TAX FLASH BULLETIN

December 2017 Update on Income Sprinkling Proposals

On December 13, 2017 the federal government released new draft legislation related to income sprinkling and the Tax on Split Income (TOSI) rules to simplify the original proposals released on July 18, 2017. The TOSI proposals remain effective as of January 1, 2018.

Background

On July 18, 2017 the federal government released draft amendments to the Income Tax Act (ITA) that may prompt small business owners to review their tax planning and corporate structuring with their personal team of professionals. Specifically, the proposed amendments attempt to significantly reduce the tax benefits associated with private corporations. The government suggested that certain strategies available to small business owners resulted in an unfair tax advantage vis-à-vis non-business owners. The objective appears to be to level the tax playing field so that everyone -- business owner or employee -- eventually pays the same amount of income tax.

Highlights of the latest proposed changes specific to income sprinkling, along with subsequent updates, are summarized below and are subject to change.

Tax on Split Income ("TOSI") – Income Sprinkling Between Family Members (the extension of the 'Kiddie Tax')

Business owners commonly add family members as, for example, shareholders or beneficiaries under a trust that holds private corporation shares. One common objective is to have income, such as dividends, distributed to family members who are at a lower marginal income tax rate level than the business principal. In this way the tax paid on the combined income is less than if all income were taxed in the hands of the principal.

The proposed amendment effectively eliminates most opportunities for avoiding TOSI. Its application will no longer be restricted to related minors. The amendment also introduces a "reasonableness test" where it is unclear that there has been a contribution commensurate with the income paid. It is to focus on the income distributed, directly or indirectly, to family members and other non-arm's length recipients (as defined in the ITA). The 'test' effectively requires that the recipient demonstrate that they have actually contributed to the business and received compensation commensurate with that work, among other things.[1] Where the test is not met, the income is to be taxed at the highest marginal income tax rate in the hands of the recipient.

[1]The proposed test will consider such factors as labour contribution; capital or equity contributions to the business; assumption of financial risks associated with the business such as co-signing a loan or other debt and/or; past contributions in respect of previous labour, capital or risk; Department of finance Canada, Backgrounder, Income Sprinkling Using Private Corporations (accessed October 19, 2017): http://www.fin.gc.ca/n17/data/17-097_1-eng.asp.

On October 17, 2017, the government announced that it intended to simplify the proposed TOSI regime after criticism of its complexity and cost of compliance. On December 13, 2017, the government released an update and the Canada Revenue Agency ("CRA") released information about how it planned to administer the new rules. The new TOSI rules continue to be scheduled to come into effect on January 1, 2018. The rules are to apply to all related individuals (but only to a degree; aunts, uncles, nieces and nephews have been excluded) who receive, directly or indirectly, income in the form of, for example, dividends, trust distributions, partnership distributions or certain capital gains derived from a business in which a related individual is actively engaged or is a significant equity owner. There are certain exceptions that exclude application of TOSI. If an exception does not apply then the reasonableness test will likely be imposed. Some exceptions and CRA administrative points are listed below.

- The person has contributed labour on a regular, continuous and substantial basis that totaled at least 20 hours per week during the year or any of the previous five years.
- Where the specified individual (as defined in the ITA) is over 24 years of age and owns at least 10% of the private corporation's voting shares and 10% of the value shares, TOSI will not apply to income derived from those shares. To take advantage of this exception, the required shareholdings should likely be in place before the end of 2018.
- The reasonableness test will be triggered where an exception does not apply and the person is over 25.
- If an exception does not apply and the person is between 18 and 24, and cannot meet the labour contribution exception, then the person is to be limited to a prescribed rate of return (currently 1%).
- TOSI will not apply to dividends paid to the owner's spouse where the business owner has attained the age of 65 and adequately contributed to the business.
- A beneficiary who is over the age of 18 and inherits shares is able to assume the 'contribution' of the deceased in relation to the [non]application of the TOSI rules. The beneficiary steps into the deceased shareholder's shoes for the purposes of TOSI.
- TOSI will not apply to taxable capital gains from the deemed disposition at death or to property acquired pursuant to a settlement agreement between spouses (nationally) or common law partners (if the province provides partners with property rights). It will similarly not apply to second generation income.

Service based private corporations, which includes professional corporations (e.g., accountants, lawyers, doctors, dentists), are likely to have tremendous difficulty avoiding TOSI.

Non-service private corporations[2] may want to do some restructuring in 2018 to ensure they meet the 10% voting/value share requirements (discussed above). However, consideration may be given to the issues of management and control of the corporation, which may supersede tax avoidance.

[2] This appears to require that at least 90% of corporate income does not come from services.

If an estate freeze was implemented, the requirements are unlikely to be met where the related shareholders do not fall into one of the exceptions. The CRA has opined that corporate ownership by a family trust and through which dividends are distributed to family member beneficiaries is unlikely to avoid TOSI (unless an exception applies). The CRA has said that the shares would need to be personally owned by the individual.

The Senate's Standing Committee on National Finance released a report on the original proposal just prior to the government's December 13, 2017 announcement. The Committee recommended that the amendments be withdrawn and a review of Canada's tax system commence, or that the effective date be postponed to 2019 to permit further consultation and study.

The revised rules are highly complex and subject to interpretation. Please contact your corporate tax professional if you have any questions about the impact of the proposals on your corporation and to determine possible actions to be taken before the end of 2017 to minimize your family's overall taxes.

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