INCOME SPRINKLING: A SIMPLIFIED APPROACH

Hendry Warren Chronicle - Tax and Accounting Simplified
December 2017

THE CURRENT PROGRAM

Under existing legislation, owners of private corporations are able to pay dividends to family members that are disproportionate to that family member's contribution to the business. As the dividend recipient is subject to graduated tax rates, current dividend sprinkling can provide for an absolute tax saving for the shareholders of a family business.

On July 18, 2017, the Department of Finance released draft legislation aimed to deter owners of private corporations from income sprinkling with family members beyond a reasonable amount. Under this proposal, starting January 1, 2018, any unreasonable dividends would be subject to the tax on split income ("TOSI") rules and taxed in the hands of the recipient at the highest marginal tax rate. The rules were highly technical and left many tax professionals unclear as to what "reasonable" meant in different circumstances.

Revised draft legislation related to income sprinkling and the TOSI was released on December 13, 2017. These rules include "bright-line" tests that will allow income sprinkling with family members, subject to a number of conditions. The revisions are meant to simplify and better target the original July 18, 2017 rules, and to reduce the potential compliance burden in their application. The remainder of this newsletter will summarize the highlights of the recent proposals with respect to income sprinkling.

Our goal is to provide updates on topical accounting and tax issues. Information contained in this newsletter is not meant to be a comprehensive summary of the issues raised. Rather, we wish to bring what we believe to be important issues to the attention of our valued clients and readers. We would be pleased to discuss any questions that you, the reader, might have in greater detail.

Related Business

The TOSI will potentially apply in respect of amounts that are received by adult individuals from a related business. Generally, a business will be a related business if an individual who is related to the adult individual either is actively engaged in the business or owns a significant portion of the equity in the corporation that carries on the business. Generally, related individuals include those connected by blood or marriage. If a business is not a related business, TOSI will not apply.

Excluded Business

The TOSI will not apply for individuals aged 18 to 24 who contribute labor to a related business on a regular, continuous and substantial basis in the year the dividends are received, or any 5 preceding taxation years. The revised draft legislation provides some clarification on what level of contributions are required for this purpose. An individual who works an average of 20 hours per week or more during the part of the year that a business operates will be deemed to be actively engaged on a regular, continuous and substantial basis for the year. If an individual does not meet the 20-hour per week threshold, then it will be a question of fact as to whether the individual was actively engaged in the business on a regular, continuous and substantial basis. In order to access the exclusion in respect of five previous years of labour contributions, it is not necessary that the five previous years be consecutive or after 2017. Any combination of five previous years would satisfy the test.

Interestingly, there does not appear to be any consideration given to the type of work performed. Regardless of the level of technical expertise required in performing a specific duty, once the 20 hour per week test is met, TOSI will not apply in respect to any dividends received.

Excluded Shares

The TOSI will also not apply to certain adult individuals in respect of income received from "excluded shares" owned by the individual. This exclusion from the TOSI will apply to income received from a share if the following conditions are met:

- the individual has attained the age of 25 years in or before the year;
- the individual owns at least 10% of the outstanding shares of a corporation in terms of votes and value; and
- the corporation meets the following conditions:
- it earns less than 90% of its income from the provision of services;
- it is not a professional corporation; and
- all or substantially all of its income is not derived from a related business in respect of the specified individual.

"The provision of services" is not defined in the draft legislation, nor is it defined in any existing legislation. In an example provided by the Canada Revenue Agency, a restaurant is considered not to be a service business, and as such, the shares of the corporation should qualify for this exception. It is

unclear at this time what type of businesses will be considered to be providing services.

Although the exclusion for excluded shares is a welcome change that will benefit many business owners, this seems to be in contrast to the government's original mandate for tax fairness. Certain businesses will continue to benefit from income sprinkling while others will not, simply due to the nature of their business.

For 2018, taxpayers seeking to rely on this exclusion will 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. Careful planning will be required to ensure that these conditions are met, where possible, going forward. For instance, shares held by family trusts do not appear to qualify, and so reorganizations to put shares in the hands of individual family members may be warranted. The merits of such planning must be reviewed on a case by case basis.

Spouses and Retirement Planning

The TOSI rules will not apply to income received by an individual from a related business if the individual's spouse made the contributions to the business and has attained the age of 65. Special rules will also apply in respect of a deceased individual, so that the surviving spouse continues to benefit from the contributions made by the deceased individual. These changes are meant to better align dividend sprinkling with existing pension splitting rules. This exclusion from TOSI will provide significant tax savings for couples in retirement.

Other Important Changes

The December 13, 2017 proposals contained a number of other important changes:

The Government will not proceed with the proposed measures to apply the TOSI to compound income (*i.e.*, income earned from the investment of an initial amount of income that is subject to the TOSI or attribution rules).

The July 18, 2017 proposals had included amendments to deem twice the amount of a taxable capital gain to be a dividend in certain circumstances. These amendments will not move forward.

The class of related individuals for the purposes of the TOSI rules will not be extended to aunts, uncles, nieces and nephews as originally proposed.

Income derived from property acquired as a result of the breakdown of marriage or common-law partnership will be exempted from the application of the TOSI rules.

Individuals aged 18 to 24 will be permitted a prescribed rate of return on capital contributed to a related business. Individuals over 24 years of age will not be subject to the TOSI where they can provide evidence that their compensation is reasonable given their labour and capital contributions, and their risk assumed with respect to the business. These reasonableness tests are similar to the original July 18, 2017 proposals.

Conclusion

The December 13, 2017 revisions offer several welcomed exceptions for taxpayers that will allow for income sprinkling with family members. The rules provide some clarity on what level of involvement is required and in many cases, rule out the possible application of TOSI entirely. To the Canada Revenue Agency's credit, they have provided a number of examples which clearly outline how they will apply the new rules in different scenarios. That being said, there is still much uncertainty.

At this stage, we offer the following observations:

As the new rules take effect on January 1, 2018, it would appear prudent for private corporations to pay dividends to its shareholders, active or not, in 2017.

Where possible, arranging for family members to work an average of 20 hours per week will ensure that TOSI will not apply. Documentation should be retained to evidence the hours worked and the duties performed.

In 2018, existing ownership structures should be reviewed to determine if the excluded share test can be met.

It is important to note that the December 13, 2017 draft legislation did not contain any updates regarding the passive income regime. Such updates are expected to be released in conjunction with the 2018 federal budget. The budget is typically released in March each year. We will continue to monitor all developments and provide updates where possible. At this time our recommendation is to wait until all legislation is provided before making any significant changes to existing corporate structures. Should you have any questions about the recent announcements and how they will impact your

HENDRY WARREN LLP
CHARTERED PROFESSIONAL ACCOUNTANTS

Jacob Milosek
CPA, CA Partner

Contact Us

Give us a call for more information about this article.

Hendry Warren LLP
881 Lady Ellen Place, Suite 200
Ottawa, ON K1Z 5L3

(613) 235-2000

Visit us on the web at
www.hwllp.ca