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WEALTH MANAGEMENT

Revised rules on income sprinkling

Planning considerations for 2018

On December 13, 2017, Canada's Minister of Finance, Bill Morneau, announced revised tax measures related to "income sprinkling" by business owners and their families. The new tax measures will take effect on January 1, 2018. Alongside Minister Morneau's announcement, the Canada Revenue Agency (CRA) released guidance on the proposed tax measures. It outlined scenarios where tax on split income (TOSI) would continue to apply as well as specific exclusions.

While the federal government intended to simplify and better target income sprinkling for those related individuals who they believe to be unfairly advantaged, the revised income sprinkling measures ultimately remain highly complex and subjective. Working through the revised tax measures, clients with a Canadian Controlled Private Corporation (CCPC) will need guidance to safeguard against being offside of TOSI or to determine what amount of income paid to related individuals will be subject to TOSI.

Summary of revised measures

The revised tax proposals continue to extend TOSI to related individuals, and also introduce numerous exemptions for certain related individuals based on age, involvement in and contribution to a CCPC, as well as on other life circumstances.

The revised tax proposals introduced or outlined the following:

- "Bright Line" tests to exclude a related individual who:
  - Is a spouse of the business owner, where the business owner meaningfully contributed to the business and is over the age of 64. This is to align with eligible pension income-splitting tax provisions;
  - Is over the age of 17 and who has made a regular, continuous and substantial labour contribution to the CCPC during the given year, or during any five previous years. Substantial labour contribution is defined as an average of 20 hours a week during the year or business operation period. If the related individual meets this definition, the CCPC is an "Excluded Business" and income from such is excluded from TOSI;
  - Is over the age of 24 and owns 10% (as of December 31, 2018) or more of the CCPC (votes and value), where the CCPC earns less than 90% of its income from providing services, is not a professional corporation, and its income is not derived from a related business of a specified individual. If the related individual's CCPC shares meet these criteria, the shares are referred to as "Excluded Shares" and income from such is excluded from TOSI;
- "Reasonableness Tests" are included for individuals over 17 who do not meet the bright line tests. The reasonableness tests will be used to determine how much income, if any, exceeds a reasonable return and therefore would be subject to TOSI. Reasonableness would be determined by comparing contributions of the related individual to the business with contributions of other related individuals. The factors that will be considered are labour and capital contributions, risks assumed and any other relevant factors.
- New proposed rules exempting inherited CCPC shares for those over the age of 17, if the deceased met any of the bright line or reasonableness tests.

In addition, Minister Morneau outlined that the federal government will not move forward with the following:

- Proposed tax measures applying TOSI to taxable capital gains that qualify for the lifetime capital gains exemption (LCGE)
- Proposed tax measures applying TOSI to compound income (income on income)
- TOSI to income derived from property acquired as a result of the breakdown of marriage or a common-law relationship
- Identifying aunts, uncles, nieces and nephews as related individuals.

Value of advice

In light of the revised tax measures, advisors need to be aware of CCPC share structures, dividend income paid, the various contributions made by related individuals in the given year or previous years, and the age of the related individuals in order to provide any guidance. The complexity and subjectivity inherent in some aspects of the proposed tax measures underscores the importance of working alongside a CCPC's professional tax advisors.

Impact on 2017 planning

CCPCs that have related individual shareholders who will not meet the bright line or reasonableness tests post-2017 may want to consider paying out a final dividend.

Planning for 2018 and beyond

Looking at the income-splitting and TOSI measures in isolation, CCPCs should consider:

- Their corporate share structure to determine if a corporate restructuring is needed to avoid TOSI post-2017
- Review prior-year records, and start formalizing a process to record contributions of related individuals to characterize "Excluded Business", "Excluded Shares" or to meet any of the various reasonableness tests. Documentation will have to be maintained in excess of seven years, unlike other tax records.

Conclusion

To reiterate, the revised income-splitting tax measures to be implemented January 1, 2018 are complex. Advisors should be cognizant of CCPC share structures and whether changes may be necessary in the future. They should also be aware of whether dividend income paid to related individuals in previous years may now be subject to TOSI in the future, and how the various contributions made by related individuals in a given year or previous years may impact on how such income is reported for tax purposes in the future. While there is much uncertainty and subjectivity regarding these tax measures, we will continue to inform and update you.

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