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TAX PLANNING RULES FOR PRIVATE CORPORATIONS

November 29, 2018

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
- ADDITIONAL TAX IS 5% FEDERAL / 8% ONTARIO
- ACTIVE INCOME NOT ELIGIBLE FOR SMALL BUSINESS RATE
- 72% OF PROFIT BECOMES GENERAL RATE INCOME POOL

CORPORATE TAXES - BASICS

INVESTMENT TAX RATE (INTEREST AND RENT)

- 50.2% CORPORATE TAX RATE ON INVESTMENT INCOME
- 30.7% OF THIS IS REFUNDABLE WHEN DIVIDENDS ARE PAID

DIVIDEND TAX RATE

- 38.3% ON PORTFOLIO DIVIDENDS
- FULLY REFUNDABLE WHEN DIVIDENDS ARE PAID

CAPITAL GAINS

- HALF TAXABLE AS INVESTMENT INCOME (SEE ABOVE)
- HALF TAX FREE, CAN BE PAID OUT WITHOUT TAXES

INDIVIDUAL SHAREHOLDER TAXES - BASICS

TOP RATE ON ORDINARY INCOME 53.5%

DIVIDEND TAX RATES - $220,000 AND OVER

- Top rate on ordinary dividends 46.7% (47.4% in 2019)
- 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

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 – NEW RULES

REDUCTION OF SMALL BUSINESS LIMIT

- Investment income in prior year over $50,000 reduces small business limit 5:1, becomes zero at $150,000
- Total investment income of company and all associated corporations
- Expanded definition of associated corporation (anti-avoidance rules)

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

Applicable to tax years beginning after 2018, Federal SBD only.

ADJUSTED AGGREGATE INVESTMENT INCOME (AAII)

Components of Adjusted Aggregate Investment Income

- 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)
- 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
- Foreign accrual property income (without any deduction for underlying foreign taxes)
- Taxable income from a life insurance policy if not already included
- Less expenses incurred to earn the investment income

NEW SMALL BUSINESS LIMIT RULES

Combine AAII for each company in the associated group for all tax years ending in the prior calendar year.

SMALL BUSINESS LIMIT REDUCTION

- If total AAII is under $50,000 in prior year no changes
- Between $50,000 and $150,000 small business limit reduced by $5 for every $1 of investment income
- If investment income is over $150,000 then no small business deduction

Small business limit is lower of amount determined by this rule, or amount determined by taxable capital rule.

ANTI-AVOIDANCE RULES

TRANSFER OF ASSETS

- A related corporation will be deemed associated (if not already) to a corporation that it lends or transfers property to 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 (e.g. amalgamation with shell corporation).

DIVIDEND REFUND STREAMING - ISSUE

Companies with GRIP and RDTOH create tax deferral arbitrage opportunity

	No GRIP	GRIP
Investment Income	100.00	100.00
Corporate Tax	(50.166)	(50.166)
Dividend refund	30.666	30.666
Dividend	80.500	80.500
Personal tax	(37.553)	(31.637)
Retained Cash	42.947	48.864
Total Tax	57.053	51.137

DIVIDEND REFUND STREAMING - ERDTOH

ELIGIBLE REFUNDABLE DIVIDEND TAX ON HAND

- Part IV tax paid on eligible dividends from unconnected corporations (generally public companies)
- Part IV tax paid on eligible dividends from connected corporations that generated a dividend from that company's ERDTOH pool
- Transitional balance (first year beginning after 2018) – 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

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DIVIDEND REFUND STREAMING - NERDTOH

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 ERDTOH

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 STREAMING - PLANNING

Holding Company
GRIP $0
RDTOH $50,000

↓

Operating Company
GRIP $200,000
RDTOH $0

ERDTOH is zero in both companies

DIVIDEND STREAMING - PLANNING

Holding Company
GRIP $135,000
RDTOH $50,000

↓ Pay $135,000 eligible dividend in last tax year beginning before 2019

Operating Company
GRIP $65,000
RDTOH $0

ERDTOH is $50,000 in Holdco
Still zero in Operating Company

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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

BILLED BASIS ACCOUNTING

Unbilled work in progress for certain professionals

- Accountants, lawyers, doctors, dentists, veterinarians

Old rule – can elect for value to be zero until billed

New rule – treated the same as inventory like any other business

- Costs need to be carried as inventory (not expensed)
- Lower of cost or fair market value
- Five year phase in – only need to recognize 20% of cost in first year, increases by 20% each following year
- Applies to each year's costs (not a reserve based on first year)
- Does not apply to contingency fee engagements

BILLED BASIS ACCOUNTING

Cost of Work in Process

No specific allocation method prescribed

Interpretation bulletin IT 473R provides guidance, specifies that cost must be more than just direct labour.

Either direct costing or absorption costing permitted:

- Direct costing is direct labour plus variable overhead costs (employee benefits)
- Absorption costing is direct labour plus both variable and fixed overhead costs (employee benefits, rent, administrative support)
- Partner time does not have cost unless it is a professional corporation with payroll

2018 FALL ECONOMIC STATEMENT

- Temporary changes to CCA rules
  - Attempt to address the impact of U.S. tax reform
  - Applicable for capital assets acquired after November 20, 2018
  - Phased out beginning in 2024

- Increased CCA deduction in the first year for most new acquisitions of capital assets
  - "Half-year" rule will not apply in the year of acquisition
  - Applicable CCA rate for the first year will be 1.5 times the normal rate
  - 82.5% deduction for computers in year of purchase
  - 100% deduction for software in year of purchase

2018 FALL ECONOMIC STATEMENT

- Industry Specific Enhancement – 100% deduction first year
  - Manufacturing and processing equipment
  - “clean energy equipment”

- Exceptions
  - capital property acquired from a related party
  - property acquired as part of a tax-deferred rollover transaction

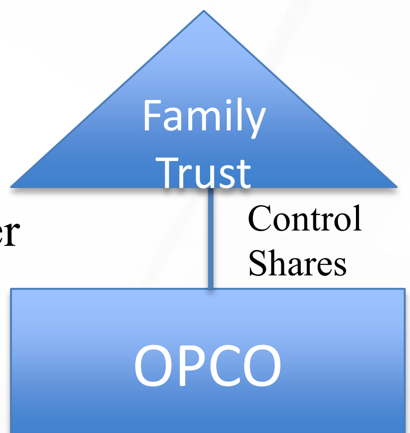
Tax on Split Income (TOSI) from Private Businesses

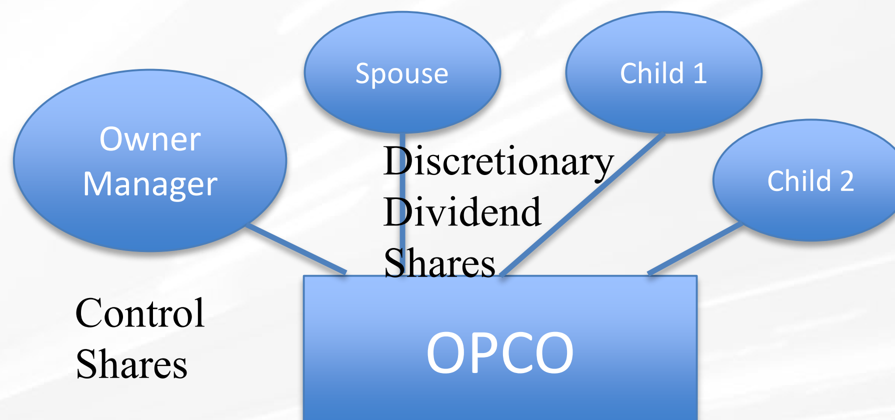
November 29, 2018

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
  - TOSI applies highest marginal rate, no personal credits
  - Different structures to achieve income sprinkling:

Trust Beneficiaries:
1) Owner Manager
2) Spouse
3) Child 1
4) Child 2





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

<u>History of TOSI and income sprinkling prior to 2018:</u>

TOSI is not a new concept!

<u>For Minors (<18):</u>

- 1999 introduced "TOSI" → prevent dividend sprinkling with minor children <18 years old

<u>For Adults (18 and Older):</u>

- Dividend sprinkling generally allowed
  - Decision in Neuman, [1998] 3 C.T.C. 177 prevailed
  - CRA argued against ability to sprinkle dividends to family
  - Supreme court disagreed with CRA!
    - Shareholders need **<u>not</u>** 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

History of TOSI and income sprinkling prior to 2018:

TOSI can now apply to almost anyone receiving "split-income"!

Pre 2018 → "TOSI" limited to minors:

- Only applicable to minors under 18 years of age
  - Parent resident in Canada during the year

January 1, 2018 onward → Expansion of "TOSI" to Adults:

- TOSI expanded to any "**specified individual**"
  - Individual resident in Canada at the end of the year (***Irrespective of Age***); or
  - Deceased persons resident in Canada on D.O.D.

Can TOSI apply to you??

Tax on Split Income (TOSI) from Private Businesses

<u>Types of "Split" Income subject to TOSI</u>

- 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)

<u>NEW types of "Split" Income subject to TOSI</u>

- Taxable Capital Gains on dispositions of property
- Interest on debts (to private corp., partnership, or trust)

<u>Income that is not "Split"</u>

– Income or gains on public corp. / mutual funds

– Reasonable Salaries

Tax on Split Income (TOSI) from Private Businesses

Exclusions / Carve-outs from TOSI

General Exclusions (Anyone):

-- Capital Gains eligible for the LCGE (sale of QSBCS / QFFP)

-- Deemed dispositions arising on death

-- Property acquired on marriage breakdown

-Under 25 years of Age

– **Inheritance Excluded Amount**

-Exclusions for 18 years of Age and older

1) No Related Business

2) Excluded Business

-Additional Exclusions for 25 years of Age and older

4) Excluded Shares

5) Reasonable Return

-Additional Exclusions for 65 years of Age and older

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"** for the year is not subject to TOSI

- Need a business!
- Business needs to be Related!

"Related" Business Requirement

-Related person active in the business; or

-Related person owns **≥10%** value of corporation shares; or

-Related person owns **any** partnership interest

At any time in the year

- Note: No partnership de minimis ownership threshold

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

“Related Business” Exclusion (18 and Older) (Cont’d)

Q. What if there used to be a Related business, but not anymore?

“Related Business” Exclusion (18 and Older)

– Income **not** derived *directly or indirectly* from a **“Related Business”** **for the year** is not subject to TOSI
  - Need a business!

“Related” Business Requirement

-Related person active in the business; or

-Related person owns **>10%** value of corporation shares; or

-Related person owns **any** partnership interest

At any time in the year

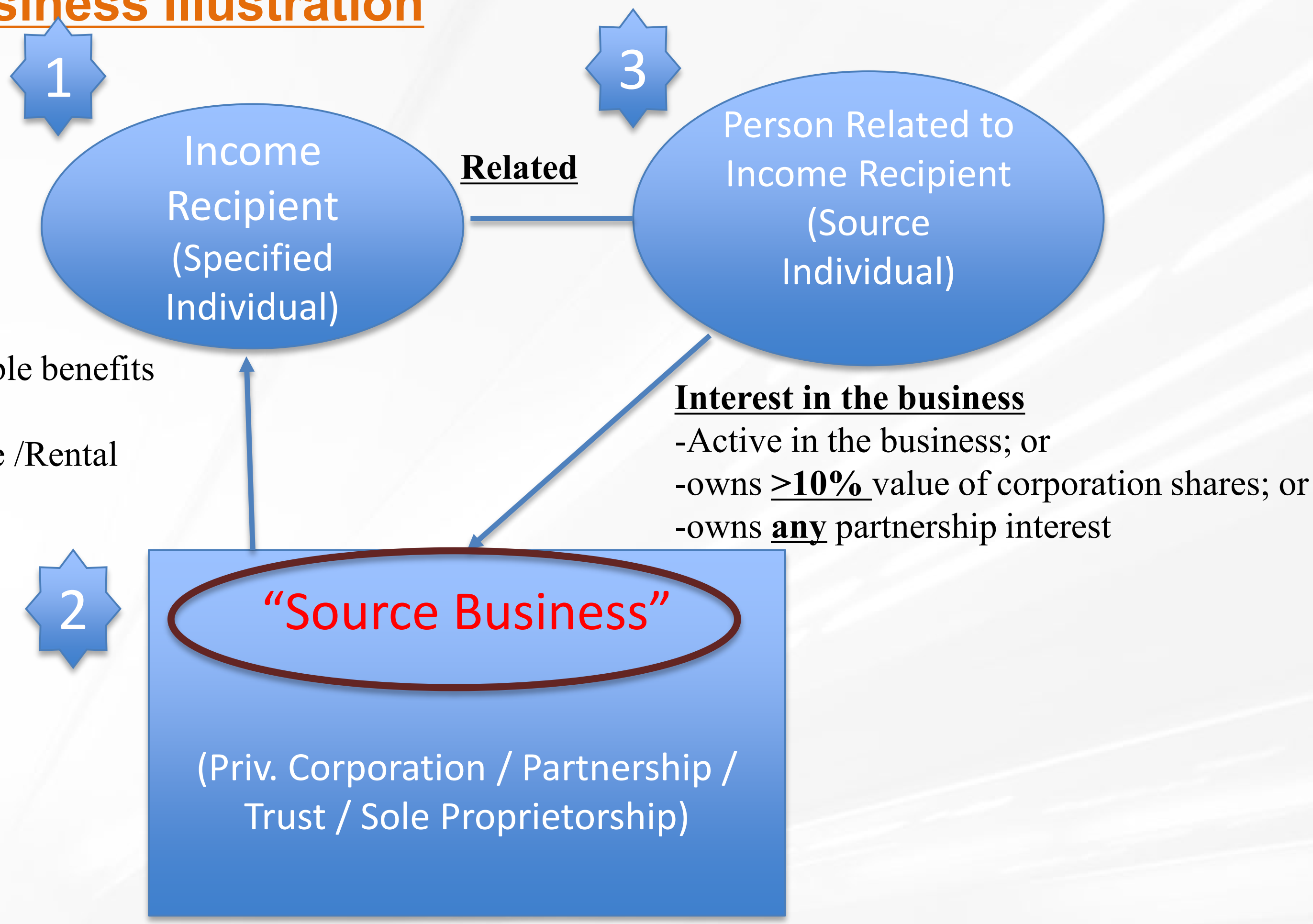
Tax on Split Income (TOSI) from Private Businesses

When TOSI will apply to adults 18yrs and older (Simplified):

Related Business Illustration

Split-Income Receipts:

- Dividends, S/H loans, taxable benefits
- Rent / Service fees
- Partnership or Trust Income /Rental Income
- Interest on debts



Tax on Split Income (TOSI) from Private Businesses

<u>“Excluded Business” Exception (18 and Older)</u>

– Income from an “Excluded Business” is not subject to TOSI

  - All or nothing “Bright Line” test

<u>What is an “*Excluded Business*”?</u>

A business in which the income recipient is **<u>actively engaged</u>** on a ***<u>regular, continuous, and substantial</u>*** basis.

<u>Actively Engaged</u>

Bright Line Test = average 20 hours/ week

(Could be less if strong justification)

I. In the year; **<u>OR</u>**

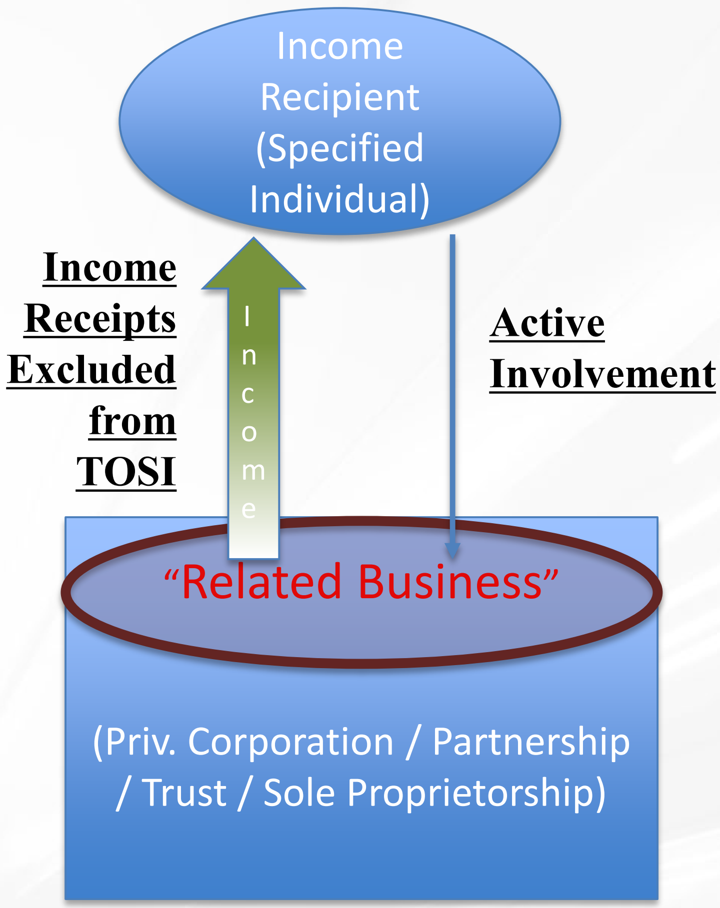
II. In a combination of any 5 previous years

(not required to be continuous / consecutive)

-Indefinite TOSI exclusion

Tax on Split Income (TOSI) from Private Businesses

Excluded BUSINESS Illustration



Tax on Split Income (TOSI) from Private Businesses

<u>“Excluded Shares” Exception (25 and older)</u>

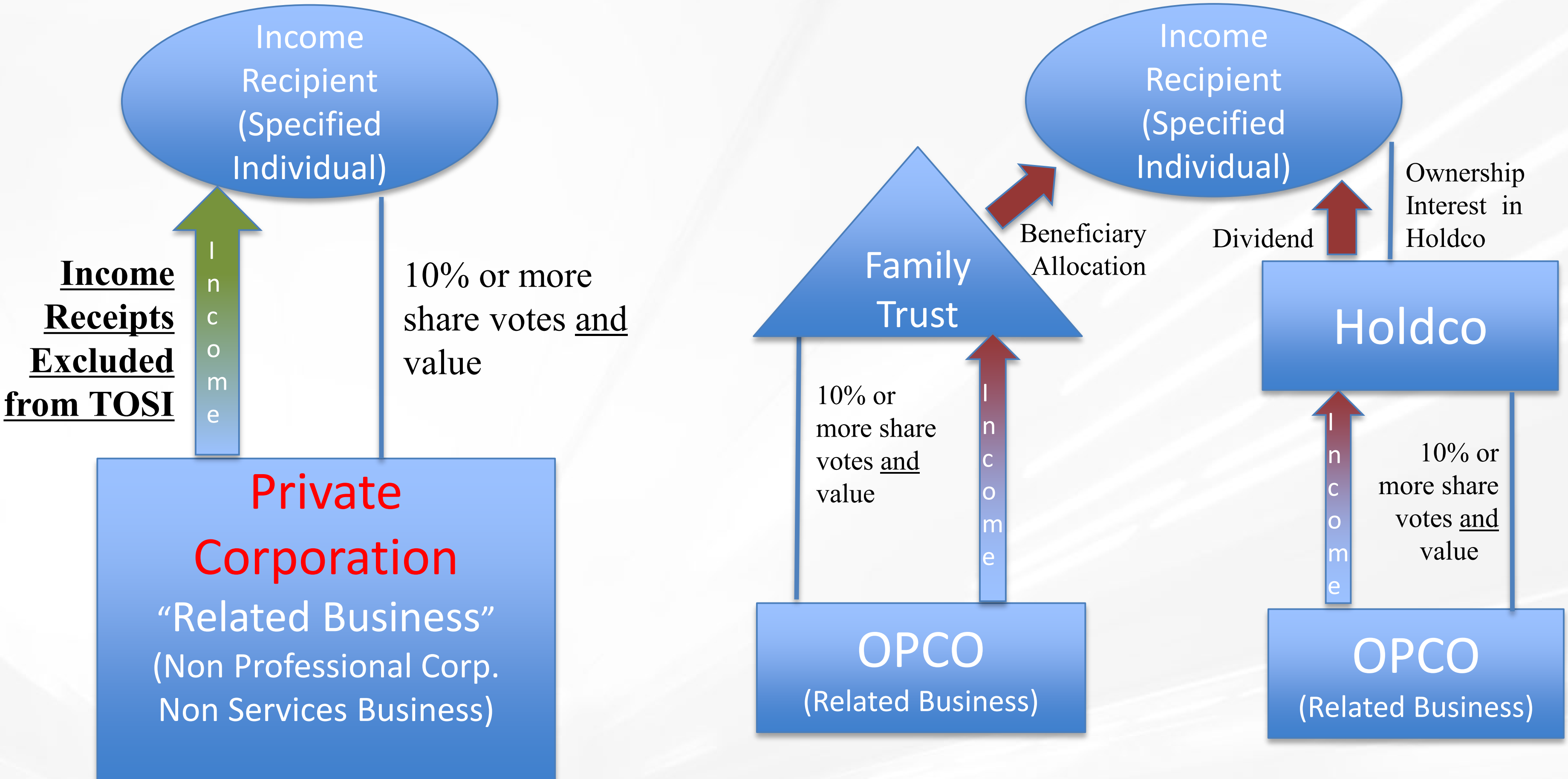
– Excludes income from or taxable capital gains on disposition of shares of a ***<u>corporation</u>*** if:

- Recipient owns 10% or more of the votes and value of the corporation’s shares;
  - *Shares must be held directly*
- Less than 90% PY Gross business income is from services;
  - *Consider separately invoicing combined deliverables*
- Not a professional corporation; and
  - ***Professional corporation*** *= incorporated accountant, dentist, lawyer, medical doctor, veterinarian or chiropractor*
- Less than 10% PY income is derived directly or indirectly from another related business;
  - *Prevents ability to split property business from services business and Exclude property business shares*

Tax on Split Income (TOSI) from Private Businesses

Excluded SHARES Illustration

Excluded | **Not Excluded**



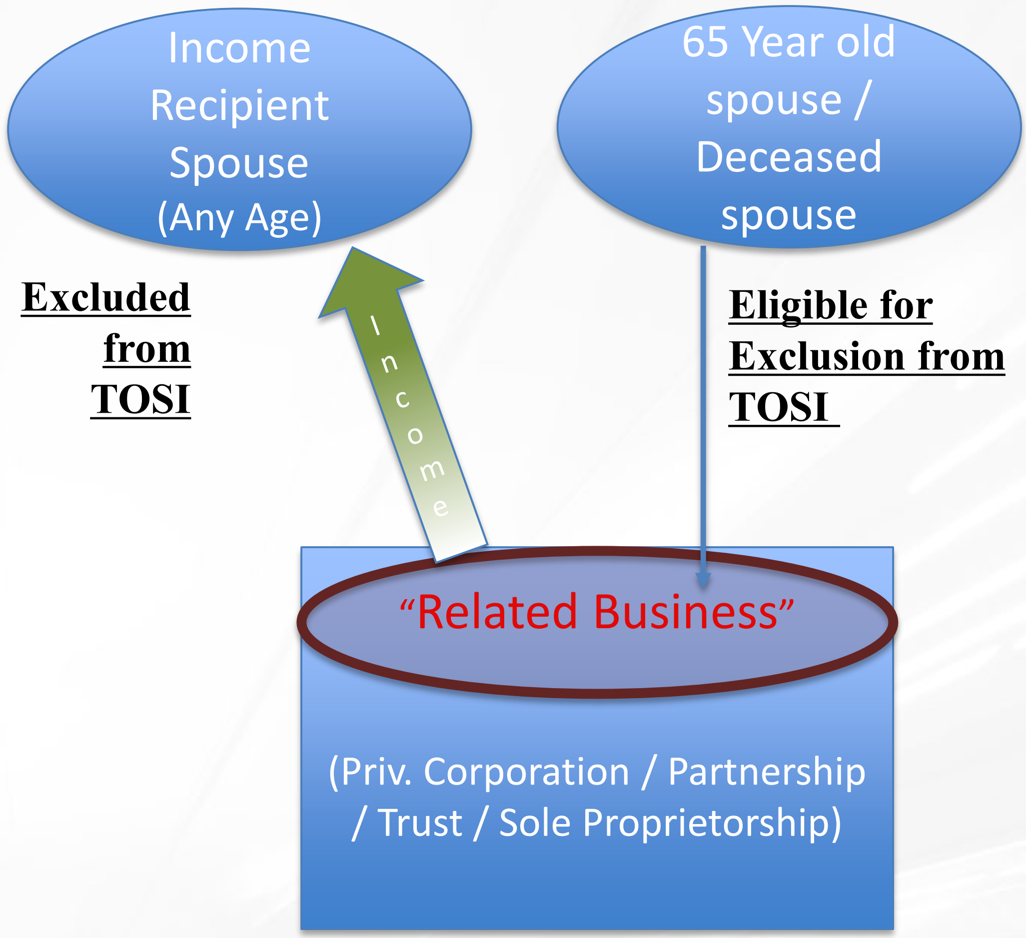
Tax on Split Income (TOSI) from Private Businesses

<u>Retirement Spousal Exclusion (Spouse over 65 years of Age)</u>

- Split-income is **not subject to** TOSI if recipient's ***spouse*** is **<u>over 64 years old</u>** (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*
  - Similar to pension income splitting

Tax on Split Income (TOSI) from Private Businesses

Retirement Spousal Exclusion Illustration



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: 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.

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

Issues with Reasonableness Exclusion

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

Tax on Split Income (TOSI) from Private Businesses

Summary of TOSI exclusions

Active Recipients (18 and older)

1) Excluded Business

Non-Active Recipients (Over 25)

1) Excluded Shares

   -No active involvement, only votes and value ownership required

2) Enhanced Reasonable Amounts

   -Includes Part-time labour contributions

   -Less restrictive reasonable return on capital

Retirement / Spousal (Source individual over 65)

1) Retirement Exclusion

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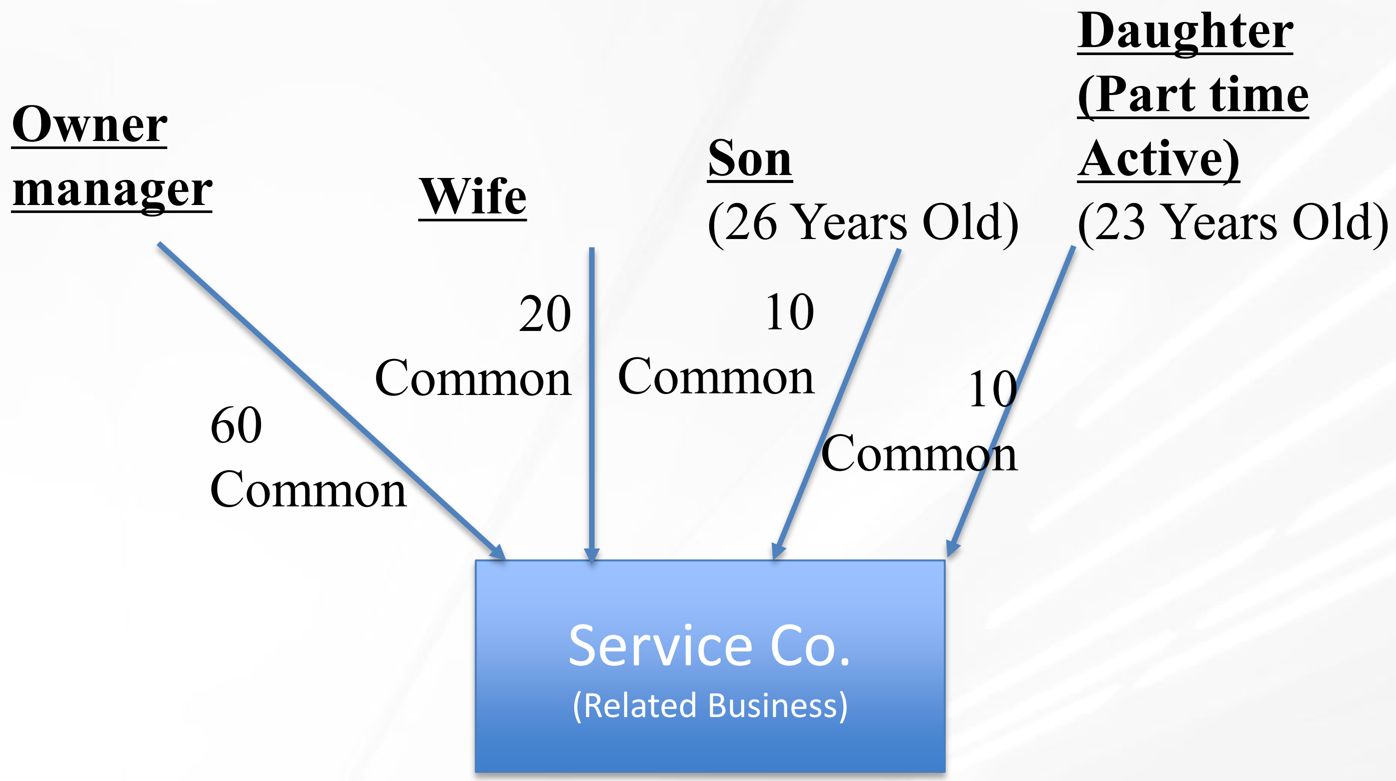
Tax on Split Income (TOSI) from Private Businesses

Illustrative Example #1

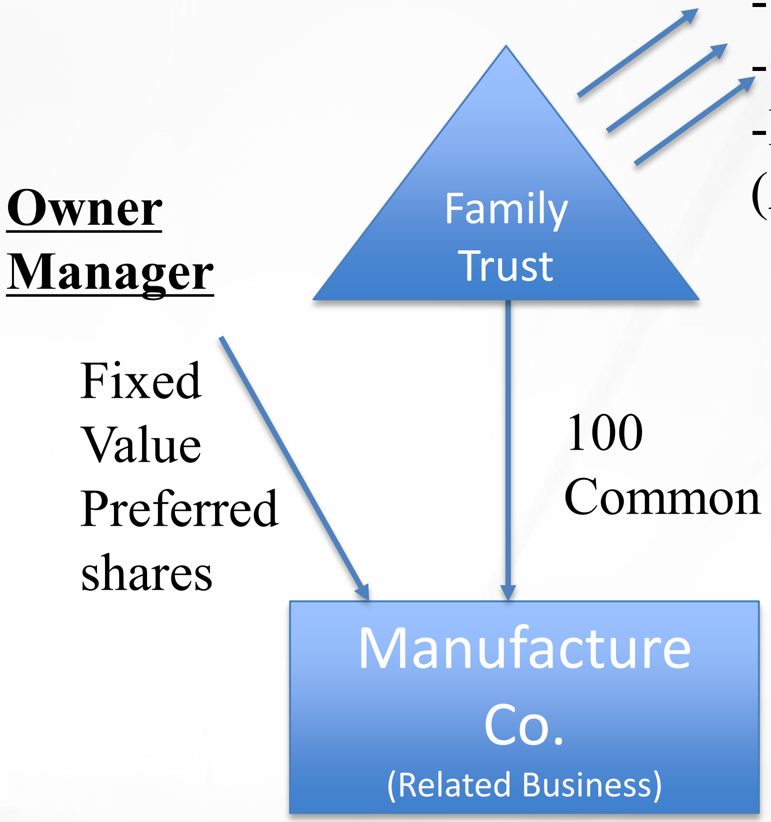


Tax on Split Income (TOSI) from Private Businesses

Illustrative Example #2

Trust Beneficiaries:

-Owner Manager
-Wife
-Son (26 Years Old)
-Daughter (23 Years Old)
(Active Part-time)



Does TOSI put an end to the era of 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**
  - Implications of loans to the business
  - Update directors / Pay reasonable salaries
- **Consider Re-Organisation / Simplification of Structures**
  - 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 / Meet Excluded share test
- **Review Estate Plans**

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
  - Assess administrative procedures
  - Review information/documentation policies
  - Metrics to be tracked
    - *Time tracking*
    - *Goods vs. services Income (Excl. Shares exception)*
    - *Separate businesses (Excl. Business Exception)*

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UPDATE ON CRA AUDIT ACTIVITIES

November 29, 2018

WHAT HAS CRA BEEN UP TO THIS PAST YEAR?

New targeted audit activity

- Capital gains reserve claims
  - Support for calculation of deferral
- RRSP audits
  - Non-qualified/prohibited assets
  - Tax advantages
- Review of international electronic funds transfers
  - Unreported offshore income/assets
- GST/HST desk audits
  - Large refunds
- Employment expenses audits
  - Shareholder-employees

IMPACT OF NEW LEGISLATION?

Potential impact of new legislation on audit activity:

- Professional fee letters
  - More reorganization fees as a result of TOSI
  - Income splitting using management/consulting fees
- Small Business Deduction letters
  - Larger gap between small business and general rates
  - Implications of SBD "grind" due to passive income
- Comprehensive payroll audits
  - Increase review of salaries to family members to avoid TOSI
- All private corporation dividends/income payments?
  - Verification of TOSI exclusions

TIPS ON HANDLING A CRA DESK AUDIT

- Most important is to respond in a timely manner
  - More difficult to file a Notice of Objection after a return as been reassessed rather than respond to the audit request
  - Usually a 30-day response time, but can request a reasonable extension
- Communicate professionally with the CRA auditor
  - Courteous and non-confrontational
  - Upfront communication may lead to an easier audit process
- Seek professional guidance
  - Clarify uncertainty of tax implications or information requested

2018 Presentation by Shimmerman Penn LLP

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