Revised rules on income sprinkling and planning considerations for business owners and incorporated professionals

On January 1, 2018, the revised tax measures with regards to “income sprinkling” by business owners and their families that were announced by Canada’s Minister of Finance, Bill Morneau, on December 13, 2017, came into effect.

While alongside the Minister of Finance’s announcement, Canada Revenue Agency (CRA) released guidelines on the proposed tax measures and that intended to simplify the rules, the revised TOSI regulations remain extremely complex and their application can be very subjective. If you are a business owner or incorporated professional and own a Canadian Controlled Private Corporation (CCPC), you will need to seek proper guidance to ensure that you are complying with TOSI rules and to determine what amount of income paid to related individuals will be subject to TOSI.

Income Sprinkling

Income sprinkling, also commonly known as income splitting, allows someone in a lower tax bracket to report income that otherwise would have been reported by a related person in a higher tax bracket. Income sprinkling allows owners of private corporations to reduce the collective tax liability of their family.

Before 2018, a Canadian Controlled Private Corporation (CCPC) could pay dividends to related parties as long as they were shareholders of the CCPC. It could also pay reasonable salaries to related parties when they were employed by the CCPC. Under Canada’s progressive or marginal tax rate system, two spouses each reporting income of $125,000 pay less tax collectively than if only one spouse reports $250,000 in income.

Income splitting can be especially valuable if one or more of the adult children who are shareholders of the corporation have no other sources of income, as the business owner can pay them tax-free dividends. Assuming that the child has no other income or deductions other than the basic personal amount and dividend tax credit, these tax-free dividends could range from $14,360 in P.E.I to $33,305 in Ontario.

Currently there are a number of provisions in the Tax Act that deny or limit the potential benefits of income sprinkling. However, the Government believes that additional measures are necessary to limit these benefits with a particular focus on investments in private corporations.

Tax on Income Splitting (TOSI)

The TOSI provisions were previously known as the "kiddie tax" because they applied to income splitting strategies that involved persons under the age of 18. These rules are to be extended to adults and where TOSI provisions apply, the split-income would be subject to the highest marginal tax rate.

The Government has not only proposed that the split-income of adults become subject to the TOSI rules, but also be subject to certain reasonableness tests.

Summary of revised measures

The revised tax proposals continue to extend TOSI to related individuals, and introduce numerous exemptions for certain related individuals based on age, involvement in and contribution to a CCPC, as well as on other life circumstances.

On the bright side, the federal government will not move forward with the following:

• Proposed tax measures applying TOSI to taxable capital gains that qualify for the lifetime capital gains exemption (LCGE). Owners of small business corporations, some farmers, and some fishers are eligible for the Lifetime Capital Gains Exemption (LCGE). Under LCGE rules if you sell shares of a qualified Canadian small business corporation in 2017, you would be eligible for a maximum lifetime capital gains exemption of $848,252. This amount will be indexed to inflation and will increase in future years. Since April, 2015, the LCGE amount for farmers and fishers has been raised to $1million.

• Proposed tax measures applying TOSI to compound income (income on income)

• Proposed tax measures applying TOSI to income derived from property acquired as a result of the breakdown of marriage or a common-law relationship

• Identifying aunts, uncles, nieces and nephews as related individuals.

In addition, the revised tax proposals introduced or outlined the following:

• "Bright Line" tests to exclude the following categories of related individual:

– a spouse of the business owner, where the business owner meaningfully contributed to the business and is over the age of 64. This is meant to ensure that the rules align with eligible pension income-splitting tax provisions;

– A related individual who is over the age of 17 and who has made a regular, continuous and substantial labour contribution to the CCPC during the given year, or during any five previous years. For this purpose, the definition of substantial labour contribution is an average of 20 hours a week during the year or business operation period. If the related individual meets this definition, the CCPC is considered an "Excluded Business" and the income earned by the related individual from the CCPC is excluded from TOSI;

– A related individual who is over the age of 24 and owns 10% (as of December 31, 2018) or more of the CCPC (votes and value), provided that the CCPC earns less than 90% of its income from providing services, is not a professional corporation, and its income is not derived from a related business of a specified individual. If the related individual's CCPC shares meet these criteria, the shares are referred to as "Excluded Shares" and income from such is excluded from TOSI;

• For individuals over 17 who do not meet the bright line tests, "Reasonableness Tests" are included. The reasonableness tests will be used to determine how much income, if any, exceeds a reasonable return and therefore would be subject to TOSI. Reasonableness would be determined by comparing

contributions of the related individual to the business with contributions of other related individuals, considering labour and capital contributions, risks assumed and any other relevant factors.

• New rules were proposed that would exempt inherited CCPC shares for related individuals over the age of 17, if the deceased met any of the bright line or reasonableness tests.

Value of good tax advice

The complexity of the proposed tax measures, makes the job of the tax advisors of business owners even more important and sensitive as they need to be aware of not only the CCPC share structures and dividend income paid, but also the various contributions made by related individuals in the given year or previous years, and the age of the related individuals to provide proper guidance.

Impact on Planning for 2018 and beyond

Given the new income-splitting and TOSI measures, business owners should consider doing the following with the aid of their tax advisors:

- Reviewing their corporate share structure to determine if a corporate restructuring is needed to avoid TOSI post-2017
- Reviewing the dividend income paid to related individuals in a given year or previous years to determine if it may now be subject to TOSI in the future
- Start formalizing a process to record contributions of related individuals to characterize "Excluded Business", "Excluded Shares" or to meet any of the various bright line or reasonableness tests. Unlike other tax records, in this case documentation will have to be maintained in excess of seven years.

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