July 18, 2017 Department of Finance Draft Legislation on

Payments to Shareholders of Private Companies

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Overview of Proposed Changes

In 1999, responding to various family structures that split income amongst family members, the federal Department of Finance introduced a tax on split income (TOSI) that eliminated any tax benefit on income split with children under the age of 18. The TOSI mandated the top personal tax rate apply to dividends paid by private corporations, or income allocated via a partnership or trust, to family members who were under the age of 18.

The proposed legislation announced in July by the Finance department will significantly increase the reach of the TOSI to include amounts paid to certain **adult** individuals who receive split income.

Specifically, the new legislation will:

i. Expand the meaning of "specified individual" (individuals to whom the highest personal tax rate will apply);
ii. Introduce a Reasonableness Test to determine whether an amount is unreasonable and therefore subject to the highest tax rates;
iii. Introduce the concept of a "connected individual";
iv. Expand what income the TOSI rules will apply to.

Specified Individual

TOSI applies to individuals who are "specified individuals". Under the proposed legislation, a specified individual is a Canadian resident, regardless of age, who receives split income derived from a business of a related individual who resides in Canada.

Reasonableness Test

The proposed legislation would apply TOSI to any specified individual's split income when the amount of income is deemed unreasonable according to certain legislated tests. Specifically, under the proposed changes, an amount would be unreasonable if it exceeds what an arm's-length (non-related) person would have agreed to pay the specified individual considering the recipient's:

- Labour Contributions, the extent to which:
  - for an adult specified individual age 18-24, the individual is actively engaged on a regular, continuous and substantial basis in the activities of the business; and
  - for an adult specified individual age 25 or older, the individual is involved in the activities of the business (e.g., contributed labour that could have otherwise been remunerated by way of salary or wages).
- Capital contributions, the extent to which:
  - for an adult specified individual age 18-24, the amount exceeds a legislatively-prescribed maximum allowable return on the assets contributed by the individual in support of the business; and
  - for an adult specified individual age 25 or older, the individual has contributed assets, or assumed risk, in support of the business.

The following is an example of the application of the proposed new TOSI rules provided by the Department of Finance in its summary document *Tax Planning Using Private Corporations*.[1]

> Morgan carries on a freight forwarding business through a corporation. Morgan owns all the voting shares of the corporation. Morgan's 26-year-old child, Jesse, is an accountant and, except as described below, does not participate in the freight forwarding business. Jesse owns dividend eligible shares of the corporation, which Jesse purchased for $1. Jesse's shares do not participate in growth of the corporation. Both Morgan and Jesse are Canadian residents.
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> During the fiscal year, the corporation paid Jesse for accounting services he performed on behalf of the corporation. The amount paid by the corporation was equivalent to what the corporation would have paid an

arm's-length party to perform the services. The corporation also declared and paid a $100,000 dividend on the shares held by Jesse.

The dividend income received by Jesse will not meet the reasonableness test and will therefore be subject to the TOSI. Although Jesse is involved in the activities of the business, Jesse's contributions were limited to providing accounting services. Jesse purchased the shares for $1, and therefore did not contribute assets or assume risks in respect of the business in any material way. Finally, although Jesse provided accounting services to the business, the business already paid Jesse for the fair market value of these services.

If, on the other hand, Jesse had contributed significant assets to the corporation, for example by purchasing shares from the corporation for a cash payment of $100,000, then Jesse would be permitted under the reasonableness test to a reasonable return on this investment without the return being subject to the TOSI. Further, if Jesse had been 24 instead of 26, the reasonableness of Jesse's dividend would be determined using a higher standard of labour contribution and imposing a prescribed maximum return on the $100,000 contributed to the corporation.

The department of finance's proposed expansion of the TOSI to adult recipients, as well as the requirement to determine what is reasonable will greatly increase the administrative burden. The burden to whom? It is unclear. Will it be the burden of the payor or the recipient? Regardless, it will be a burden none-the-less.

Connected Individual

The proposed addition of the connected individual test applies in respect of income from a corporation. The "connected individual" definition provides a link for the purposes of the TOSI rules between the specified individual who receives an amount, the corporation from which the amount is derived and the connected individual who is related to the specified individual and has a presumed degree of influence over the circumstances in which the amount is paid.

A 'connected individual' in respect of a corporation would mean an individual (other than a trust) who is resident in Canada where <u>any</u> of the following conditions are met:

- Strategic Influence: the individual has factual control of the corporation alone or as part of a related group of persons;
- Equity Influence: the individual owns property representing 10% or more of the equity value of the corporation;
- Earnings influence: with respect to a service corporation the individual or a related individual owns shares of the corporation and either the individual's services are the primary contributor to the activities or the revenues of the corporation's business, or the individual performs all or part of the services and, for the corporation to carry on the service business, the performance of those services is regulated under the laws of Canada, a province or territory;
- Investment Influence: 10% or more of the value of the corporation's property is derived from property acquired from the individual or from another corporation in respect of which the individual is a 'connected individual'.

Adult family members of connected individuals who receive dividends will be required to determine what amount, if any, is unreasonable.

In the above example, Jesse is the "specified individual", and Morgan would be the "connected individual".

Expand What Income the TOSI will Apply To

The various types of income that the TOSI would apply to is expanded to include:

- Interest income from loans to private companies, partnerships or trusts,
- Capital gains from the disposition after 2017 of certain property the income of which would be split income, and
- In the case of a minor specified individual and adult specified individuals under age 25, income from property that is the proceeds from income previously subject to the TOSI or the attribution rules.

Potential Impact if Changes Become Law

If these measures are implemented the ability of a business owner to split income with family members in a tax efficient manner through a corporation, partnership or family trust will be severely restricted. If, at any time, the business owner wishes to distribute income to a shareholder, partner or beneficiary they will need to assess the reasonableness of amount being paid and whether the recipient will risk paying tax on the income at the highest personal tax rate or not.

Practically speaking, the draft legislation is short on direction on what is reasonable. How will the individual determine the value of work done for a business, what are reasonable rates of returns, or who can receive distributions that are not split income when a business is run with little shareholder involvement?

What Should You Do Now?

Consider:

- reviewing current tax planning measures to determine the impact the new rules will have,
- paying larger than normal dividends to various family members who are currently not Specified Individuals by the end of 2017,
- for Specified Individuals over the age of 24, consider having them lend the large dividend back into the private company and have them collect interest at a reasonable rate, specified Individuals between the ages of 18 and 24 could lend back to the private company but be limited to the prescribed interest rate, which is currently 1%,
- assessing which shareholders under the revised definition will become Specified Individuals and, be affected by the new legislation in 2018,starting to document the contribution these shareholders are making to the business to support the reasonableness of payments made.

What Are We Doing?

As part of DFK Canada, we are pro-actively seeking changes to these proposals by discussing their impact with our clients and contacting local MP's to advise them of the far-reaching impact these rule changes will have on all clients. Those most impacted by the proposals are being portrayed as the wealthiest of Canadians. We know otherwise. We will continue to keep our clients up to date as we learn more about the proposed changes.