TAX PLANNING USING PRIVATE CORPORATIONS

CI GLOBAL ASSET MANAGEMENT

The new income sprinkling and passive investing rules

During their 2015 federal election campaign, based on a report by Michael Wolfson from the University of Ottawa, the Liberal party stated that they would "ensure that [CCPC] status is not used to reduce personal income tax obligations for high-income earners rather than supporting small businesses"[1]. The party was subsequently elected, and on July 18, 2017, Finance Minister Bill Morneau released tax proposals aimed at three main areas related to private company tax planning: i) income sprinkling, ii) passive investing within a corporation,and iii) the conversion of income to capital gains. The government asked for feedback on the proposals, which came in the form of a consultation paper during a public consultation period that ended on October 2, 2017, and received lots of it. Over 21,000 submissions were received from various business groups, industry associations and other parties. Thereafter, on December 13, 2017 and February 27, 2018, respectively, the government announced its intention to move forward with modified measures that limit.

- income sprinkling to adult family members, and
- tax-deferral benefits when low-rate business income is reinvested passively within a corporation.

The proposal to limit the conversion of income to capital gains was withdrawn because of possible unintended consequences.

This article discusses the changes, which have since become law, and related planning opportunities.

TO BEGIN OUR DISCUSSION, CONSIDER THE FOLLOWING:

Michael Muir (age 50) is the owner of an incorporated dental practice (a professional corporation) based in Ontario. His spouse, Marva (45), manages the family household. The Muirs have two children, Rachel (19) and Claire (20). None of Marva, Rachel or Claire have ever worked in the family business, and, apart from nominal amounts used to purchase their non-voting shares, none have contributed assets or risk to the business. In 2017, the family's tax situation was as follows:

Net practice income	$500,000
Less: Salary to Michael[2]	$306,330
Taxable income – corporation	$193,670
Less: Corporate tax @ 15% (Ontario)	$29,051
After-tax retained earnings	**$164,619**
Less:	
Dividend paid to Marva	$30,000
Dividend paid to Rachel	$30,000
Dividend paid to Claire	$30,000
Retained earnings available to invest corporately	**$74,619**

After-tax cash flow for the family was as follows:

Michael – salary[3]	$178,986
Marva – dividends	$30,000
Rachel – dividends	$30,000
Claire – dividends	$30,000
Current year cash flow for the family	**$268,986**
Corporate retained earnings	**$74,619**

By using a corporation, the Muirs were able to take advantage of a low small business tax rate (15% in 2017) to create $74,619 of retained earnings they would not have had if the business was not incorporated – earnings that could be used to earn passive income. And, because Marva, Rachel and Claire are shareholders of the business, they were able to receive dividends that, while taxable in their hands, were not subject to tax because they had no other income and can receive

[1] Liberal election platform (2015) - A New Plan for a Strong Middle Class [2] Pre-tax [3] After tax (2017 graduated tax rates – Ontario)

significant amounts of dividends tax-free due to basic personal and dividend tax credits. These are the benefits the government finds unfair. Because these benefits are not available to employees or unincorporated businesses, the government has changed these rules.

INCOME SPRINKLING

The income sprinkling measures are designed to eliminate the shifting of income to lower-income family members (eg. spouse, common-law partner, child, grandchild) for tax reasons. In brief, unless specific exclusions apply, payments to family members (eg. dividends, interest and certain capital gains) will be considered "split income" and a special "tax on split income" (TOSI) will apply resulting in taxation at the top marginal tax rate. This tax is the same tax that applies to split income paid to minors (ie. "kiddie tax"). It has been extended to adults and includes more types of income. The new rules took effect on January 1, 2018.

Under what circumstances does TOSI not apply? The answer depends on age and a number of other factors. The following tables describe the exclusions:

Exclusions – For family members age 18 or older, TOSI will NOT apply if any of the following apply:
Family member (age 18-24) contributed property to the business in exchange for a reasonable return[2]
Family member is the owner's spouse and owner is 65 or older and meaningfully contributed to the business
Capital gains from property sold qualifies for the LCGE[3] or is a result of death
Income is received pursuant to an agreement after a relationship breakdown
Family member (age 18-24) receives an amount from inherited property[4]
Family member owns 10% or more of the votes and value of the business and business is NOT primarily a services business[1] or professional corporation
Amount received is "reasonable" based on labour or capital contributions, risks assumed, prior amounts received from the corporation and other relevant factors
Family member owns 10% or more of the votes and value of the business and business is NOT primarily a services business[5] or professional corporation
Amount received is "reasonable" based on labour or capital contributions, risks assumed, prior amounts received from the corporation and other relevant factors

A FEW THINGS TO NOTE ABOUT THE EXCLUSIONS:

- There are two sets of exclusions. The first applies to family members who are age 18 or older. The second applies to those age 25 and older. Unless specified otherwise, family members who are 25 or older can avoid TOSI by qualifying for either set of exclusions.
- For family members age 18 or older, to avoid TOSI by contributing labour to the business, the family member is normally required to work an average of 20 hours per week in the year or any five previous years. The years do not need to be consecutive and, where a business operates only seasonally, the 20-hour per week average can be met with regards to the seasonal period.
- Where a business owner is age 65 or older and has meaningfully contributed to his/her business, he/she can pay dividends to a spouse or common-law partner without TOSI applying regardless of the spouse's age or contributions to the business. This measure is designed to provide flexibility for retirement income and align with existing pension income splitting rules.
- TOSI can be avoided when certain payments are received on the sale of a business, on death or after a relationship breakdown.
- Where a family member is 25 or older, provided they own at least 10% or more of the votes and value of the business, they can be exempt from TOSI – note though, if the business is a services business, professional corporation or gets too much of its income from a related business, this exclusion is not available.

These provisions appear to be targeted primarily at income sprinkling arrangements that involve family members between the ages of 18 and 24, services businesses and professional corporations where the family member does not meaningfully contribute to the business. Outside of these situations, the above exclusions provide some flexibility, subject to conditions.

Applying these concepts to the Muir family, effective 2018, in the absence of contributions to the business by Marva, Rachel or Claire, dividends paid to them would be subject to TOSI and taxed at top rates. Also, as the business is a

[1]An average of 20 hours per week in the year or any five previous years; [2]Amounts in excess will be subject to TOSI [3]Lifetime capital exemption (qualified small business corporation shares or farming/fishing properties) [4]From a parent or, if enrolled in post-secondary school or disabled, any person [5]90% of corporation's business income is from the provision of services

professional corporation, Marva would not qualify for the ownership interest exclusion for family members age 25 or older.

INCOME SPRINKLING – PLANNING STRATEGIES GOING FORWARD

The following strategies can reduce the impact of the new income sprinkling rules:

Delay certain payments: Where dividend payments would be subject to TOSI if paid to a family member under 25 but would not be subject to TOSI if paid after 25, consider delaying the payments past age 25. Likewise, where a business owner is nearing retirement, consider delaying payments to a spouse until after the owner reaches age 65.

Pay a reasonable salary instead of dividends: Where a family member under age 25 works in the business but does not work an average of at least 20 hours per week, consider paying a reasonable salary instead of paying dividends.

Review corporate structures: For family members who are 25 or older, consider increasing share ownership to 10% or more.[1] Also, consider different classes of shares for each shareholder (or group of shareholders) to avoid having a declared dividend taxed at graduated rates for some shareholders and TOSI rates for others.

Review the payment of household expenses: Instead of income splitting through the payment of dividends, have higher-income spouse pay household expenses while lower income spouse invests.

PASSIVE INVESTING WITHIN A CORPORATION

The passive investing measures are meant to eliminate tax benefits achieved when active business income (ABI) is taxed at low rates and reinvested passively within a corporation. Unlike employees and unincorporated businesses where employment and net business income are taxed at higher rates (50% - 2021 national average, top marginal rate), corporate active business income of up to $500,000[2] is eligible for a small business deduction resulting in taxation at lower tax rates (11% - 2021 national average). The net result? Corporations have access to greater after-tax capital; where this capital is used to earn investment income as opposed to additional business income, in the eyes of the government an unfair benefit is achieved.

To address this, in the 2018 federal budget the government proposed a new measure designed to reduce access to the small business tax rate where "significant" passive income is earned in a private corporation. Specifically, where passive income – known as "adjusted aggregate investment income" (AAII) – exceeds $50,000[5] for a given year, the corporation's access to the small business tax rate (9% federally for 2021) for the following year will be reduced. Once AAII reaches $150,000, none of the corporation's ABI will be eligible for the small business rate and instead will be taxed at the general corporate rate (15% federally for 2021). More specifically, the small business deduction limit ($500,000 currently) will be reduced by $5 for every $1 of AAII above the $50,000 threshold, such that the limit will be reduced to zero at $150,000 of AAII. The formula for calculating the reduction is $500,000 – [(AAII - $50,000) X 5]. The following charts illustrate the impact of the reduction at various levels of AAII:

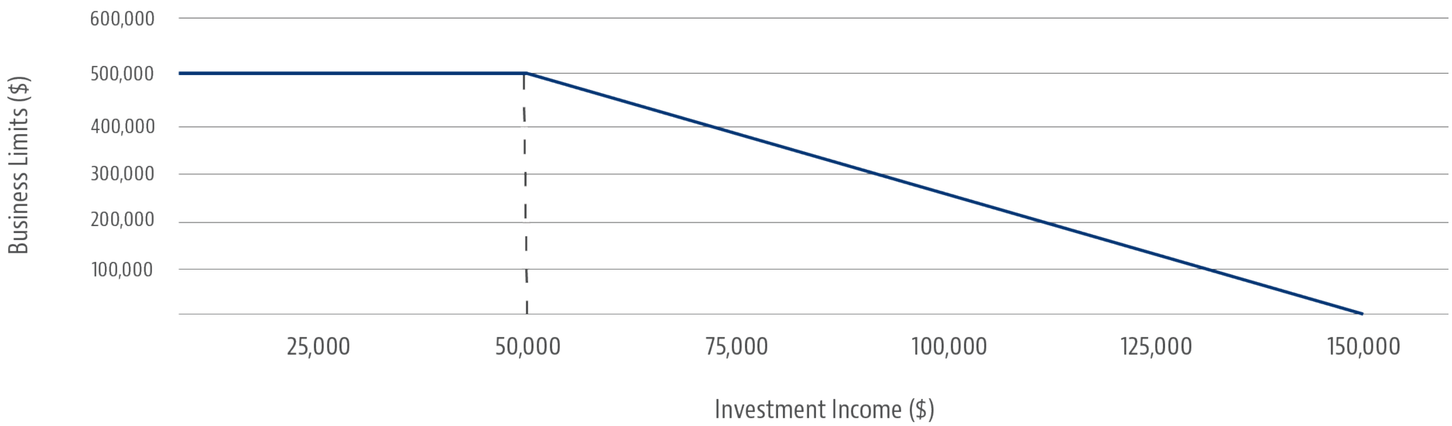
AAII	Amount eligible for the small business tax rate[3]
$50,000	$500,000 – ($50,000-$50,000) x 5 = $500,000
$75,000	$500,000 – ($75,000-$50,000) x 5 = $375,000
$100,000	$500,000 – ($100,000-$50,000) x 5 = $250,000
$125,000	$500,000 – ($125,000-$50,000) x 5 = $125,000
$150,000	$500,000 – ($150,000-$50,000) x 5 = $0

Departing from proposed measures discussed in the 2017 consultation paper, this proposal did not include an increase to investment income tax rates. Refundable tax rates also remain the same.

AAII includes common forms of investment income such as interest, portfolio dividends and taxable capital gains, but exclude capital gains/losses from the sale of property used principally in a Canadian active business and the sale of shares of a connected corporation, subject to conditions. Net capital losses from other years are excluded from the calculation as is income that is incidental to an active business (e.g., interest from short-term investments held for operational purposes).

[1]Will not work for services businesses or professional corporations or if too much income is derived from other related businesses. | [2]$600K in Saskatchewan
[3] Federal rules, the reduction also applies for provincial and territorial tax purposes with the exception of Ontario and New Brunswick.

REDUCTION IN SMALL BUSINESS DEDUCTION LIMIT BASED ON PASSIVE INVESTMENT INCOME



Source: 2018 Federal Budget

A few things to note about these rules:

- The reduction to the small business deduction took effect as of 2019.
- The reduction applies to Canadian-controlled private corporations (CCPCs) and their associated corporations. In other words, these corporations are viewed as one for purposes of this rule.
- CCPCs that do not have ABI that qualifies for the small business tax rate (such as investment holding companies that are not associated with a corporation that claims the small business deduction) are not impacted.
- The changes apply for federal tax purposes and also for provincial and territorial purposes with the exception of Ontario and New Brunswick. That said, planning should still be considered in Ontario and New Brunswick as corporations in those provinces are also subject to federal tax.

Applying these measures to the Muir family, if, in a given year, their corporation earned $75,000 of AAII, access to the small business tax rate would decrease for the following year. Instead of $500,000 of ABI being eligible for the small business rate, $375,000 would be eligible. The remaining $125,000 would be taxed at the general corporate rate.

PASSIVE INVESTING – PLANNING STRATEGIES GOING FORWARD

The following strategies can reduce the impact of the new passive investing rules:

Invest for capital gains: Unlike ordinary income where 100% is included in AAII, only 50% of realized capital gains are included. Therefore, capital gains reduce the potential for reductions to the small business limit. Corporate class mutual funds or non-dividend paying stocks can help.

Buy and hold to defer capital gains: Defer taxable capital gains to a more favourable time – e.g., when AAII is below the $50,000 passive investing threshold. Also, selling investments over time can allow for greater access to small business rates.

Consider corporate-owned exempt life insurance: Investing within an exempt life insurance policy will not impact AAII. Where the policy will be used for estate planning purposes (e.g., tax-free payout at death), it can be an effective vehicle for maximizing wealth. Where cash surrender values are withdrawn before death, AAII may be impacted.

Pay sufficient salary to maximize RRSPs and TFSAs: Doing so will provide a tax deduction at the corporate level, which can reduce tax at the general corporate tax rate. Investment income from RRSP and TFSA contributions will also grow tax-sheltered.

Consider whether an Individual Pension Plan (IPP) may be appropriate: Contributions to an IPP provide tax deductions at the corporate level, which can keep business income below the small business threshold. Also, because investment income earned within an IPP is separate from corporate assets, it will not add to AAII. IPPs have ongoing administration costs and are not suitable for everyone. Working with a professional to determine suitability makes sense.

CONCLUSION

These changes impact tax measures that have been in place for some time. The passive investing rules, for example, have been in place since 1972. Believing that change was needed, the federal government changed the rules, altering the planning landscape going forward. Business owners should work with their investment, tax and legal advisors to determine how they are impacted by the new rules.

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