New Income Sprinkling Rules – What You Need to Know

Government Releases New Measures to Restrict Income Sprinkling

Government of Canada Proposed Tax Changes for Private Corporations | 2017

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On July 18, 2017, the federal government introduced plans that substantially change the taxation of private corporations. Three changes were proposed:

1. Increasing the tax on passive income earned inside a corporation;
2. Curtailing transactions which converted ordinary dividends to capital gains; and
3. Splitting income among family members using dividends.

The government is still studying the first proposal. It has withdrawn the second. Today, the government proposed a revised set of rules on income splitting.

How Income Splitting Works

Canada's tax system is primarily based on the income of the individual, not of the family, and tax rates are steeply graduated with income. Consequently, a family with one income earner receiving $100,000 will pay more tax than a family where two spouses each earn $50,000.

Income splitting is considered common practice for incorporated small businesses. Family members subscribe for shares in a corporation, sometimes using a trust. The corporation pays dividends to family members, "splitting" the income and reducing the overall tax. There are often business and succession advantages in such a plan as well.

The Government's Original Proposal

The current federal government would like to curtail income splitting. In short, the government proposed to evaluate the contribution of each family member to a business' results. Any dividends or capital gains realized from that business in excess of a "reasonable" return on labour and capital would be taxed at the top marginal rate. This is called "Tax on Split Income," or TOSI.

The challenge was that determining each person's contribution would be a complicated, subjective and expensive process. Virtually all commentators – accountants, lawyers, the Senate Finance Committee, and even two Chief Justices of the Tax Court of Canada, said that it would be very difficult to administer.

The Revised Proposal

The revised proposal alleviates some of these concerns. The government has kept the reasonableness tests, but narrowed the scope by adding safe harbours, where TOSI would not apply:

1. Where a business owner is age 65 or older and splits income with a spouse (aligning the rules with the existing pension income splitting rules);
2. If a capital gain qualifies for the Capital Gains Deduction (Qualified Small Business Corporation Shares or Qualified Farm Property); and
3. In the case of shares inherited from a deceased by will, if income or gain on the shares would not be TOSI to the decedent.

Excluded business

There will be two exemptions from the labour reasonability test. The individual will be exempt from TOSI if the individual:

1. Works more than 20 hours per week in the current year (pro-rated in case the business operates for only a portion of a year), or
2. Has previously met the above test for at least five years. This can be any five years; they need not be continuous or recent. If this test is met, then income can be split for a lifetime.

Excluded shares

The individual will be exempt from TOSI if the individual:

1. Is at least 25 years old by the end of the year, and
2. Owns 10 percent of the business (by votes and value),

and the corporation meets the following conditions:

1. It earns less than 90 percent of its income from the provision of services, and
2. It is not a professional corporation.

Other Changes to the July 2017 Proposals

In order to simplify the application of the TOSI rules, as well as to address potential unintended consequences associated with the July 2017 proposals, the federal government has proposed the following changes:

- TOSI will not apply to compound income, or income derived from property acquired as a result of a marital breakdown.
- Aunts, uncles, nieces and nephews will not be considered "related individuals" for purposes of the TOSI rules.
- Confirmation that the broad rules countering conversion of regular income to capital gains have been abandoned.
- Under the original proposal, individuals aged 18-24 were permitted to only earn the prescribed rate of return on capital contributions before TOSI applied. They will now be entitled to earn a reasonable return, but only on contributions sourced from an unrelated business.

Legislative process and Effective Date

The revised income sprinkling measures are proposed to be effective for the 2018 and subsequent taxation years and will be legislated as part of the federal budget process (likely in March 2018).

In our view, the draft legislation has been rushed, considering the Standing Senate Committee on National Finance released a report on the same day "urging government to axe tax act changes" and instead, a full review of the Canadian taxation system be undertaken. We believe this would be a better approach.

If the rules are to be effective January 1, 2018, the government has given taxpayers less than three weeks to review their business and tax planning needs in light of these proposals.

What These Changes Mean To You

The new rules address some of the difficulties of the July 18, 2017 proposals; however, they still raise significant challenges in planning, compliance and audit. While bright-line tests have been introduced, there are still many situations where amounts paid will be subject to a reasonability test which will lead to disputes between taxpayers and the Canada Revenue Agency.

While it is clear that opportunities to income split will now be more limited than in prior years, the proposals are less punitive than what was originally planned. The rules and specific exceptions to exclude a taxpayer from TOSI are complex. We would encourage you to consult your MNP advisor to see how you can maximize your ability to split income under the new rules.

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Everything Counts

When it comes to tax, it's all about the details. Knowing the rules and regulations, what qualifies, what doesn't and how to structure your business and claims most effectively. Our specialized teams are focused on every facet of tax. We have the in-depth knowledge and experience that will allow you to capitalize on all the opportunities available. We know what to look for, right down to the smallest details. And it's the small details that can add up to make a big difference.