# Proposed Changes to Taxation of Private Corporations: Where are We Now?

Kevin J. Kilgour, CPA, CGA
January 16, 2018

# Agenda

1. Review of proposed changes
2. (Dis)integration update
3. Review issues and impact
4. What do you do now?

# Review of proposed changes
# July 18, 2017 Consultation Paper Proposals

Three main areas of interest:

1. Income sprinkling with family members – later modified
2. Converting dividend income into capital gains (i.e. "surplus stripping") – later rescinded
3. Holding passive investments in a private corporation – later modified

# Review of proposed changes
# Income Sprinkling

Expanded concept of Tax On Split Income (TOSI)

Current rules:

- Also known as "kiddie tax" since it only applies to minors
- Affected income is taxed at top marginal rate for that type
- No tax credits allowed other than foreign tax credits and dividend tax credits
- Non-arm's length capital gains are deemed to be non-eligible dividends – higher tax and no access to lifetime capital gains exemption (LCGE)

# Review of proposed changes
# Income Sprinkling

<u>Expanded concept of Tax On Split Income (TOSI) – cont.</u>

Highlights of proposed changes:

- Will now apply to adults who are related to a business owner or “connected individual”
- Introduction of a reasonableness test for adults resulting in only the “split portion” being subject to TOSI
- Will apply to interest on private company debt obligations
- Will apply to capital gains realized by adults from dispositions of property, the income from which would be split income if it were received, **<u>even if at arm’s length</u>**
    - Note: Adults will not be subject to dividend treatment as minors would

# Review of proposed changes
# Income Sprinkling

Expanded concept of Tax On Split Income (TOSI) – cont.

Exceptions (i.e. safe harbours):

- Will not apply where adult's other income already exceeds top marginal tax bracket threshold
- Will not apply to capital gains on disposition of property that could qualify for the LCGE
- Will not apply to income from property derived as a result of a marital breakdown
- Will not apply where the business owner is aged 65 or older and splits income with a spouse
- Will not apply to an "excluded business" or "excluded shares"
- Will not apply dividend taxation to minors where the capital gain arises as a consequence of death

# Review of proposed changes
# Income Sprinkling

<u>Expanded concept of Tax On Split Income (TOSI) – cont.</u>

New concept of "connected individual":

- Someone with presumed influence over a corporation that pays income to a specified individual
- Presumption of influence based on:
  1. Strategic influence – individual or related group has factual control
  2. Equity influence – individual owns property representing 10% or more of equity value
  3. Earnings influence – service business primarily driven by an individual who is regulated
  4. Investment influence – 10% or more of corporation's property acquired from individual or another corporation to which individual is connected
- If no related specified shareholder or connected individual, there may be no TOSI

# Review of proposed changes
# Income Sprinkling

<u>Expanded concept of Tax On Split Income (TOSI) – cont.</u>

New concept of "split portion":

- Represents the "unreasonable" portion of the income
- Reasonable portion is based on:
  1. Labour contributions – value of services
  2. Capital contributed – share capital or loans
  3. Risks assumed – personal assets at risk
  4. Previous remunerations/returns – prior salaries/dividends, etc.
- Adults aged 18-24 are subjected to more stringent tests for labour and capital contributions
- Split portion is amount that is subject to TOSI for adults

Johnsen Archer LLP
Taxation • Accounting • Assurance
30 Years of Original Thinking

# Review of proposed changes
# Income Sprinkling

Expanded concept of Tax On Split Income (TOSI) – cont.

New concept of "excluded business":

- Business will be excluded where individual is "actively engaged on a regular, continuous and substantial basis" in the year or in any five (5) preceding years
- This test will be deemed to be met where the individual works in the business for an average of at least 20 hours per week for the relevant year (or portion in which the business operates if seasonal)

# Review of proposed changes
# Income Sprinkling

<u>Expanded concept of Tax On Split Income (TOSI) – cont.</u>

New concept of “excluded shares”:

- Only applies to those aged 25 years or older
- Individual must directly own 10% of shares in terms of votes AND value
- Corporation must meet three conditions:
    1. Earns less than 90% of its income from provision of services
    2. Is not a professional corporation (i.e. doctor, lawyer, accountant, etc.)
    3. All or substantially all of its income is not derived from a related business in respect of the specified individual

# Review of proposed changes
# Income Sprinkling

<u>Expanded concept of Tax On Split Income (TOSI) – cont.</u>

Transitional rules:

- All proposed changes apply in 2018 and subsequent years
- Test for 10% ownership of excluded shares can be met at any time in 2018 (i.e. up to and including December 31, 2018)

# Review of proposed changes
# Holding Passive Investments in a Private Corporation

- Finance concerned that tax-deferred savings opportunity is greater for incorporated private businesses
- Finance considered the 1972 approach with an additional refundable tax on non-eligible investments – concluded it was not viable even though it was relatively simple to implement
- Finance decided to propose a deferred taxation approach which retains the deferral but significantly increases the effective tax rate on passive income
- Unlike the other proposals, no draft legislation was provided

# Review of proposed changes
# Holding Passive Investments in a Private Corporation

Impact of changes to taxation of certain passive income:

- Denial of refundable dividend tax on hand (RDTOH)
- Denial of capital dividend account (CDA)
- Denial of general rate income pool (GRIP) on portfolio dividends

No definition of "passive investment" yet, but expect to be any asset that would be held in a "specified investment business"

Some exceptions proposed:

- Pre-existing assets ("go-forward" only)
- Assets acquired with tax-paid shareholder funds
- Assets acquired with general rate corporate tax paid (partial exception only)
- First $50,000 per year of passive investment income

# Review of proposed changes
# Holding Passive Investments in a Private Corporation

Proposed methods to deal with exceptions:

1. Apportionment method
   - Small business income pool, General rate income pool, and Shareholder contribution pool
   - Annual retained earnings are apportioned prorata to these pools
   - Dividends are designated to be paid out of each pool (non-eligible, eligible or capital, respectively)
2. Elective method
   - Dividends paid would all be eligible
   - No ability to account for shareholder contributions
   - No small business deduction available
3. Election for investment companies
   - Available in combination with either of above two methods
   - All income taxed as passive investment income under existing rules
   - Dividends received out of business income are subject to an additional refundable tax to eliminate any tax deferral opportunity

JOHNSEN ARCHER LLP
TAXATION • ACCOUNTING • ASSURANCE
30 Years of Original Thinking

# Review of proposed changes
# Holding Passive Investments in a Private Corporation

Transitional rules:

- No transitional rules provided yet as the implementation date is unknown
- Expect draft legislation and transitional rules in the 2018 Federal Budget

# Integration update

# Integration update
# Integration in BC – 2018 (Current Rules)

| | General income | SBD income | Interest income | Capital gains | Eligible dividends | Ordinary dividends |
|---|---|---|---|---|---|---|
| Income via corporation | 10,000 | 10,000 | 10,000 | 10,000 | 10,000 | 10,000 |
| Corporate tax | (2,700) | (1,250) | (5,067) | (2,533) | (3,833) | (3,833) |
| Dividend refund | 0 | 0 | 3,067 | 1,533 | 3,833 | 3,833 |
| Available for dividend | 7,300 | 8,750 | 8,000 | 9,000 | 10,000 | 10,000 |
| Personal tax | (2,496) | (3,826) | (3,498) | (1,749) | (3,419) | (4,373) |
| Net after-tax cash | 4,804 | 4,924 | 4,502 | 7,251 | 6,581 | 5,627 |
| Personal income | 10,000 | 10,000 | 10,000 | 10,000 | 10,000 | 10,000 |
| Personal tax | (4,980) | (4,980) | (4,980) | (2,490) | (3,419) | (4,373) |
| Net after-tax cash | 5,020 | 5,020 | 5,020 | 7,510 | 6,581 | 5,627 |
| Deferral % | 22.8% | 37.3% | (0.9%) | (0.4%) | (4.1%) | 5.4% |
| Savings (cost) % | (2.2%) | (1.0%) | (5.2%) | (2.6%) | 0.0% | 0.0% |

JOHNSEN ARCHER LLP
TAXATION • ACCOUNTING • ASSURANCE
*30 Years of Original Thinking*

# Integration update
# Integration in BC – SBD/ABI and Capital Gains Mix

Consider what happens when a corporation realizes a capital gain equal to the retained earnings resulting from earning business income…

| | SBD/Capital gains mix | ABI/Capital gains mix |
|---|---|---|
| Income via corporation | 10,000 | 10,000 |
| Corporate tax | (1,250) | (2,700) |
| Capital gain required | 8,750 | 7,300 |
| Corporate tax (CG) | (2,217) | (1,849) |
| Dividend refund | 1,342 | 1,119 |
| Available for dividend | 7,875 | 6,570 |
| Personal tax | (1,530) | (998) |
| Net after-tax cash | 6,345 | 5,572 |
| | | |
| Personal income | 10,000 | 10,000 |
| Personal tax | (4,980) | (4,980) |
| Net after-tax cash | 5,020 | 5,020 |
| | | |
| Deferral % | 37.3% | 22.8% |
| Savings (cost) % | 13.2% | 5.5% |

# Integration update
# Integration in BC – 2018 (Proposed General Rules)

| | Interest income | Capital gains | Eligible dividends | Ordinary dividends |
|---|---|---|---|---|
| Income via corporation | 10,000 | 10,000 | 10,000 | 10,000 |
| Corporate tax | (5,067) | (2,533) | (3,833) | (3,833) |
| Dividend refund | N/A | N/A | N/A | N/A |
| Available for dividend | 4,933 | 7,467 | 6,167 | 6,167 |
| Personal tax | (2,157) | (3,265) | (2,697) | (2,697) |
| Net after-tax cash | 2,776 | 4,202 | 3,470 | 3,490 |
| Personal income | 10,000 | 10,000 | 10,000 | 10,000 |
| Personal tax | (4,980) | (2,490) | (3,419) | (4,341) |
| Net after-tax cash | 5,020 | 7,510 | 6,581 | 5,659 |
| Deferral % | (0.9%) | (0.4%) | (4.1%) | 5.4% |
| Savings (cost) % | (22.4%) | (33.1%) | (31.1%) | (21.6%) |

# Review issues and impact

JOHNSEN ARCHER LLP
TAXATION • ACCOUNTING • ASSURANCE
30 Years of Original Thinking

# Review issues and impact
# Income Sprinkling

- No credit (grandfathering) for pre-2018 accrued capital gains
- Potential taxation at higher rate than attributed income
- Inability to utilize tax credits/losses
- Even $1 of split income at graduated rates taints the entire amount under TOSI – disproportionate effect
- Need for documentation of reasonable amount determination
- Why are service businesses given harsher treatment?
- How will CRA administer these rules?
- Will it be worth the fight – cost/benefit?

JOHNSEN ARCHER LLP
TAXATION • ACCOUNTING • ASSURANCE
30 Years of Original Thinking

# Review issues and impact
# Holding Passive Investments in a Private Corporation

- Extremely harsh under-integration
- Effective tax rate on business income earned from a non-connected company (e.g. public company) can approach 75%
- Forced to choose between tax deferral and tax cost
- Timeline to recover additional tax could be 20 years+
- What is a “passive investment”?
- Added complexity – compliance costs will be higher
- What will the transitional rules look like?
- How will passive assets held at transition be tracked?

# What do you do now?

# What do you do now?
# Income Sprinkling

- Documentation?
- Prescribed rate loans?
- Use salary instead of dividends (lower audit risk)?
- Reorganize to create multiple share classes (if not already)?
- Reorganize to bring in family members as direct voting shareholders if shares could then be excluded?
- Crystallize capital gains or pay dividends to adults before 2018 to use up graduated tax rates, losses, or tax credits?

# What do you do now?
# Holding Passive Investments in a Private Corporation

- Give up the deferral and distribute?
- Life insurance (exempt)?
- IPP/RCA structures?
- Maximize passive asset acquisitions prior to transition?
- Transfer all passive assets to a holding company and elect?

Be careful as much could change!

# Questions?

JOHNSEN ARCHER LLP
TAXATION • ACCOUNTING • ASSURANCE
30 Years of Original Thinking

# Thank you!

JOHNSEN ARCHER LLP
TAXATION • ACCOUNTING • ASSURANCE
30 Years of Original Thinking