MAKING SENSE OF A SEA OF TAX CHANGES

Paul McVean, BAccS, CPA, CGA, CFP, TEP
Barbara Da Fonseca, CPA, CA

BDCA CHARTERED PROFESSIONAL ACCOUNTANTS

Agenda

- Recent Tax Changes:
  - *Inter-Corporate Dividends – 2015 Budget*
  - *Small Business Deduction – 2016 Budget*
  - *Tax On Split Income – 2018 Budget*
  - *Passive investments of private corporations – 2018 Budget*

- What do we do now

BDCA CHARTERED PROFESSIONAL ACCOUNTANTS

INTER-CORPORATE DIVIDENDS

BDCA CHARTERED PROFESSIONAL ACCOUNTANTS

Inter-Corporate Dividends

- Old rules:
  - Dividends could flow tax-free between:
    - “Connected” corporations (>10% of votes & value)
    - Controlling interest (>50% of votes) owned by recipient corporation combined with those related to it
  - If paid in contemplation of a sale, we needed to worry about “safe income”

Inter-Corporate Dividends

- New rules:
  - We now almost always need to worry about “safe income”, where tax-free inter-corporate dividends:
    - Reduce the potential capital gain on the sale of shares
    - Causes a significant reduction in the FMV of any share
  - Doesn’t any dividend lower the value of the shares?
    - Dividend = after-tax distribution of corporate assets

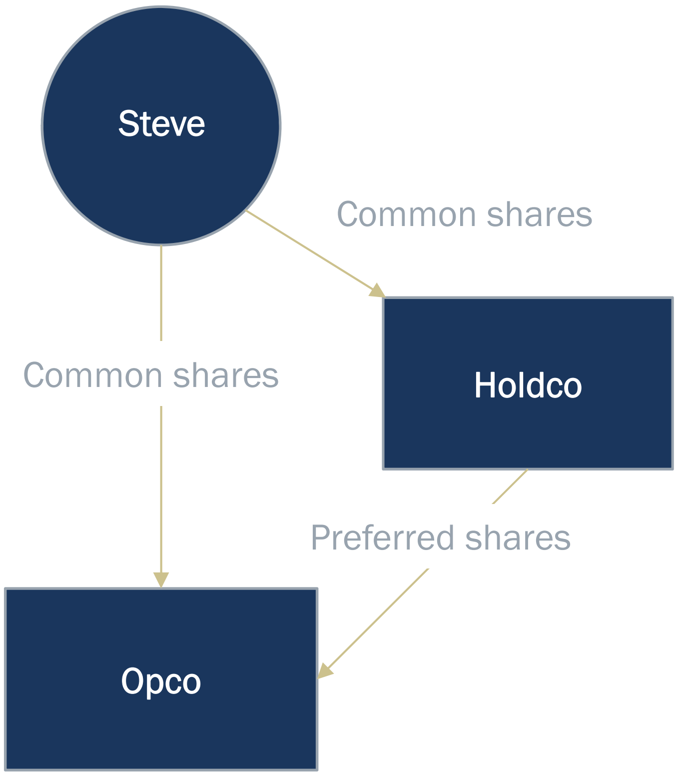
BDCA CHARTERED PROFESSIONAL ACCOUNTANTS

Inter-Corporate Dividends

- New rules:
  - Safe income calculation now required far more often
  - No longer can rely on related party exception unless shares are being redeemed
  - Impact on skinny shares being held by holdco

BDCA CHARTERED PROFESSIONAL ACCOUNTANTS

Inter-Corporate Dividends



- We used to like:
  - Steve owning growth shares for:
    - Capital gains exemption
    - Better integrated tax rate when no CGE is available
  - Holdco owning non-growth shares to be able to receive tax-free inter-corporate dividends to keep Opco purified
- Now need to be concerned about safe income of preferred shares for dividends to flow tax-free

BDCA CHARTERED PROFESSIONAL ACCOUNTANTS

SMALL BUSINESS DEDUCTION

CHARTERED PROFESSIONAL ACCOUNTANTS

Small Business Deduction

- Low corporate tax rate on first $500K of Active Business Income
  - Have to share SBD limit amongst "associated" corporations
  - Grind where taxable capital exceeds $10M through $15M
- Small Business Deduction rate fell from 15% to 13.5% on first $500K of ABI

BDCA CHARTERED PROFESSIONAL ACCOUNTANTS

Small Business Deduction

- Non-eligible dividends now taxed higher as a result
- Integration - lower corporate tax = higher personal tax
- Old: 15% corporate tax, 45.3% personal tax
  - *Integrated tax = 15% + (100% - 15%) x 45.3% = 53.5%*
- New: 13.5% corp tax, 46.84% personal tax
  - *Integrated tax = 13.5% + (100% - 13.5%) x 46.84% = 54.02%*
- Well-disguised tax increase for business owners!
  - Applies where ABI was earned at 15% tax but withdrawn personally under new dividend tax rate
  - *Integrated tax = 15% + (100% - 15%) x 46.84% = 54.8%*

BDCA CHARTERED PROFESSIONAL ACCOUNTANTS

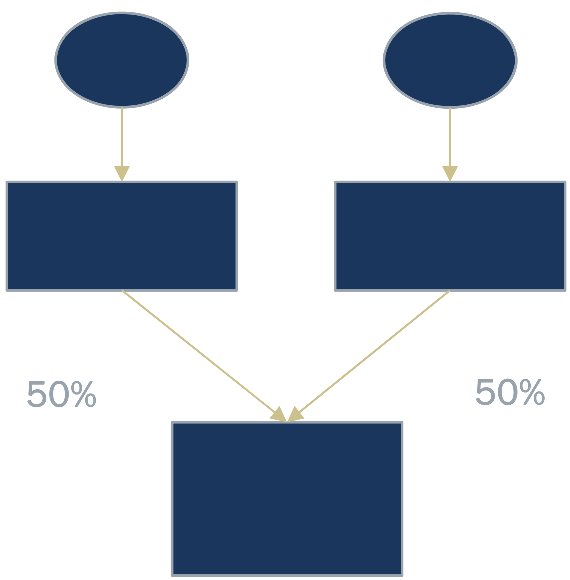
Small Business Deduction

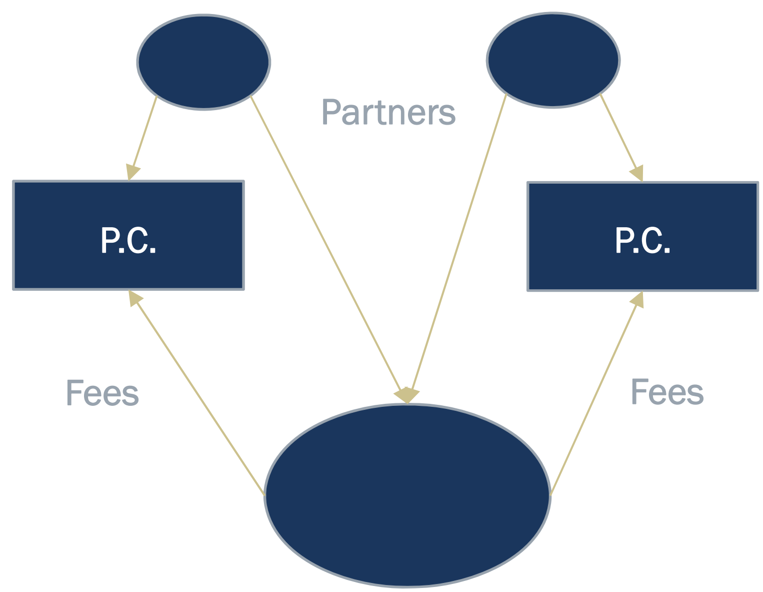
- Specified Corporate Income
  - One private corporation earns active business income from another where:
    - At any time in the year, the corporation or a shareholder or person not dealing at arm's length with a shareholder holds a direct or indirect interest in each of the private corporations, the payer must allocate a portion of its own SBD limit for the recipient to be able to have the income taxed at the SBD rate
  - Exception where recipient corporation earns "all or substantially all" of its income from arm's length sources

BDCA CHARTERED PROFESSIONAL ACCOUNTANTS

Small Business Deduction

- These rules drastically reduce opportunities to multiply the SBD (i.e. mothership structure, PC partnerships, etc.)





TOSI RULES

BDCA CHARTERED PROFESSIONAL ACCOUNTANTS

Tax On Split Income

- Benefit to splitting income within family groups
- Example:
  - Two individuals each earning $100K pay about $25K personal tax = $50K total
  - One individual earning $200K pays about $71K
- Maximum benefit in Ontario for 2018 = $37K

BDCA CHARTERED PROFESSIONAL ACCOUNTANTS

Tax On Split Income

- With right share structure being implemented correctly, it has been relatively easy to split income for families who own businesses
- Salaries always subject to reasonability test
- Old rules – dividends not subject to reasonability test

BDCA CHARTERED PROFESSIONAL ACCOUNTANTS

Tax On Split Income

- New Income Splitting Rules for 2018
  - Tax On Split Income or “TOSI”
  - You are stuck in TOSI unless you find a way out!

BDCA CHARTERED PROFESSIONAL ACCOUNTANTS

Tax On Split Income

- Out #1 – **Specified Individual**
  - Are you an adult who is resident in Canada, or are you under 18 with a parent resident in Canada?
    - No = ~~TOSI~~
    - Yes = → Out #2

Tax On Split Income

- Out #2 – **Split Income**
  - Did you earn any of these forms of split income?
    a) Private company taxable dividends, shareholder benefits
    b) Partnership income derived from a *related business* (*related person is involved directly or indirectly, or owns 10% or more)* or rental business where a *related person* (*spouse/CLP, lineal relatives including in-laws, siblings, siblings-in-law)* is involved
    c) Trust income from (a) or (b)
    d) Interest income from a private corporation, partnership or trust
    e) Income or capital gains from dispositions of private company shares or other capital property with historical TOSI
  - No = ~~TOSI~~
  - Yes = → Out #3

BDCA CHARTERED PROFESSIONAL ACCOUNTANTS

Tax On Split Income

- Out #3 – Do any of the following apply?
  - Did you earn any of these forms of split income?
    a) **Under 25:** *received the property from death of parent*
    b) **Under 25:** *received the property from death of anyone AND enrolled as a full-time student or entitled to disability tax credit*
    c) **Anybody:** *Property received in respect of a separation agreement or judgement resulting from a marriage or CLP breakdown*
    d) **Anybody:** *Taxable capital gain on deemed disposition on death*
    e) **Over 17:** *Taxable capital gain on QFP, QFP or QSBC shares*
    f) **If spouse is 65+ or deceased:** *if no TOSI for spouse*
  - Yes = ~~TOSI~~
  - No = ➡ Out #4A (18+) / #4B (<18)

BDCA CHARTERED PROFESSIONAL ACCOUNTANTS

Tax On Split Income

- Out #4A – Age 18+ - **Related Business**
  - Is the income or gain derived from a related business? *(related person is involved directly or indirectly, or owns 10% or more)*
  - No = ~~TOSI~~
  - Yes = → Out #5

Tax On Split Income

- Out #4B – Under age 18 - **Sale of Shares by Minors**
  - Is the capital gain from the sale of private corporation shares to a non-arm's length person?
  - No = TOSI rules apply on the capital gain to tax it at the top marginal rate – 53.53% x 50% = 26.765%
  - Yes = TOSI rules cause capital gain to be deemed a non-eligible dividend and taxed at the top marginal rate – 46.84%

BDCA CHARTERED PROFESSIONAL ACCOUNTANTS

Tax On Split Income

- Out #5 – Age 18+ - **Excluded Business**
  - Are you actively engaged on a regular, continuous and substantial basis in the business in the current or any five preceding years, either on a factual basis or by meeting a threshold of an average of 20 hours per week?
  - Yes = ~~TOSI~~
  - No = → Out #6A (age 25+) & #6B (age 18-24)

BDCA CHARTERED PROFESSIONAL ACCOUNTANTS

Tax On Split Income

- Out #6A – Age 25+ - **Excluded Shares**
  - Does the income/gain relate to shares where all conditions are met?
    - a) Less than 90% of the corporation's business income for the last year was from providing services
    - b) The corporation is not a Professional Corporation
    - c) You own shares in aggregate that give you at least 10% of votes and value AND less than 10% of the income of the corporation in the prior year was derived from a related business
  - Yes = ~~TOSI~~
  - No = → Out #7A

BDCA CHARTERED PROFESSIONAL ACCOUNTANTS

Tax On Split Income

- Out #6B – Age 18-24 – **Safe Harbour Capital Return**
  - Is the split income in excess of the safe harbour capital return (*prescribed rate x FMV of property contributed*)
  - No = ~~TOSI~~
  - Yes = → Out #7B (age 18-24)

BDCA CHARTERED PROFESSIONAL ACCOUNTANTS

Tax On Split Income

- Out #7A – Age 25+ - **Reasonable Return**
  - Is the split income in excess of a reasonable return base on the relative contributions from you and each related person considering the following:
    a) The work performed
    b) The property contributed directly or indirectly
    c) The risks assumed
    d) The total amounts already paid to or for the benefit of the individual
    e) Any other factors that may be relevant
  - Yes (*non-reasonable return*) = TOSI applies
  - No (*reasonable return*) = ~~TOSI~~

BDCA CHARTERED PROFESSIONAL ACCOUNTANTS

Tax On Split Income

- Out #7B – Age 18-24 – **Reasonable Return in Respect of Arm's Length Capital**
  – Is the split income in excess of a reasonable return based on the relative contributions from you and each related person, but considering only your contribution of arm's length capital?
  – Yes (*non-reasonable return*) = TOSI applies
  – No (*reasonable return*) = ~~TOSI~~

BDCA CHARTERED PROFESSIONAL ACCOUNTANTS

Tax On Split Income

- Lots of issues with new rules:
  - How to value efforts?
  - How do past payments relate?
  - What about capital that has since been repaid?
  - What if the individual can't contribute to the business for some period of time, parental leave, becomes disabled, etc.?
  - No personal exemptions available to offset split income
  - No exemptions for disabilities
  - Applies to non-resident businesses too

BDCA CHARTERED PROFESSIONAL ACCOUNTANTS

PASSIVE INVESTMENT RULES

BDCA

CHARTERED PROFESSIONAL ACCOUNTANTS

SBD & Passive Investment Income

- SBD limit to be reduced when passive investment ("*Adjusted Aggregate Investment Income*") income exceeds $50K/year
  - *Penalizes active companies, not investment holdco's*
- Effective for years beginning after 2018
- SBD limit reduced by $5 for every $1 in excess of $50K
- SBD fully eliminated at $150K of passive investment income
- AAII of all associated corporations

BDCA CHARTERED PROFESSIONAL ACCOUNTANTS

SBD & Passive Investment Income

- AAII includes:
  - Portfolio income (capital gains, interest, foreign income, eligible and non-eligible dividends)
  - Taxable capital gains unless the gain arises from the disposition of:
    - *A property that is used principally in an active business carried on primarily in Canada by the CCPC or by a related CCPC; or*
    - *A share of another CCPC that is connected with the CCPC, where, in general terms, all or substantially all of the fair market value of the assets of the other CCPC is attributable directly or indirectly to assets that are used principally in an active business carried on primarily in Canada*
  - Dividends from non-connected corporations
  - Rental income (*in most circumstances*)
  - Income from non-exempt life insurance policies
  - Subtract expenses that relate to investments

BDCA CHARTERED PROFESSIONAL ACCOUNTANTS

SBD & Passive Investment Income

- Example:
  - AAII of $100,000
  - $100,000 - $50,000 cushion = $50,000 x $5 = $250,000 reduction of SBD
  - $500,000 SBD - $250,000 reduction = $250,000 remaining SBD
  - Active business income of $500,000
  - $250,000 x 13.5% + $250,000 x 26.5% = $33,750 + $66,250 = $100,000 corporate tax
  - Old rules - $500,000 x 13.5% = $67,500 = $32,500 increase
- One slight offsetting benefit is creation of GRIP (*ability to pay eligible dividends*) of $250,000 (*ABI taxed at high rate*) x 72% = $180,000
  - *Personal tax rates lower on eligible dividends than non-eligible dividends*

BDCA CHARTERED PROFESSIONAL ACCOUNTANTS

WHAT DO WE DO NOW?

BDCA CHARTERED PROFESSIONAL ACCOUNTANTS

Seek Professional Advice!

What Do We Do Now?

Inter-Company Dividends

- Monitor/calculate “Safe Income”
- Transfer shares to holdco and redeem rather than pay dividends

Small Business Deduction

- Be mindful of new rules!
- Review corporate structures
  - Separate ownership
  - Change how corporations invoice if possible (*e.g. separate corporations each bill clients rather than one corporation*)

BDCA CHARTERED PROFESSIONAL ACCOUNTANTS

What Do We Do Now?

Tax On Split Income

- Salaries instead of dividends
- Separate businesses into different corporations with different owners
  - Income from related businesses are a problem
    - Rent, interest, royalties, management fees
  - PC + office services/management, hygiene corp, etc.
  - Service corp + parts corp
- Document all efforts towards business (*20hrs/week*)
- Look for alternative ways to split income

BDCA CHARTERED PROFESSIONAL ACCOUNTANTS

What Do We Do Now?

Passive Investment Rules

- Greater consideration to funding RRSP's, IPP's, RCA's, exempt life insurance
- Watch tax characteristics of investments
- Trigger large capital gains infrequently rather than small gains frequently or vice versa
- Not an issue if active business income is low
- Not an issue in last year of active business income or retirement

BDCA

CHARTERED PROFESSIONAL ACCOUNTANTS

Paul McVean
BACCS, CPA, CGA, CFP, TEP
416.490.1042
paul.mcvean@bdca.ca

Barbara Da Fonseca
PRINCIPAL, CPA, CA
416.490.1042 x 25
barbara.dafonseca@bdca.ca

200 YORKLAND BLVD, SUITE 960, TORONTO, ONTARIO M2J 5C1 WWW.BDCA.CA