Revised proposals to limit income sprinkling

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Tax Alert

On December 13, 2017, the federal government released revised draft legislative proposals to limit the ability of owners of private corporations to lower their personal income taxes by sprinkling their income to family members who are subject to lower personal tax rates and do not directly contribute to the business. To assist taxpayers to better understand the application of these proposals, the Canada Revenue Agency (CRA) also released guidance[i] on how these revised proposals would apply under various common scenarios.

These revised income sprinkling measures are proposed to be effective for the 2018 and subsequent taxation years.

The government also reconfirmed that it will move forward with measures to limit tax deferral opportunities related to passive investments, and details of this plan will be included in Budget 2018. When introduced, the passive investment measures will apply only on a go-forward basis.

The government also reconfirmed that it will not move forward with changes that would limit access to the Lifetime Capital Gains Exemption (LCGEs) to rules or conversion of income to capital gains.

Application of revised income sprinkling rules

Under the current income tax rules, tax on split income (TOSI) applies the highest marginal tax rate (currently 33% for federal tax purposes) to "split income" of an individual under the age of 18 years old. In general, an individual's split income includes certain taxable dividends, taxable capital gains and income from partnerships or trusts.

The new draft measures proposes to extend the application of the TOSI rules to individuals over the age of 17 years old, but only with respect to income derived from a "related business" (i.e., a business whereby a related individual is either actively engaged in the business or owns a significant portion of the equity in the corporation that carries on the business).

The proposed changes however, will not apply to individual members of a business owner's family who fall into any of the following categories:

- The business owner's spouse, provided that the owner meaningfully contributed to the business and is 65 years old or older. This reflects the fact that a business can play an important part in supporting its owner in retirement and aligns with the existing pension income splitting rules.
- Individuals who are 18 years or older who were engaged on a regular, continuous and substantial basis in the activities of the business (i.e., generally an average of at least 20 hours per week) to the business during the year, or during any five previous years[ii]. For businesses with seasonal operations, such as may be the case with farms and fisheries, the labour contribution requirement will be applied for the part of the year in which the business operates.
- Individuals who are 25 years old or older, who own 10 per cent or more[iii] of the votes and value of a corporation that earns less than 90 per cent of its income from the provision of services and is not a professional corporation (i.e., a corporation that carries on the professional practice of an accountant, dentist, lawyer, medical doctor, veterinarian or chiropractor)[iv].

In certain cases, individuals aged 18 to 24 years old who have contributed to a family business with their own capital will be able to use the reasonableness test on the related income.

The following amounts will also be excluded from the split income of an individual for a tax year and therefore, not subject to the TOSI rules:

- Taxable capital gains from the disposition of property that can qualify for the LCGE (i.e., qualified farm or fishing property or qualified small business corporation shares). Note, this does not include taxable capital gains from the disposition of certain shares to a person that does not deal at arm's length with the individual, when the individual is under the age of 18 years old;
- Income or taxable capital gain from the disposition of inherited property received by individuals who are under 25 years old;
- A taxable capital gain that arises on the deemed disposition of capital property as a result of the death of an individual;
- Income from property acquired by the individual as a result of the breakdown of marriage or common-law partnership.

Summary

These revised proposed measures may have a significant impact on you, your family and your business. Please contact your Grant Thornton advisor if you would like to discuss these proposals further. We can help you prepare for these changes.

[i] https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/federal-government-budgets/income-sprinkling.html

[ii] A business in which an adult individual is actively engaged on a regular, continuous and substantial basis in the activities of the business in the taxation year or in any five prior taxation years of the individual is considered an "excluded business". An individual will not be subject to the TOSI on amounts received from an "excluded business."

[iii] As a transitional measure, taxpayers will have until the end of 2018 to meet the condition of owning at least 10 per cent of the outstanding shares of a corporation in terms of votes and value; this will provide taxpayers a year to organize themselves in a manner that will enable them to meet this requirement.

[iv] Shares of a corporation whereby an individual who is 25 years or older owns 10 per cent or more of a corporation that earns less than 90 per cent of its income from the provision of services and is not a professional corporation is considered "excluded shares". An individual will not be subject to the TOSI on amounts received from "excluded shares" owned by the individual.