Private Company Income Splitting

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Topics to Review

1. Background to proposed changes
2. Current rules for income splitting with CCPC
3. Proposed changes for income splitting with CCPC
   - Expanding base of individuals
   - Expanding types of split income
   - Exemptions
4. Planning issues
   - What is no longer available or restricted
   - What is still available
   - To do prior to 2018
5. Take-aways

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Background to Proposed Tax Changes

- Federal budget 2017 warning about government concerns as to tax Issues for private corporations
- July 18, 2017 Department of Finance draft legislation, explanatory notes and consultation paper proposing to fundamentally overhaul system of taxation of private corporations, their shareholders and family members
- Very broad changes targeting Canadian-controlled private corporations ("CCPC") regardless of sector or industry

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Background to Proposed Tax Changes …cont'd

- Government projection of additional income tax revenue from income splitting changes is relatively minor so likely motivated largely by political issues for attacking high income earners to appeal to middle class
- Issues targeted are:
  - Income splitting/sprinkling
  - Lifetime capital gains exemption
  - Capital gains tax
  - Holding passive investments in a private corporation

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Background to Proposed Tax Changes …cont'd

- Scope of proposals go beyond expectations of tax professionals
- Changes will affect all or most CCPCs
- I will be dealing with proposals for income splitting
- New rules to become effective 2018
- Much opposition to changes so question of what, if any, changes
- Ontario Medical Association particularly upset as Ontario government specifically allowed income splitting for professional corporations of physicians as part of settlement with OMA over fee schedule

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Current Rules as to Income Splitting with CCPCs

- Current restrictions to restrict income splitting with minors and spouses under various attribution rules and special rules that limit income splitting to minors (kiddie tax)
- Kiddie tax results in taxation at top marginal rate
- Maximum annual tax savings by dividend splitting approximately $25,000 to $35,000 per individual if no other income
- Savings decrease significantly if family member has other income

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Current Rules as to Income Splitting with CCPCs

Income Splitting by Dividends

- Current rules allow for income splitting by dividends to spouses and adult children if structured properly to avoid personal attribution rules and corporate attribution rules
- Common tax planning has spouse and adult children owning shares directly or through a family trust to allow dividends paid to various family members with flexibility
- CRA previously attacked income splitting by dividends to family members
- Courts determined that income splitting by dividend is legal if properly set up regardless of services provided or other contributions by the shareholder

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Current Rules as to Income Splitting with CCPCs

Income Splitting by Salary

- Alternative income splitting to family members by corporation pay a salary
- Always has been limited to what is reasonable relative to the services provided (arm's length test)
- Risk of double tax if deduction by corporation disallowed
- Commonly used and CRA not overly aggressive if salary not too aggressive
- Question if CRA will be more aggressive on proposed "reasonableness" test for dividends

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Proposed Changes for Income Splitting

Expanding Base of Individuals – Specified Individuals

- Significant changes to add significant restrictions and uncertainty to limiting income splitting among family members by CCPC
- The tax on split income ("TOSI") (formerly limited to kiddie tax) will apply not only to minor children but to "specified individuals"
- Will apply to children over 18 and other related individuals, including spouses, common-law partners, aunts, uncles, nieces and nephews
- Limited to individuals resident of Canada

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Proposed Changes for Income Splitting

Expanding Types of Split Income

- Gains from property that would produce "split income" (i.e. shares of the CCPC)
- Related proposed change to deny capital gains exemption on such shares (to be dealt with by another speaker)
- Gain on such a share on non-arm's length disposition is taxed as non-eligible dividend instead of capital gain

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Proposed Changes for Income Splitting

Expanding Types of Split Income …cont'd

- Income from loans to a corporation, partnership or trust in certain situations (i.e. interest on loan to a corporation)
- Income on previously split income if the individual is under age 25
- Amounts included in income because of benefit conferred by another person

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Proposed Changes for Income Splitting

Exemptions from TOSI

- For individuals age 25 or over exemption if the amount is reasonable relative to what would be paid to an arm's length person taking into consideration
  - Assets contributed to the business
  - Labour contributed to the business
  - Previous returns and remuneration

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Proposed Changes for Income Splitting

Exemptions from TOSI …cont'd

- Stricter tests for individuals age 18 to 24 years old
  - Consider labour only if acted on a regular and continuous basis
  - Only prescribe maximum return on assets contributed
- Practical problem to determine what is reasonable amount, which will depend in each situation, resulting in significant uncertainty

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Proposed Changes for Income Splitting

Exemptions from TOSI …cont'd

- Anti-avoidance provision if more than fifty percent of the income of a business is from property or its principal purpose is to derive income from property (e.g. a holding company) then individual deemed not to have performed any labour function in respect of the business

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Planning Issues

What is No Longer Available or Restricted

- In context of an estate freeze there will be restrictions on dividends to family members based on reasonableness test (stricter if under age 25)
- In connection with setting up new corporation restrictions on dividends to family members based on reasonableness test (stricter if under age 25)
- Reinvestment of split income by child under age 25

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Planning Issues

Planning Still Available

- Salaries to the extent reasonable
- Dividends to a child aged 25 or over and spouse to extent reasonable relative to capital and labour provided taking into consideration previous returns and remuneration (? catch-up payments)
- Estate freeze still useful to freeze capital gains tax on death of freezor with family trust owning new growth shares to allow flexibility for future allocation of growth shares among family members

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Planning Issues

Planning Still Available …cont’d

- Dividends to individuals already subject to top tax rate
- Prescribed interest rate loans (currently 1%) reinvested by spouse and children, subject to payment of annual interest by January 30 each year
- Splitting eligible pension income between spouses
- Income earned on property received from a parent on death

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Planning Issues

Planning Prior to 2018

- Consider maximizing dividends to family members by December 31, 2017 before new restrictions apply

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Take-Aways

- If proposed income splitting changes become effective will impact all or most CCPCs
- Need to review all CCPCs and dividends paid
- Significant uncertainty as to what will be considered by CRA a reasonable amount of dividends in each situation
- Uncertainty as to how aggressive CRA will be in challenging dividends (past practice with salaries)
- Most of the tax savings occur at relatively low amounts of dividends
- Consider paying dividends by the end of 2017

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Questions?

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