Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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Income splitting through private corporations

Announced on December 13, 2017

On July 18, 2017, the Department of Finance released a consultation paper, along with draft legislation, proposing a number of tax changes that were aimed at private corporations. The changes were intended to remove the perceived unfair tax advantages available to owners of private corporations. The government provided a consultation period and requested comments on their proposals by October 2, 2017. Following a review of the submissions received during the consultation period, the government announced a number of changes to the original proposals in October 2017. Please refer to our article "Update on private company tax proposals" for a summary of these announcements.

Based on feedback received during the consultation period, on December 13, 2017, the government released revised draft legislative proposals (the "proposals") that narrowed the scope and provided more clarity with respect to income splitting using private corporations. The revised income splitting measures are effective for the 2018 and subsequent taxation years; however, the measures will be legislated as part of the 2018 budget process.

Income splitting using private corporations

Currently, the "tax on split income" (TOSI) rules, commonly referred to as "kiddie tax" rules, limit splitting certain types of income with minor children. These TOSI rules apply to many types of income received from a private corporation, such as dividends, but they do not apply to salaries or bonuses. Where TOSI applies, the income is subject to tax at the highest marginal rate and the minor child loses the ability to claim personal tax credits on the split income, such as the basic personal tax credit.

The government proposes to expand the TOSI rules so that they will now potentially apply to certain amounts received, either directly or indirectly from a related business, by adults aged 18 and over. Generally, a related business is one where a person is related to an individual who is either actively engaged in the business, or owns a significant portion of the equity in the corporation that carries on the business. The amounts subject to TOSI do not include salary paid by the related business, but could include interest or dividends, as well as certain capital gains, unless the amount falls within a specific exclusion.

The government provided bright- line tests for determining whether family members are significantly involved in the business and therefore excluded from the TOSI rules. A summary of these tests and the new rules is provided below.

Adult individuals aged 18 or over

For individuals aged 18 or over, amounts received from an “excluded business” will be excluded from TOSI. An excluded business is one in which the individual is actively engaged on a regular, continuous and substantial basis (“actively engaged”) in the current tax year or in any five previous tax years. The five taxation years do not need to be consecutive, or after 2017.

An individual will be deemed to be actively engaged if they work in the business at least an average of 20 hours per week during the part of the year the business operates. For example, if a farm or fishing business operates for 4 months of the year, the individual would be considered to be actively engaged in the business for the full year if they were actively engaged during that 4-month period.

If the individual does not meet the 20-hour threshold, then it is a question of fact as to whether they are actively engaged in the business.

Adult individuals aged 25 or older

For individuals aged 25 or older, income from “excluded shares” or taxable capital gains from disposing of excluded shares will be excluded from TOSI. Excluded shares are shares of a corporation owned by an individual if the following conditions are met:

- The individual owns at least 10% of the shares of a corporation in terms of votes and value;
- The corporation earns less than 90% of its business income from providing services;
- The corporation is not a professional corporation (such as a corporation that carries on the professional practice of an accountant, a lawyer, a doctor or a dentist); and
- All or substantially all of the income of the corporation is not derived from another related business.

> If you currently use your private corporation to split income with family members, you may be affected by these rules.

If an individual intends to rely on this exclusion, they have until the end of 2018 to meet the condition of owning at least 10% of the outstanding shares of a corporation in terms of votes and value.

If you run a services business and want to continue to income split with family members, consider employing them in your business and paying them a reasonable salary.

Individuals aged 25 or older who do not meet the excluded shares or excluded business exceptions would be subject to a reasonableness test to determine how much income, if any, would be subject to TOSI. Amounts received that qualify as a “reasonable return” will be excluded from TOSI.

To determine whether an individual received a reasonable return from a related business, a number of factors may be considered, including the individual’s labour contributions, capital contributions, risks assumed, previous amounts received from the business, as well as any other relevant factors. The Canada Revenue Agency (CRA) has provided guidance on the application of the income splitting rules for adults and, in particular, elaborated on the factors it will consider in determining whether a payment is a reasonable return.

Adult individuals aged 18 to 24

If individuals between the ages of 18 and 24 do not meet the excluded business exception, they will be entitled to a return on the capital contributed.

If the individual contributed “arm’s length capital”, the individual will be able to use the reasonableness test and be permitted a reasonable return on the contribution. Arm’s length capital is essentially any capital contributed to the business other than property income from a related business, borrowed funds, or funds received from a related person (other than inherited property).

If the capital contributed is not arm’s length capital, the individual will be permitted to receive a return based upon a prescribed formula.

Spouse of a business owner

If a business owner is 65 years or older in the year, and if an amount paid to them would not be subject to TOSI under one of the exceptions, then any amount paid to their spouse would also not be subject to TOSI. This attempts to recognize the challenges associated with planning for retirement and better aligns the TOSI rules with the existing pension income splitting rules.

Any individual (including minors)

The government clarified that taxable capital gains realized from the disposition of qualified farm or fishing property and qualified small business corporation shares will not be subject to TOSI. This ensures that the TOSI rules do not limit access to the lifetime capital gains exemption (LCGE). It also places more importance on satisfying the active business asset test for qualified small business corporation shares.

If a trust holds qualified farm or fishing property, or qualified small business corporation shares and disposes of the property to an arm's length person, the taxable capital gain realized as a result of the disposition can be allocated out to the beneficiaries (including a minor beneficiary) and be excluded from TOSI. The beneficiaries of the trust may be able to use their LCGE to shelter the capital gains from tax.

For greater clarity, capital gains realized by an adult individual who disposes of these types of properties to a non-arm's length person, will not be deemed to be a dividend, as originally proposed in July 2017. It is important to note, however, that these proposed measures do not modify the existing rule that applies where a minor, either directly or indirectly through a trust, disposes of qualified farm or fishing property or qualified small business corporation shares to a non-arm's length person. In such a case, the capital gain realized on the disposition will be deemed to be a dividend, subject to tax at the highest marginal tax rate. As a result, a minor will not be able to claim the LCGE on the disposition of the property to a non-arm's length person.

Other income excluded from TOSI

The following types of income will be excluded from TOSI:

- Capital gains arising on an individual's death.
- Income or capital gains from property received as a result of breakdown of marriage or common-law relationship.
- The current rules that apply to exclude certain inherited property (such as property inherited from a parent) from TOSI for a minor would be extended to apply to adults individuals aged 18 or older, including a spouse. This means that the individual who inherited the property continues to benefit from the contributions made by the deceased individual.

In light of these proposed changes, if you are involved, either directly or indirectly, in a private corporation, you will want to review the current corporate structure and any tax planning strategies you have implemented that relate to the private corporation.

Related proposals not being implemented

The government has decided to not move forward with some measures originally proposed in its consultation paper. They decided to not extend the TOSI rules to apply to compound income (i.e., income earned on the income that was subject to TOSI). They also decided to not extend the TOSI rules to include other family members (such as aunts, uncles, nieces and nephews).

The original proposals in July 2017 provided an exception where TOSI would not apply to income or capital gains received by an individual already subject to tax at the highest marginal rate for the year. This exception was not included in the revised draft legislation.

Conclusion

In light of these proposed changes, if you are involved, either directly or indirectly, in a private corporation, you will want to review the current corporate structure and any tax planning strategies you have implemented that relate to the private corporation. We strongly recommend that you reach out to your tax and legal advisors to determine how the proposed legislation could impact you and your future plans.

This article may contain several strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal or tax advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax and/or legal advisor before acting on any of the information in this article.