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INCOME SPRINKLING: Where Are We Now?

On December 13, 2017, the Department of Finance released a number of **updates** relating to the **income sprinkling proposals** (originally announced on July 18, 2017). Below is a summary of the proposals as they are currently drafted.

Individuals that receive certain types of income derived from a “related business” will be subject to **Tax on Split Income** (TOSI) unless an exclusion applies. TOSI is subject to the **highest personal tax rate** with **no benefit of personal credits**.

Commencing on **January 1, 2018** TOSI will potentially **apply** in respect of **amounts** that are **received by adults**, not just those under 18 years. The application of TOSI to individuals under age 18 (commonly known as the “kiddie tax”) would not generally change.

Income Streams at Risk
Private corporation dividends, partnership allocations, trust allocations, capital gains, and income from debt may all be subject to TOSI.

Related Business
A related business includes **any business**, where another **individual related** to the recipient of income does **any** of the following:

- personally **carries on the business** (this means income from a sole proprietorship to a related person can be subject to TOSI);
- is actively engaged in the business carried on by a partnership, corporation or trust;
- **owns shares** of the **corporation** carrying on the business;
- **owns property** the **value** of which is **derived from shares** of the corporation having a **fair market value not less than 10%** of the fair market value of all of the shares of the corporation; or
- is a **member of a partnership** which carries on the business.

The definition is **broadly drafted** to capture income derived **directly or indirectly** from the business.

Exceptions and Exclusions
Several exclusions from the TOSI rules for adult individuals have been introduced.

Some **exclusions depend** on the **age of the taxpayer** at the start of the taxation year. Different rules apply to taxpayers at least 17 years of age at the start of the year (i.e. these exceptions are first available in the year the taxpayer turns 18) and to those at least 24 years of age at the start of the year (i.e. these exceptions are first available in the year the taxpayer turns 25). For the purposes of this analysis, the first age group will be referred to as those "**over age 17**" while the second group will be referred to as those "**over age 24**".

The exclusions are as follows:

1. **Excluded Business**: A taxpayer **over age 17** will not be subject to TOSI on amounts received from an excluded business. An excluded business is one where the taxpayer is **actively engaged** on a **regular, continuous and substantial basis** in either the **year** in which the **income** is **received**, **or** in **any five previous years**. The five taxation **years need not be consecutive**.

   An individual will be **deemed** to be **actively engaged** in any year where the individual **works** in the business at least an average of **20 hours/week** during the portion of the taxation year that the business operates. A person not meeting this bright line test may also be "actively engaged" depending on the facts, but this will carry greater risk of challenge by CRA.

2. **Excluded Shares**: A taxpayer **over age 24** will be **exempt from TOSI** in respect of income received from **excluded shares**, including capital gains realized on such shares.

Many restrictions apply to qualify for this exclusion, which makes it **quite complex** and **uncertain**. The taxpayer must directly own shares accounting for at least 10% of the votes and value of the corporation's total share capital. For 2018, this test can be met by December 31. In later years, it must be met when the income is received. Also, the corporation can not be a **professional corporation** (i.e. a corporation carrying on the business of an accountant, chiropractor, lawyer, dentist, medical doctor or veterinarian). Further, it must earn **less than 90%** of its **business income** from provision of **services**. Finally, **substantially all** of its income (generally interpreted as 90% or more) must be derived from **sources other than related businesses**, which will be problematic for holding companies.

3. **Reasonable Return**: TOSI will not apply to amounts which reflect a reasonable return.
   - For taxpayers **over age 24**, an amount which is reasonable is based on **work performed, property contributed**, **risks assumed,** amounts **paid or payable** from the business, and **any other factors** in respect of the business which may be applicable.
   - For taxpayers **over age 17**, but **not over age 24**, the rules are more restrictive. Only a reasonable return in respect of **contributions of capital** will be considered.

4. **Certain Capital Gains**: Although TOSI will be expanded to apply to **capital gains** of interests in entities through which a **related business** is carried on, some gains will be excluded. For example, capital gains arising due to a deemed disposition on death. Also, capital gains on **qualified farm or fishing property**, or **qualified small business corporation shares** will generally be **excluded** from TOSI.

5. **Retirement Income Splitting**: The **TOSI** rules will **not apply** to **income** received by an individual **from a related business** if the recipient's spouse was age **65** in or before the year in which the amounts are received and the amount would have been **excluded from TOSI** had it been received by the **recipient's spouse**.

INCOME SPRINKLING: Where Are We Now? (Continued)

6. **Additional exclusions** apply for some income from **inherited property** and property acquired as a result of a **relationship breakdown**.

This new draft legislation is a **substantial change** from the current rules. The provisions are **lengthy, complex and nuanced**, and it is likely that additional concerns and challenges will be identified. It is **uncertain** whether there will be **further changes**, given the concerns which have already been identified, as well as the recommendations of the Senate Finance Committee released on the same date as these proposals.

Action Item: Review whether your earnings may be impacted. Consider whether additional documentation should be kept to prove meaningful contributions and time worked. Also, restructuring of ownership or working relationships may be beneficial in some cases.

INPUT TAX CREDITS: Checking Up On Suppliers

Do I have to check up on a supplier when paying them GST/HST? Yes!

In a January 29, 2016 **Tax Court of Canada** case it was noted that CRA had **denied** over $500,000 of input tax credits **(ITCs)**, and assessed **penalties and interest**, in respect of GST and QST paid to **twelve suppliers**. Unknown to the taxpayer, the **suppliers did not remit the tax**.

The taxpayer, a scrap metal dealer, **obtained evidence** of prospective **suppliers' GST** and QST **registration** prior to accepting them as suppliers.

Taxpayer wins – mostly

A taxpayer must use **reasonable procedures** to verify that suppliers are **valid registrants**, their **registration numbers** actually **exist,** and that they are in the **name of that person or business**.

The Court held that the **taxpayer's procedures** (reviewing the suppliers' registrations, stamped by Revenue Quebec) were **generally sufficient**. It was **not relevant** that some suppliers did not have **scrapyards and/or vehicles** to carry on scrap businesses, nor that **payment** was often made **in cash**, making it difficult to verify the suppliers' revenues. The taxpayer could not be expected to query government officials to ensure that GST registrations were properly issued.

However, in respect of **one supplier**, the facts showed that the taxpayer had been **sloppy** to the point of **gross negligence** in accepting evidence of registration where it was **clear** that the **registered supplier** was **not acting on their own account**. Those **ITCs** were **denied**, and the related **gross negligence penalty upheld**.

As well, one purchase was made **on the date the supplier's registration was cancelled**, so the supplier was **not a registrant** on that date, and the **ITC** was **properly denied**. However, the related **gross negligence penalty** was **reversed**, based on the due diligence undertaken in respect of the supplier previously.

INPUT TAX CREDITS: Checking Up On Suppliers (Continued)

Action Item: Implement a system for checking GST/HST numbers, especially for major purchases, in CRA's GST/HST registry. You may want to select a purchase dollar level for which extra revision of supplier GST/HST numbers is performed. The registry is located at
https://www.businessregistration-inscriptionentreprise.gc.ca/ebci/brom/registry/

LOANS TO A RELATIVE'S BUSINESS: What Happens When It Goes Bad?

You've loaned money to a family member's corporation. Perhaps it was an investment, maybe it was a favor, or both. Or, perhaps, it was made for a completely separate reason. Regardless, sometimes the loan may go bad and you are not able to collect on the debt. What happens from a tax perspective when this occurs?

If the loan was made to earn income and other conditions are met, you may be able to write-off half against your regular income as an allowable business investment loss (ABIL). A recent tax court case shed some light on defining whether the loan was made to earn income.

In a November 3, 2016 **Tax Court of Canada** case, at issue was whether an ABIL could be claimed in respect of the **loan from a taxpayer to his daughter's start-up company**. Within approximately two years, operations had ceased and the daughter had claimed personal bankruptcy.

The loan agreement stipulated that **interest at 6%** was to be charged from the onset, but no payments would be made for approximately the first two years, which, as it would turn out, was after the business eventually ceased. The Minister argued that **no interest was charged**, and therefore, there was no intent to earn income. This was partially **based on accounting records** of the daughter's company which were inconsistent in their reflection of accrued interest.

Taxpayer wins

Despite the **conflicting records,** the Court opined that the interest rate included in the agreement was legitimate and that there was an **intent to earn income**. The **ABIL was allowed**.

The Court **did not opine** on whether the **intention to earn income** requirement would have been met if the agreement only stipulated that interest would begin to be charged or accrued at the time that repayment commenced (i.e. interest-free loan for first two years, but interest generating thereafter).

Action Point: Loans to businesses of relatives are more closely scrutinized by CRA due to the inherent possibility that it was made for non-income earning reasons. If considering a loan to a relative's business, ensure that the income earning nature is clearly documented.

BUSINESS FAILURE: Personal Liability for Corporate Tax Debt

There are special laws which hold a director personally liable for certain amounts that their corporation fails to deduct, withhold, remit, or pay. Most commonly, these amounts include federal sales tax (GST/HST) and payroll withholdings (income tax, EI and CPP). It does not generally include normal corporate income tax liabilities.

In a June 22, 2017 **Tax Court of Canada** case**,** at issue was whether the **director of a corporation** could be held liable for $66,865 in unremitted source deductions, related penalties, and interest **six years after** the corporation went **bankrupt**. The taxpayer presented various defenses.

Two-Year Limitation

In general, **CRA must issue an assessment** against the director **within two years** from the time they **last ceased to be a director**. The taxpayer argued he should not be liable since he was **forced off the property** and **denied access** by the Trustee in bankruptcy more than two years before the assessment. However, the Court determined that **only once one is removed as director** under the **governing corporations act** will such liability be absolved. In this case (under the Ontario Business Corporations Act), **bankruptcy** does **not remove directors** from their position. As the taxpayer **never officially ceased to be a director**, the two-year period had not commenced, and therefore, had not expired at the date of assessment.

Due Diligence

Liability **can be absolved** if the director **can show due diligence**. In this case, the director argued that **he was waiting for large investment tax refunds** to fund the liability, and also, **entered into a creditor proposal** so as to enable the corporation to continue to pay off the liability. However, the Court noted that **diligence was required** to **prevent non-remittance** rather than simply diligence to pay after the fact. As there was **insufficient proof** to demonstrate diligence at the **prevention stage**, this argument was also unsuccessful.

With All Due Dispatch

Finally, the taxpayer argued that the issuance of the assessment **6 years after bankruptcy was inordinate** and **unreasonable**, thereby contravening the requirement to assess with **all due dispatch**. The Court, however, found that **this requirement** related to the **assessment of a filed tax return** as opposed to the assessment of director liability. In particular, the law allowing CRA to hold the director liable states that "the Minister may **at any time assess any amount payable**". This defense was also unsuccessful.

The Minister's **assessment of liability** to the director **was upheld**.

Action Point: Ensure that the charging, collecting, and payment of GST/HST and source deductions is always done properly. Not doing so can result in personal liability for the director. Also, note that CRA has the ability to directly garnish a corporation or person's bank account for such amounts, even if an objection has been filed.

COMMISSION PAID TO A CORPORATION: Any Issues?

Consider the successful real estate or insurance agent, the financial product vendor, the area sales representative, or any other person earning commission income. One day they are asked, if they ever considered running their activities through a corporation as opposed to providing the services personally. There are definitely some valuable possibilities, but there are dangers too.

In a July 11, 2017 **Technical Interpretation**, CRA opined that whether a **corporation** is actually **carrying on a business** and **earning commission income** is a question of fact and **requires more than** a mere **assignment of income**.

CRA noted that "if insurance agents, realtors, mutual fund salespersons, or other professionals are **legally**… **precluded from assigning** their commissions to a corporation, then the commission income must be **reported by the individuals**, and cannot be reported through a corporation, regardless of the documentation provided". Care must be taken to **document** that it is truly the corporation providing the services and not just an individual. Commission contracts identifying the corporation as the service provider rather than simply the individual would be valuable.

While **some professionals** earning commission income are legally **prohibited from incorporating** (due to the provincial/ territorial laws), others may be practically precluded from doing so due to, for example, a refusal by customers or key suppliers to contract with a corporation.

If a corporation does earn commission income, one must **ensure** that the corporation would **not** be considered a **personal services business** (PSB). A PSB is essentially an individual acting as an employee for a third party, but for the presence of their own personal corporation as an intermediary. For example, consider John, an employee of a car manufacturer (CarCo). If John set up a new corporation, had CarCo pay his corporation, but kept on doing the same things under the same terms and conditions as his previous employment contract, he would likely be conducting a PSB. If classified as a PSB, the worker and their corporation could be subject to **substantially higher taxes**, plus the **denial** of **several types of deductions**.

Action Point: Take care when incorporating a business to earn employment-like commissions. Talk to an advisor to determine if it is right for you.