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Paying Dividends to Family Members

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Personal taxation for families that operate a business through a Canadian Controlled Private Corporation has drastically changed since the announcement of the new Tax on Split Income (TOSI) rules for adults in July of 2017. Prior to the changes, a shareholder could receive unlimited dividends. However, under the new rules, it is very difficult to pay dividends to family members and have those dividends taxed at their marginal rates, unless they are working full-time in the business. In developing the legislation, the Department of Finance recognized that a shareholder may contribute to the profit of a business even though they may not be working full-time in the business and considered this in the various TOSI exceptions. One such exception is when a shareholder is actively engaged on a regular, continuous and substantial basis in the business in the current year or any five preceding years, either on a factual basis or by meeting a threshold of an average of 20 hours per week for the period of the year the business operates.

We are often asked by clients, "Can I meet this test and how do I prove it?"

Determining if a person satisfies the test of being actively engaged in the business is based on the facts and circumstances of the situation. If a shareholder is clearly substantially contributing to the business, this test may be fairly easily satisfied. Because this test is very subjective, the legislation also provides a "bright line test" of 20-hour average per week.

Keep in mind that under this "excluded business" exception, if relying on the hours per week threshold, the individual does not need to work 20 hours every week of the year, however, they would need to meet the average of 20 hours over the operating period. For example, a person working full-time for a number of weeks and reduced hours or not at all during other weeks may still meet this average 20- hour threshold.

It is possible and quite likely that the CRA will begin to audit corporations and shareholders to determine if the level of activity and involvement in a business supports the payment of dividends that are not subject to TOSI. In that regard, where dividends are being paid to family members working in the business, we are advising clients to maintain records to support the hours worked including the following:

- Timesheets and work schedules
- Payroll records showing hours per period
- Evidence of the work performed by that individual such as sign-off and dating on completion of tasks

It is also advisable that the shareholder ensure other staff are familiar with the nature of the role and the tasks performed by the individual as they may also be interviewed or asked about the shareholder's involvement as part of the audit. It is also recommended that the shareholder have an employment contract including a full job description and list of duties to be performed.

The CRA has acknowledged that where the shareholder's work history over five prior years is being considered, and supporting documentations may no longer be available, they intend to be reasonable in evaluating such situations.

Any information available related to the history of the business and the extent and nature of the person's involvement will be considered. Therefore compiling these details early will hopefully avoid unwanted reassessments should records become old and unavailable.

Don't Be Found GILTI

By Justin K. Hoffman,
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In December 2017, the U.S. introduced sweeping tax reforms that included the introduction of a new tax on international income called the "Global Intangible Low-Taxed Income" (GILTI).

Beginning in 2018, this tax would require U.S. shareholders of controlled foreign corporations (CFC) to include on their personal U.S. tax returns any income earned by the corporation in excess of a 10% return on the corporation's tangible depreciable capital property. In future years practitioners must carefully plan for the impact of this tax.

Who May Face the Tax?

For the tax to potentially apply two conditions must be present:

1) **The corporation must be a CFC**
To be a CFC, **MORE** than 50% of votes **OR** value of the foreign corporation (i.e. a Canadian company) must be owned U.S. citizens, U.S. permanent residents or other U.S. resident entities.

2) **The shareholder must qualify as a "U.S. Shareholder"**
To be a U.S. shareholder, a person must own directly, indirectly or constructively at least 10% of the votes **OR** value of the foreign company.

Options to Mitigate the Tax

1) Payment of a Bonus
The simplest but perhaps least tax efficient option for eliminating GILTI is to eliminate the income of the corporation by fully distributing it as a wage. This will align the U.S. and Canadian taxation of the income and create sufficient foreign tax credits (FTC) to fully offset the U.S. tax owing.

2) Payment of a Dividend
On November 28, 2018 the IRS released proposed regulations that provided for the allocation of FTCs to specific "baskets" of income. The result was that all of a corporation's pre-2018 retained earnings must be distributed before any tax on dividends can be allocated against GILTI. As such, using dividends to create an offsetting FTC will only be viable in cases of corporations with insignificant pre-2018 retained earnings.

3) Adjustments to Ownership
For family-owned corporations, it may be advantageous to restructure the ownership of the company so that U.S. persons own no more than 50% of the votes or value of the corporation. By limiting ownership to 50%, the company will cease to be a CFC and the GILTI provisions won't apply.

4) Utilization of a 962 Election to be Taxed as a Corporation
For U.S. tax purposes, an individual can elect under Section 962 to be taxed as a corporation for the purposes of determining income from a CFC. This has several benefits:

1) A reduced 21% tax rate on the GILTI inclusion.
2) An entitlement to an offsetting 50% deduction against any GILTI inclusion.
3) An ability to claim 80% of the Canadian corporate taxes as an indirect foreign tax credit.

With these benefits, provided that the corporation pays Canadian tax of at least 13.125%, in making the 962 election, the shareholder will be able to defer all immediate U.S. tax on their corporate income. Should the taxes paid in Canada be lower than 13.125% any taxes remaining in the U.S. after the 962 election will represent a true double-tax.