Commentary on December 13th Government Proposals for "Income Sprinking" and Private Corporation Tax Planning

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Ever since the Department of Finance proposed significant changes to the taxation of private corporations and their shareholders on July 18, 2017, business owners and their families have been waiting for more clarity on what those changes would mean to them. There have been a few verbal pronouncements and a legislative change to reduce the lower corporate income tax rate, but no new draft legislation or details – until now. For a quick refresher on what was proposed in July, please see our summary here.

Full analysis of the Dec 13, 2017 revised proposals will take some time, we can say with some certainty that the main items from this new information are as follows:

PROPOSED CHANGES COMPLETELY REMOVED

- Proposed changes to restrict on claiming the capital gains exemption by shareholders not active in the company, or when the gain accrued while the shares were held in a Trust, or the shareholder was under 18.
- Proposed changes to increase the scope of situations where other types of income and returns of capital from companies to their shareholders would be converted to dividends.
- Proposed changes that would decrease the usefulness of adjusted cost base on shares that had given rise to a capital gain by a related person in the past.

The exclusion of these proposed changes from the Dec 13 proposal is welcome confirmation of the verbal announcements that had been made in October. Taxpayers can now proceed with more certainty in these areas.

REVISED RULES RELEASED

Revised draft legislation and explanatory notes were released regarding transactions that have become known as "income sprinkling" – where dividends and other types of income are paid to related individuals (generally in lower tax brackets) from a private company instead of the company's main shareholder. These rules are still meant to take effect on January 1, 2018, but have been changed from the original proposal in some significant ways.

Several specific situations have been identified that will not attract the penalizing "Tax On Split Income" (TOSI) – where income is subject to the highest marginal tax rate in the individual recipients province with limited personal tax credits. In simple terms, people in the situations described below can still receive income from private companies with the same personal tax result going forward as they would have been subject to under the current rules:

- Individuals 18 and older who are active in the business of the company at least an average of 20 hours per week that the business is active in the taxation year, or that have been active in this capacity in at least 5 years in the past.

- Individuals 25 and older who receive income, or earn a gain, on shares of a company where the individual owns shares that represent at least 10% of the voting shares and 10% of the fair market value of the entire company. That company must also receive less than 90% of its income from provision of services, and cannot be a "Professional Corporation". As well, the company must derive all or substantially all (generally considered to mean 90%) of its income from sources that are NOT "Related Businesses".
- Individuals receiving income from a company that their spouse provided a meaningful contribution to, if the spouse was over 65 in the taxation year.
- Individuals that recognize a capital gain from "qualified small business corporation shares" or "qualified farming or fishing property". These are two defined terms in the Income Tax Act with specific criteria necessary to qualify.

The new proposals released have also eliminated some of the other areas where the July 18th proposals attempted to expand the situations where TOSI would apply or expanded the originally proposed limits on income that could be earned before TOSI would apply.

Even if a situation does not fit one of these specific exclusions and income earned by an individual might be subject to the expanded TOSI regime, there is still a general exclusion for income earned that could be considered a "reasonable" return. The proposals lay out the factors that will be considered in determining this reasonable return and the Canada Revenue Agency has offered guidance as well. The original 4 factors have been simplified in the Dec 13th release but can be summarized as:

- Work performed for the business
- Property contributed to the business
- Risks assumed in relation to the business, and
- Amounts received, directly or indirectly, in respect of the business

And a fifth factor has been added, although it does not provide much clarity:

- Such other factors as may be relevant.

More time and analysis is necessary to fully understand the total effect of the changes to these proposals, but an effective date of January 1st, 2018 does not allow much time for that. The revised proposals make concession for this tight timeline by allowing to the end of 2018 to adjust corporate ownership structures to the new exclusions outlined above. However, this does not appear to be much help to situations outside the specific exclusions.

STILL TO COME

The last major section of the July proposals related to taxation of income from passive investments in private companies. Generally, feedback was requested related to options for "fixing" a perceived unfairness in the current system but no draft rules were released. This perceived unfairness related to allowing corporations to pay less tax on active income than an individual would pay and then investing the larger after-tax amounts in passive, instead of active, investments. In October, Finance announced that a $50,000 per year "exemption" would be put in place as part of any new system to give corporations a window to earn income outside of active business without immediately being subject to the new taxation rates. Other than this, no significant definitive information has been released.

The proposals confirm that additional information on any revised rules for taxation of passive income in private companies will be released in the future and are intended to be part of the 2018 Federal Budget.

CONCLUSION

While the information released on Dec 13, 2017 addressed some of the many concerns that arose from the July 18th proposals, we anticipate there will still be significant opposition to the new system outlined. We will be spending significant time and effort to further analyze and interpret the draft legislation and determine how it will affect our clients and taxpayers in general. Links to the Department of Finance announcement and related information can be found below and we will be issuing further information as it becomes available.

Read the Department of Finance's announcement here.

If you have any questions on these proposals or tax planning using private corporations in general, please do not hesitate to contact us:

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