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Tax

New tax proposals will overturn decades of settled law

By **Robert Kepes**

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(September 12, 2017, 9:02 AM EDT) -- The firestorm from the July 18, 2017, federal tax proposals has been met with fury from the tax community and from small and medium enterprises. Some of the changes will dramatically change tax planning for private corporations, including many professional corporations.

The proposals are contained in a consultation paper that was promised in the federal budget of March 2017. The budget set out the government's intention to close "tax loopholes," reinstitute "fairness," and end "tax-planning strategies using private corporations, which can result in high-income individuals gaining unfair tax advantages."

It's difficult to reconcile these statements with the fact that one strategy was approved by the Supreme Court of Canada in the 1990s. The strategy in question concerns sprinkling income amongst family members using private corporations. In this way, the corporation would pay dividend income to the spouse and children of the founder, in lieu of the founder paying tax at the highest rate on all his/her income earned.

For example, a private corporation can have multiple classes of shares that are held by different family members. Sometimes the family owns those shares from incorporation, or the share capital is later reorganized to allow the spouse and children to subscribe for new classes of common shares, while the founder owns a class of preferred shares. After paying corporate tax, the corporation would pay dividends to the spouse and children who are in a lower tax bracket than the founder.

Overall tax savings for the family is achieved through a combination of the founder's top tax-rate salary and of low-tax dividends to the spouse and children.

The government's consultation paper describes this as an unintended benefit to higher-income individuals that is unfair and inconsistent with the tax system. However, it fails to mention that the Supreme Court has already approved such a plan. And not once, but twice.

The facts in *McClurg v. MNR* [1990] 3 S.C.R. 1020 and *Neuman v. Canada (MNR)* [1998] 1 S.C.R. 770 were similar — private companies with two classes of common shares. The voting shares were owned by the husbands and the non-voting shares were owned by their wives. However, what differentiated the cases was that in *McClurg*, Mrs. McClurg was actively involved in the business, while in *Neuman* the spouse had no involvement at all. In both cases the directors could declare dividends on any class to the exclusion of another. Also, in both cases the Supreme Court upheld the discretionary dividends paid to the spouses.

More importantly, in *Neuman* the court rejected the government's argument that the spouse's lack of involvement in the business would require the dividend to be taxable in her husband's hands. The court stated that this approach "ignores the fundamental nature of dividends; a dividend is a payment which is related by way of entitlement to one's capital or share interests in the corporation and not to any other consideration. Thus, the quantum of one's contribution to a company, and any dividends received from the corporation, are mutually independent of one another."

The 1999 federal budget eliminated the tax benefits of income splitting with minor children. It introduced the tax on split income (TOSI) as a flat tax equal to the top marginal rate on certain "split

income" earned by individuals under the age of 18, including dividends from a private corporation.

The government's proposals seek to overturn *Neuman* and extend the TOSI to "split income" of spouses and adult children in excess of a reasonable amount. What is a reasonable amount? The TOSI will apply to the extent that the income exceeds what an arm's-length party would have agreed to pay for the services of the spouse or adult children. New statutory criteria lists a number of factors, such as their labour or capital contributions and assumed risk in the business.

Considering that the burden in tax appeals is on the taxpayer, it is difficult to imagine the level of evidentiary proof required in order to satisfy a CRA field auditor of such reasonability. Does this mean spouses should start to keep dockets and time sheets?

It's disingenuous for the government to characterize entrepreneurs as using tax loopholes when they are following the decision in *Neuman*. The government has the right to legislate a tax policy that overrules *Neuman*, but the TOSI is not targeted at the top one per cent and applies to all private corporations even if the founder is not in the top tax bracket. With these proposals the government is alienating its constituency of professionals and small business enterprises, and should reconsider.

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