# PRIVATE CORPORATION TAX CHANGES: FINANCE CLARIFIES INCOME SPRINKLING

## *Understanding the Implications of Revised Income Sprinkling Measures on Private Corporations in Canada*

**By: Joseph A. Gill, Lawyer McKercher LLP**

**On December 13, 2017, the Department of Finance ("Finance") provided clarifications on its earlier proposed changes concerning income sprinkling (see here). For a review of the original proposals, please see my earlier blog post here. The concept of "income sprinkling" is essentially making arrangements to share the tax burden among related persons. This most commonly takes the form of dividends coming out of a private corporation to various family members; by doing this, the full tax burden of the family is divided up among the various family members. As one can imagine, various forms of "income sprinkling" greatly offended Finance and so new rules were proposed to address this practice. The purpose of this document is to provide an overview of the clarifications which Finance provided to its original proposed changes.**

In this blog post, the term "**TOSI**" will be used frequently. TOSI refers to "tax on split income", which is generally any income that would be taxed at the highest marginal tax rate as a result of the new "income sprinkling" rules. While TOSI can arise in a number of situations, the most common would be on a potential dividend payment out of a corporation to a family member of the owner of that corporation. My earlier blog post discusses the full scope of TOSI but this simplified explanation is provided for current purposes. Readers are cautioned that TOSI can also apply to trust distributions, partnership distributions, and certain capital gains.

### 1. Clarified Tests for Different Age Categories

The revisions to the "income sprinkling" proposals provided clarity depending upon the age and family position (i.e. spouse, child) of the person receiving dividends (or other forms of income subject to TOSI):

- ***Spouse*** - There will not be any TOSI on dividends paid to a spouse of a business owner where that owner (i) meaningfully contributed to the business, and (ii) is aged 65 or over.

- ***Adults (18 Years and Older)*** - There will not be any TOSI on dividends paid to an adult aged 18 or over where the adult is "actively engaged on a regular, continuous and substantial basis" in the business during either (i) the current tax year, or (ii) any 5 previous years. Where the adult works an average of 20 hours per week during the part of the year that the business operates, they will be deemed to be "actively engaged on a regular, continuous and substantial basis". Thankfully as well, if a business is seasonal and only operates part of a year, the "20 Hours Per Week" rule only has to be met during the time that the business operates (not all year). For adults who don't meet the "20 Hours Per Week" rule, it will be a case-by-case analysis whether they meet the "actively engaged on a regular, continuous and substantial basis" test.

  Additionally, if an adult aged 18 or over receives shares by way of inheritance, they will be able to "step into the shoes" of the deceased individual. Effectively, any labour contributions of the

deceased individual (which would count positively towards the adult's contributions to the business) are deemed to be contributions of the adult.

- ***Adults (25 Years and Older)*** - There will not be any TOSI on dividends paid to an adult aged 24 or over where all of the following conditions are met:

  - the adult directly owns more than 10% of the business (this refers to the adult owning shares representing both (i) 10% or more of the value of the business, and (ii) 10% or more of the votes for the business). Note that, for 2018, an adult has until the end of 2018 to acquire his or her 10% shares in order to satisfy this condition for all of 2018;
  - the business earns less than 90% of its income from providing services;
  - the business is a not a professional corporation (e.g. corporation that carries on professional practice of professional such as lawyer, accountant, doctor, etc.); and
  - the business does not derive more than 10% of its income from a "related business". The idea of a "related business" is best illustrated where Corporation A (owned by children) charges rent on a building it owns to Corporation B (owned by father); Corporation A would otherwise satisfy the three prior conditions above but it makes most of its money from Corporation B and so fails on this final condition.

- ***Aunts, Uncles, Nieces, Nephews*** - The revised rules will not extend TOSI to income paid to nieces, nephews, aunts, and uncles.

- ***Divorcees*** - Income derived from property as a result of breakdown of marriage or common-law partnership will not be considered TOSI.

For anyone not falling within these exceptions, they would need to satisfy the reasonableness test discussed below.

**2. Clarification of Reasonableness Test**

The reasonableness test differs depending upon whether the individual receiving dividends (i.e. potential TOSI) is between 18-24 years of age or over the age of 25:

- ***Age 18-24*** - These individuals will be limited to receiving only a prescribed rate of return (currently 1%) on any capital they contributed to the business. In most cases, these adults only contribute nominal amounts to the business meaning that any "return" paid to them would be very small. Consequently, the hope is that these individuals fall within the "20 Hours Per Week" rule noted above. Alternatively, if the property generating the income for the adult is financed through arm's length borrowing (e.g. loan from a bank), any income on that property would not be TOSI.

- ***Age 25+*** - The reasonableness of any payment will be assessed by looking at the following factors:

  - Labour Contributions: The nature of the tasks performed; hours required to complete the tasks; a competitive salary/wage for the tasks in relation to businesses of similar size and industry;

education, training and experience; degree of activities and nature of activities in relation to those of a business of a comparable nature and size; time spent on the activity in comparison to time spent in other activities or undertakings; particular knowledge, skills or know-how that the individual possessed; business acumen; and past performance of functions.

- Property Contributions: the amount of capital contributed to the business; the amount of loans to the business; the fair market value of property (both tangible and intangible property) transferred to the business, including technical knowledge, experience, skill, or know-how; whether the individual has provided property as collateral for loans or other undertakings; whether other sources of capital or loans are readily available; whether comparable property are readily available; whether property are unique or personal to the individual; opportunity costs; and past property contributions.
- Risk Assumption: whether the individual is exposed to the financial liabilities of the business, whether through guarantees of mortgages, loans or lines of credit or otherwise; whether the individual is exposed to statutory liabilities related to the business; extent of the risk that contributions made by the individual to the business may be lost, whether in whole or part; whether any risk is indemnified or otherwise limited in the circumstances, whether by agreement or otherwise; whether the individual's reputation or personal goodwill is at risk; and past or ongoing risk assumption.
- Historical Payments: other amounts previously paid to the individual. This should generally include any payment of any kind (including salary or other remuneration or compensation, dividends, interest, proceeds, and fees), benefits, and deemed payments (as may be reasonably required in the circumstances).

Additionally, Finance has stated that "taxpayers should be prepared to support their position that the amount of [a] payment is a reasonable amount not subject to [TOSI]." It should go without saying that Finance will expect taxpayers to have records supporting their reasonableness arguments.

**3. Example Scenarios from Finance**

Perhaps in a nod to the ambiguity of the "income sprinkling" measures, Finance has provided a number of examples of how these proposals would operate. These examples are available here, here, and here. If you are concerned as to whether your particular scenario would trigger TOSI, a review of these various examples may be helpful. Additionally, Finance has created a webpage (see here) with some frequently asked questions on these "income sprinkling" measures.

**4. Lifetime Capital Gains Exemption**

In a very welcome "about face", Finance has decided not to proceed forward with its earlier proposals to curtail access to the lifetime capital gains exemption (the "**LCGE**"). As many readers will know, the LCGE potentially shelters up to $835,714 (on 2017 numbers – indexed to inflation for later years) of capital gains on the sale of shares of a small business shares. There are a number of very technical requirements for access to the LCGE that are not mentioned here; readers are encouraged to seek professional advice in any situation where they may be able to claim the LCGE.

Thankfully as well, any capital gains arising from the sale of property eligible for the LCGE (e.g. small

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business shares, qualified farm or fishing property) will not be treated as TOSI. However, this doesn't apply if the individual incurring the gain is under the age of 18 (and applies whether they incur the gain directly or potentially indirectly through an entity such as a trust). Critically, capital gains that are not covered by the LCGE would still be subject to TOSI. Unfortunately, there doesn't appear to be any "safe harbor" for non-LCGE capital gains up to the date of implementation of those proposals. Consequently, it seems historical non-LCGE capital gains up to 2017 may get pulled into TOSI.

**5. Final Comments**

As with any new tax proposals, the implementation of these "income sprinkling" measures will ultimately show how these are to be applied in the real world. Clearly, any reader with a private corporation that has family members as shareholders (whether directly or indirectly through another corporation or a trust) should be paying attention to these new proposals. There are some specific planning items that should be kept in mind:

- ***Services Businesses and Professional Corporations*** - As noted above, these corporations face more restrictive access to certain of the "safe harbours" discussed above.
- ***Holding and Operating Company Structures*** - As noted above under "*Adults (25 Years and Older)*", businesses need to be careful of earning too much income from a "related business". It is not entirely clear, however, how this would apply in a situation where a parent corporation earns the majority of its income from a related subsidiary corporation.
- ***2018 Corporate Restructuring*** - In order to meet the 10% ownership requirement noted above for "*Adults (25 Years and Older)*", businesses will likely need to undertake reorganizations to meet this requirement. Particular attention should be paid to the fact that the 10% requirement is based on direct ownership. Consequently, structures where family members hold shares indirectly through corporations and trusts may need to be revisited.
- ***Record-Keeping*** - If a particular individual is not fortunate enough to fall within one of the "safe harbours" discussed above, it will be extremely important for business owners to document that individual's contributions to the business. Reference should, where possible, be paid to those factors noted above as part of the discussion on the reasonableness test.

The proposals are all anticipated to take effect ton January 1, 2018. Consequently, opportunities for "income sprinkling" still exist in 2017. We here at McKercher are familiar with these new proposals and are available to assist you with the impact of these changes on your particular corporate structure.

Joseph A. Gill
Lawyer, McKercher LLP
j.gill@mckercher.ca
306-664-1276

**ABOUT THE AUTHOR:**

Joe is an associate in McKercher LLP's Saskatoon office and maintains a general corporate and commercial law practice with particular emphasis in the areas of Corporate Finance, Securities Laws, Mergers & Acquisitions, and Taxation.