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Government Backtracks on Anti-Surplus Stripping Proposals, and Looks to Develop Alternative Proposals

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Happily, on October 19, 2017, the Federal Government announced it is not proceeding with yet another measure in its July 18 proposals this time, the anti-surplus stripping proposals. Earlier in the week, the Government announced that it will (i) simplify the income sprinkling proposals and not proceed with proposed measures to limit access to the Lifetime Capital Gains Exemption and (ii) add a safe harbour for the proposals impacting the taxation of passive income in a private corporation.

It may be fair to suggest (or obvious to say) that the Government should have consulted with the business and tax community prior to the introduction of the proposals. Among other things, a skeptic may view these announcements as politically-motivated vote-getting (first introducing rules that the Government thought would only adversely impact the "1%" – and be appealing to the other 99% – and then quickly backtrack, with a markedly different tone towards business owners, after finding the proposals not only flawed, but very unpopular among far more than the 1%).

That said, knowingly or unknowingly, the Government may have perfectly executed the "door-in-the face" persuasion technique. The July 18 proposals represented a large unreasonable request that resulted in the metaphorical slamming of the door in the Government's face (during the consultation process the Government received a staggering 21,000 plus submissions, presumably few, if any, of which offered support for the proposals). Now the public may be more happy with (or less opposed to) the revised, more reasonable proposals, as compared to if the July 18 proposals were never released.

Today's Announcement

Under today's announcement, the prior anti-surplus stripping proposals that are abandoned seemingly include:

1. expansion of an existing anti-avoidance rule that prevents individuals from transferring shares to non-arm's length parties in order to realize a capital gain rather than extracting cash through a dividend (to which a higher tax rate applies); and
2. a general anti-stripping rule that would apply to a non-arm's length transaction where it is reasonable to consider that 'one of the purposes' of the 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 have been treated as a taxable dividend).

These proposals caused significant concern throughout the tax community. Among other things, the proposals would have increased the cost of intergenerational business transfers and frustrated "pipeline" transactions, the latter of which is a popular planning technique to avoid double taxation that can occur with respect to private company shares on the death of a shareholder. (As an aside, the Government suggested in today's announcement that this impact on pipeline transactions was unintended; however, officials at the Department of Finance previously suggested that it was an intentional consequence of the proposals).

It would appear that developing new proposals to curb surplus stripping is still on the Government's radar, with the Government indicating that in the coming year it will " continue its outreach to farmers, fishers and other business owners to develop proposals to better accommodate intergenerational transfers of businesses while protecting the fairness of the tax system."

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