THE NEW LANDSCAPE OF "INCOME SPRINKLING"

DECEMBER 15, 2017 RELEASE

Introduction

When the July 18, 2017 consultation paper was released by the Department of Finance, it became apparent the proposed tax changes would have a significant impact on business owners across Canada. Following thousands of submissions from business owners, advisors and other constituents, we have seen our Liberal government pull back on the limitation to the capital gains exemption and changes with respect to related party transactions, at least for now. Further, the changes to passive investments within a private corporation have been tabled until the 2018 Federal budget, at which point our Liberal government has stated further commentary will be provided. However, it was confirmed the changes to "income sprinkling" would be pursued, with an effective date of January 1, 2018.

After much anticipation for the revisions to the "income sprinkling" legislation, the Department of Finance released revised draft legislation on December 13, 2017 and Canada Revenue Agency (CRA) released guidelines with respect to the implementation of this new legislation.

Please note the items discussed below are based on proposed amendments only and <u>have not</u> been introduced to legislation at this particular point in time. However, these proposals will more likely than not be passed as legislation, at which point the legislation will become effective January 1, 2018. The below analysis has been entirely based on CRA's release on December 13, 2017 labelled "Guidance on the application of the split income rules for adults".

Overview

The proposed amendments' aim to expand the definition of Tax on Split Income (TOSI), which is a concept the Income Tax Act of Canada (ITA) has contained historically but only applied to minor child (under age 18), and has commonly been referred to as "Kiddie Tax". Where income is classified as TOSI, it automatically becomes taxable at the highest marginal tax rate, which is currently 54% in Nova Scotia. As such, it is prudent planning to ensure income is not caught under the TOSI rules.

The expanded definition of TOSI captures all dividends (including deemed dividends resulting from the redemption of shares) and interest, but not salary, paid by a private corporation to an individual from a related business and certain capital gains, unless one of the provided exclusions are met. In very general terms, a "related business" is essentially a business carried on by a related person. For the purposes of the ITA, related persons include parents, spouses, siblings, children and grandchildren, but does not include aunts, uncles and cousins. Each of the exclusions from TOSI have been briefly outlined below, following by various examples to illustrate the application of these exclusions.

Exclusions

Adult Individuals (18 or older) - Excluded Business

Where an adult individual is actively engaged on a regular, continuous and substantial basis ("actively engaged") in the activities of the related business in either the tax year, or any 5 prior taxation years, the related business shall be considered an "excluded business" and the TOSI rules shall not apply.

Current guidance suggests that in order to be actively engaged the individual must work in the related business an average of 20 hours per week during the operating season (i.e. - only during the operating months if the business is seasonal), or meet the actively engaged threshold in ***any*** 5 preceding years. As the 5 preceding years do not need to be consecutive years, it will be possible for an individual to meet this exclusion if they have been actively engaged in the related business for at least 5 years within the history of the business. For example, if an individual had met the actively engaged threshold in the years 2009, 2010, 2011, 2013 and 2015, but has since retired and no longer works in the business, that individual continues to meet the actively engaged test. As such, the excluded business exclusion will apply and any income received by that individual from the corporation will not be subject to TOSI.

Individuals age 25 or older - Excluded Shares

Shares of a related business corporation owned by an individual are excluded shares, meaning TOSI will not apply, if:

1. Less than 90% of the corporation's business income from the provision of services (i.e. - More than 10% of income must be from an income source other than services);

2. The corporation is not a professional corporation (being a practice of an accountant, dentist, lawyer, medical doctor, veterinarian, or chiropractor);

3. The shares represent more than 10% of the votes and value of the corporation; and

4. All or substantially all (90% or more) of the income of the corporation is not derived from a related business of the individual (i.e. - less than 10% of the corporation’s income can come from a related business);

Individuals age 25 or older - Reasonable Return

Any payments received from a related business corporation that are considered to be a "reasonable return" shall be excluded from TOSI. The criteria that will be considered for a reasonable return are as follows:

1. Labour contribution - Work performed by the individual in support of the related business (i.e. - hours worked, labour provided, etc.);

2. Property contribution - Property contributed by the individual in support of the related business (i.e. - cash, fixed assets, etc.);

3. Risk assumption - Risks assumed by the individual in support of the related business (personal guarantees, loans secured by personal assets, etc.);

The CRA has not provided any specific formula to calculate a reasonable rate of return for each of the above items as the determination is subjective and largely dependent on the facts present in each specific circumstance. However, as a general statement, we expect CRA will be assessing the "reasonableness" based on amounts which would be paid in an arm's length context – (unrelated persons). For example, labour contributions will likely be assessed against market rates for an unrelated individual with a similar skill set and property contributions will likely be assessed against market rates (i.e. - bank interest rates for loans, etc.). The reasonable test for risks incurred is likely the most subjective; however, CRA has stated the CRA will not substitute its judgement for what is a reasonable amount where the taxpayers have made a good faith attempt to determine a reasonable return based on the reasonableness criteria.

Individuals age 18 to 24 - Safe Harbour Capital Return & Arm's Length Capital

If an individual 18 to 24 contributes any property to the related business corporation and the return does not exceed a prescribed capital return (prescribed rate to be set by CRA), the income shall be considered Safe Harbour Capital Return and will not be subject to TOSI.

If an individual contributes property which was received at arm's length (i.e. - not received from the related business or a related person) and was not borrowed, income up to a reasonable rate of return shall fall under the Arm's Length Capital exclusion and will not be subject to TSOI.

All Individuals - Capital Gains

All capital gains realized on death, or from the disposition of qualified farm or fishing property and qualified small business corporation shares shall be excluded from TOSI. This exclusion from TOSI is particularly relevant as it ensures the ability to utilize structures that allow for multiple individuals to access the capital gains exemption (i.e. - a trust) will continue without attracting the application of TOSI.

Individuals age 18 and over - Inherited property

If an individual owns property (shares, debt, etc.) in relation to the related business corporation and that property was received as a consequence of the death of another person (inheritance), the attributes of the deceased person (i.e. - actively engaged, contributions in support of the business, etc.) with respect to these new TOSI rules shall be considered attributes of the individual.

Individuals age 65 and over

If an individual receives dividends, interest or capital gains in a given taxation year that would be caught by these new TOSI rules, such amounts shall be considered an excluded amount if:

i. The amount would be an excluded amount had they been dividends, interest or capital gains to that individuals spouse or common-law partner; and

ii. The individual's spouse or common-law partner is age 65 or over;

As a result of the above exclusion, individuals who are age 65 and over will be permitted to income sprinkle with a spouse who otherwise would have been caught by the new TOSI rules, so long as the aggregate amounts received by the individual and the spouse do not exceed the aggregate excluded amount of the individual (in most cases there will not be a limit to the amount).

Application

After reviewing each of the specific exclusions, you are likely left wondering how these may actually apply to you. To provide some clarification on their application, we have provided an overview of the application to each affected group. It is important to remember TOSI only applies where the individual is receiving income from a related business (i.e. - a business carried on by a person related to the individual).

Minor Children (under age 18) - Dividends and interest

Prior to the changes to the TOSI rules, all dividends and interest paid to minor children by a related business were caught by the previous TOSI rules. As this aspect of TOSI remains unchanged, all dividends and interest paid to minor children from a related business will continue to be caught by the new TOSI rules.

Minor Children (under age 18) - Capital gains

All capital gains realized by a minor child with respect to a related business will be caught by the new TOSI rules unless the capital gain is a result of death or the corporation is a qualified farming / fishing corporation or a small business corporation. As minor children would generally not own shares of the corporation directly, rather only indirectly through a family / business trust, there would generally be discretion to only allocate capital gains to a minor which would qualify for an exclusion. As such, we do not see this widely impacting our clients.

Individuals age 18 and over - Inherited property

The application of the inherited property exclusion is best illustrated through an example. Assume the business was an excluded business to the deceased by virtue of them being actively engaged in the business. The individual who inherited the property is not actively engaged in the business; therefore, the business is not an excluded business in isolation of their attributes only. However, the individual also looks to the attributes of the deceased, deeming the business to be an excluded business to them by virtue of the attributes of the deceased. As a result, the new TOSI rules would not apply under these particular circumstances.

This inherited property exclusion will likely become relevant in many situations, as it is not uncommon for a family member to receive shares of a corporation in which they are not involved via an inheritance.

Dividends or interest paid to adult individual between ages 18 and 24

All dividends or interest paid to an individual between ages 18 and 24 from a related business will be caught by the new TOSI rules unless:

i. The individual is actively engaged in the business (works 20 hours per week or more, on average, during the operating period of the related business in either the tax year, or any 5 previous taxation years); or

ii. The individual has contributed property (from any source) in support of the business and the rate of return does not exceed the rate of return prescribed by CRA;

It is important to note there is no "reasonable test" for adult individuals between ages 18 and 24. As a result, if an individual between ages 18 and 24 is not actively engaged in the business (they do not meet the 20 hours per week on average), but does provide a labour contribution at a market wage rate, any dividends or interest paid to that individual would still be caught by TOSI. To ensure TOSI does not apply in these situations, it would be advisable to pay that individual a wage / salary rather than dividends or interest.

Capital gains realized by an adult individual between ages 18 and 24

All capital gains realized by an individual between ages 18 and 24 in relation to a related business will be caught by the new TOSI rules unless:

i. The individual is actively engaged in the business (works 20 hours per week or more, on average, during the operating period of the related business in either the tax year, or any 5 previous taxation years); or

ii. The capital gain is a result of death of the individual or the corporation is a qualified farming / fishing corporation or a small business corporation;

In situations where an individual between ages 18 and 24 owns shares of the related business corporation directly and they are not actively engaged in the business, it will become prudent planning to ensure the corporation qualifies as a qualified farming / fishing corporation or a small business corporation at the time of realizing any capital gains, ensuring an exclusion from TOSI will apply.

Dividends or interest paid to adult individual age 25 and older

All dividends or interest paid to an individual age 25 and older from a related business will be caught by the new TOSI rules unless ***one*** of the following exclusions applies:

i. The individual is actively engaged in the business (works 20 hours per week or more, on average, during the operating period of the related business in either the tax year, or any 5 previous taxation years); or

ii. The shares of the corporation are excluded shares, meaning:

   a) More than 10 % of the corporation's income comes from an income source other than services;

   b) The corporation is not a professional corporation (being a practice of an accountant, dentist, lawyer, medical doctor, veterinarian, or chiropractor);

   c) The shares represent more than 10% of the votes and value of the corporation; and

   d) Less than 10% of the corporation’s income comes from another related business; or

iii. The amount of income or dividends received by the individual is considered a reasonable rate of return with respect to labour involvement, property contributions, and / or risk exposure.

In reference to the above exclusion under (i), the primary business operator should be able to easily meet the actively engaged test, meaning the new TOSI rules will not impact the primary business operator directly. However, if the corporation has historically paid interest or dividends to related persons (i.e. - spouse and / or children), the exclusion under (i) will only apply to those individuals in the event they are actively engaged in the business. In the event they are not actively engaged in the business, consideration of the exclusions under (ii) and (iii) will need to be given to ensure the new TOSI rules do not apply.

In reference to the above exclusion under (ii), corporations which ***<u>are not</u>*** professional corporations and generate more than 10% of their income from a source other than services, will apply for this exclusion provided the shares held by the individual have more than 10% of the votes and value of the company. If your business is a professional corporation or generates 90% or more of its income from the provision of services, the exclusion under (ii) cannot be relied upon.

In circumstances where the individual does not directly own shares of the corporation with votes and value exceeding 10%, rather they are a beneficiary of a family / business trust which owns shares of the corporation exceeding the 10% votes and value, the CRA has stated this exclusion cannot be met as the individual does not own shares. Based on this, the "excluded shares" exemption is not available to individuals who receive dividends through a trust and do not hold shares in the corporation directly. As such, allocation of dividends from a trust to a beneficiary age 25 or older will need to be limited to amounts covered by the actively engaged or reasonableness exclusions only.

Further, if the dividends paid to the individual have historically been paid on discretionary dividend (DD) preferred shares of the company, these shares will also not meet the greater than 10% of votes and value test as DD preferred shares have no value, regardless of their voting rights. As such, payment of dividends on DD preferred shares will need to be limited to amounts covered by the actively engaged or reasonableness exclusions only.

Due to the subjective nature of the exclusion under (iii) above, we would suggest reliance on this exclusion would only occur where the exclusion under (i) and (ii) cannot be met. With respect to relying on this exclusion, we would suggest the following documentation is imperative:

i. Labour contributions - Documentation of the individuals skill set, market rate for an individual with a comparable skill set, and the labour contributions of the individual (hours worked);

ii. Property contributions - Documentation of the property contributed (including value), reasoning why the contribution was required and whether or not other sources were readily available (i.e. bank financing);

iii. Risk assumption - Documentation of the risks assumed by the individual (financial liability exposure of the individual including loans, personal guarantees, etc.), extent of risk that the financial liability may result in a loss to the individual, whether or not the risk is indemnified and whether or not the risk results in a negative impact on the individual's reputation or personal goodwill;

Through documentation of the above and discussions with our firm, we will assist you in determining what a reasonable amount may be under each of the above categories.

Capital gains realized by an adult individual age 25 and older

All capital gains realized by an individual age 25 and older in relation to a related business will be caught by the new TOSI rules unless:

i. One of the exclusions discussed under the heading "Dividends or interest paid to adult individual age 25 and older" are met; or

ii. The capital gain is a result of death or the corporation is a qualified farming / fishing corporation or a small business corporation;

In situations where an individual age 25 or older owns shares of the related business corporation directly and cannot qualify for one of the exclusions under the heading "Dividends or interest paid to adult individual age 25 and older", it will become prudent planning to ensure the corporation qualifies as a qualified farming / fishing corporation or a small business corporation at the time of realizing any capital gains, ensuring an exclusion from TOSI will apply.

Individuals age 65 and over

The application of the exclusion for spouses of individuals age 65 and over will provide an avenue for seniors to continue with income sprinkling. This will become particularly relevant in situations where an individual (***age 65 or over only***) and their spouse each own shares of a corporation, but the spouse has never been involved in the business and the shares held by the spouse are not excluded shares.

For example, assume the maximum excluded amount the individual can withdraw is $100,000 in the current taxation year. To minimize taxes as a family unit, it is beneficial to pay $50,000 to each of the individual and his/her spouse. In applying the above exclusion, the $50,000 dividends paid to the spouse will be excluded from TOSI on the basis the aggregate dividends received by the individual and spouse do not exceed the $100,000 maximum excluded amount available to the individual.

Planning Considerations

In light of the application of these proposed amendments, it has become evident that Finance has directly targeted "income sprinkling" with children between the ages of 18 and 24. We do not think it is a coincidence this time frame largely catches the years in which children attend post secondary education, which historically allowed income sprinkling to provide significant tax savings. Although these changes are certainly unfavourable, we would like to take the opportunity to highlight a few planning considerations. Prior to acting on these considerations, we would encourage you to reach out to a member of our firm.

1. As these proposed amendments will not become effective until January 1, 2018, any dividends paid prior to December 31, 2017 will fall under the old rules. As such,

consideration should be given to paying larger dividends to adult children (18 years of age or older) than you otherwise would. You may not necessarily require sufficient cash to pay the entire dividend prior to December 31, 2017, as the cash could physically be paid a later date, but sufficient cash flow to cover the tax associated with the dividends will be required by April 30, 2018;

2. In the event you have minor children and intended to use "income sprinkling" to fund education costs, these proposed amendments may prevent you from doing so. As such, you may wish to consider other strategies for funding your childrens' education, such as Registered Education Savings Plans (RESP) which have a government grant component;

Conclusion

Although the above addresses "proposed amendments", we have every reason to believe these amendments will be enacted as legislation in their current draft form. As such, we feel it is important to understand the application of these changes and the impact they may have in your specific circumstances. We understand these changes are complex and the above analysis is not tailored to your specific situation; however, we suggest you reach out to a member of our firm if you have any questions or concerns regarding the contents of this letter.

Yours truly,

Belliveau Veinotte Inc.

Paul MacNeil, CPA CMA CBV
Partner – Tax & Business Valuation
Belliveau Veinotte Inc.

With offices located in 6 convenient locations to service your needs!

Barrington Passage	Shelburne	Liverpool	Bridgewater	Chester	Halifax
3289 Highway 3 Barrington, NS (902) 637-1637	157 Water Street Shelburne, NS (902) 875-1051	7B Henry Hensey Dr. Liverpool, NS (902) 356-4278	11 Dominion Street Bridgewater, NS (902) 543-4278	4171 Highway 3 Chester, NS (902) 273-3080	620 Nine Mile Dr. Halifax, NS (902) 444-4278