A Whole New World: Private Corporation Tax Planning

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In July 2017, the federal government released a discussion paper and draft legislation that addressed tax planning strategies for private corporations. Nearly a year after the initial release, and following public consultation, a series of government announcements in October 2017, the release of the Federal budget in February 2018, and passing of legislation in June 2018, we are now able to finally provide some additional guidance regarding the new legislation, which addresses sprinkling income using private corporations and holding passive investments inside a private corporation.

The following is a general overview of the government's new legislation in these areas.

SPRINKLING INCOME

Previously, taxpayers were able to split income with members of their family through the payment of dividends on private corporation shares held by family members, held by a family trust, or through certain other arrangements. If the family member had minimal other income, this allowed dividends to be paid from the corporation with very little or no personal income tax.

Beginning in 2018, subject to certain exceptions described below, only <u>reasonable</u> dividends paid to family members of the active shareholder will be taxed at the family member's marginal tax rate. To the extent a dividend is considered unreasonable, it will be taxed to the family member shareholder at the highest marginal rate of tax, currently 46.84% in Ontario. This has been accomplished through expanding the tax on split income ("TOSI") rules, which previously applied only on amounts received by minors.

The new legislation provides a number of specific exclusions to the TOSI regime, the most relevant of which are as follows:

a) Excluded Business Test: Dividends paid to adults **aged 18 or over** are excluded if the individual has made a substantial labour contribution (generally an average of at least 20 hours per week) to the business during the year, or during any five previous years. Individuals who are indirect shareholders of the active company, such as through a holding corporation or a trust, can meet this exclusion.

b) Excluded Shares Test: Dividends paid to adults **aged 25 or over** who **own 10 percent or more** of the votes and value of the active corporation are excluded if the business earns less than 90% of its income from services or from another related business, and if the corporation is not a professional corporation. Unlike the excluded business test above, the individual must hold a direct interest in the active company to meet this test. Dividends received via a holding company or a trust will not be eligible for this exclusion.

c) Retirement Age Test: Dividends paid to an active business owner's spouse are excluded, if the active owner is **aged 65 or over**, and meaningfully contributed to the business. It is the age of the active spouse that is relevant for this exception, not the spouse's age.

d) Reasonableness Test: There may be situations where the dividend paid is reasonable, but does not meet any of the quantifiable tests above. Whether these dividends are reasonable, and therefore, excluded from TOSI, is a question of fact, and would need to be considered on a case by case basis. Consideration would need to be given to what a person who is not connected with the business would receive based on their labour and capital contributions, risks assumed, and historical dividends received. Dividends paid to individuals aged 18-24 will be further limited to a prescribed rate of return based on the property or capital contributed by that individual.

e) Other Circumstances: Dividends paid on certain shares received as a result of the death or divorce are generally excluded. Other restrictions may apply.

Next Steps:

a) Identify if dividends paid by your corporation may be subject to TOSI, and document how an exception is met, including the labour and capital contributions of family member shareholders.

b) Consider restructuring the corporation's shareholdings to meet the "excluded share" test by December 31, 2018.

c) Consider restructuring the corporation's shareholdings if multiple individuals hold the same class of shares, and TOSI will apply to any one shareholder. This will allow flexibility to pay dividends to only the shareholder not subject to TOSI.

HOLDING PASSIVE INVESTMENTS INSIDE A CORPORATION

Previously, as corporate tax rates on active income are much lower than top personal tax rates, active income earned in a corporation and then invested in passive assets creates additional investable funds (without any negative tax result) relative to funds available to an individual who earns income personally, pays personal tax, and then invests in a portfolio. This deferral advantage for corporate portfolios is a result of the compounding of income on the additional funds invested.

Beginning in 2019, two measures were passed to reduce the tax deferral benefit from corporate portfolios.

Business Limit Reduction: The small business deduction will be reduced on a straight line basis beginning when passive income for an associated group of companies exceeds $50,000, with the small business deduction completely eliminated when passive income reaches $150,000. In 2018, the small business deduction reduces the corporate tax rate from 26.5% to 13.5% on up to $500,000 of active business income. While loss of the small business deduction will result in higher corporate tax up front, the after tax profits can be distributed to shareholders as eligible dividends, resulting in lower personal income tax. As such, these new measures reduce the tax deferral available, but <u>do not</u> have a material impact on the overall tax liability once earnings are fully distributed to individual shareholders.

For purposes of the limitation on the small business deduction, investment income of all associated companies will be considered, with adjustments for several factors, including:

a) Excluding certain net capital gains on the sale of assets and shares of an active business.
b) Excluding investment income that is incidental to an active business.
c) Including adjustments for net capital losses carried over from other years.
d) Including dividends from non-connected corporations, such as dividends on portfolio investments.
e) Including certain adjustments for income from life insurance policies.

Refundability of Taxes on Investment Income: A portion of the corporate tax paid on investment income is added to the refundable dividend tax on hand ("RDTOH") and is generally refundable to the corporation when taxable dividends are paid to a shareholder. Previously, the RDTOH recovered in a corporation was the same, regardless whether an eligible or ineligible dividend was paid to the shareholder, even though eligible dividends were taxed at a preferential personal tax rate to the individual shareholder.

Now, a refund of RDTOH will generally only be available where a private corporation pays an ineligible dividend, unless the RDTOH relates to an eligible dividend received (for example, on portfolio dividend income). To accomplish this, transitional rules were introduced to bifurcate existing RDTOH into two pools, eligible RDTOH and ineligible RDTOH.

Next Steps:

To minimize and /or prepare for the impact of these measures, consider the following:

a) Consider the benefit of paying eligible dividends in 2018 to obtain a refund of RDTOH, before applicability of the new rules.

b) Consider (with the assistance of your financial advisor) rebalancing investments to move towards capital gains and away from dividends and interest, as only 50% of capital gains are included in investment income.

c) Consider utilizing tax deferred investment plans such as life insurance and individual pension plans (IPPs).

d) Companies that lose access to the small business deduction will be subject to higher corporate tax rates. As a result, corporate tax instalment payments may not be sufficient to cover the tax balance due. The cash flow implications of this change should be considered and planned for.

e) Corporate income tax balances will be due two months after year end versus three months after year end if the small business deduction was not claimed in one of the two prior years.

For more information on how these measures may impact you and your business please contact your **Roth Mosey advisor**.

ABOUT THE AUTHOR

Linda Cook, CPA, CA
Senior Tax Manager

Linda is currently a senior tax manager and provides guidance in the areas of personal and corporate tax planning, preparation of corporate, personal, and trust tax returns, estate and succession planning, purchase and sale transactions, corporate restructuring, and compliance with indirect taxes such as HST. Linda specializes in providing advice for owner-managed businesses, and tax planning for Canadian / U.S. cross border business activities.

Linda joined Roth Mosey & Partners in 2006, received her Honours Bachelor of Business Administration degree from Wilfrid Laurier University in 2008, and received her CA designation in 2010. She has completed numerous tax courses sponsored by CPA Canada, including the In-Depth Tax Courses, the In-Depth Tax Issues for Owner-Managed Business Course and the In-Depth HST/GST Tax Course.

Contact Linda
D: 519-962-5113
E: lcook@rothmosey.com