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On July 18, 2017, the Government of Canada released a discussion paper on tax planning using private corporations. It addressed three primary issues: tax deferral, income splitting, and conversion of dividends to capital gains, also known as “earnings stripping”. The government plans to reduce the tax benefit of all three of these strategies. This article addresses only income splitting, the most contentious of the three.

In this first part of this two-part series, I will describe the background to income splitting, some of the mechanisms used to accomplish it, and the technical rules proposed by the government.

FAIRNESS

The government argues—correctly in my view—it is not enough for the tax system to merely be fair, but that it must be seen to be fair. The government argues small businesses are “gaming” the system to obtain unfair benefits.

MOTIVATION TO SPLIT INCOME

Canada has graduated personal tax rates—the more one earns, the higher the tax rate. And personal tax rates, especially for high-income individuals, are high, compared to other trade partners such as the United States and the United Kingdom.

Canada’s corporate tax rates are considerably lower than the top marginal personal rates. As a result, using a corporation to defer tax and split income with family members is a long-established Canadian tax-reduction strategy. These strategies are so common that both the current prime minister and finance minister have used them.[1]

INTEGRATION

Canada has a policy of corporate-personal tax integration: income earned through a corporation and paid out as dividends is subject to roughly the same income tax as that earned by salary, or without a corporation. The objective is horizontal tax neutrality, so people would not be inclined to use a corporation, operate without one, or be inclined to pay dividends or salary over the alternative. Those decisions should be made on a non-tax basis.

This system of integration is based on the Carter Commission Report,[2] a seminal inquiry which affects tax policy in Canada and around the world to this day.

The report argued in favor of a comprehensive income tax base,[3] also known as Haig-Simons income.[4]The challenge, particularly with income flowing through a corporation, is that measurement of comprehensive income is very difficult.

Small Business Income

What is commonly known as “small business income” is especially well integrated. It is necessary to do so, because those businesses have a great deal of flexibility in structuring their affairs.

The major part of this income is active business income earned from a business carried on in Canada through a Canadian-controlled private corporation. It is designed to be limited to $500,000 per corporate group.[5] Integration is accomplished by providing a deduction from tax otherwise payable.[6] It results in an effective combined federal-provincial tax rate of 10.5–18.5 per cent.

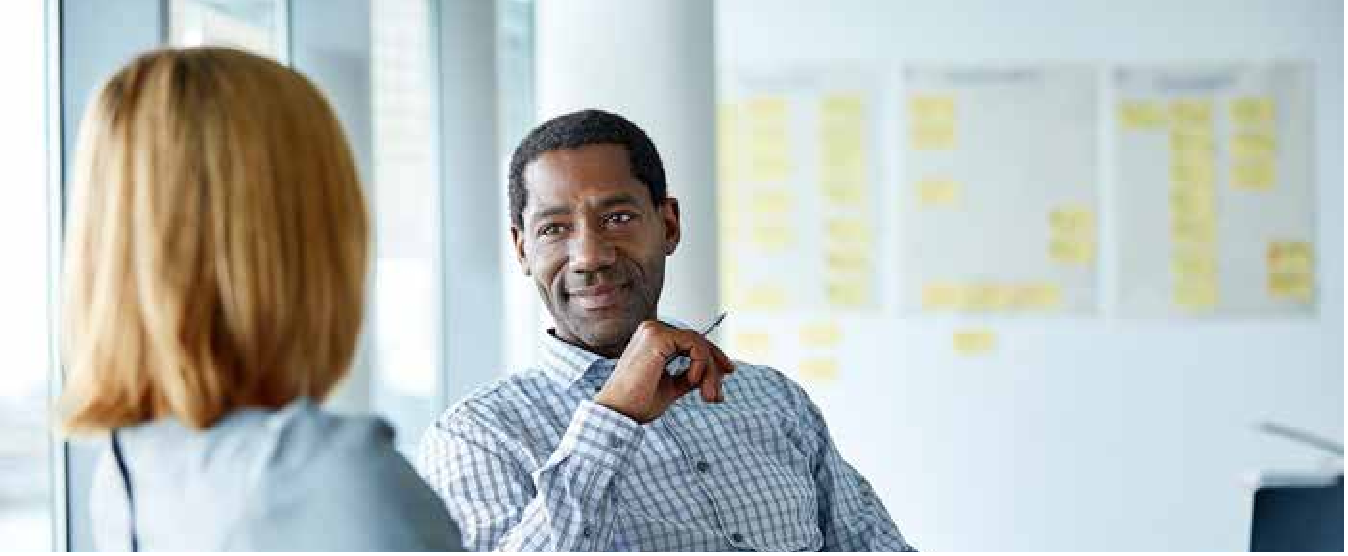
When such income is distributed to an individual shareholder,[7] it is subject to personal tax. This “ineligible” dividend is conceptually equal to the corporation’s after-tax income. The dividend gross-up causes the amount of income recognized by the individual to include the tax the company has paid.[8] The individual is then allowed a dividend tax credit, which is notionally equal to the corporate tax.[9] The result is that the total tax is roughly the same as what would be paid by an individual earning the income with no corporate intermediary.

Large Business Income

Other business income is taxed at the “general” rate—around 26–31 per cent. Dividends out of this income (“eligible dividends”) have different personal gross-up and credit rates to accommodate the higher corporate tax rate. In most cases, there is a small amount of “underintegration”; the total tax paid is 1–3 points higher than it would be if the income were earned outside a corporation.

Investment Income

For closely-held companies, investment income and capital gains have an added dimension of complexity. Since both the general and corporate tax rates on business income are markedly lower than the top personal tax rates, in the absence of countervailing rules there would be an incentive to use a corporation to earn investment income. The tax system puts in place a number of additional taxes. These taxes cause such income to be taxed at roughly 50 per cent—close to the top combined federal/provincial personal tax



rate. Upon payment of a dividend, these extra taxes are refunded to the company in order to ensure the net corporate tax is equal to the target rate to make integration work.[10]

Any difference between the top personal marginal tax rate and the corporate tax rate poses challenges to the integration system. The small business deduction itself runs contrary to the report's recommendations, which had suggested a single corporate tax rate of 50 per cent.[11]

Integration is a positive theory, but the complexity needed to manage it is daunting. And there is always debate over how close the corporate system needs to come to ensure taxation of income on an equitable basis: Can corporate income ever be taxed in a way that is identical to employment income?

INCREASING CORPORATE-PERSONAL TAX GAP

Corporate business tax rates have declined over time to roughly 15 per cent for small business and 27 per cent for others. They used to be in the high 20s and mid-40s respectively. Small business rates, always lower than the general rates, have dropped in tandem.

At the same time, personal tax rates, particularly on high-income earners, have climbed in recent years, so that almost three quarters of Canadians face top combined marginal rates over 50 per cent (in every province, from Manitoba eastward). The other provinces' rates are close.

INCOME SPLITTING

Because of the graduated rates, where it is possible to "move" income from a higher-income family member to a lower-income one, the family's total tax will usually decrease.

Most people are employees of third parties and they have little ability to do this. But people with other types of income have more flexibility.

There is no general scheme in the *Income Tax Act* restricting income splitting, but there are many specific rules around the concept. There are "attribution" rules restricting the ability to merely move money to family members and then earn investment income.[12] In contrast, spouses are specifically authorized to split pension income.[13]

With a business, there is more flexibility. A business can pay a family member salary or wages. However, this strategy only works to the extent of the value of the services provided.[14] In many cases, this value will be small, or the amount of income desired to be split will be considerably larger than can be justified.

As a result, it is common practice with small businesses to split income via dividends. A company is incorporated, and many family members (spouses, children, and parents) are issued shares, sometimes via a trust. In time, the business earns income and pays out dividends to all of these shareholders. The company pays its tax. The shareholders pay at their marginal rates. Because of the dividend tax credit, the total tax (including the corporate tax) effectively paid by each individual is roughly the same as if it had been earned directly. In the case of adult children in school, the tax is often zero, because of the special tax credits they receive.[15]

The courts have held that any amount of legally-declared dividends can be "split", the income will not be attributed to other persons.[16] Not surprisingly, this is now standard planning.

In previous years, governments have been content with this situation. It was viewed as one of the perks of running a small business and small business has been historically favoured by governments. It was also thought that countering this strategy would be impossible without great complexity or unfairness.

Philosophical Background

The fact that income earned through family businesses is taxed differently than employment income can be attributed to several primary factors:

- It is logistically harder to tax business and investment income because they are measured on a net basis, after expenses, whereas employment income is subject to very restricted deductions;[17]

- Income taxed at two levels is often difficult to attribute to a specific individual; and

- Measuring the value of contributions by each individual in a family enterprise is inherently difficult. Employment income is subject to less variability and there are more third-party comparisons available.

Income splitting can be supported using the presumption a family is the basic tax-paying unit.

This issue is not a new one. The Carter Commission (the principles upon which many of the current proposals are based) addressed it in 1966 and recommended "that the income of families should be aggregated and taxed as a unit on a separate rate schedule." The rules against income splitting could largely be withdrawn because splitting would have no significance.[18]

A major difficulty is that the Canadian tax system contains substantial elements of both philosophies.

Notionally, the taxable person is the individual. On the other hand, Canada has many areas where the family is seen as the essential economic unit. The *Income Tax Act* specifically allows pension income splitting.[19] It has provisions allowing a higher-income spouse to contribute to a Registered Retirement Savings Plan in favor of a lower-earning one.[20] Many social programs are delivered through, or are dependent upon, the income tax system. The Goods and Services Tax Credit[21] and the Child Tax Benefit[22] are calculated with respect to family income.

Political Background

Over the past decade, the previous Conservative government supported expanding income splitting for all taxpayers (not just corporate shareholders) as a policy, and instituted the Family Tax Cut.[23] They saw families with children as likely supporters. The widening gap between corporate and personal tax rates was a pleasant happenstance for their small-business supporters (business owners and upper-middle-income people consistently prefer conservative politicians).[24]

The Liberal Party, drawing less of its support from this group and more from younger voters[25] (who tend to be less affluent and less likely to own businesses), opposed the concept in principle. Following their 2015 election victory, they repealed this credit.

Impetus for the Proposed Changes

What seems to have irked the current government most is that over time, many high-income people, especially professionals, have incorporated their businesses primarily for these reasons. With comparatively-high incomes, professionals often have lower-income spouses and children who are more likely to attend post-secondary education.[26]

But corporate income splitting is not just a sharp tax planning strategy. Governments have proactively used the concept. In the early 2000s, the Ontario government was negotiating with the Ontario Medical Association ("OMA") over fees. As usual, there was a gap between what the OMA was seeking and what the government was willing to pay. To bridge this gap, the government ensured medical professional corporations could have family members as shareholders.[27] Because they provide some covered services, dentists were given the same rights.[28] Other Ontario professionals could not do this.[29] In time, many other provinces decided all professionals should receive equivalent treatment, but Ontario retained the restriction on other professions.

SUMMARY OF THE STATUS QUO

The controversy over income splitting can be seen as a long-standing and predicted consequence of failing to decide whether the tax system is an individual-based or family-based one.

The government argues income splitting is a loophole wealthy taxpayers exploit to avoid paying their fair share. As an accountant, I see income splitting and deferral using a corporation as standard corporate tax planning practices, not just for professionals, but substantially all family businesses (many taxpayers using such strategies are not in the top income bracket, which begins at income of $220,000).[30]

TECHNICAL CHANGES

The legislation is conceptually simple, but the devil is in the details and they are exceedingly complex. There are 27 pages of new legislation.

Income Splitting

CURRENT LAW

Canada already has a tax on split income ("TOSI"). It has a restricted application: a "specified individual" (subject to TOSI) is a child (under 18 at the end of the year),[31] resident in Canada and who has a parent resident in Canada.

"Split income" is almost any type of income received from a non-publicly traded entity other than salary or business income.[32]

The child is subject to TOSI at the highest marginal tax rate,[33] now 33 per cent[34] (in most cases, over 50 per cent with provincial tax). This provision effectively stops income splitting with minor children.

PROPOSED LAW

The implicit assumption of the proposed revisions is that for every private business entity, there is a main person who is primarily responsible for the generation of value in a business. For ease of comprehension, I refer to this main person as the Founder, and the person with whom income is split (the "specified individual") as the Family Member.

Publicly-traded entities are, for all intents and purposes, exempt from these rules, presumably because the scope for abuse is smaller, due to public market scrutiny.

As with the current TOSI, split income and certain capital gains realized by a Family Member will be subject to tax at the highest rate.

CAPITAL GAINS DEDUCTION

No capital gains deduction will be allowed in respect of capital gains that are:

- TOSI, or
- Accrued while
  - An individual was under 18 or
  - The shares are held in a trust (other than an alter-ego or similar trust, or an employee share ownership trust).[35]

To effect grandfathering, it will be possible to make an election to claim a capital gains deduction for gains accrued, but unrealized, to a date the taxpayer chooses in 2018.[36]

THE TARGET FAMILY MEMBER — A "SPECIFIED INDIVIDUAL"

The proposals extend the concept of a "specified individual" (Family Member) to anyone who is related to an "other individual" (the Founder). The normal relationship rules apply: a lineal descendant or ancestor, a spouse (including common-law), a parent and their spouses.[37] For the purpose of these rules, the group will be expanded to include an aunt, uncle, niece, or nephew.[38]

But this is not a simple familial taxonomy. To be in this category, the Family Member must receive income that can reasonably be considered to be derived, directly or indirectly, from:

- A business carried on by the Founder;
- A corporation of which he or she is a specified shareholder or a connected individual;
- A partnership or trust, if he or she is actively engaged on a regular basis in that entity's activities; or
- A partnership in which he or she has a direct or indirect interest.[39]

THE TARGET FOUNDER — A "SPECIFIED SHAREHOLDER" OR "CONNECTED INDIVIDUAL"

The target Founder is essentially unchanged—a 10 per cent owner. There are two categories:

1. A "specified shareholder" is one who owns at least 10 per cent of the shares of any class.[40] The wording has been expanded to make it more difficult to avoid this status through indirect ownership or an indirect flow of funds.
2. A "connected individual" is one who meets one of these tests:
   - **A.** Controls the corporation, directly, indirectly, or in any manner whatever, or is a member of a related group that does;
   - **B.** Owns at least 10 per cent of a corporation's stock (by fair market value), or property that derives its value from such shares (parent company stock, options, etc.);
     - **C.** Meets all of the following tests:
       - **a.** Alone or with related persons, owns shares of a corporation or property that derives its value from such shares;
       - **b.** The corporation provides services,
       - **c.** And
         - **01.** Those services are provided primarily by the individual;
         - **02.** The corporation's business revenue is primarily attributable to those services;
         - **03.** he corporation's share of income is primarily attributable to those services, or
         - **04.** The individual performs all or part of those services and is required to be licensed to do so, or is permitted to join a professional organization authorized to render those services, or
       - **d.** Owns shares of a corporation, or property that derives its value from those shares, and at least 10 per cent of the value of the corporation's property

was obtained after 2017 for discounted consideration, or for a loan which has not been fully paid.[41]

THE INCOME THAT IS CAUGHT—"SPLIT INCOME"

The definition of split income is modified to allow for broader wording. Interest has been added (this change had been long contemplated), and a large portion of the definition is now subsumed into the term "related source".[42] Again, the wording is broader, and the objective here is to catch payments that are made through intermediary arrangements.

SECOND-ORDER INCOME IS ALSO CAUGHT

The proposals also catch what was called "second-order" income for Family Members under age 24. Historically, it would have been possible to arrange to have income earned by a Family Member that would be caught under the split income or attribution rules. However, the subsequent income earned on that income would not be split income or attributed.[43] The provision is designed to grandfather amounts prior to 2018.

As before, there is a concept of an "excluded amount", that is not subject to TOSI. This is income or gains in respect of property acquired as a consequence of the death of

a. A parent, or
b. Any person, if the individual is a full-time student or disabled.[44]

This definition is amended to remove the "split portion". This will be subject to TOSI.

REASONABLE AMOUNTS RECEIVED ARE EXEMPT FROM TOSI

With the exception of the extension of the TOSI rules to adult family members, the items described above are mostly what tax practitioners call housekeeping. They tighten up definitions, and expand some to catch taxpayers who have arranged their affairs to avoid application of the provisions.

The substantive change is that with adult Family Members, all income from these activities is potentially caught. The government did not intend all income to be subject to TOSI, so it will bifurcate what would be split income into two parts—one that is subject to TOSI (the "split portion"),[45] and one that is not.

The split portion is split income to the extent it is in excess of what would be paid to an arm's-length person, having regard to the individual's:

- Labour contributions,
- Assets contributed,
- Risks assumed, and
- Previous remuneration.

If an individual's labour contribution is worth $50,000 and he receives salary of $40,000 and dividends of $10,000, none will be a split portion, and TOSI will not apply. If an individual's capital contribution would ordinarily yield 4–6 per cent, and he receives dividends at a rate of 5 per cent, the same would be true.[46] If the returns in either case were higher, the excess would be a split portion and subject to TOSI.

It is unclear how previous remuneration will affect the calculation. If the cumulative value of contributions exceeds the cumulative income received, then presumably the difference can be paid out without being a split portion. But if an individual has a history of receiving salary or dividends, does that make the continuation of a similar level acceptable on its own? Neither the legislation nor the explanatory notes make this clear.

YOUNG ADULTS

In the case of a Family Member under age 24, there are additional restrictions:

- He or she is considered to have made a labour contribution only to the extent that he or she is "actively engaged on a regular, continuous and substantial basis". That probably means something close to a full-time involvement.
- Any return on capital in excess of the prescribed rate (now 1% *per annum*), is a split portion. There is no recognition of risk.[47]

ANTI-AVOIDANCE

If the principal purpose of the business is to derive income from property, or at least 50 per cent of the income was from property or taxable capital gains from its disposition, then the Family Member is deemed not to have provided services.[48]

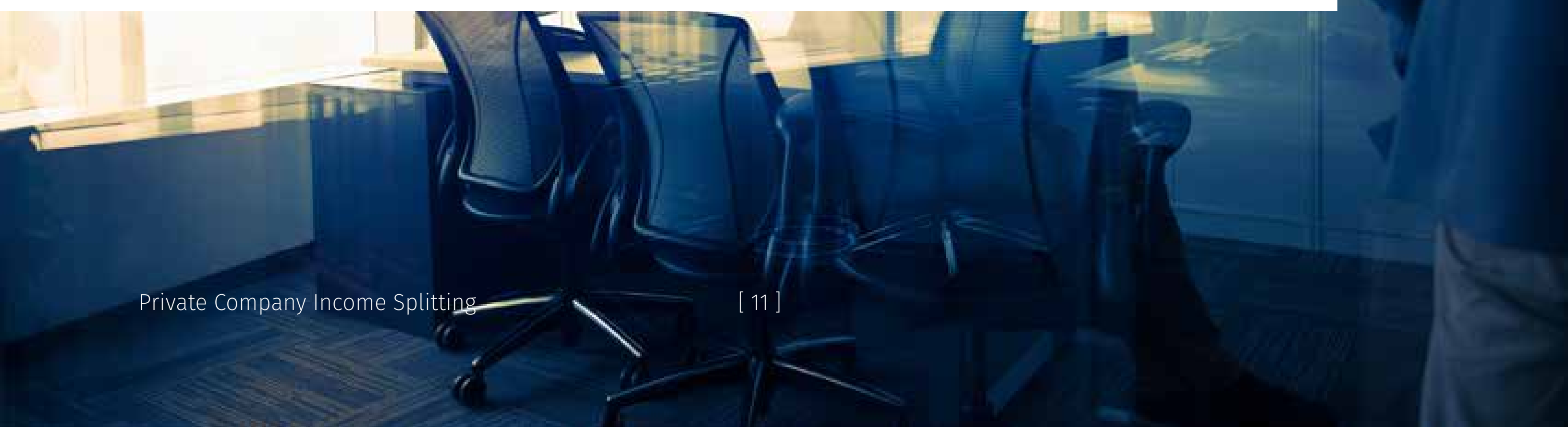
To the extent a related person provided financial assistance (such as guaranteeing a debt), the Family Member is deemed not to have contributed assets.[49]

These two rules do not apply in the case of inherited property. The Family Member is deemed to have performed the services and provided the capital of the deceased.[50]

The Department of Finance expresses no distinction among salary, dividends, and (entire, not "taxable") capital gains, even though the tax levied on each of these is different.

The proposal would make the Founder jointly and severally liable for the TOSI of an individual under age 24.[51]

A number of consequential changes are made to related income-measurement items (the age credit, GST/HST credit, Canada Child Benefit, Working Income Tax Benefit, and Old Age Security clawback).



EFFECTIVE DATE

The rules are proposed to be effective for 2018 and subsequent years.

OBSERVATIONS

The government seeks to make the tax system neutral between employees and self-employed people who use corporations. While this objective is laudable, and roughly achievable, there is a level of granularity below which it is simply not practical to go.

Proposed changes affecting private corporations are still under discussion and are likely to undergo many important revisions prior to finalization. Protect your clients – don't miss a single update. Wolters Kluwer's leading tax experts analyze and provide insight on developments continually – through proposed legislative updates, articles and in-depth commentary. To learn more visit: *https://go.wolterskluwer.ca/intelliconnect/*

Footnotes

1. http://ottawacitizen.com/news/politics/trudeau-among-wealthy-canadians-he-says-benefit-from-small-business-tax-deductions; http://www.ctvnews.ca/politics/morneau-expects-to-be-hit-personally-by-closing-tax-loopholes-1.3507642
2. Kenneth Carter, Report of the Royal Commission on Taxation, Vol. 1, pg 7, Privy Council's Office, Queen's Printer, 1966.
3. Ibid, Vol 2, Ch 2, pg 42.
4. Robert Haig, «The Concept of Income—Economic and Legal Aspects». The Federal Income Tax. New York: Columbia University Press; Henry Simons, Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy. p. 49, University of Chicago Press, Chicago, 1938.
5. Income Tax Act (Canada), RSC 1985 c1 (5th Supp), as amended (herein referred to as "the Act"), subsection 125(2). Unless otherwise stated, statutory references in this article are to the Act.
6. Paragraph 125(1)(a).
7. In this paper, "individual" refers to a natural person.
8. Subsection 82(1).
9. Section 121.
10. Sections 123,129, and 186.
11. Neil Brooks, Canadian Tax Journal: The Second Decade—1963-1972, Canadian Tax Journal (2002) Vol 50 No 2 @650
12. Sections 74.1–75.2.
13. Paragraphs 56(1)(a.2) and 60(c) and section 60.03.
14. Section 67.
15. Section 118.5.

16. Melville Neuman v. R, 98 DTC 6297 (SCC).
17. Section 8.
18. Supra 2, volume 1.
19. Paragraphs 56(1)(a.2) and 60(c) and section 60.03.
20. Paragraph 146(5.1)(a).
21. Section 122.5.
22. Sections 122.61–122.64.
23. Former subsection 119.1(2) (repealed).
24. https://www.theatlantic.com/business/archive/2012/10/how-your-job-and-your-wage-predicts-your-vote/263942/
25. http://abacusdata.ca/the-next-canada-politics-political-engagement-and-priorities-of-canadas-next-electoral-powerhouse-young-canadians/
26. https://www.theatlantic.com/education/archive/2016/04/the-growing-wealth-gap-in-who-earns-college-degrees/479688/
27. Regulation 665/05: Health Profession Corporations 2(1)(2).
28. Ibid 3(1)(2).
29. E.g., Public Accounting Act, 2004 (Ontario) SO 2004 c8 §11(1).
30. Brackets and rates used are those in Ontario, except as noted.
31. Subsection 120.4(1) "specified individual".
32. Subsection 120.4(1) "split income".
33. Subsection 120.4(2).
34. Paragraph 117(2)(e).
35. Proposed subsections 110.6(1) "eligible LCGE trust", (12), and (12.1).
36. Proposed subsections 110.6(18), (18.1), and (24)-(30).
37. Paragraphs 251(2)(a) and (b) and subsection 251(6).
38. Proposed paragraph 120.4(1.1)(a).
39. Proposed subsection 120.4(1) "specified individual".
40. Subsection 248(1) "specified shareholder".
41. Proposed subsection 120.4(1) "connected individual".
42. Proposed subsection 120.4(1) "related source".
43. Proposed subsection 120.4(1) "split income" (g).
44. Subsection 120.4(1) "excluded amount".
45. Proposed subsection 120.4(1) "split portion".
46. Canada, Department of Finance, Legislative Proposals and Explanatory Notes Relating to Private corporations, Clause 2 (Ottawa: Department of Finance, July 18, 2017).
47. Proposed subsection 120.4(1) "split portion" (e)(iii).
48. Proposed subsection 120.4(1) "split portion" (e)(ii)(A).
49. Ibid (B).
50. Ibid (C).
51. Proposed subsection 160(1.2).

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