Updates to
Proposed Changes to
Tax Planning for Private Corporations

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Income Sprinkling Changes

- Finance has altered their proposed income sprinkling changes since the initial July 2017 consultation paper. Proposed rules have now been relaxed
- Initial proposed changes regarding conversion of income to capital gains has been eliminated completely
- Income sprinkling refers to the concept of reducing income taxes that would otherwise be realized by high income earners to be realized instead by low income family members (e.g. spouse). Overall family taxes will be lower compared with one person receiving the income

Income Sprinkling Changes

- Two main proposed changes initially announced:
  - Extension of Tax on Split Income (“TOSI”) rules
    - Finance recently released commentary in Dec 2017 to give more details about the TOSI rule changes. See following slides
  - Constraining multiplying lifetime capital gains exemption (“LCGE”)
    - Finance announced that it was no longer moving forward with the measures that would have significantly limited access to the LCGE

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Background - Current TOSI Rules

- The current TOSI rules only apply to individuals under 18. Effectively taxes split income to minors at the highest marginal tax rate – commonly referred to as “kiddie tax”
  - Most common application: minors that receive dividends from their parents’ private corporations will be subject to kiddie tax

- Spouses and adult children that hold shares in the company can receive discretionary amount of dividends to utilize their respective low marginal tax rates (e.g. dividend sprinkling)

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Proposed TOSI Rules

- Proposed changes to the TOSI rules would result in:
  - Expanding the individuals subject to the TOSI rules to include any Canadian resident individual that receives income from a business of a related individual
  - Including a new "reasonableness test" for adult individuals to determine if the TOSI rules would apply

Timing - Proposed TOSI Rules

- Finance has indicated the proposed TOSI rules would apply to the 2018 and later taxation years

- This would allow income splitting strategies under the current rules for the 2017 year

- Salaries are not caught under the TOSI rules

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Exceptions to Proposed TOSI Rules

- Based on Finance's December 13, 2017 updates, under the Proposals, the following will be Excluded Amounts from split income:
  - Excluded Business (for all adult individuals)
  - Excluded Shares (for ages 25+)
  - Reasonable Return (for ages 25+)
  - Safe Harbour Capital Return (ages 18-24)
  - Arm's Length Capital (ages 18-24)

**** Excluded Amounts = Allows for income splitting ****

Exception - Excluded Business

- **Excluded Business for all adults:**
  - Are amounts derived from a Related Business where the individual was actively engaged on a regular, continuous and substantial basis ("Actively Engaged") in the activities of the business in the taxation year or in any five prior taxation years of the individual
  - An individual will be deemed to be Actively Engaged if the <u>individual works in the business at least an average of 20 hours per week</u> during the portion of the taxation year of the individual that the business operates, or meets that requirement for any five prior years

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Exception - Excluded Shares

- **Excluded Shares for 25+ years of age**: shares of a corporation owned by an individual are excluded shares where:
  - Less than 90% of the corporation's business income was from the provision of services <u>and the corporation is not a professional corporation</u>
  - The shares represent 10% or more of the votes and value of the corporation
  - All or substantially all of the income of the corporation is not derived from another Related Business in respect of the individual

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Exception – Reasonable Return

- **Reasonable Return for 25+ years of age**: payments that represent a reasonable return based on the following criteria (the "Reasonableness Criteria"):
  - The work performed in support of the Related Business
  - The property contributed directly or indirectly in support of the Related Business
  - The risks assumed in respect of the Related Business;
  - The total amounts paid or payable by any person or partnership to or for the benefit of the individual in respect of the Related Business
  - Such other factors that may be relevant

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Example – Reasonable Return

Example: Dividends to spouse in professional corporation (per Finance)

- Opco is a professional corporation and as a result of the governing provincial law, Spouse B is not permitted to own voting shares in Opco
- Opco has added during its start-up phase an operating line of credit from a financial institution and Spouse B was required by the institution to act as guarantor of the operating line of credit for the business which guarantee is secured by a mortgage on the matrimonial home. Opco does not pay Spouse B any fee for the guarantee
- Opco pays a dividend on the class of shares held by Spouse B. The amount of the dividend received by Spouse B is similar to the amount of an arm's length guarantee fee

Conclusion

- The dividend received by Spouse B will be an Excluded Amount as a Reasonable Return based on the risks assumed in respect of Opco's business. Therefore, income splitting can be achieved

Exceptions for Ages 18-24

- **Safe harbor capital return**: In order for the TOSI rules not to apply to individuals between the ages of 18-24, they need to have contributed property in support of the business. Only allows a reasonable return up to a prescribed rate

- **Arm's length capital:** generally refers to property inherited by the individual or earned by the individual (e.g. salary). An amount will be an excluded amount to the extent that it does not exceed a reasonable return on arm's length capital contributed by individuals that are 18-24 years of age

Passive Investment Changes

- Due to low corporate income tax rates, private corporations can invest after-tax funds in passive investments (e.g. GICs, stocks, real estate)

- Companies start with a higher initial capital base compared with individuals who earn their income directly, resulting in a higher retirement portfolio for business owners

Proposed Passive Investment Rules

- Finance has stated it will be moving forward with its proposed measures to limit the deferral benefits of passive investments within private corporations

- Draft legislation is expected to be released in Budget 2018

Proposed Passive Investment Rules

- Finance has stated that investments already made by private corporations, including the future income earned from such investments, are protected. The new measures will only apply on a go-forward basis

- In Oct 2017, Finance announced a passive income threshold of $50,000 per year for future, go-forward investments. Accordingly, there will be no tax increase on investment income below this threshold
  - The details of the proposed measures will be released in Budget 2018, including a technical description of how the passive investment income threshold of $50k will be applied

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