


TAX PLANNING RULES FOR PRIVATE CORPORATIONS

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TAX LAW – CHANGE IN FEDERAL PERSPECTIVES

2000 to 2015 – small business growth is to be encouraged

Significant changes to tax law reducing the burden on CCPC's and their owners:

- Capital gains reduced from $\frac{3}{4}$ to $\frac{1}{2}$, increased exemption limits
- High corporate rate reduced from 29% to 15%
- Eligible dividends with higher dividend tax credit

2015 to 2018 – small businesses are a source of tax revenue

- At least 15 Federal tax increases or deduction restrictions proposed since December 2015
- Most are specifically targeted to owner managed businesses

CORPORATE TAXES - BASICS

SMALL BUSINESS DEDUCTION

- 13.5% CORPORATE TAX RATE ON ACTIVE BUSINESS INCOME
- \$500,000 ANNUAL LIMIT – SUBJECT TO REDUCTIONS
- SHARED BY ASSOCIATED COMPANIES

GENERAL TAX RATE

- 26.5% CORPORATE TAX RATE
- ACTIVE INCOME NOT ELIGIBLE FOR SMALL BUSINESS RATE

DIVIDENDS MUST BE PAID FOR PERSONAL SPENDING

- DIFFERENT RATE BASED ON CORPORATE TAX RATE PAID

SHAREHOLDER TAXES - BASICS

TOP RATE ON ORDINARY INCOME 53.5%

DIVIDEND TAX RATES - \$220,000 AND OVER

- Top rate on ordinary dividends 46.9%
- Top rate on eligible dividends 39.3%

CAPTIAL GAINS ON SHARE SALE

- Top rate on capital gains 26.8%
- Capital gains exemption limit \$848,252
 - Personal sale of Canadian controlled private corporation with substantially all assets used to carry on an active business in Canada

CORPORATE TAXES – THEORETICAL FRAMEWORK

INTEGRATION AND EQUALIZATION

- Decision to incorporate should be tax neutral through to the individual taxpayer
- Dividend tax credit to individual for tax paid by corporation
- Business income taxed at low rate to encourage growth
- Passive income taxed at high rate to deter deferral

BUSINESS TAX + DIVIDEND TAX = PERSONAL TAX RATE

PASSIVE INCOME TAX + REFUNDABLE TAX = PERSONAL TAX RATE

NEW RULES #1 – 2016 FEDERAL BUDGET

ISSUE – SMALL BUSINESS TAX RATE IS LOW ENOUGH

- Enacted tax rate reductions scheduled for the 2017, 2018 and 2019 calendar years are repealed
- Federal small business rate fixed at 10.5% for 2016 and future

ISSUE – MULTIPLE SMALL BUSINESS DEDUCTION CLAIMS

- Specified corporate income rules
- Specified partnership business limit
- Specified partnership income
- Taxable capital calculation rules

Effective for tax years beginning after March 21, 2016

NEW RULES #2 – 2017 FEDERAL BUDGET

ISSUE – MULTIPLE SMALL BUSINESS DEDUCTION CLAIMS

- Expansion of de-facto control rules

ISSUE – TAX NOT BEING PAID FAST ENOUGH

- End of billed-basis accounting for specified professionals, phased in over two tax years
- Effective for tax years beginning after March 21, 2017

REVIEW OF TAX PLANNING STRATEGIES ANNOUNCED

NEW RULES #3 – JULY 18, 2017 PROPOSALS

ISSUE – INCOME SPRINKLING

- Expanding KIDDIE TAX rules to adults if the income is sourced from a corporation or business linked to a related person
- Exception for “reasonable return on investment or effort” based on cumulative efforts, assets and risks compared to accumulated income

ISSUE – CAPITAL GAINS EXEMPTION MULTIPLICATION

- CGE not available for gains realized by a trust, gains accruing prior to a rollout from a trust, and gains accruing before age 18

ISSUE – SURPLUS STRIPPING

- New provisions that recharacterize proceeds of disposition from capital gain or repayment of tax paid cost base to dividends, retroactive to 1984

ISSUE – CORPORATE TAX DEFERRAL

- Discussion of possible methods that could be used to discourage retaining profits for investment purposes

ROLLBACK ANNOUNCEMENTS

SEPTEMBER 8, 2017

- Phase in period for billed-basis accounting changed from two years to five years

OCTOBER 16, 2017

- Small business tax rate reductions reinstated (consequential increase to tax rate on ordinary dividends)
- Government “will not be moving forward with measures to limit access to the Capital Gains Exemption”
- Corporations with family members who “meaningfully contribute to the business” will not be impacted by the proposed measures on income sprinkling

ROLLBACK ANNOUNCEMENTS CONTINUED

OCTOBER 18, 2017

- All past investments and the income earned from those investments will be protected from the new passive corporate income rules
- Businesses can continue to save for contingencies and growth
- \$50,000 annual threshold on passive income
- Incentives for venture capital and angel investors
- Measures will be released in 2018 budget

OCTOBER 19, 2017

- Announcement that the government will not be moving forward with measures relating to conversion of income into capital gains

DRAFT LEGISLATION FINALLY ISSUED

DECEMBER 13, 2017

- Income Sprinkling draft legislation and explanatory notes issued, effective for 2018 and subsequent tax years

FEBRUARY 27, 2018

- 2018 Federal budget issued including passive income rules for Canadian controlled private corporations

MARCH 27, 2018

- Passive Income draft legislation and explanatory notes issued, effective for tax years beginning after 2018

WHERE ARE WE NOW

2016 SMALL BUSINESS INCOME RULES

- Legislation enacted
- Effective for years beginning after March 21, 2016

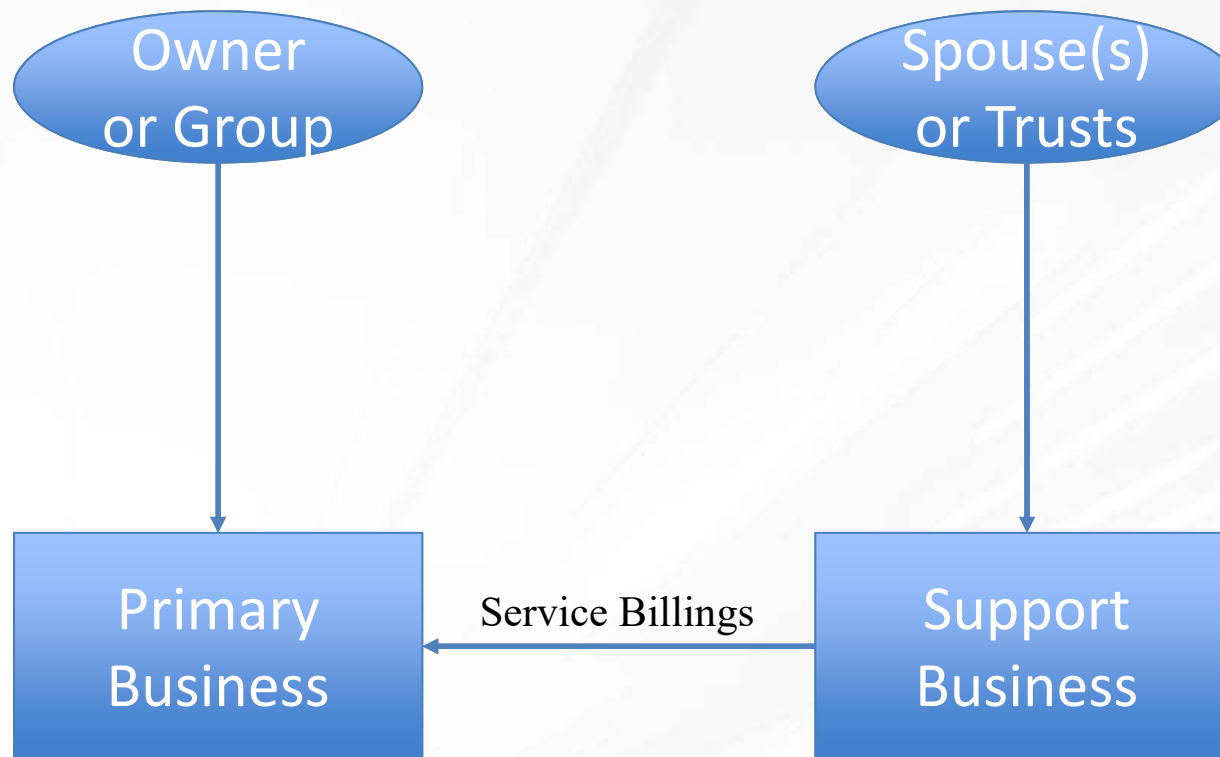
INCOME SPRINKLING

- Draft legislation introduced March 27, 2018
- Effective 2018

CORPORATE TAX DEFFERAL

- Draft legislation introduced March 27, 2018
- Effective for corporate tax years beginning after 2018

SPECIFIED CORPORATE INCOME



SPECIFIED CORPORATE INCOME

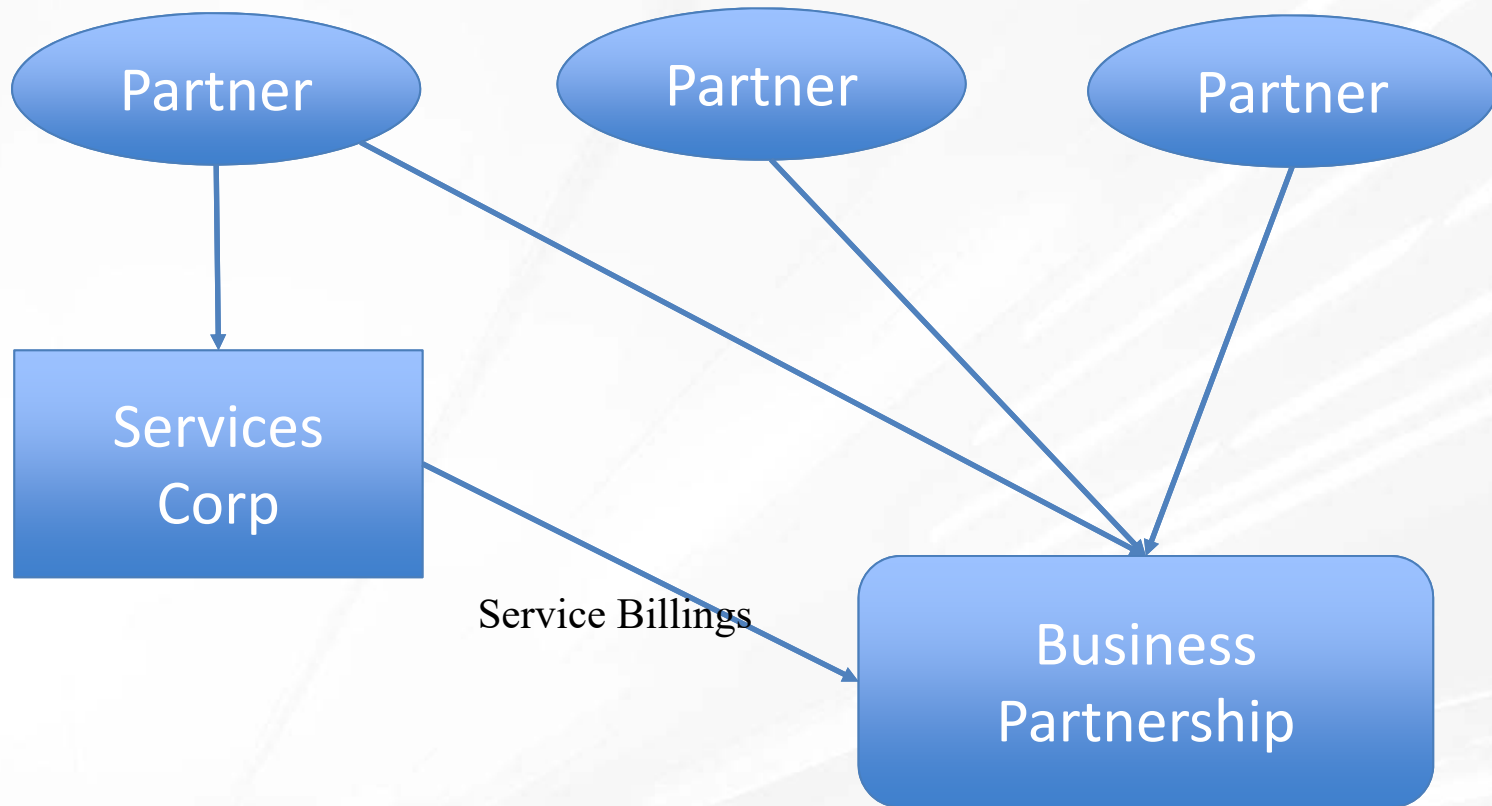
OLD RULES

- Each company had a separate \$500,000 small business limit
- Up to \$1,000,000 taxed at low rate

NEW RULES

- If the two companies have a common shareholder, or any shareholder of one company is related to any shareholder of the other
- Income from fees received by Support Business are not eligible for the small business deduction
- Exception if over 90% of Support revenue is from third parties
- Small Business Limit can be assigned from Primary to Support if Primary does not need the full \$500,000
- Only customer - maximum \$500,000 taxed at low rate

SPECIFIED PARTNERSHIP BUSINESS LIMIT



SPECIFIED PARTNERSHIP BUSINESS LIMIT

OLD RULES

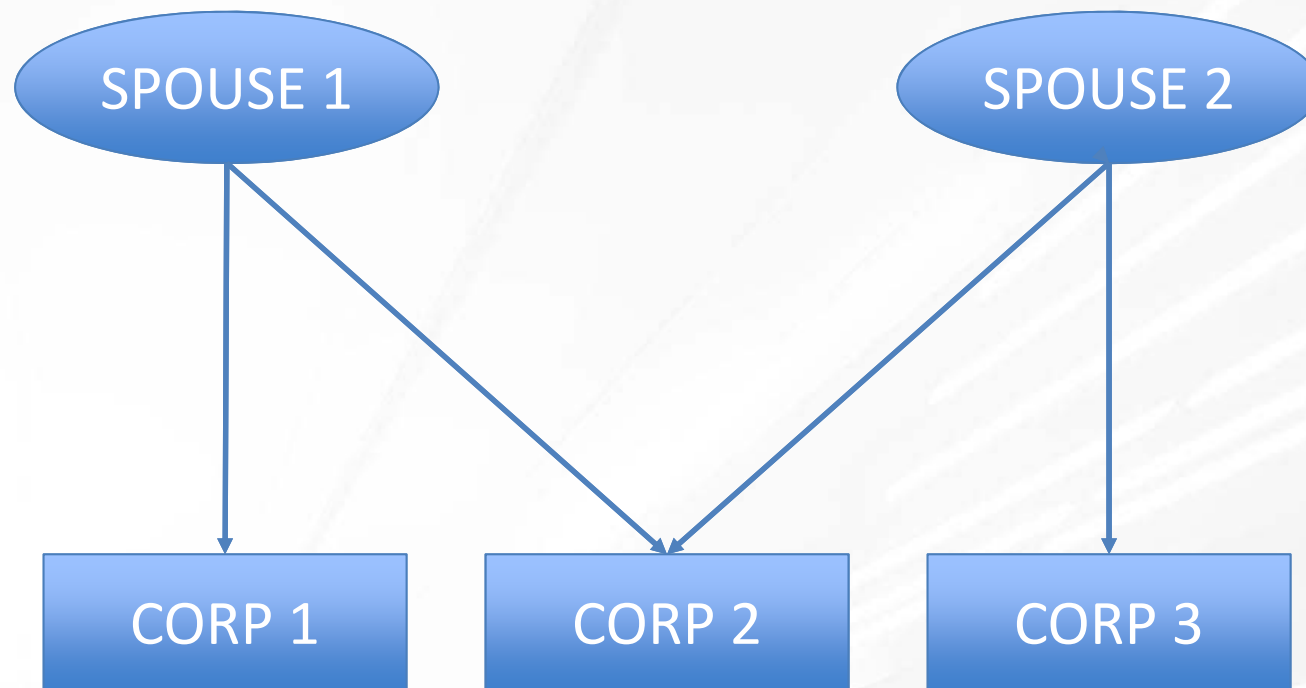
- Services Corp has a \$500,000 small business limit
- Not required to prorate based on partnership ownership

NEW RULES

- Services Corp is a designated partner
- Fee revenue is deemed to be partnership income
- Specified partnership income (eligible for SBD) is deemed to be nil
- Other partners can assign unused Specified Partnership Business Limit to Professional Corp, but total can not exceed \$500,000

Ownership link effectively deems Services Corp to be a partner

TAXABLE CAPITAL FOR SBD LIMIT PURPOSES



TAXABLE CAPITAL FOR SBD LIMIT PURPOSES

OLD RULES

- CORP2 election under 256(2)(b)(ii) broke association between CORP1 and CORP3
- CORP2 was not associated with either CORP1 or CORP3
- CORP2 taxable capital disappeared from both groups

NEW RULES

- CORP2 election under 256(2)(b)(ii) still breaks association between CORP1 AND CORP3
- CORP2 is still associated with both CORP1 and CORP3
- CORP2 taxable capital will affect SBD limit of both CORP1 and CORP3

CONTROL IN FACT

LEGAL CONTROL

- Person or persons who by virtue of share ownership can elect a majority of the board of directors

CONTROL IN FACT

- Person who has influence that result in factual control of the company separate from shareholding rights

2016 court case restricted interpretation of existing provision, new legislation overrides case and re-establishes broad interpretation.

SMALL BUSINESS CHANGES - SUMMARY

NEW RULES ARE MECHANICAL

- SBD multiplication structures no longer effective
- One business = one small business deduction
- Potential for unfair overreach in small markets
- Elections and designations will make filings more complex
- Forms do not exist for some elections

Broad drafting (no minimum ownership) makes it very difficult to plan around. Only exemption is third party revenue.

Distribute profits as bonuses, or accept the 26.5% tax rate over limit.

PASSIVE INVESTMENTS - ISSUE

NO TAX DEFERRAL ON PASSIVE INCOME IN CORPORATION

- Corporate tax rate on interest is 50.2%, public dividends is 38.3%
- Top personal tax rate on interest is 53.5%, public dividends 39.3%

CONCERN IS CAPITAL AVAILABLE TO INVEST

- Individual investment (top rate) 46.5% of income
- Small business 86.5%
- Large business 73.5%

Personal dividend on original capital will equalize but there will be more after-tax investment income from the higher initial investment

PASSIVE INVESTMENTS – ORIGINAL PROPOSALS

JULY 2017 PROPOSED AMENDMENTS

- Eliminate refundable portion of corporate tax
- Eliminate capital dividend account from corporate gains
- Complicated sourcing and tracking proposals
- Existing investments would be grandfathered

TOP INTEGRATED TAX RATES

- 73.5% on income
- 39.8% on capital gains

PASSIVE INVESTMENTS – COMPLETE REWRITE

RESTRICT ACCESS TO DIVIDEND REFUND

- RDTOH account to be streamed by source (investment income, ordinary dividends, eligible dividends)
- Dividend refund will depend on type of dividend paid

REDUCTION OF SMALL BUSINESS LIMIT

- Investment income in prior year over \$50,000 reduces small business limit 10:1
- Total investment income of company and all associated corporations
- Expanded definition of associated corporation (anti-avoidance rules)

Applicable to tax years beginning after 2018.

DIVIDEND REFUND STREAMING

NON-ELIGIBLE REFUNDABLE DIVIDEND TAX ON HAND

- Refundable portion of Part I tax (30.67% of investment income, adjusted for foreign tax credits claimed)
- Part IV tax paid on dividends from connected corporations that do not create eligible refundable dividend tax

Dividend refund only generated by payment of non-eligible dividends

Protects integration of investment income by preventing eligible dividends (business income) being used to recover refundable tax paid on investment income.

DIVIDEND REFUND STREAMING

ELIGIBLE REFUNDABLE DIVIDEND TAX ON HAND

- Part IV tax paid on eligible dividends from unconnected corporations
- Part IV tax paid on eligible dividends from connected corporations that generated a dividend from that company's eligible RDTOH pool
- 2019 transitional balance – lesser of RDTOH balance for 2018 or 38.33% of GRIP balance for 2018 after accounting for 2018 dividends

Dividend refund generated by payment of any taxable dividend

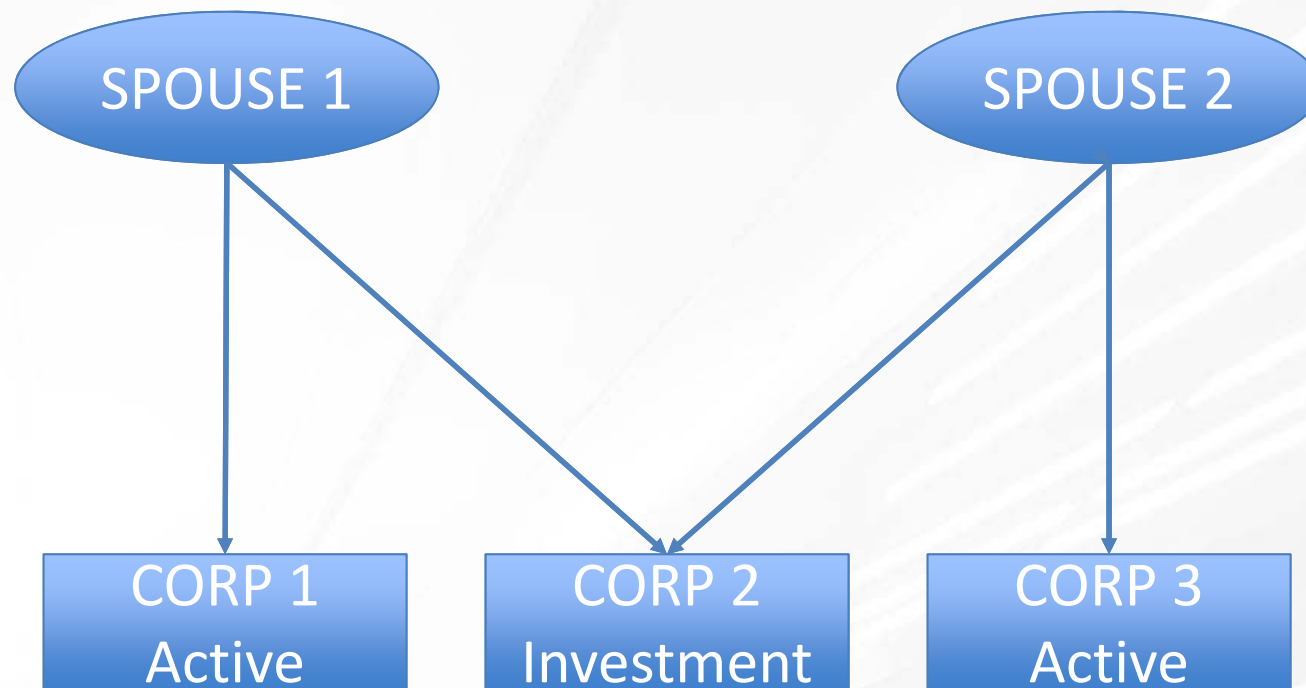
NEW SMALL BUSINESS LIMIT RULES

SMALL BUSINESS LIMIT REDUCTION

- If aggregate adjusted investment income under \$50,000 in prior year no changes
- Between \$50,000 and \$150,000 small business limit reduced by \$10 for every \$1 of investment income
- If investment income is over \$150,000 then no small business deduction

Aggregate all investment income earned by each company in the associated group for tax years ending in the prior calendar year.

INVESTMENT INCOME FOR SBD LIMIT PURPOSES



ADJUSTED AGGREGATE INVESTMENT INCOME

Components of Adjusted Aggregate Investment Income

- Net taxable capital gains (50% of actual gain), other than from the sale of active business assets or shares of a connected small business corporation
- Interest and dividends, other than dividends from a connected corporation
- Net income or loss from a specified investment business (e.g. real estate rental business)
- Taxable income from a life insurance policy if not already included
- Foreign accrual property income (without any deduction for underlying foreign taxes)
- Less expenses incurred to earn the investment income

ANTI-AVOIDANCE RULES

TRANSFER OF ASSETS

- A related corporation will be deemed associated (if not already) to a corporation that lends or transfers property in order to reduce its investment assets

EARLY APPLICATION

- New rules will apply to years ending in 2019 if the company uses a short tax year in 2018 to defer implementation date.

PASSIVE INVESTMENT INCOME SUMMARY

- Dividend refund streaming rules eliminate an unintended advantage that unfairly increased deferral benefits
- The \$50,000 annual income represents a notional 5% yield on \$1,000,000 of savings, intended to mimic reasonable RRSP savings accumulation for employee
 - No grandfathering of existing positions
 - Not indexed
 - What if interest rates / inflation drives market yields higher?
- Lose 13% of invested capital with elimination of small business deduction, but still better than 40% loss if paid as bonus

Tax on Split Income (TOSI) from Private Businesses

May 23, 2018



Tax on Split Income (TOSI) from Private Businesses

The Incentive to Income Split

- Shift income from high income earners to lower income earners to take advantage of credits and/or lower marginal tax rates
- **Tax Free Income (2018 rates) (Assumes no other income)**
 - Ordinary Income: \$11,809
 - Non-eligible dividends \$30,500
 - Eligible Dividends: \$57,325
- **Savings to top marginal rates (Per split)**
 - Ordinary Income (220K): \$36,200
 - Non-Eligible dividends (\$190K):\$36,225
 - Eligible Dividends (\$159K): \$35,725

Tax on Split Income (TOSI) from Private Businesses

Current rules to prevent income splitting:

- **74.1, 74.2, and 74.3: General Attribution rules**
 - Transfers or loans of property between spouses and minor children for less than FMV consideration
- **74.4: Corporate attribution rules**
 - Transfers or loans of property to a corporation if main purpose to reduce the person's income and benefit a spouse or related minor
- **56(4.1)** Loan's between non-arm's length parties with main purpose to income split
- **75(2) Reversionary Trust Rules**
- **103(1.1)** partnership allocations that are "unreasonable"
- **S. 67** denial of deductions for unreasonable salaries
- **56(2) and (4):** Specific Anti Avoidance rule for Indirect payments and transfers of rights to payments

Tax on Split Income (TOSI) from Private Businesses

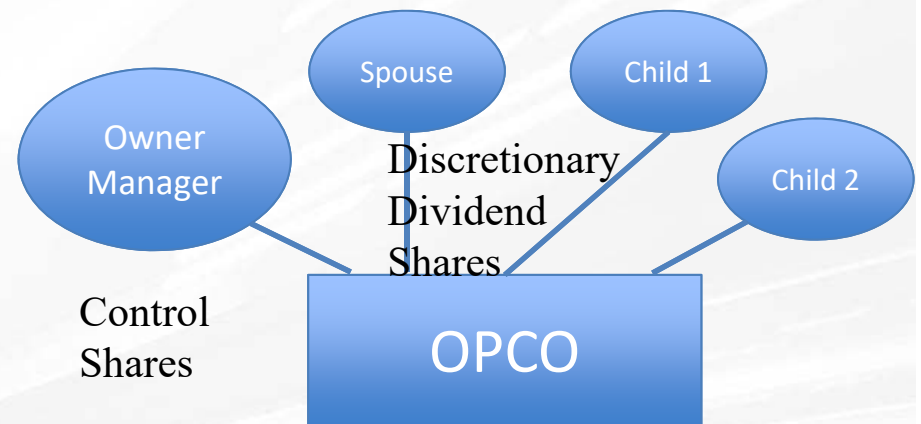
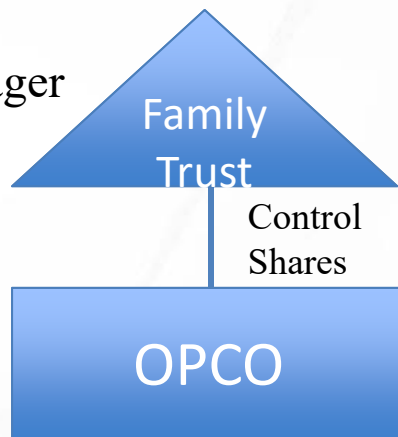
What does dividend income sprinkling refer to?

- Paying dividends to multiple family members which would have otherwise been received by the primary owner/manager
 - Objective to utilise the lower marginal tax rates of family members to achieve an overall lower family tax bill
 - Different structures to achieve income sprinkling, typically resemble the following:

Trust

Beneficiaries:

- 1) Owner Manager
- 2) Spouse
- 3) Child 1
- 4) Child 2



History of TOSI and dividend sprinkling prior to 2018:

TOSI is not a new concept!

For Minors:

- Tax on Split Income Rules “TOSI” introduced in 1999 to prevent dividend sprinkling with minor children <18 years old

For Adults:

- Dividend sprinkling generally allowed
 - Decision in [Neuman, \[1998\] 3 C.T.C. 177](#) prevailed
 - CRA argued that 56(2) applies to sprinkled dividends to family
 - Supreme court disagreed with CRA!
 - Shareholders need **not** contribute services to a corporation to be entitled to a dividend
 - Dividends belong to the corporation until they’re paid

Tax on Split Income (TOSI) from Private Businesses

Can TOSI apply to you??

Pre 2018 “TOSI” limited to minors:

- Only applicable to minors under 18 years of age
 - A parent needed to be resident in Canada during the year

2018 and beyond expansion of “TOSI” to Adults

- January 1, 2018 expansion of TOSI concept to “**specified individuals**”
 - Includes any individual resident in Canada at the end of the year (*Irrespective of Age*)
 - Includes deceased persons resident in Canada on death

TOSI can apply to almost anyone receiving “split-income”!

Tax on Split Income (TOSI) from Private Businesses

Types of “Split” Income subject to TOSI

- Dividends, S/H loans, taxable benefits from private corporations
- Rent / Service fees charged to a “**Related Business**”
- Partnership or Trust Income from a “**Related Business**”
 - Rental income from a trust or partnership in which a related person is an active participant.
- Non arm’s length Taxable Capital disposition of shares (re-characterized as dividends for minors)

NEW types of “Split” Income subject to TOSI

- Taxable Capital Gains on dispositions of property
 - Exclusion for deemed gains on death
 - Exclusion of gains on QSBC shares eligible for LCGE
- Interest on debts

Income that is not “Split”?

- Income or gains on public corp. / mutual funds
- Reasonable Salaries

Tax on Split Income (TOSI) from Private Businesses

Exclusions / Carve-outs from TOSI

-Under 25 years of Age

– Inheritance Excluded Amount

-Exclusions for Over 18 years of Age

1) *No Related Business*

2) *Excluded Business*

-Additional Exclusions for Over 25 years of Age

4) *Excluded Shares*

5) *Reasonable Return*

-Additional Exclusions for Over 65 years of Age

6) *Retirement exclusion*

Tax on Split Income (TOSI) from Private Businesses

“Related Business” Exclusion (18 and Older)

- Income not derived directly or indirectly from a “Related Business” is not subject to TOSI
 - Income must be from a business!

“Related” Business

- Related person is actively engaged in the business; or
- Related person owns >10% value of corporation shares; or
- Related person owns any partnership interest
 - Note: No de-minimus ownership threshold for partnership

RELATED PERSON: Grandparents, parents, siblings, children, and all corresponding in-laws

Tax on Split Income (TOSI) from Private Businesses

“Excluded Business” Exception (18 and Older)

- Income from an “Excluded Business” is not subject to TOSI
 - All or nothing “Bright Line” test

What is an “Excluded Business”?

A business in which the income recipient is **actively engaged** on a regular, continuous and substantive basis

Actively Engaged

Bright Line Test = average 20 hours/ week

-Could be less if strong justification

- I. In the year; OR
 - II. In a combination of any 5 previous years
- do not need to be continuous

Tax on Split Income (TOSI) from Private Businesses

“Excluded Shares” Exception (25 and older)

- Excludes income from or taxable capital gains on disposition of shares of a **corporation** if:
 - Recipient owns 10% or more of the votes and value of the corporation’s shares
 - *Shares must be held directly*
 - Less than 90% business income is from services
 - Not a professional corporation
 - *Professional corporation = incorporated accountant, dentist, lawyer, medical doctor, veterinarian or chiropractor*
 - Income not derived directly or indirectly from another business
 - *Prevents ability to split property business from services business and Exclude property business shares*

Tax on Split Income (TOSI) from Private Businesses

Retirement Exclusion (Spouse over 65 years of Age)

- Split-income is **not subject to** TOSI if recipient's **spouse** is **over 65 years old** (or deceased)
 - Eligible for TOSI exclusion if recipient's spouse would not be subject to TOSI
 - No age requirement for recipient
 - Allows for accumulated capital to be split in retirement
 - *Both income and gains excluded*
 - *Doesn't matter if it was a services business*
 - Passive investment rules
 - Similar to pension income splitting

Tax on Split Income (TOSI) from Private Businesses

The “Reasonableness” Exclusion (18 and older)

- TOSI will not apply to “**reasonable**” returns for **contributions to a business relative to other related persons**
 - **Contributions** considered for “**reasonable**” returns depend on the age of the recipient (Continuous Concept)
 - Retroactive / cumulative
 - Considers pre 2018 contributions
 - Reduced by previous dividends/salaries/compensation
- 25 yrs. of age:** FMV of contributions of efforts, property (i.e. Capital) and risks assumed
- 18-24 yrs. of age:** Prescribed rate (currently 2%) on capital; or Reasonable Return on “*Arm’s length capital*” invested
- “*Arm’s Length*” = Inherited or salary earned by the individual.

Tax on Split Income (TOSI) from Private Businesses

What is considered reasonable? (Reasonableness Exclusion Cont'd)

Issues with Reasonableness Exclusion

- Subjective and ambiguous
 - *Not an exact science / Relative proportions*
- Administrative Burden
 - *Retroactive calculations*
 - *Information tracking*
- Withstand CRA challenge?

Tax on Split Income (TOSI) from Private Businesses

Analysis / General observations of TOSI exclusions and opportunities to split income

Active Recipients (18 and older)

1) Excluded Business

Non-Active Recipients (Over 25)

1) Retirement Exclusion

-Spouse recipient not required to be active

2) Excluded Shares

-Related recipient not required to be active provided owns 10% or more votes and value

Active/Non-Active Recipients

Reasonableness Exception

Tax on Split Income (TOSI) from Private Businesses

Does TOSI end income splitting?

- **Opportunities to income split still exist!**
 - Exclusions from TOSI
 - Income sourced from public corporations or mutual funds
 - Prescribed Rate Loans
 - Where TOSI doesn't apply
 - Cannot circumvent TOSI!
 - Reasonable Salaries
 - Arm's length market value
 - CPP, EI and EHT implications
 - Risk of double tax if unreasonable

Tax on Split Income (TOSI) from Private Businesses

Actions to be taken – advice for a new TOSI world

- Analyse business structures for TOSI implications
 - *Update directors*
 - *Pay reasonable salaries*
- Consider Re-Organisation / Simplification of Structures
 - *Are shareholdings still relevant?*
 - *Separate classes of shares by shareholder*
- Consider transferring / consolidating shares
 - *Reduce related links to Related Business*
 - *Meet 10% Excluded Share test*
 - *Simplify allocation of reasonable amounts*
- Consider holding properties/shares personally
 - *Avoid split-income*
 - *Excluded share test*

Tax on Split Income (TOSI) from Private Businesses

Actions to be taken – advice for a new TOSI world

Documentation Requirements

- Documentation needed to rebut TOSI presumption
 - *Burden of proof on taxpayers*
 - *How and what information will be collected?*
- Determine feasibility of supporting exclusion
 - *Beneficial Exclusion?*
 - *Retroactive Information*
 - *Metrics to be tracked*
 - Time tracking
 - *Assess administrative procedures*
 - *Review information/documentation policies*



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