July 18, 2017 Department of Finance Draft Legislation on

Converting Income into Capital Gains

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The Current Rules on Capital Gains from Sales of Shares

In general, when an individual sells shares of a corporation for an amount in excess of what they paid for the shares, they realize a capital gain. Depending upon the assets of the company and the personal tax history of the vendor, the capital gain may or may not be eligible to be offset by a capital gains deduction such that no personal tax is paid.

Currently an anti-avoidance rule results when a sale made to a "non-arm's length corporation" (1) is essentially tax-free. The tax policy is that individuals should not be able to extract funds from their own company (or a non-arm's length company) and trigger a capital gains deduction in order to pay no tax. In these cases, from a tax perspective, the sale results are treated as a dividend and taxes would have to be paid.

The Proposed Changes

On July 18, 2017, the Department of Finance released draft legislation to further extend the reach of this anti-avoidance provision to apply to all transactions where a non-arm's length person realizes a capital gain on shares regardless of whether any tax results from the transaction. The new policy is that individuals should not be able to extract any funds from their own company at capital gains rates, but should always pay the higher dividend rates.

The proposed changes will cause genuine hardships and problems for families, including:

- Potential double tax upon the death of a shareholder as a result of the elimination of the "pipeline plan" (2); and
- Potential double tax upon the transfer of a family business from one generation to the next.

Finance did note in their discussion paper that it would consider views and ideas of ways, "it would be possible to better accommodate genuine intergenerational business transfers while still protecting against potential abuses of any such accommodation".

The Department has also proposed to introduce a broad new anti-avoidance rule that will apply to all transactions where an individual has received a distribution from a company on a tax-reduced or tax-free basis in a non-arm's length context and treat those amounts as taxable dividends. The Department refers to this a "surplus stripping". The Explanatory Notes to the Draft Legislation provide that these rules apply to:

"*the portion of the amount received or receivable, directly or indirectly, by an individual in a taxation year, as part of a transaction or event, or series of transactions or events, if the following conditions are met:*

a) the individual is resident in Canada in the taxation year;
b) the amount was received or receivable, directly or indirectly in any manner whatever, from a person with whom the individual was not dealing at arm's length (including in situations where an accommodating third party that purportedly deals at arm's length with the individual is used as an intermediary to avoid subsection (1));
c) as part of the transaction, event or series, there is a disposition of property or an increase or reduction in the paid-up capital in the capital stock of a corporation; and
d) it can reasonably be considered that one of the purposes of the transaction, event or series was to effect a significant reduction or disappearance of assets of a private corporation (including assets that the private corporation acquires or holds an interest in, directly or indirectly) at any time in a manner such that any part of tax otherwise payable under the Act by the individual with respect to the portion, and in consequence of any distribution of property of the corporation, is avoided."

In other words, where an individual is able to extract funds, either directly or indirectly, from a non-arm's length company at a tax rate lower than they would have paid on a dividend, this rule will apply to treat the receipt as a taxable dividend. The rules specifically note that where amounts are added to the capital dividend account ("CDA")

as a part of the series of transactions resulting in the distribution, the CDA will be reduced by that amount and any amounts received will be treated as regular taxable dividends.

The Problems with Finance's Approach

While the extension of these anti-avoidance provisions eliminates the ability of certain taxpayers to engage in plans that allowed them to obtain funds from non-arm's length companies at reduced tax rates, it also destroys many legitimate planning opportunities to avoid double taxation.

What Should You Do?

As these proposed tax changes may have a significant impact upon your planning, please call us prior to considering any transactions to sell shares and/or to extract retained earnings from your company.

What Are We Doing?

As part of DFK Canada, we are pro-actively seeking changes to these proposals by discussing their impact with our clients and contacting local MP's to advise them of the far-reaching impact these rule changes will have on all clients. Those most impacted by the proposals are being portrayed as the wealthiest of Canadians. We know otherwise. We will continue to keep our clients up to date as we learn more about the proposed changes.

(1) A non-arm's length company is one you and/or persons related to you directly or indirectly control. This concept can be expanded beyond related individuals where non-related parties act in concert. For instance, where one of your good friends facilitates a transaction as an intermediary with the result that you realize a capital gain instead of a dividend, you will very likely be considered to be acting in concert and hence, related for purposes of these provisions.

(2) Pipeline Plan is one that allows the beneficiaries of an estate to avoid tax on shares they inherit where the deceased relative paid tax upon the deemed disposition of those shares on their death. The plan gives recognition to the fact that tax has already been paid on the shares up to their value on the date of death.