MNP TAX UPDATE Part 1: INCOME SPRINKLING

How the Proposed Legislation Impacts You and Your Business

Government of Canada Proposed Tax Changes for Private Corporations | 2017

Contents

On July 18, 2017, the Honourable Bill Morneau, Minister of Finance, released draft legislation and explanatory notes intended to "close loopholes and deal with tax planning strategies that involved the use of private corporations." One of the key issues addressed was income sprinkling (commonly known as income splitting) by private corporations to achieve access to lower marginal tax rates. In this update, we will take an in-depth look at the proposed rules relating to income sprinkling.

1. Overview of Proposed Legislation

The government has proposed a taxation plan that greatly reduces the ability to income split, resulting in higher taxes for shareholders of most private corporations.

Extension of the Tax on Split Income (TOSI) Rules

Historically, TOSI was only applied to minors and known as the kiddie tax wherein any dividends, business income and capital gains on a disposition to a related person would be subjected to the highest tax rates when earned by a minor.

The draft legislation proposes to expand the definition of what is subject to TOSI to include interest on loans, capital gains if the income on the shares would have been subject to a higher tax rate and second-generation income if it is earned on income that was itself subject to a higher tax rate for people under 25 years old.

If this legislation passes in its current form, the new rules are broadened to include adult family members, including spouses and children. You or your family may be subjected to these punitive tax consequences if you are a Canadian resident who receives TOSI from a business (i.e. dividends, interest, capital gains) and you are related to another person who is involved in the business and has ownership in the business.

Reasonability of Income

For the income not to be subject to TOSI, it must be considered reasonable in the circumstances. To be reasonable, it cannot exceed what would have been paid or payable to a third party for the same activities, considering the following:

- Work performed
- Capital contributed
- Risk assumed
- Compensation for services already completed

Where an individual under 25 is in receipt of income from a business, they must be actively engaged on a regular, continuous and substantial basis in the activities of the business to avoid the TOSI recharacterization.

This reasonability test may be a safe harbour for some, but what is considered reasonable is currently unclear and will likely be fact driven for each situation.

If the dividends being distributed to the shareholder are from corporate taxed capital gains or investment income, the reasonability test will not provide a safe harbour and the income may be deemed to be unreasonable and subject to the highest personal tax rates.

Is any Income Exempt from TOSI?

If a child is under 25 and the income was earned as a consequence of the death of his or her parent, it will generally not be subject to TOSI.

Tax on Capital Gains

In addition to the changes to TOSI, if an individual or trust incurs a capital gain selling shares of a private company to a related person, the shareholder will be deemed to have received an ineligible dividend (which can be taxed as high as 45%, depending on the province of residence) rather than a capital gain.

This could make it significantly more difficult to transfer a business from one generation to the next.

Restricting Access to the Lifetime Capital Gain Exemption (LCGE)

The capital gain deduction is important to every entrepreneur, farmer and fisherman, as it allows them to protect a lifetime limit of $835,714 for qualified small business corporation (QSBC) shares or $1,000,000 for qualified farm property (QFP) or qualified fishing property (QFP).

Limitations on Dispositions after 2017:

There are new limitations on the ability to access the LCGE of qualified farm property, qualified fishing property and qualified small business corporation shares for dispositions after 2017. These include:

- Minors*:* The capital gain deduction will no longer be available to minors.
- Gains Accruing while a Minor*:* If the individual held the shares while they were a minor, any portion of the capital gains accruing during that time is not eligible for the capital gain deduction.
- Split Income*:* If the taxable capital gain is considered split income, it will not be sheltered by the capital gain deduction.
- Gains Accruing Prior to Rollout from Trust*:* If a personal trust holds the shares, any capital gain accruing while the shares were held by the trust will not be eligible for capital gain deduction.

Planning Opportunity

There will be an opportunity to create a deemed disposition in 2018 of qualified farm property, qualified fishing property and qualified small business corporation shares to create a disposition of the property and shelter the capital gain with the capital gain deduction. This will allow individuals and trusts to use their capital gains deduction before it is lost to them. It will be important to determine the actual Fair Market Value (FMV) of the property before filing the designation, as if the elected amount exceeds the FMV (whether inadvertently or intentionally) there will be adverse tax consequences.

This election will be due on the due date of filing the personal or trust tax return for 2018.

2. What will these changes mean to you?

If you have family members as shareholders, whether directly or indirectly through a family trust, this legislation may require you to defend the reasonability of the work performed. It may require you to have formal job descriptions for people and consider what the business would pay a third party for the same duties. Record keeping and documentation will be important, as will establishing a methodology for determining and justifying reasonableness.

If there are preferred shares outstanding, consider paying dividends on the preferred shares rather than the common shares, as they may be reasonable based on capital contributed.

There may be a renewed bias to remunerate family members with salaries as opposed to dividends. This will create CPP contributions (in theory, increasing eventual payments from the CPP), earned income room for RRSP purposes and will have source deduction requirements.

The proposed rules are complicated and your MNP Tax Advisor can help you make sense of it all.

- Is your current business structure still suitable for your needs?
- Do you have to develop a new remuneration strategy?
- Should you elect on a deemed disposition to access your capital gains deduction?

These are the types of questions that need to be addressed in order for you to be prepared if these proposed rules are passed into legislation.

Consultation with Government

MNP will be preparing a written submission to the Department of Finance on the technical aspects of the proposed legislation. The consultation period ends on October 2, 2017. Following the consultation period, the government will table a revised form of this legislation.

3. What do you need to do?

Contact your local MNP Advisor to understand how these changes may affect your interests. Even though the government is still in consultation phase, it is best to understand the effect these proposed changes could have on your business as well as your options to minimize the effect if the legislation moves forward.

Click here to find an MNP Professional

Everything Counts

When it comes to tax, it's all about the details. Knowing the rules and regulations, what qualifies, what doesn't and how to structure your business and claims most effectively. Our specialized teams are focussed on every facet of tax. We have the in-depth knowledge and experience that will allow you to capitalize on all the opportunities available. We know what to look for, right down to the smallest details. And it's the small details that can add up to make a big difference.