CANADIAN FEDERATION OF APARTMENT ASSOCIATIONS **Sept 18, 2017**

THE PROPOSED CORPORATE TAX REFORMS

The proposed corporate tax changes only apply to people who hold real estate through corporations or who receive income as dividends from private corporations. Many mid-sized landlords fall in those categories. (There is no change to those who hold real estate in their own name or with their spouse.)

Here is the link to the government consultation paper: https://www.fin.gc.ca/activty/consult/tppc-pfsp-eng.pdf The first several pages (and numerous other pages) are political self-congratulations, but the examples and text can be useful if you want more details. The paper also gives the rationales for the proposed changes.

Several articles by various expert commentators are available at links set out below.

Current combined tax rates (federal with average provincial rate)

The four main types of corporate income are:

Type of income	Combined Tax Rate Federal & Provincial – on average	Comments
1. active business income up to the small business limit ($500,000 federal limit)	13.5%	For landlords, this rate is only available for the income that results from management activities or fees.
2. active business income in excess of the small business limit;	27%	Includes rental income earned by corporate rental housing providers with more than 5 full-time employees
3. Passive income	50%	Includes rental income of corporations and rental housing businesses with fewer than 6 full-time employees
4. Portfolio dividend income	38%	This tax is refundable when the dividends are paid out, since they are then taxed in the hands of the payees.
TOP PERSONAL TAX RATE	50%	Or slightly higher in some provinces

For more details, see Kraft, June 30, at http://www.advisor.ca/tax/tax-news/how-active-versus-passive-business-income-is-taxed-236663

For a view of the fairness question see the Globe & Mail editorial, Sept 9, at https://beta.theglobeandmail.com/opinion/editorials/globe-editorial-on-small-business-taxes-the-liberals-are-mostly-right-in-theory/article36215634/?ref=http://www.theglobeandmail.com&

Income sprinkling (also called income splitting)

Current regime – with the right corporate set-up, some business income can be directed to a spouse or adult children (who have low incomes), thus reducing the total tax paid by a family. (That typically works best with active business income, but it can work with passive income in some situations.)

Proposed regime – preventing income sprinkling by tests of reasonableness of the payouts compared to the capital and work contributed to the business. For more details, see Connolly, Aug. 8, at http://www.advisor.ca/tax/tax-news/how-proposed-tax-changes-target-income-sprinkling-239316 OR see govt consultation paper at pages 18 – 28.

Issues and implications – this is an area on which the doctors and other professionals are up in arms. It may affect relatively few landlords as landlords. Those affected have created Canadian controlled private corporations ("CCPCs") to collect a management fee, thus turning some rental income (which would usually be passive income) into active business income to gain the small business rate.

Depending on how the rules are written, these changes could potentially affect estate freezes, which people did to push the growth of their portfolios out to the next generation (to avoid capital gains tax on their deaths).

Reports say the government is looking to gain $250M of tax revenue per year by stopping income sprinkling. That is a small part of these proposed reforms, but it is the part that has generated most of the heat.

Consultation questions - The Government says:

- it is committed to "responding to" income sprinkling
- it is seeking input on whether the reasonableness test provides an appropriate mechanism for responding to income sprinkling. (It says that previous efforts to constrain income sprinkling involving private corporations — which included seeking to apply the tax attribution rules based on the lack of labour contributions by the shareholders receiving dividends — have not been successful in the courts.)
- Stakeholders who choose to question the use of the proposed new mechanisms are encouraged to identify in their submissions alternative mechanisms that would respond [i.e. restrict] to income sprinkling arrangements.
- Stakeholders are also invited to comment on whether the proposed measures fully address income sprinkling, including whether alternative or additional measures should be considered [to "tax the rich" more effectively.]

Lifetime Capital Gains Exemption

Current regime – allows a family business or farm to be passed on to family members with an exemption from capital gains tax for about $850,000 of capital gains. That does not apply to rental property.

Business people can apparently gain more than one such exemption by giving shares to their spouse or children and channeling earnings so that the capital gains appear in the hands of the spouse or children.

Proposed regime – will prevent that

Impact on landlords – should be minor since rental properties cannot be sheltered in that way, only a management company can be (if it has seen capital appreciation, which most do not.)

For more details, see govt consultation paper at pages 28 – 31. The consultation questions are as set out above for income sprinkling.

Taxing passive income earned within a corporation

Current regime – corporations which earn income typically do one or two or three things with the income: namely, reinvest it into the business, distribute it (as dividends or salary), or invest it in other businesses or investments. Some of those investments produce passive income: e.g. real estate. That passive income is taxed at the high rates, but the objection is that the active income that went into the investment was taxed at lower rates, and that gives those owners an advantage over other people who paid tax on their incomes at the higher rates.

Proposed regime – increase the tax rate on such "second generation" income above-normal rates. The stated goal is to be fair between income which received the favourable rates, and income which did not. The government proposes a tracking system [which may be an accounting nightmare].

Apparently, for pure holding companies (which did not receive tax-preferred income) no increases will apply, and they are to be able to avoid the tracking system. That would save many people who hold rental property through corporations from being negatively affected by the proposed reforms.

For more details, see govt consultation paper at pages 32 – 53.

Implications – The higher taxes could apply to the "second generation income" of landlords who receive the active business tax rate on rental income, (because of having five or more full time employees.) That could affect a great many mid-size landlords to a large extent.

Reports say the government is looking to gain $1B to $2B of tax revenue per year by taxing passive income in corporation. That is almost certainly the largest part of these proposed reforms, but it is a part that has generated little public heat so far.

Some suggest that REIT unit holders will not be affected because REITs already report out income to their unit holders who then proceed as if the income (or capital gains) were received by them individually. The REITs may be affected in their management arms.

The impact on REIT management arms and mid-size landlords may be where CFAA should put much of our weight, with a focus on the mid-size landlords, who can be presented with a somewhat human face.

Consultation questions - The Government says:

It will be designing new rules over the coming months to tax corporate passive income in a way "that is more fair for Canadians." Stakeholders are invited to share views on any aspect of these new rules that you feel are important to bring to the Government's attention. In particular,

1. what approach would be preferable in order to improve the fairness of the tax system with respect to passive income?
    a. Proposed CFAA answer: Leave it alone!
2. If you prefer the apportionment or elective methods described in this paper, what criteria or broad considerations should the Government consider in selecting a method?

   a. Proposed CFAA answer: Make a simple option available.

3. Regarding the tax treatment of corporations mostly engaged in passive investments, are there considerations that you would like to bring to the Government's attention?
   a. Proposed CFAA answer: Yes, leave them out of any reformed rules, by setting a test for the proportion of investment funding they can receive which active business income. That proportion could be 80% or 90% for example.
4. What would be the appropriate scope of the new tax regime with respect to capital gains? What criteria should be used by the Government in making this determination?
   a. Proposed CFAA answer: there are valid reasons for treating capital gains as they are treated now. Capital gains are measured in current dollars so that much of what appears to be capital gains is merely an adjustment for inflation. In addition, capital gains tend to occur when capital is at risk, and taking risks is good for the economy. We can attach the paper CFAA submitted in the capital gains discussion in the Spring [attached.]
5. Are there key transition issues that you would like to bring to the Government's attention?
   a. Proposed CFAA answer: Not yet.
6. Is there any reason why any aspects of the new rules should not apply to private corporations other than Canadian-controlled private corporations?
   a. Proposed CFAA answer: Yes, publicly traded corporations should be left out of the reformed rules since publicly traded corporations are open for investment by salaried people (who can take advantage of any preference such corporation may benefit from, if indeed there is any.)

Converting income into capital gains ("surplus stripping")

Current regime – Capital gains are taxed at half the rate of other income, since only 50% of capital gains are taken into income. Most cases are straight forward, but some owners seek to present income as capital gains through certain inter-company transaction as explained at page 57 and 58 of the govt consultation paper. in most cases the attempts are foiled by s. 84.1 of the Income Tax Act. In other cases CRA applies the general anti-avoidance provision (GAAR). However, CRA is unhappy with the courts' treatment of inter-generational transfers.

Proposed regime – the Government proposes that section 84.1 be amended to prevent individual taxpayers from using non-arm's length transactions that 'step-up' the cost base of shares of a corporation in order to avoid the application of section 84.1 on a subsequent transaction. The Government also proposes that the *Income Tax Act* be amended to add a separate anti-stripping rule applicable to any a non-arm's length transaction where it is reasonable to consider that 'one of the purposes' of a transaction or series of transactions is to pay an individual shareholder/vendor non-share consideration (e.g., cash) that is otherwise treated as a capital gain out of a private corporation's surplus in a manner that involves a significant disappearance of the corporation's assets. In such a case, the non-share consideration would be treated as a taxable dividend.

Consultation questions - The Government says:

Draft legislation for the proposed amendment to section 84.1 and the proposed anti-stripping rule is being released for comment. The Government invites views and ideas on whether, and how, it would be possible to better accommodate genuine intergenerational business transfers.

Political background and issues

For the political background, see the article by Clark, Sept. 5, at https://beta.theglobeandmail.com/opinion/caught-between-anger-and-indifference-finance-minister-faces-real-political-test-with-tax-changes/article36180480/

the article by Curry and Stone, Sept. 5, at https://beta.theglobeandmail.com/news/politics/liberals-will-not-back-down-on-tax-reform-morneau/article36180040/

and the article by Stone, Sept. 6 at https://beta.theglobeandmail.com/news/politics/trudeau-stands-firm-on-tax-plan-but-open-to-tweaks/article36193570/

Essentially the government says it is willing to look at changes to the details, but it will press ahead, despite the pressure it is under. Backing that up is a recent poll that said 75% of the public favours the changes. (Taxing the rich is popular.) The Conservatives have come out in opposition to the changes, but that may hurt us rather than help us.

Rather than outright opposition, some commentators have written nuanced pieces. See for example:

Savage article, Sept. 8, at https://beta.theglobeandmail.com/report-on-business/rob-commentary/lets-focus-on-enforcing-tax-rules-not-changing-them/article36214560/

Coyne, Sept. 6, #5 at http://nationalpost.com/news/andrew-coyne-why-the-liberals-proposed-tax-changes-are-taking-a-pounding

Lanthier article, Sept. 7, at http://business.financialpost.com/opinion/the-good-bad-and-downright-offensive-in-morneaus-tax-reform-proposals

Steinberg, Sept. 14, at http://business.financialpost.com/opinion/ottawas-rush-to-reform-the-tax-system-could-end-up-deforming-it