Update on Proposed Small Business Tax Changes

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PRESENTERS

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INTRODUCTION

- On July 18, 2017, the federal government announced proposed legislative changes that will have a far reaching impact on small business owners and their families

- During the week of October 16 to 20, 2017, the federal government made a series of announcements which modified or eliminated some of the original proposals

- On December 13, 2017, the federal government announced final details regarding proposed income splitting tax rules

JULY 18 PROPOSED TAX CHANGES

The original tax change proposals affected these four areas:

- Income splitting
- Lifetime capital gains exemption
- Converting income to taxable capital gains
- Taxation of passive income and assets

OCTOBER 16 TO 20 ANNOUNCEMENTS

During the week there was a series of announcements (but little detail):

- Will simplify the income splitting proposals
- Will not move forward with proposals affecting Lifetime Capital Gains Exemption
- Reducing federal small business tax rate from 10.5% to 10% on Jan. 1, 2018 and to 9% on Jan. 1, 2019
- Modifications to passive investment proposals
- Will not move forward with proposals relating to the conversion of income into capital gains
- Will ensure that incentives are maintained for venture capital and angel investors

DECEMBER 13 FINAL "SIMPLIFIED" SPLIT INCOME RULES

Original July proposal for split income - payment of dividends to family members not active in the business will be taxed at the top marginal rate (46.9% in New Brunswick) with no basic personal exemption, subject to a reasonableness test

December 13 announced "simplified measures to restrict income sprinkling" by expanding the application of the Tax On Split Income ("TOSI")

TAX ON SPLIT INCOME (“TOSI”)

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APPLICATION OF TAX ON SPLIT INCOME ("TOSI")

The expanded TOSI rules will potentially apply in respect of amounts that are received by specified adult individuals, either directly or indirectly, from a related business

Generally, a business will be a related business if an individual who is related to the specified adult individual either is actively engaged in the business or owns a significant portion of the equity in the corporation that carries on the business

The TOSI rules will apply unless the business or owners fit into one of the exceptions

APPLICATION OF TAX ON SPLIT INCOME ("TOSI")

Types of Income Subject to TOSI Rules:

- Dividends, shareholder benefits **AND** interest income from private corporation, partnership or trust

- Partnership income from related businesses

- Capital gains on the above

EXAMPLE

• Mr. Logan and Mrs. Logan each own 50% of the shares of a corporation which operates a convenience store. Mrs. Logan works the store front and manages the operations while Mr. Logan is not “active” in the business. The store makes a profit for tax purposes of $150,000 and the couple need $100,000 to cover living costs. They each draw a $50,000 dividend. This is their only source of income.

EXAMPLE

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	Store	Mrs. Logan	Mr. Logan	Total Tax
Old Rules				
Taxable Income	$150,000	$50,000	$50,000	
Income Tax	19,500	5,941	5,941	$31,382
Net Income	$130,500	$44,059	$44,059	
New Rules				
Taxable Income	$150,000	$50,000	$50,000	
Income Tax	19,500	5,941	23,450	$48,891
Net Income	$130,500	$44,059	$26,850	
Additional Tax				$17,509 (56%)

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EXCEPTIONS TO TAX ON SPLIT INCOME ("TOSI")

EXCEPTIONS TO TAX ON SPLIT INCOME (“TOSI”)

1. Excluded Business

2. Excluded Shares

3. Retirement or Death

4. Inherited Property

5. Lifetime Capital Gains Exemption (“LCGE”)

6. Reasonableness Test

EXCEPTIONS TO TAX ON SPLIT INCOME ("TOSI")

1. Excluded Business

- A business in which an individual 18 years or older is actively engaged on a regular, continuous and substantial basis (at least 20 hours or more per week) in the year **OR**

- A business in which an individual 18 years or older was actively engaged on a regular, continuous and substantial basis in **ANY** 5 previous years

EXCEPTIONS TO TAX ON SPLIT INCOME ("TOSI")

1. Excluded Business – EXAMPLE 1

- Stephanie worked in her parents' manufacturing business on a full-time basis from age 30 to age 37. Stephanie then stepped back from being involved in the business for 3 years. During these 3 years Stephanie received dividends from the business. Will TOSI apply?

-TOSI will **NOT** apply because she was actively engaged on a regular, continuous and substantial basis (at least 20 hours per week) for at least 5 years

EXCEPTIONS TO TAX ON SPLIT INCOME ("TOSI")

1. Excluded Business – EXAMPLE 2

- Stephanie worked in her parents' manufacturing business on a part-time basis (3 mornings per week) from age 30 to age 37. Stephanie then stepped back from being involved in the business for 3 years. During these 3 years Stephanie received dividends from the business. Will TOSI apply?

-TOSI **WILL** apply because Stephanie did not work at least 20 hours per week for at least 5 years

EXCEPTIONS TO TAX ON SPLIT INCOME ("TOSI")

2. Excluded Shares

- An individual 25 or older owns shares representing at least 10% of votes and value **AND**

- The corporation earns less than 90% of its business income from the provision of services **AND**

- The corporation is not a professional corporation **AND**

- Less than 10% of its income is derived from one or more related businesses

EXCEPTIONS TO TAX ON SPLIT INCOME ("TOSI")

2. Excluded Shares - EXAMPLE 1

- Mary is 40 years old. Mary and her husband Bill each own 50 voting common shares in a company that operates a grocery store. There are no other classes of shares and no other shareholders. Mary has never worked in the grocery store. The company pays a dividend to Mary. Will TOSI apply?

- TOSI will **NOT** apply because Mary owns at least 10% of the votes and value of the company, the company is not a professional corporation and it does not earn more than 90% of its income from providing services or from a related business

EXCEPTIONS TO TAX ON SPLIT INCOME ("TOSI")

2. Excluded Shares - EXAMPLE 2

- Mary is 40 years old. Mary owns 50 non-voting shares and her husband Bill owns 50 voting common shares in a company that operates a grocery store. There are no other classes of shares and no other shareholders. Mary has never worked in the grocery store. The company pays a dividend to Mary. Will TOSI apply?

- TOSI **WILL** apply because Mary does not own at least 10% of the votes and value of the company

EXCEPTIONS TO TAX ON SPLIT INCOME (“TOSI”)

3. Retirement or Death

- If an individual is excluded from the TOSI rules and their spouse is not excluded from the rules, when the individual turns 65 or dies, their spouse will no longer be subject to TOSI

EXCEPTIONS TO TAX ON SPLIT INCOME ("TOSI")

3. Retirement – EXAMPLE 1

- Dr. Smith is 66 years old and has run his practice as a doctor through a Professional Corporation for his 30 year career in medicine. Dr. Smith's wife Andrea is 59 years old and she owns non-voting shares in the PC. The PC pays dividends to Andrea. Will TOSI apply?

- TOSI will **NOT** apply to Andrea because her spouse Dr. Smith is over 65 and he has worked more than 20 hours per week for more than 5 years

EXCEPTIONS TO TAX ON SPLIT INCOME ("TOSI")

3. Retirement – EXAMPLE 2

- Dr. Smith is 59 years old and has run his practice as a doctor through a Professional Corporation for his 30 year career in medicine. Dr. Smith's wife Andrea is 66 years old and she owns non-voting shares in the PC. The PC pays dividends to Andrea. Will TOSI apply?

- TOSI **WILL** apply to Andrea because her spouse Dr. Smith is under 65

EXCEPTIONS TO TAX ON SPLIT INCOME ("TOSI")

4. Inherited Property

- A continuity rule where generally the person inheriting the property takes on the characteristics of the person from whom the property was inherited

EXCEPTIONS TO TAX ON SPLIT INCOME ("TOSI")

4. Inherited Property – EXAMPLE 1

- Bob dies at age 50. Prior to his death he owned 20% of a corporation that operates a restaurant. Bob was not involved in the business. Bob leaves all of his shares to his 22 year old niece Kate who does not intend to work in the business. Will TOSI apply to dividends paid to Kate?

- TOSI will **NOT** apply because Bob owned more than 10% of the votes and value of the business, the company is not a professional corporation and it does not earn more than 90% of its income from providing services or from a related business

EXCEPTIONS TO TAX ON SPLIT INCOME ("TOSI")

4. Inherited Property – EXAMPLE 2

- Bob dies at age 50. Prior to his death he owned 20% of a corporation that provides consulting services. Bob was not involved in the business. Bob leaves all of his shares to his 22 year old niece Kate who does not intend to work in the business. Will TOSI apply to dividends paid to Kate?

- TOSI **WILL** apply because the company earns more than 90% of its income from providing services

EXCEPTIONS TO TAX ON SPLIT INCOME (“TOSI”)

5. Lifetime Capital Gains Exemption (“LCGE”)

- Taxable capital gains from the disposition of property which qualifies for the LCGE (Qualified Small Business Corporation shares or Qualified Farm or Fishing Property)

EXCEPTIONS TO TAX ON SPLIT INCOME ("TOSI")

5. Lifetime Capital Gains Exemption ("LCGE") – EXAMPLE 1

- Julie and Kenny are selling the shares of a consulting company they own 50/50. The shares qualify for the lifetime capital gains exemption. Julie has worked full time in the business since she started it 15 years ago. Kenny has never worked in the business. Will TOSI apply to Kenny's gain on selling his shares?

- TOSI will **NOT** apply to taxable capital gains from the disposition of property that qualifies for the LCGE

EXCEPTIONS TO TAX ON SPLIT INCOME ("TOSI")

5. Lifetime Capital Gains Exemption ("LCGE") – EXAMPLE 2

- Julie and Kenny are selling the shares of a consulting company they own 50/50. The shares do not qualify for the lifetime capital gains exemption due to excessive inactive assets in the business. Julie has worked full time in the business since she started it 15 years ago. Kenny has never worked in the business. Will TOSI apply to Kenny's gain on selling his shares?

- TOSI **WILL** apply to taxable capital gains from the disposition of property that does not qualifies for the LCGE

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APPLICATION OF TAX ON SPLIT INCOME (“TOSI”)

6. Reasonableness Test

Dictionary.com definition of “reasonable” includes logical, not excessive

APPLICATION OF TAX ON SPLIT INCOME (“TOSI”)

6. Reasonableness Test

- If you are 25 or older, TOSI applies only to the extent that amounts received exceed a reasonable return based on labour contributions, capital contributions, risks assumed, previous amounts received, and other relevant factors (note – if age 17 to 24 need to look at safe harbour capital return or reasonable return taking into account contributions of arm’s length capital by the individual)

APPLICATION OF TAX ON SPLIT INCOME (“TOSI”)

6. Reasonableness Test

- Amounts in excess of a “reasonable amount” will be taxed at the highest marginal tax rate

APPLICATION OF TAX ON SPLIT INCOME ("TOSI")

6. Reasonableness Test– EXAMPLE

- Mrs. Smith is 29 and runs a shoe store and works in the business on average 50 hrs per week. Mr. Smith loaned the business $100,000 for inventory and personally guaranteed the corporation's line of credit. Mr. Smith does not work in the business. They each own 50% of the corporation shares but Mr. Smith's shares are non-voting. They each receive $50,000 in dividends on the corporation's shares. Will TOSI apply to Mr. Smith's dividends?

- We don't know with any degree of certainty.

APPLICATION OF TAX ON SPLIT INCOME ("TOSI")

Some Remaining Uncertainties

- The Holdco Problem - will dividends from an operating company to a holding company and then from a holding company to an individual be subject to TOSI because the holding company receives all of its income from a related business?

- How will CRA apply the reasonableness test?

- Does "business income" mean net income, taxable income or gross revenue?

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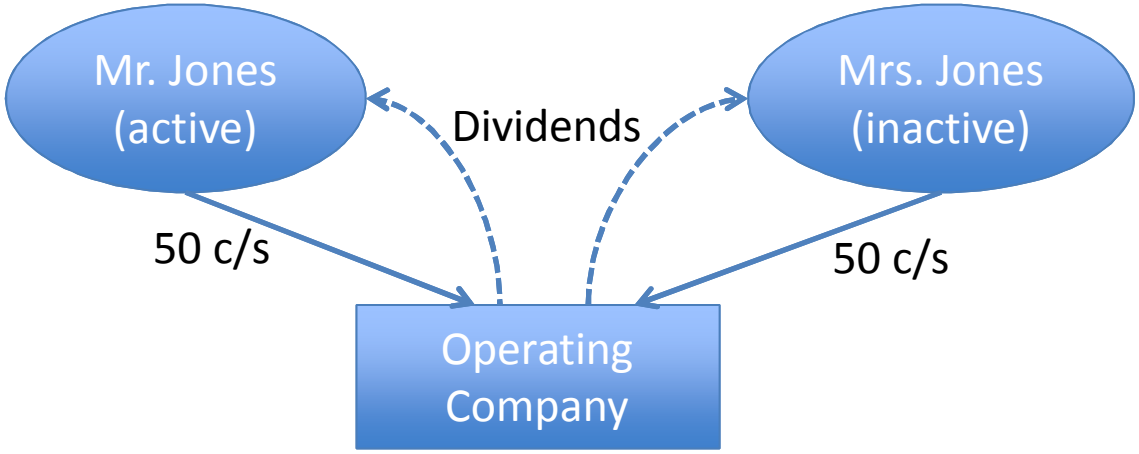
APPLICATION OF TAX ON SPLIT INCOME ("TOSI")

Operating company selling products:



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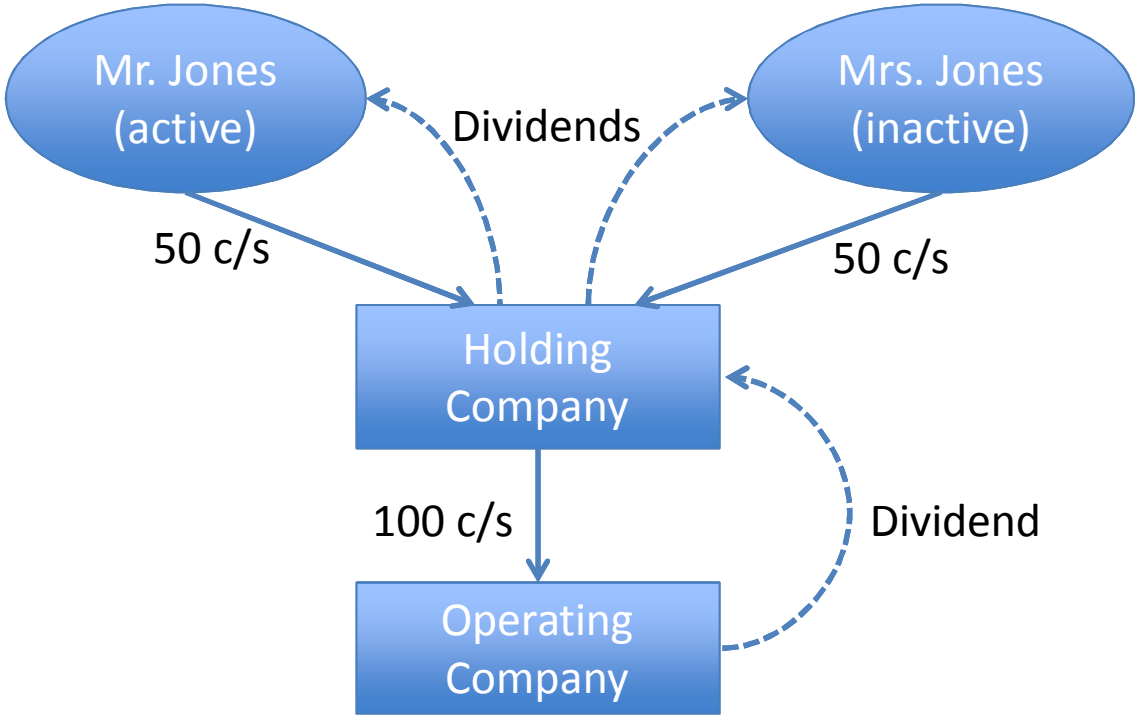
APPLICATION OF TAX ON SPLIT INCOME ("TOSI")

The Holdco Problem



APPLICATION OF TAX ON SPLIT INCOME ("TOSI")

The Holdco Problem

- Shares of Operating Company are excluded shares because it earns less than 90% of its income from providing services, it is not a PC and it earns less than 10% of its income from a related business

- Shares of Holding Company are not excluded shares because it earns more than 90% of its income from a related business (Operating Company)

- Therefore dividends to Mrs. Jones **WILL** be subject to TOSI

APPLICATION OF TAX ON SPLIT INCOME ("TOSI")

Planning Considerations

- May need to transfer shares out of a family trust to an individual so that the individual meets the 10% of votes and value test (have until Dec. 31, 2018 to meet this test)
- May need to restructure to avoid the Holdco Problem
- May need to restructure or exchange non-voting shares for voting shares in order to meet the 10% of votes and value test
- Document hours, tasks, employment contract, etc. to support family member working more than 20 hours per week
- Be careful if sale of products is close to 10% of income
- If in doubt consider a reasonable salary rather than dividends

UPDATE ON STATUS OF PASSIVE INVESTMENT RULES

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UPDATE ON STATUS OF PASSIVE INVESTMENT RULES

- UNDER CURRENT REGIME

  - Designed for integration of corp. and personal tax so you are not better or worse off investing in a corp. vs. investing personally

  - Taxed at 52.7% in New Brunswick with a 30.7% refundable portion being refunded when dividends are paid out of the corp.

  - ½ of taxable capital gains can be paid out tax-free as capital dividends

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UPDATE ON STATUS OF PASSIVE INVESTMENT RULES

- UNDER THE PROPOSED CHANGES
  - Issue raised is that the deferral of tax by not extracting income from the corp. gives business owners the ability to make larger principal investments
  - Alternate methods to reduce refundable tax, GRIP and CDA
  - Carve out existing investments so that new rules will not apply retroactively
  - Carve out “new” investments that generate income up to $50,000
  - The implementation date for these proposals has not been determined- 2018 budget

UPDATE ON STATUS OF PASSIVE INVESTMENT RULES

- IMPACT
  - High degree of uncertainty (eg. Passive investments not defined)
  - Extremely complex compliance
  - Higher compliance costs
  - Increased combined personal and corporate tax rate to potentially as high as 70% or more (depending on which option is ultimately enacted)

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UPDATE ON STATUS OF PASSIVE INVESTMENT RULES

- WHAT CAN WE DO?
  - Do not do anything hasty just yet – details will be announced in upcoming federal budget
  - We need to see what approach the government actually takes
  - Consider borrowing to invest prior to implementation of new rules (caveat: discuss this with your investment and tax advisors first!)
  - Consider investing via life insurance policy or Individual Pension Plan
  - If you sell your business, carefully consider the impact of these rules
  - Consider moving excess cash into savings or investment account to qualify for “grandfathering”

BIG PICTURE IMPACT

- Increased costs for small businesses – higher tax cost and higher compliance cost

- Estate and succession planning will be more complicated

- Current structures may need to be modified – discuss with your tax professional

THE TAKEAWAY

- These changes are much better than the original July proposals
- The unprecedented response from the small business community undoubtedly had a major impact
- These changes are very complex and you should seek advice from your professional advisor

QUESTIONS?

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