since business income earned by a CCPC does achieve integration even if the income is subject to the general corporate tax rate. As such, there is now a disincentive for a CCPC to earn investment income, since investment income triggers the RDTOH regime which prevents the ability to defer tax yet no longer offers any absolute tax savings over business income subject to the general corporate rate. In that vein, a new rule-of-thumb for a CCPC earning investment income should be to convert that income to active business income to the extent possible. Of course, the "tax tail" should never "wag the dog", but if the nature of the CCPC's activities in earning the income is active to some degree, it is worthwhile to examine whether there are sufficient arguments to support a characterization of business income.⁸⁰ If the CCPC carries on a "specified investment business" (SIB) and is considering its human resources requirements,⁸¹ being excluded from the definition of a SIB so that

⁸⁰ Whether income is derived from business or property is a question of fact, and courts have primarily focused on the range of service offered and the level of activity in making this determination.

⁸¹ "Specified investment business" is defined in subsection 125(7).

the income may generate GRIP could add an incentive to increasing the number of its full-time employees to more than five.

Further, because of the eligible dividend/LRIP regime, it is now preferential to earn investment income through a corporation that is not a CCPC (a non-CCPC). The RDTOH rules do not apply to a non-CCPC and any income or taxable capital gain earned by a non-CCPC is subject to the general corporate tax rates.⁸² Since the corporation is a non-CCPC, it can designate eligible dividends to the extent it does not have a LRIP at the time the dividend is paid. Managed properly, a non-CCPC can be kept from having any LRIP (normally, LRIP only arise upon conversion from a CCPC or from receiving non-eligible dividends from another corporation; note that investment income is added to LRIP under element D of the LRIP definition in subsection 89(1), but that only applies if the non-CCPC is a CCPC that has elected to be treated as a non-CCPC). This structure should achieve a net tax cost that is equivalent to personally-earned investment income (because the eligible dividend regime provides for integration), but there would be the added benefit of having the ability to defer personal tax by retaining the income in the corporation.

There are generally two approaches to setting up this type of non-CCPC structures: i) having the investment income earned by a corporation whose mind and management resides outside of Canada, or ii) having the investment income earned by a corporation that is controlled by a non-resident person (which could be a foreign corporation or a foreign trust). The main issues with undertaking either of these approaches is the administrative cost and practical difficulty of keeping mind and management of the corporation, or of the non-resident person, offshore, and potentially subjecting the income to taxation by foreign jurisdictions. A potential solution to partially mitigate these issues is to rely on paragraph 251(5)(b) which provides that a right under a contract to acquire shares or voting rights of a corporation is deemed to have been exercised for purpose of determining CCPC status. Therefore, a Canadian corporation is not a CCPC if a non-resident corporation (or trust) holds an option to acquire voting control, or shares sufficient to constitute control, in the Canadian corporation. Structured this way, the income of the corporation should remain outside of the foreign jurisdiction's tax net, and it may be administratively and practically easier to maintain offshore residency since the activity of the option-holding non-resident would be minimal.

It is possible (even likely) that this type of structure will be targeted by the Department of Finance in the future. For instance, the government could propose tax rate increase for a non-CCPC earning investment income. Therefore, before entering into such a structure, it is advisable to consider how the structure can be unwound in the future if unfavorable rules are proposed or if circumstances change. However, while a corporation that becomes controlled by a non-resident person may be able to retain its CDA provided that it remains a private corporation,⁸³ a corporation that was originally controlled by non-

⁸² According to its definition in subsection 123.4(1), "full rate taxable income" only excludes aggregate investment income if the corporation is a CCPC. Therefore, a non-CCPC's full rate taxable income includes income from property and taxable capital gains, and the income will therefore be entitled to the general rate reductions under subsection 123.4(2). Further, aggregate investment income is only subject to the RDTOH regime under section 123.3 and paragraph (a) of the definition of RDTOH if it is earned by a CCPC.

⁸³ "Private corporation" is defined in subsection 89(1).

residents but becomes a CCPC other than by a change in residence of its shareholders is required to reset its CDA to zero at the time of the change in control.⁸⁴ Therefore, prior to any conversion of a non-CCPC back to a CCPC, it would be prudent to consider the corporation's CDA and the possibility of paying out the capital dividend prior to conversion provided that the anti-avoidance provisions of subsection 83(2.1) and paragraph 83(2.2)(d) do not apply.

Old rule of thumb: earn investment income personally rather than through an investment holding company; for CCPC's, strong preference to earn investment income for RDTOH integration to avoid double tax.

New rule of thumb: earn investment income in a corporation that is a non-CCPC and retain funds in the corporation.

e) Tax on Death Becoming a Larger Issue

Upon death, an individual is deemed to have disposed of all capital property for proceeds of dispositions equal to the fair market value of the property pursuant to subsection 70(5). Also, depending on the province, if property passes through probate, the estate may be subject to probate fees based on the fair market value of the property. In the past, taxes payable on a deemed disposition arising from death would be somewhat mitigated by the active CCPC's standard practice of bonusing-down. Since the ability to pay eligible dividends from GRIP under the current regime encourages CCPC's to retain income in the corporation, private companies are now more likely to increase in value due to deliberate accumulation of equity in the corporation.

Since private corporations will likely increase in value under the current regime, tax on death is now a more significant issue to OM's and their advisors.

Old rule of thumb: tax on death issue minimized due to bonus-down practices.

New rule of thumb: tax on death becomes a larger issue due to deliberate accumulation of funds in corporation.

f) Increased Importance of Estate Freezes and Use of Trusts

Estate freezes and the use of trusts to implement them have always been part of a tax practitioner's succession and estate planning toolkit. A typical estate freeze transaction involves an exchange of existing common shares in a private corporation into fixed value redeemable preferred shares (the freeze shares). The exchange usually occurs on a tax-deferred basis pursuant to the rules of section 85, 86 or 51, or by issuing a stock dividend, and the exchange usually has the effect of assigning all the value of the corporation to the freeze shares. Then, a family trust with the freezor's family members as beneficiaries, subscribes for new common shares (the growth shares) in the corporation for a nominal amount.

⁸⁴ Subsection 89(1.1) requires a deduction from the CDA of the new CCPC the amount that was in the corporation's CDA immediately before the change in control.

This creates a floor for the beneficiaries of the trust with regards to their future taxation of the company's value. Some income splitting objective may be achieved since future value growth will be taxed at the beneficiaries' marginal rate (assuming the kiddie tax does for split income)) and potentially be sheltered by their lifetime capital gains exemptions.⁸⁵ The freeze also allows the freezor to manage and plan his terminal income tax and probate fees liability upon death since the value of the freeze shares will not be affected by future growth of the business and could be redeemed during his lifetime through a so-called "wasting estate freeze" plan.

Under the current regime, the incentive for private corporations to accumulate funds will likely cause the growth of the value of their shareholder's equity to accelerate. Without proper planning, unanticipated and substantial tax could be triggered upon death of the OM or upon succession by the next generation due to the value built-up on the shares held by the OM. Therefore, estate freezes and the use of trusts in implementing estate freezes are now even more important as planning tools.

Old rule of thumb: estate freezes and use of trust somewhat beneficial, but only if corporation appreciates in value.

New rule of thumb: estate freezes and use of trust more important as private corporations will increase in value if funds accumulate.

g) Creditor Proofing More Important

In the past, when it was standard practice for active CCPC's to bonus-down to their small business limits, the funds were often loaned-back to the CCPC to be reinvested in the business. This had the additional benefit of being a straight-forward and effective method of creditor-proofing since it made the OM a creditor of the CCPC and kept the CCPC's net equity low. With the current eligible dividend regime, bonusing-down is no longer the default remuneration strategy while private corporations will be more likely to accumulate excess cash. Therefore, OM's and their advisors need to factor creditor-proofing into their ever growing list of planning considerations. A traditional method of creditor-proofing is for the operating company to pay a dividend to a connected holding company which then loans the dividend proceeds back to the operating company. Provided that subsection 55(2) has been considered,⁸⁶ such transaction is still effective today and should not result in negative tax implications since the holding company should be entitled to the section 112 deduction and Part IV tax should not apply between connected corporations.⁸⁷

⁸⁵ Supra, note [16] and [17].

⁸⁶ Subsection 55(2) is an anti-avoidance rule aimed at "capital gains stripping", whereby a capital gain would be turned into an intercorporate dividend that would be tax-free before of section 112. A detailed discussion of section 55 is beyond the scope of this paper.

⁸⁷ Assuming that the payment of the dividend to the connected corporation has not triggered a dividend refund. A private corporation is subject to Part IV tax at 1/3 of the dividend received from another corporation if it is not "connected" with the other corporation. For this purpose, the concept of "connected" is described in subsections 186(2) and (4).

Consider also a more sophisticated structure that involves employing trusts with corporate beneficiaries. Typically, this involves adding a corporation (Investco) as a discretionary beneficiary of a family trust, and the trust subscribes for shares in an operating company. Over time, the operating company pays out excess cash as dividends to the trust, which then distributes them out to Investco.⁸⁸ Such dividends are received free of Part I and Part IV tax by Investco,⁸⁹ provided that Opco is connected with Investco.⁹⁰ Investco may then invest the cash in other ventures or loan it back to the operating company. This strategy achieves creditor proofing objectives and provides for great flexibility in terms of cash deployment particularly if there are multiple Investco beneficiaries. However, such plans do increase complexity and administration costs, and carries potential traps if not properly planned (e.g. the Investco's not being connected with the dividend payer thus triggering Part IV tax) but could be an elegant solution depending on the OM's specific facts and circumstances.

Old rule of thumb: creditor-proofing is important, bonus and loan-back is an easy way.

New rule of thumb: creditor-proofing now even more important, consider dividend to holding company and loan-back, or use trust and corporate beneficiary structure.

h) Choice Between Post-Mortem Pipeline versus Subsection 164(6) Capital Loss Carry-Back More Nuanced

Subsection 70(5) deems a taxpayer, immediately before death, to have disposed of all capital property for proceeds of disposition equal to the fair market value of the property. Therefore, when an OM who owns shares of a private corporation passes away, the OM would typically realize a capital gain on the deemed disposition of those shares immediately before death (unless he/she has high ACB in those shares which is unlikely to be the case if the OM started the business long in the past). The heirs of the OM will inherit the shares at ACB equal to the fair market value at the date of the OM's death. In most cases, the heirs will not be able to sell the inherited shares to a third party. Therefore, to access the value, the corporation will either have to pay a dividend or redeem the shares and wind-up, resulting in income inclusion to the heirs either as regular dividend income under subsection 82(1) or deemed dividend income under subsection 84(2) or (3).⁹¹ Arguably, this represents double taxation since the value of the dividend or redemption/winding-up proceeds has already been taxed once as capital gains on the terminal return of the deceased OM as a result of the deemed disposition.

⁸⁸ Supra, note [16].

⁸⁹ Subsection 104(19) allows the character of dividend income to be preserved when flowed through to a beneficiary. Thus, a corporate beneficiary can benefit from the subsection 112(1) deduction against the dividend income.

⁹⁰ Subsection 186(4) provides that a dividend payer is connected with a dividend recipient if the payer corporation is controlled by the dividend recipient. Subsection 186(2) modifies the concept of control for purposes of subsection 186(4) so that one corporation is controlled by another corporation if more than 50% of its voting shares belongs to the other corporation or to persons with whom the other corporation does not deal at arm's length. Further, subsection 55(2), an anti-avoidance provision against "capital gains stripping", may apply to deem the dividend to be a taxable capital gain in certain circumstances.

⁹¹ Generally speaking, if winding-up proceeds or redemption proceeds exceed the paid-up capital in respect of the shares, subsection 84(2) or (3) applies to deem the excess as a dividend.

There are typically two strategies commonly used by executors of estates to avoid this double-taxation: the subsection 164(6) capital loss carry-back strategy and the post-mortem pipeline strategy.

Regarding the first strategy, subsection 164(6) provides a taxpayer with the possibility of carrying back an estate's capital loss, resulting from a winding-up or a redemption of the shares of the capital stock of a private corporation, to offset the deemed capital gain realized by the deceased. This planning must be implemented within the first taxation year of the estate. The result of this strategy is to eliminate the capital gain arising on the deemed disposition by the deceased and to characterize the taxation on the extraction of the company's value as deemed dividends.

The second strategy is the post-mortem pipeline strategy. Under the pipeline strategy, an estate sells its shares in a private company to a new company (Newco) in exchange for a promissory note. The private corporation later winds-up into Newco, and Newco uses the wind-up proceeds to repay the promissory note owing to the estate or the beneficiaries of the estate. The sale of the shares by the estate to Newco does not result in any capital gain to the estate since the fair market value for the shares should usually be the same as their ACB, i.e. the fair market value at date of death. The result of this strategy is to avoid any deemed dividend to the estate and to characterize the taxation on the extraction of the company's value as capital gains.

Prior to the introduction of the eligible dividend regime in 2006, tax rates on taxable dividends significantly exceeded those on capital gains in most cases. For example, in 2005, the effective top personal rate on taxable dividend was 24.1 percent in Alberta and 28.3 percent in Saskatchewan, whereas the rate for capital gains was 19.5 percent in Alberta and 22 percent in Saskatchewan. Consequently, all things being equal, the preference was towards using the pipeline strategy in order to have the extraction of the company's value be taxed as capital gains rather than as dividends particularly if the company had no significant RDTOH or CDA.

However, the introduction of the eligible dividend rules has resulted in a situation in some provinces where the tax on eligible dividends are close to that of capital gains. In Alberta, the two rates are effectively the same: 19.29 percent tax on eligible dividends and 19.5 percent tax on capital gains. However, in some provinces such as Manitoba, the rate on capital gains is still substantially lower: 32.27 percent on eligible dividends versus 23.2 percent on capital gains for 2013. Consequently, where a corporation has sufficient GRIP, the executor needs to consider the tax treatment of dividend income versus capital gains for the applicable province. For Alberta, there is no clear bias between the two strategies, but in Manitoba, the preference would be towards capital gains, i.e. the pipeline strategy. In making this determination, the executor must also consider the corporation's RDTOH and CDA balances. Where the corporation has significant RDTOH or CDA, it will generally be beneficial to recover these amounts regardless of whether or not the corporation has a GRIP balance. The subsection 164(6) capital loss carry back planning allows for the extraction of CDA and refund of the RDTOH balance while pipeline planning does not.

Finally, in contemplating a pipeline strategy, one should consider the risk of subsection 84(2) applying to the transactions. Subsection 84(2) deems a dividend to have been paid where funds or property of a

corporation have been distributed or otherwise appropriated in any manner whatever to or for the benefit of shareholders on the winding-up, discontinuance or reorganization of its business. If subsection 84(2) applies, it would deem the estate to have received a dividend thereby defeating the purpose of the pipeline transaction. It appears that the CRA's previous administrative position was that subsection 84(2) would not apply to pipeline strategies. However, in recent rulings, the CRA has stated that subsection 84(2) may apply since the corporation is effectively paying a dividend to the estate on the winding-up of the business. It appears that the distinguishing feature between the previous and recent rulings was that in the positive rulings (that subsection 84(2) would not apply) the corporation would remain a separate entity for one year and continue to carry on business during that period.⁹²

However, in the recent FCA's decision of *HMQ vs MacDonald*,⁹³ the FCA found that subsection 84(2) applied to a transaction that is very similar to a vanilla pipeline strategy. The FCA took a very broad approach to subsection 84(2) by relying on the words "in any manner whatever" contained in the provision and looked past the legal form of the transactions to see if funds or property of a corporation find their way into a shareholder's hands, even if they happen to pass through intermediary third parties and change in character to a debt repayment on a share sale. This wide interpretation of subsection 84(2) seems debatable to us, as there are more specific provisions in the Act that appear to target pipelines such as section 84.1. General statutory interpretation principles would indicate that a general provision such as subsection 84(2) should not have application when a specific provision like section 84.1 does not apply. There is no doubt that the CRA will be happy with the FCA decision and use it to suggest that its recent comments regarding pipeline transactions have been correct. Therefore, this decision (pending a possible appeal to the SCC) will need to be considered when implementing pipeline transactions whether in a post-mortem or an *inter vivos* context. Accordingly, a pipeline transaction with an immediate distribution of the funds is likely to attract the application of subsection 84(2) given the reasoning in the FCA decision of *MacDonald*.

Old rule of thumb: on death, use post-mortem pipeline to avoid double taxation unless significant CDA or RDTOH.

New rule of thumb: on death, weigh the merits of both the pipeline strategy and the subsection 164(6) capital loss carry-back strategy and for pipelines, manage subsection 84(2) risk by holding off on distribution for at least one year.

i) Safe Income Strip Will Become More Common

A taxable gain on the disposition of the operating company shares may be reduced if, prior to the sale, the operating company pays tax-free intercorporate dividends to a connected holding company up to

⁹² See CRA Rulings 2002-0154223 and 2005-0142111R3, and CRA External Interpretation no. 2006-0170641E5.

⁹³ 2013 FCA 110

the amount of the operating company's "safe income" (a "safe income strip").⁹⁴ Generally speaking, safe income can be thought of as the aggregate amounts of historical income for tax purposes attributable to a particular share and not distributed to a shareholder.⁹⁵ Provided that the dividends paid do not exceed the operating company's safe income, the dividends will not be recharacterized as a gain or as proceeds of disposition under subsection 55(2).

In the past, an active CCPC's standard practice of bonusing-down minimized the opportunity to strip safe income since the practice kept retained earnings (and therefore safe income) low. However, as private corporations deliberately retain earnings in the corporation to take advantage of the tax deferral opportunity under the current regime, it will become more important for practitioners to be mindful of opportunity to strip out safe income prior to sale transactions.

Old rule of thumb: safe income strip not common as low retained earnings.

New rule of thumb: safe income strip more common as earnings are accumulated over time.

j) Insurance More Important

To fund tax liabilities on death, estate planning strategies often involve obtaining sufficient life insurance to cover the tax on latent capital gains on the shares held by the OM. Under the current regime, private corporations are more likely to accumulate earnings, thereby increasing the value of their issued shares. Therefore, it will be prudent for OMs to monitor the earning accumulation in their corporations and increase life insurance coverage accordingly over time if available and if the cost does not exceed the benefit.

Old rule of thumb: insurance to cover capital gains tax on value of company operations.

New rule of thumb: increase in insurance to cover funds accumulated.

3. Common issues when Designating Eligible Dividends

a) Timing of GRIP calculation and eligible dividend

The GRIP of a CCPC is calculated at the end of the corporate tax year.⁹⁶ This creates a timing issue because a CCPC can declare dividend at any time in the year, and an eligible dividend must be designated at the time of payment. This creates difficulty in practice since the corporation may not know at the time of the dividend declaration how large its GRIP balance will be by the end of the year, and it may not have the ability to control or affect the components in calculating GRIP. This issue has now been somewhat mitigated by the new late designation and partial designation provisions discussed below.

⁹⁴ Section 112 provides a full deduction for taxable dividends received from taxable Canadian corporations, but subsection 55(2), an anti-avoidance provision against "capital gains stripping", may apply to deem the dividend to be a taxable capital gain in certain circumstances. Paying dividend from "safe income" is one of the exceptions from the application of subsection 55(2).

⁹⁵ The Act does not contain a definition of "safe income" and its computation is complex.

⁹⁶ The preamble for the definition of GRIP in subsection 89(1) refers the GRIP calculation at the end of a particular taxation year.

b) *Method of designation*

In accordance with subsection 89(14), a corporation has to designate each eligible dividend that it pays, and notifies shareholders in writing that the dividend is eligible. As a transitional measure, the CRA accepted identification of eligible dividends on T3 and T5 slips as sufficient designation for the 2006 year. For 2007 and subsequent years, this is no longer an acceptable method of designation. For public corporations, the CRA would accept that proper notification has been made if the corporation made a blanket designation that all dividends are eligible unless otherwise indicated (since public corporations can designate any taxable dividends as eligible dividends unless it has LRIP). For corporations other than public corporations, the notification requirements must be met each time a dividend is paid (but see new measures allowing late designation below), and the CRA has listed the following as examples of notification that will be compliant with subsection 89(14): identifying eligible dividends through letters to shareholders and dividend cheque stubs, or where all shareholders are directors of a corporation, a notation in the minutes.⁹⁷

c) *Late and partial designation of eligible dividend*

Prior to measures proposed by the 2012 federal budget, the notification to each shareholder of an eligible dividend designation must be made at the time of payment and the designation cannot be late-filed. In addition, the Act did not provide for partial designation of a portion of a single dividend to be designated as an eligible dividend and the remainder as a non-eligible dividend. Therefore, if only a portion of a dividend was attributable to GRIP, a corporation could not designate that dividend as an eligible dividend. To overcome this practical challenge, it was common place for corporations to declare multiple smaller dividends in order to reduce the consequences to shareholders should an eligible dividend be improperly declared.

In response to these issues, the government proposed in its 2012 federal budget to allow for late designation and for partial designation. These came into law effective for dividends paid after March 28, 2012. Subsection 89(14.1) enables the Minister to accept an eligible dividend designation that is filed up to three years after the day on which the dividend is paid if, in the opinion of the Minister, the circumstances are such that it would be “just and equitable” to permit such a late designation. To allow for partial designation, subsection 89(14) was amended to permit designation of a portion of a dividend as an eligible dividend.

Although the late designation is subject to the Minister’s discretion, these changes are still welcome relief that should ease the compliance burden and practical issues in connection with eligible dividend designations.

⁹⁷ CRA Views Document no. 2006-0217891Z0.

E. OTHER OM PLANNING TECHNIQUES TODAY

The balance of the paper will cover certain other OM remuneration planning techniques that continue to be useful today, as well as certain techniques that may be effective with proper planning but should carry with them a “buyer beware” warning.

1. Managing Shareholder Loan Debit Balances and Maximizing Cash Extraction From Corporations

If a shareholder has taken money out of the company and created a debit balance in the shareholder loan account, this has income tax consequences and managing such debit balance in part dictates the remuneration strategy. Where a shareholder has a debit balance, it can be assessed as income either under subsection 15(1) or (2).

Generally, when a shareholder of a corporation (or a person connected to a shareholder of a corporation) receives a loan from, or has become indebted to, the corporation (or any other related corporation), subsection 15(2) applies to include the amount of the loan or indebtedness in the income of the person. The income inclusion occurs in the year in which the loan is made, but there are a number of exceptions to the application of subsection 15(2). One exception is provided by subsection 15(2.6) which exempts loans that are repaid by the end of the second taxation year from which the loan arose and are not part of a series of loans repayments. The CRA does not appear to strictly enforce the series of loans and repayment rule, and provided the debit balances are “cleared out” by year-end it is usually sufficient for the exception to apply.⁹⁸ Another exception common in the OM planning context is for loans made for certain purposes (purchasing shares of the company from the company to be held by the shareholder, purchasing a car for use in employment duties, or purchasing a house, or a loan which is made in the normal course of business) and carry bona fide repayment terms.⁹⁹ However, per paragraph 15(2.4)(e), such specific-purpose loans cannot be made by virtue of a person’s position as a shareholder. Consequently, housing loans to major shareholders, which were popular prior to April 26, 1995, are generally not recommended since there is great risk that the loan would be considered to have been made for reason of the debtor’s position as shareholder and thus be assessed as income to the debtor.¹⁰⁰

Subsection 15(1) is applicable on appropriations of corporate property. Specifically it states that, subject to certain exceptions, at any time where a benefit is conferred on a shareholder (or on a person in

⁹⁸ See paragraph 29 of CRA Interpretation Bulletin IT-119R4 where the CRA stated that running loan accounts are not automatically considered a series. Also, in *Meeuse v R* [1994] 1 C.T.C. 2737, *Bowman J* confirmed this element of the term “series” with respect to what constitutes a “series of loans and repayments,” stating, “I do not think that a mere succession of loans is sufficient to constitute them a series without more.”

⁹⁹ Subsections 15(2.3) and (2.4).

¹⁰⁰ In CRA External Interpretation no. 2005-0159061E5, the CRA commented that a housing loan to a 50% shareholder / employee would ordinarily be considered to have been received by virtue of shareholdings, not employment. However, a benefit is considered conferred qua employee if it can be considered as part of a reasonable employee remuneration package, even in the case a home purchase loan where the shareholder-employee is the sole employee of a corporation – see CRA External Interpretation no. 2008-0270201E5.

contemplation of them becoming a shareholder) by a corporation, the value of the benefit is included in the income of the shareholder.¹⁰¹ Subsection 15(1) may therefore apply to shareholder advances if the advances are not in fact loans or indebtedness or if there is no documentation to support their nature as loans or indebtedness.

Neither the application of subsection 15(1) nor (2) produces a desirable result since the corporation obtains no deduction; yet the shareholder must report the entire amount as income. An eligible dividend or a non-eligible dividend from the corporation would have resulted in less tax since personal tax rates on dividends are always lower than on regular income. Thus, given the prospect of being subject to subsections 15(1) or (2), it is generally better to take a salary or dividend and to offset this against the debit balance. In addition, if the corporation has RDTOH, a dividend refund will be given for payment of a taxable dividend, whereas no relief will be given for an appropriation of property or a shareholder loan/indebtedness assessed as income. Also, if an amount is assessed under subsection 15(1), it is common for the CRA to attempt to apply the gross negligence penalty pursuant to subsection 163(2) as well. Further, unlike a subsection 15(2) income inclusion where the shareholder can make an offsetting deduction in the year of repayment of the loan/indebtedness (pursuant to paragraph 20(1)(j)), there is no similar relief for subsection 15(1) benefit income inclusion even if the benefit is subsequently reversed.

Even in situations where a shareholder debit balance does not give rise to benefits under section 15, section 80.4 may nevertheless be applicable to impute interest to the shareholder. Therefore, it is useful to close off debit balances early in the year or at various times during the year, rather than at the end of the year. To do so, dividends can be paid on a regular basis or paid early in the year, creating a credit balance at the beginning of the year which can be drawn against.

There are a large number of ways in which shareholder debit balances could be offset besides having the corporation pay a dividend or a salary to the shareholder personally. Some of the common ones include:

- the transfer to the corporation of other assets (usually illiquid assets);
- the recouping of the cost of the shareholder's investment in the company;
- offsets of debits and credits within a corporate group;
- a payment of a capital dividend (tax free to the shareholder)¹⁰²;
- reducing personal cash needs by defraying expenses to the corporation, which will reduce the build up of shareholder debit balances;
- a reduction of paid up capital in the shares of the corporation; or
- use of partnership structures instead of corporate structures.¹⁰³

¹⁰¹ Amendments have been proposed to subsection 15(1), one of which is to clarify that it applies to benefit conferred by a corporation on a member of a partnership that is a shareholder.

¹⁰² *Supra*, note [75].

¹⁰³ There are no parallel provisions to subsection 15(2) for loans from a partnership (except for a partnership in which a corporation is a member).

All of the above strategies can also be used to maximize the extraction of cash from a corporation if elimination of shareholder debit balances is not an objective or is not necessary. We will discuss a number of these strategies in more detail below.

a) *Transfer in Illiquid Assets*

One way to offset a debit balance is to transfer assets to the corporation in satisfaction of the amount owing. If a shareholder debit balance is not an issue, the shareholder can take back cash or a promissory note from the corporation as consideration. Real estate assets are useful for this purpose, especially if they are going to be retained long term and do not produce much in the way of income (as discussed earlier, there is no longer a preference for CCPC to earn income from property or capital gains since the RDTOH mechanism does not result in better integration that can otherwise be achieved through eligible dividends). Also, it is key that the real estate is not personal use property, otherwise, any personal use may be deemed as subsection 15(1) income to the shareholder.

For illustration, assume that John is the sole shareholder of a corporation and he has an outstanding shareholder debit balance that he would like to reduce. John also owns real estate capital property with fair market value of \$200,000 which is in excess of his ACB of \$100,000, and the real estate is not a personal use property. John could consider transferring the real estate to the corporation in full or partial satisfaction of the amount he owes the corporation – in other words, a repayment by a contribution in kind. The shareholder debit balance would be reduced by \$200,000, and John would incur a capital gain of \$100,000 on the transfer. Reducing shareholder debit balances (or extracting cash/promissory note) in this manner results in a lower tax cost than if it were to be done with a dividend or salary, since John is only subject to tax on the gain on the transferred asset (and not on the entire value extracted which would be the case for salary or dividend) and the tax rate on capital gains is more favourable than for eligible or non-eligible dividends (in most provinces).

Valuation may become an issue when determining the fair market value at which the asset is transferred, particularly if there is a lack of market value comparable. Potential GST / HST implications and land transfer tax liability should also be considered where the asset is located outside of Alberta.

b) *Repatriate Arm's Length ACB*

When planning for an OM's affairs, advisors often overlook the fact that the OM may have purchased shares of a company in an arm's length transaction (or at least a transaction in which no non-arm's length person claimed the section 110.6 capital gains exemption).¹⁰⁴ If so, the ACB of the shares can be recovered in a tax-free manner. To illustrate, assume John purchased 40 percent of the shares of an operating company (Opco) at arm's length for \$120,000, and assume that no non-arm's length person claimed the capital gains exemption (otherwise, section 84.1 needs to be considered – as we will

¹⁰⁴ The term "arm's length" is defined in subsection 251(1) in the negative—that is, by reference to circumstances in which persons will be considered not to deal at arm's length. "Related persons" are deemed not to deal with each other at arm's length, and rules governing "related persons" are contained in subsection 251(2).

illustrate in the next example). What can John do to extract cash from, or offset shareholder balance owing to, Opco without triggering negative tax implications?

John can set up a holding company (John Holdco) and transfer the shares of Opco on a tax-deferred basis to John Holdco under subsection 85(1). In exchange for the transfer, John can take back common shares of John Holdco and a note for \$120,000. After this, Opco can pay a dividend to John Holdco which provides a source of funds for repayment of the note, and John Holdco can claim a section 112 deduction against the full amount of the dividend. In this way, John can extract the amount he paid for the shares on a tax-free basis. Alternatively, if there is an outstanding shareholder debit balance between Opco and John, Opco can transfer \$120,000 of the shareholder receivable to John Holdco as a dividend in-kind, which John Holdco can in turn set-off against its note payable to John and no tax should be triggered as a result since Opco and John Holdco are connected (provided that subsection 55(2) does not apply).¹⁰⁵

It should be noted that a similar arrangement can work where a person inherits shares (say on death of a parent), provided the amount that is extracted does not derive from any non-arm's length persons' claiming of the section 110.6 capital gains exemption (otherwise section 84.1 can apply). Also, if subsections 26(3) and (7) of the Income Tax Application Rules (ITAR) applied to the shares, this can grind the ACB for purposes of section 84.1 as well.

For this reason, it is always important to know the history of a client's shareholdings.

What is the implication of a repatriation of "soft" ACB?

Section 84.1 is probably the most common cause of lawsuits against tax advisors for errors in tax planning. It applies where the ACB of shares is extracted (as previously described) and a non-arm's length person has claimed the capital gains exemption (or if ITAR 26(3) and (7) apply).

Suppose that John purchased the shares from his brother who claimed the capital gains exemption in respect of the \$120,000 sale price. If so, upon John transferring the shares to John Holdco and taking back a note for \$120,000, paragraph 84.1(1)(b) will deem John Holdco to have paid a dividend to John of \$120,000 on which John will be subject to tax.¹⁰⁶

Since subsection 84.1(1) is applicable for disposition to a non-arm's length purchaser corporation, a similar result can occur if John were to sell the shares to a related person who purchases them through a corporation (for instance, John's son purchasing those shares through his own holding company) and John takes back non-share consideration such as a note. In that case, John would be deemed by paragraph 84.1(1)(b) to have received his proceeds as a dividend and not capital gain. This can apply whether or not John claims the capital gains exemption under section 110.6. Given the large disparity

¹⁰⁵ Supra, note [86] and [90].

¹⁰⁶ John and his brother are related persons by reason of blood relationship – see subsections 251(6) and (2). Therefore, they do not deal at arm's length with each other per subsection 251(1).

between tax rate on capital gains and the tax rate on dividends for some provinces, this is now a bigger problem than it has been in previous years.

c) Offsets Within Group

In certain cases, an individual may have a debit balance from one corporation and a credit balance from another, or alternatively a close family member may have such a credit balance. In such circumstances, it may be possible to offset one balance against the other.

Suppose that John owns JohnCo. and John's wife, Mary, owns Spouse Co. JohnCo. has a shareholder debit balance of \$75,000 owing from John, whereas Spouse Co has excess cash and a shareholder credit balance owing to Mary for \$75,000. Here is the sequence of transactions that could be undertaken to offset John's shareholder debit balance with JohnCo. against the credit balance owed to Mary from Spouse Co:

- 1) Mary assigns her \$75,000 credit balance to John by way of a gift or possibly a sale for a note;
- 2) John assigns his \$75,000 receivable from Spouse Co to JohnCo. in exchange for JohnCo granting to him an amount payable of \$75,000.
- 3) At this stage, JohnCo has an amount receivable and an amount payable to John, and they undertake to offset them against one another.

The ending result would be that Spouse Co owes \$75,000 to JohnCo, but this generally has no negative tax issues since neither subsections 15(2) nor 80.4(2) apply to debts between two Canadian corporations. At the personal level, John may owe Mary a note payable for the amount that was transferred, or alternatively he may owe nothing if it was structured as a gift.

Documentation needs to accompany each of the steps in order to evidence the transaction and the parties' intentions, as it is not sufficient to simply contra the amounts to offset them. The legal formalities involved must be respected.

2. Remuneration Strategies

When designing remuneration strategies, there may be an opportunity to leverage existing tax attributes of the corporate group or convert what would otherwise be salary or dividend income into capital gains or gains on eligible capital property.

a) Leveraging RDTOH in the Corporate Group

Suppose John is the sole shareholder of both an operating business, JohnCo, and a business which generates refundable taxes (Invest Co). JohnCo has excess cash which John would like to pay out as either a salary or a dividend, and Invest Co has a RDTOH balance but no cash to distribute.

To maximize the tax efficiency of the remuneration plan, John can reorganize the structure of the group so that JohnCo is a subsidiary of Invest Co. A dividend may then be paid from JohnCo to Invest Co without attracting Part I or Part IV tax since subsection 112(1) provides for tax-free dividend between

corporations and subsection 186(1) does not apply Part IV tax on dividends between connected corporations.¹⁰⁷ With the dividend proceeds, Invest Co may in turn pay a taxable dividend to John thereby triggering a refund of RDTOH balance pursuant to subsection 129(1). If JohnCo has sufficient GRIP, it can designate its dividend payment as an eligible dividend, which will in turn allow Invest Co to make a similar eligible dividend designation on its dividend to John. Either eligible or non-eligible dividends will trigger a refund of RDTOH.

Under the existing structure, Invest Co pays tax at approximately 45 percent. With the reorganized structure and given that the dividend is paid, Invest Co receives a subsection 129(1) dividend refund of 26 2/3 percent of its income or one-third of the dividend. At the personal level, John will receive a dividend, either from JohnCo or Invest Co, so his personal tax is the same in either case. The tax savings from re-routing the dividend through Invest Co instead of being paid directly from JohnCo is derived from the dividend refund at the corporate level. However, potential application of subsection 55(2) should be considered whenever dividends are paid between corporations.

A drawback of holding an operating company through an investment holding company is that this may cause John to lose his eligibility to claim a section 110.6 deduction for disposition of QSBC shares.¹⁰⁸ To qualify under the definition of a QSBC share under subsection 110.6(1), various tests in respect of the proportion of active business assets versus other assets must be met. If John indirectly holds JohnCo through Invest Co, the shares personally held by John may no longer qualify for QSBC shares. This problem can be overcome by freezing JohnCo shares first and then transferring only targeted amount of preferred shares to Invest Co. As a result of this modified structure, John still holds sufficient JohnCo shares personally to allow him to fully benefit from the capital gains exemption, while the targeted preferred shares holdings in JohnCo by Invest Co allows dividends to flow from JohnCo through Invest Co to take advantage of RDTOH refund opportunities.

b) *Remuneration Through Capital Gains or Gains on ECP*

Earlier, we described as a cash extraction/shareholder debit management strategy where an OM personally owns illiquid asset (e.g. real estate), the OM could transfer the asset to a corporation in consideration for cash or a promissory note. Even if the transfer triggers capital gains, the tax cost is still lower than if the OM took funds out of the corporation as a salary or a dividend (the latter depends on the province).

A similar type of plan can be used to take advantage of latent gains in property held at the corporate level. As illustration, suppose that an operating company (AppleCo) owns an intangible asset with fair market value in excess of tax cost. If AppleCo disposes of the asset at fair market value to a related corporation for cash or a note payable, it will recognize a capital gain under subsection 39(1) or a gain on an ECP under subsection 14(1) depending on the nature of the intangible asset. Either way, the gain generates CDA at one-half for AppleCo, from which AppleCo can pay out a tax-free capital dividend to its

¹⁰⁷ Supra, note [90].

¹⁰⁸ Supra, note [74].

shareholder by virtue of subsection 83(2). A downside to this strategy is that the Act restricts the amount that a non-arm's length¹⁰⁹ purchaser can add to its cumulative eligible capital or its undepreciated capital cost pools to the transferor's cost plus one-half of its gain on the disposition.¹¹⁰

As mentioned previously, timing of the capital dividend payment needs to be considered if the gain arises from disposition of ECP since the addition of the non-taxable portion of such gain to the corporation's CDA does not occur until the end of the year of the sale. Also, if the gain is a capital gain and AppleCo is a CCPC, the gain will give rise to refundable tax and addition to RDTOH, whereas a gain from ECP is not considered aggregate investment income and therefore does not trigger similar implications.

3. Buyer Beware Planning: Planning With Management Fees

For years, OM's and their advisors have attempted to use management fees as a flexible form of remuneration and tax planning. Besides the basic objective of getting funds in the OM's personal hands, many have attempted to use management fees as the tools to achieve tax planning objectives such as income deferral (by using accruals and staggered year-ends), shifting of income to loss corporations, multiply access to small business limits (by paying management fees to the holding companies of unrelated shareholders), or to avoid payroll withholding requirements under the Act.¹¹¹

There are numerous issues that must be considered when using management fees as a remuneration and tax planning tool:

1) Are the management fees a sham?

To avoid finding of a sham, written management contracts should be entered into. Management fees should be evidenced by invoice and cheques that are actually issued – journal entries are not sufficient evidence (see for example the recent case of *Bibby v. R* where the judgement included the following telling statement: “Generally speaking, bookkeeping entries do not create reality”.¹¹²)

2) Are the management fees reasonable?

If management fees were not reasonable or if they were not incurred for the purpose of earning income from a business or property, section 67 or paragraph 18(1)(a) could deny the deduction of the payment of the management fees by the payer. The CRA's administrative policy on salaries to active shareholders as discussed earlier does not extend to inter-corporate

¹⁰⁹ Supra, note [104].

¹¹⁰ If the property is an ECP, proposed amendments in the definition of “cumulative eligible capital” (CEC) in subsection 14(5) restricts additions to the CEC pool of a non-arm's length acquirer. Parallel rules are contained in paragraph 13(7)(e) for depreciable property in respect of additions to underpreciated capital property.

¹¹¹ Subsection 153(1).

¹¹² *Bibby v R*, 2009 DTC 2116.

management fees and therefore cannot be relied on.¹¹³ Traditionally, the CRA generally accepts a 15 percent mark-up over cost in respect of management fees to a related company.¹¹⁴ That said, a company charging management fees should have employees or other resources that would support their ability to provide services at a level that is commensurate with the fees charged.

- 3) If the arrangement involves income deferral by means of payments and accruals to a related corporation(s), can such deferral be challenged?

Such arrangement could be challenged on the grounds that there is no substance to the management fees charged by the related company. Also, paragraph 12(1)(b) requires income inclusion of any amount receivable for services rendered even if not due (the “receivable” method), and if paragraph 12(1)(b) does not otherwise apply, the income may have to be included under subsection 9(1) in any case (the “earned method”).¹¹⁵

- 4) What are the GST implications?

GST issues should not be ignored just because it is a “wash”, as there may be timing issues in respect of GST payable on the management fee and the refund of input tax credit. Where applicable, HST implications should also be considered, especially for those for whom HST does not produce an input tax credit. In certain provinces, the applicable provincial sales tax legislation should also be reviewed for possible application.

In *Nielsen Development Co. Ltd v. Queen*,¹¹⁶ management fees paid to manage a hotel were paid by a corporation owned by the husband to another corporation which was owned by his spouse. The fees were challenged by the CRA as unreasonable, but the court disagreed and listed a number of factors to be considered in determining reasonability:

- the nature of the management services;
- whether the management was on site;
- how efficient the hotel operations were in comparison with similar hotel operations in similar markets;
- the effort devoted to, and the responsibility for budgeting, renovations, improvements, planning and execution, finances, and staff;
- profitability of the hotel;
- the presence or absence of a management services contract; and
- whether the management services corporation had any special expertise, training, or experience.

¹¹³ CRA Ruling no. 2001-0114993.

¹¹⁴ See Revenue Canada Roundtable, 1985 Canadian Tax Foundation conference report, p.49:10, q.18, and CRA Views Document no. 2010-0373441C6.

¹¹⁵ See CRA document no. 2003-0054061I7, February 20, 2004, and CRA document no. 2004-0070121E5, June 4, 2004, wherein the CRA states that its position regarding management fees is to follow the earned method or receivable method.

¹¹⁶ *Nielsen Development Co. Ltd v. HMQ*, 2009 DTC 1219 (TCC).

In the 2011 court decision of *Mark A. Sochatsky v HMQ*,¹¹⁷ the court found subsection 56(2) to apply to the taxpayer's management fee arrangements, resulting in double-taxation to the taxpayer. This case is interesting since many "management fee" cases involve the non-deductibility of "management fees" due to the fees not being reasonable or that the management fees have no business purpose. This is one of the only cases in recent memory where the CRA used subsection 56(2) of the Act to reassess the taxpayer.

With proper planning and properly supported by substance, management fees can be an effective tool in OM remuneration planning, but this tool is frequently misused and often subjects the OM to risk of reassessment – buyer beware!

4. Buyer Beware Planning: Planning With Trust Allocation and Deliberate Use of Subsection 75(2)

a) Income allocation to a lossco

Trusts are an important tool for tax practitioners especially given their inherent flexibility. Some aggressive "planning" that we have seen leverages a trust's flexibility in regards to income and capital distributions. Suppose that a discretionary trust has both individual and corporate beneficiaries, and the corporate beneficiary has substantial loss carry-forwards. During the year, the trust earned income and it distributed trust funds to an individual who is a capital beneficiary. By virtue of subsection 107(2), the capital distribution should be a tax-free receipt to the individual. In the same year, the trust allocates its income to the corporate beneficiary and it issues a promissory note in satisfaction of the allocation.¹¹⁸ The corporate beneficiary offsets the allocated income against its loss carry-forwards. As a result of this plan, funds are removed from a trust yet no tax is paid on the trust's income.

Potential risks for such plans include:

- For the income allocation to be deductible by the trust pursuant to paragraph 104(6)(b), the amount must have become payable in the year to the beneficiary. If the trust does not have sufficient asset remaining to satisfy the note it issued to the corporate beneficiary, then arguably the amount has not become payable to the beneficiary. Also, if the trust has no intention to repay the note, it is questionable whether the note is truly a liability.
- There is perhaps a risk that the individual has constructively received income. However, a recent CRA Round Table response may lend support that there is no constructive receipt of income. In the response, the CRA stated that subsection 56(2) will not apply to a trustee in respect of dispositions made in favour of discretionary beneficiaries related to the trustee where no similar distribution is made to the trustee in the trustee's capacity as a discretionary beneficiary.¹¹⁹
- GAAR may apply to the series of transactions.

¹¹⁷ *Mark A. Sochatsky v. HMQ* 2011 TCC 41.

¹¹⁸ *Supra*, note [16].

¹¹⁹ CRA Views Document no. 2012-0457551C6.

b) Planning Through Deliberate Use of Subsection 75(2)

Practitioners have also developed plans which deliberately cause subsection 75(2) to apply in order to obtain a desirable tax result. Subsection 75(2) is an anti-avoidance provision that applies to attribute income, losses, capital gains, and capital losses to a person who transfers property to a trust if the property or property substituted therefor may revert to that person, that person may determine who will receive the property, or the property cannot be disposed of without that person's consent or direction. Consider the following situation:

- Mr. Apple is the sole shareholder of an operating company (Opco)
- A discretionary trust (Trust) has been set up with Mr. Apple, his family, and an unrelated corporation (Lossco) as beneficiaries.
- Lossco has significant loss carry-forwards.

As part of the plan, Mr. Apple exchanges his shares of Opco into fixed value preferred shares and Opco issues common shares to Lossco at a nominal amount. Lossco gifts the Opco common shares to the Trust, then Opco pays a dividend on those common shares. Subsection 75(2) applies to attribute the dividends back to Lossco since Lossco contributed the shares and those shares can revert back to Lossco as a beneficiary. Lossco absorbs the dividend income with its losses, and, being not connected to Opco,¹²⁰ is subject to Part IV tax but offsets its Part IV tax liability against its losses.¹²¹ The cash that is sitting in the trust from the dividend can be returned to the individual beneficiaries as a tax-free return of capital (pursuant to subsection 107(2)) as there is no income on hand in the Trust.

There is another version of this subsection 75(2) plan that does not require the use of a "lossco". A holding company can gift a share of an operating subsidiary to a family trust in which the holding company is one of the beneficiaries, thereby causing subsection 75(2) to attribute any future dividend income on that subsidiary's share back to the holding company. The holding company will pay no Part I tax on the dividend income attributed because of subsection 112(1) and no Part IV tax because it is connected with the subsidiary. Meanwhile, the individual beneficiaries can extract cash from the trust as tax-free return of capital.

In CRA Views Document no. 2006-0196231C6 (2006 APFF Conference), the CRA made a comment that any income, loss, taxable capital gain or allowable capital loss earned by a trust on a share issued by a corporation (Corp Y) that can revert back to Corp Y as a beneficiary is subject to subsection 75(2) attribution, but the use of an anti-avoidance rule such as subsection 75(2) in order to obtain a tax benefit would trigger application of the GAAR. However, in CRA Views Document no. 2007-0243241C6 (2007 APFF Conference), the CRA reversed its previous position in the 2006 APFF conference and stated that subsection 75(2) would not apply since subsection 75(2) should apply only to a person who owned the property before it was held by the trust, and no person held the shares of Corp Y prior to their

¹²⁰ Supra, note [90].

¹²¹ Paragraph 186(1)(d) allows non-capital losses to be used to shelter Part IV tax.

issuance to the trust. The CRA's reasoning does not appear to be convincing, since the receipt of property does not require the existence of the property prior to its receipt.

Most recently, in 2010-0373621C6 (2010 APFF Conference), the CRA comments that using subsection 75(2) with a subsection 112(1) deduction to strip tax-free cash from a corporation will be subject to GAAR.

Both versions of the subsection 75(2) plan we described above fall outside of the 2007 CRA technical interpretation because in both versions of the plan a corporation did own the common shares of the operating company before the trust did, i.e. it was not a straight share subscription by the trust. Also, both versions of the plan fall outside of the FCA's decision of *Sommerer* that subsection 75(2) does not apply to taxable sales, since the shares of the operating company were gifted to the trust in both versions of the plan.¹²²

The second version of the plan (the one not requiring the use of a "lossco") falls into the CRA's GAAR position because it relies on subsection 75(2) and subsection 112(1) to obtain a tax benefit. However, the first version of the plan (the one involving a "lossco") does not fall squarely into the CRA's GAAR position since subsection 112(1) is not utilized. However, it is still an open question as to whether the first version of the plan is subject to GAAR. In the 2012 CTF National Conference, the CRA has noted concerns with subsection 75(2) strip plans. Therefore, "buyer beware" if your client is considering a plan that intentionally triggers subsection 75(2) to obtain a tax objective.

5. Buyer Beware Planning: Stock Option Sidecar

A stock option sidecar (also known as an employee "buyco" plan) is a commonly used plan for providing liquidity to a CCPC's arm's length employees who have been issued stock options. The plan typically involves the creation of a "Purchaseco" by a CCPC to facilitate the sale of the employee's stock option shares. After exercise of the option, if the employee simply submit his or her shares to the employer corporation for redemption or cancellation, the employee will be subject to deemed dividend treatment. Whereas, if the employee sells the shares to the Purchaseco, the employee will obtain capital gains treatment and may be able to shelter the gains with his or her lifetime capital gains exemption.

At the 2012 CTF National Conference, the CRA commented that, as a result of recent cases, including *Petro-Canada v R.*,¹²³ the CRA has now concluded that because of the degree of accommodation between the parties in these arrangements none of the employees are dealing at arm's length. The CRA's presentation cited the comments regarding the meaning of "arm's length" contained in the *Petro-*

¹²² Sommerer, 2012 FCA 207, aff'g 2011 TCC 212.

¹²³ *Petro-Canada v R.*, 2004 D.T.C. 6329.

Canada case.¹²⁴ As a result, the CRA cannot rule favourably on the application of the deemed dividend rule in section 84.1 in these circumstances.

The CRA's statement certainly brings an element of risk to the stock option sidecar plan. Application of section 84.1 will deem the capital gains be dividend income to the selling employees, thus defeating the purpose of the structure. Companies that have already established this type of structure should find and document evidence of their arm's length relationship with their employees.

F. CONCLUSION

There can be no question that the dramatic and fast-paced changes in the area of OM remuneration planning demands practitioners to stay up-to-date in this area. OM's themselves should be educated of these changes since many of them conduct do-it-yourself remuneration planning and can easily fall into traps and tax efficiencies if they rely on "rules of thumbs" that are now obsolete.

¹²⁴ *Ibid*, at paragraphs 52 to 55.