The July 18, 2017 Proposed Tax Changes – How They Might Impact Your Business and What Steps to Take

Further to our emailed message to all of our small business clients that went out on July 28, 2017, here is some additional information about the Proposed Changes, what steps might be taken in the next two months before some of the changes are enacted and how some planning might change in the future. Additionally, if you are so inclined, make your voice heard through some links to a couple of petitions or by writing how this will impact your business. Links for these are at the bottom.

On July 18, 2017, the Department of Finance released 26 pages of draft legislation, many pages of explanatory notes, a detailed consultation paper and a PowerPoint slide deck, all focused on tax planning involving private corporations. A 75-day consultation period was provided. The deadline for submissions is October 2, 2017.

This email provides highlights and outlines some measures that small business owners that are affected with these rule changes can take. It does not cover every aspect and the amendments are difficult to interpret with certainty. If you have questions about your situation, please contact our office as soon as possible.

Measure #1:
Tax on Split Income ("TOSI") to Address Income Sprinkling

(Effective Date: January 1, 2018)

What the the Rule Changes?
Under our current tax rules there is an additional tax for certain types of income received by someone under 17 years of age that has a Canadian resident parent. For Alberta, if that minor received income subject to the TOSI rules, they will incur tax at the highest marginal personal tax rate without any personal tax credits (i.e. do not get the first $11k or $18k that does not incur any tax).

Under the proposed rules, there is an expansion of both the type of individual and the type of income that the TOSI applies to.

Types of Income subject to TOSI under the proposed rules includes:

- Taxable dividends from private corporations
- Certain income from partnerships and trusts derived from a business, profession or rental activity of a related person
- 'Compound income', which is income derived from the investment of income previously subject to TOSI, earned by an individual under the age of 25
- Income from certain debt arrangements with Specified Individuals
- Gains from dispositions of certain property. Gains previously eligible for the Capital Gains Exemption may be dividends to a shareholder to which the gain may be 'unreasonable' based on facts.

Specified Individuals under the proposed rules includes:

- Canadian resident individuals, minor or adult, that are
- 'Related Persons', now expanded to include aunts, uncles, nieces and nephews (also includes children, spouse, parents, siblings)

Income to a Specified Individual will be subject to TOSI rules (i.e. taxed at the highest marginal tax rate in the hands of the recipient) if it does not meet the reasonableness tests. What is 'Reasonable' is dependent on several factors:

- Compensation For Labour contributions:
  - Specified individuals age 18-24 years old must be actively engaged on a regular, continuous and substantial basis in the activities of the business; and
  - Specified individuals 25 years old and older must be involved in the activity of the business by contributing labour that could have otherwise been remunerated by way of a salary.
- Compensation For Capital contributions:
  - Specified individuals age 18-24 years old cannot receive more than the legislatively-prescribed maximum allowable return on the assets contributed by the individual in support of the business (currently 1%). For example, if shares were issued to daughter for $100, $1 of dividends is reasonable.
  - Specified individuals age 25 years or older, the individual is receiving a reasonable rate of return on assets contributed to the business or as compensation for assuming some level of risk in support of the business.
- All previous amounts paid or payable to the individual in respect of the business as a return or remuneration.

What Impact to Your Business and Shareholders

If you currently pay dividends to shareholders that are family members who are not active in the business operations, these rules apply to those dividend payments. If you have any lending arrangements with related parties, these rules apply to the interest received. If you are planning to sell shares of a corporation and utilize the

What to do?

1. Consider paying out more significant dividends to family members in 2017, before the rules apply (effective January 1, 2018).

2. For family members active in the business operations and receive dividends, consider paying salaries. (Consider CPP, EI and WCB requirements).

3. Consider whether a post-2017 sale of shares or other assets should be accelerated into 2017 to avoid the TOSI rules applying to a sale of shares.

4. Determine if the reasonableness test can be met for split income. If not, likely best to minimize any split income amounts paid.

5. Determine how to calculate and track split income and to document the reasonability of the income. Timesheets, task descriptions, rates are all helpful.

6. Determine and retain all documentation required for evidencing past contributions and services of shareholders since the incorporation of the company.

7. If there are shareholder agreements that specify dividend payments or remuneration, consider whether or not there are any split income issues that result and if the agreement needs to be amended.

8. Review trusts and consider if there are still any tax advantages to having them and, if not, if the non-tax reasons outweigh additional tax burdens. If not, consider winding up the trust.

Measure #2: Removing Retained Earnings of a Corporation

(Effective Date: July 18, 2017)

The draft legislation proposes to amend sections 84.1 and introduces new section 246.1, both effective July 18, 2017.

What Impact to the Business Shareholders?

Section 84.1 will increase the tax liability arising as a result of a person's death if the shares of the corporation are to be distributed to beneficiaries and will result in double taxation where shares are sold to a non-arm's length corporation.

Section 246.1 will treat the receipt of a capital dividend received in many circumstances as a taxable dividend and will eliminate the company's capital dividend account.

What to do?

1. Obtain and keep all corporate records that document share transactions, reorganizations, tax returns that show reporting of share transactions (for 84.1).

2. Pay attention to the one-year limitation to redeem or repurchase shares received by an estate following the death of a taxpayer (for 84.1)

3. Until S.246.1 is enacted, there should be extreme caution in paying any dividends from a corporation's capital dividend account or returning paid-up capital to an individual shareholder.

4. Record the purpose of all transactions that affect the capital dividend account. Was the life insurance acquired due to contractual requirements or as a tax-efficient investment? If the latter, the capital dividend account balance may not carry forward.

Measure #3:
Higher Tax on Ineligible Passive Investments Held in a Business Corporation

(Not yet draft legislation. Likely to have draft legislation for March 2018 budget with possible effective date of January 1, 2019)

What is the Essence of the Proposals?

The objective of the proposals are to promote a neutral tax regime where an individual investing through his or her corporation should be no better off than a salaried individual investing his or her after-tax earnings.

The Department of Finance has illustrated a number of possible approaches to establish this objective, although the Deferred Taxation Approach was best explained. If implemented, income that was originally subjected to the small business rate of 13.5% in Alberta and is then retained in the corporation for investing in 'Ineligible Investments' will have a higher tax rate. And, any passive income earned on those Ineligible Investments would be subject to a 48% or 50% tax rate that will now be non-refundable (previously refundable). This could cause a tax rate of more than 70% overall on some income when it is finally distributed to shareholders.