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UNINTENDED TAX CONSEQUENCES

Much has been written, by me as well as many others, decrying the dishonesty of the Liberal government of Justin Trudeau and Bill Morneau in labelling legitimate tax planning as "loopholes". A loophole is an unintended tax consequence, and the tax changes that they have introduced, as well as the ones that they are proposing, deal with existing tax structures which operate, more or less, as intended.

But there are tax consequences to their proposals that are, hopefully, unintended. Because if they are intended, then it displays a shocking degree of dishonesty and mean-spiritedness.

In the 2016 Federal Budget, there were proposed amendments to the *Income Tax Act* (the "Act") designed to reduce or eliminate the multiplication of the Small Business Deduction (SBD) among affiliated companies. Please note that when I refer to "affiliated" companies, I mean it in the ordinary sense, not in the technical tax sense.

These provisions were introduced, so they say, to target structures that avoided the corporate partnership rules and were designed to multiply access to the low rate of tax on the first $500,000 of active business income. Although I have no problem taking credit for setting up such structures, I am not offended by their attempt to invalidate such structures.

However, I have clients who are exactly the middle income taxpayers that the Liberals say they are trying to benefit, who do business with companies owned by related individuals. The one that comes to mind immediately, let's call him Mr. B, has done business for 40 years with his brother's companies. They have always operated on an arm's length fair market basis.

As a result of the attempt to target the higher income businesses that take advantage of the structures I mentioned, they have increased Mr. B's corporate income tax by 10%. There was no intent to do anything untoward. He is just a middle income taxpayer trying to carry on business and provide jobs. I would like to think that this is an unintended consequence. But I haven't seen any move by the Liberals to address this unfairness.

Similar unintended consequences will arise if the current proposals become law.

Earlier today I met with a client to discuss his estate planning. He is a successful businessman who has 3 sons. The oldest son is actively working in the business. The middle son is still going to school and working part-time in the business. The 3rd son is still too young to work in the business. His hope is that, in the future, all of his sons will be in the business with him.

The planning issue is how to reward the oldest son for his efforts before the younger brothers come into the business. His current efforts are helping to build the business and he deserves to be rewarded for that. Assume that he works in the business for 5 years before his next brother joins the company. Then, the 2 brothers will be helping to build the business for the next few years until the youngest brother joins, and there should be some recognition for their efforts. Perhaps one or more of the sons decide not to join the business or, having joined, decide to leave and do something else. How does this father deal with shares to be given to his sons to recognize their efforts. This is **NOT** a tax issue, but a family estate planning issue. It does, however, have tax implications.

The father can't simply gift shares to his sons as they join the business without triggering gains on the disposition of the shares. He can't have the company simply issue new shares without triggering tax consequences including, potentially benefits of employment for the sons or shareholder benefits. And if one of the sons leaves, then how will the shares be dealt with?

The simplest way to deal with these issues is to have the shares owned by a discretionary family trust and to have an agreement, or at least an understanding, about how the sons are to be rewarded by having shares transferred to them by the trust.

Under the Morneau proposals, if the shares are owned by a trust, then the capital gain that accrues during the period of ownership by the trust will not qualify for the Lifetime Capital Gains Exemption. Whatever unfairness Morneau perceive, this is not in any way offensive. It is ordinary estate planning. But the tax system should not be an obstacle to reasonable estate planning. This is, again, an unintended consequence – at least one hopes it is unintended.

If the shares are owned, in some fashion, by the sons directly there perhaps a bigger problem, even ignoring the tax issues, discussed above, surrounding the manner in which the sons acquire their shares.

Under the new proposals, there will be a reasonableness test for the payment of dividends. It is clear from decades of decided cases, that there is currently no such test regarding dividends.

The reasonableness test is proposed to apply differently based on the age of the adult specified individual (i.e., whether the individual is between 18 and 24 or is 25 or older).

Ignoring the dividends being paid to the father, a CRA auditor will now have to review dividends paid to each of the 3 sons to determine whether the dividends paid are reasonable. The CRA does not have nearly sufficient resources to do this. The appeals process is severely backed up and the Tax Court is unable to keep up with the appeals being filed. How will it be possible for either the CRA appeals section or the Tax Court to keep up with the potential of an appeal from each shareholder as to whether their particular dividends are reasonable?

Again, this client's problem is not about improper tax planning. It isn't really about tax planning at all. It is about a business man trying to do estate planning in a manner that is fair to all of his children. The Liberal government is making this about tax. Again, one hopes that this is an unintended result.

The Liberals have, yet again, used an elephant gun approach to deal with legitimate tax planning that may be misused in a small percentage of cases. We can only hope that Morneau and Trudeau will seek to redress the unintended tax consequences of their actions with the same vigour.