STRUCTURING YOUR CONTRACTING BUSINESS

Part Two: Effects of Proposed New Tax Rules

By now, you have most likely heard the news: there are big tax changes in the works in Ottawa. The Department of Finance has been working on changes that target tax strategies employed by private Canadian corporations. On July 18, 2017, they released proposed changes to the following three areas: income sprinkling, capital gains deductions and passive investment within a private corporation.

Income Sprinkling

Many contracting businesses involve the entire family in the ownership of the corporation, either directly or through a trust. This has many benefits, both from a tax perspective and for the long-term succession of the business. The proposed changes significantly expand the rules surrounding income splitting among family members, reducing the benefits of this practice.

Tax on Split Income (TOSI)

Previously, this concept was often called the 'kiddie-tax' as it resulted in a high tax rate on minors receiving dividends from private companies. In addition to minors, the TOSI is now proposed to apply to any related persons, including spouses, adult children, siblings, parents, in-laws and extended family.

The draft legislation also proposes to expand the definition of what is included as split income.

Reasonability of Income

For the income to not be subject to TOSI, it must be considered reasonable in the circumstances. It cannot exceed what would be paid to an arm's length person for the same activities, considering the following:

- Work performed
- Capital contributed
- Risk assumed

Where an individual between ages 18-24 receives income from a business for labour, they must be actively engaged on a regular, continuous and substantial basis in the activities of the business to avoid the tax on split income. They will be allowed a prescribed return on any assets contributed.

Case Scenario Example: Implications to Jim

How does this affect Jim, our contractor described in the Summer 2017 issue? In the past, Jim could restructure his business to split income with family members and reduce the family's tax burden. With these proposed rules, he would only be able to pay reasonable amounts to family members based on the new criteria. For Sarah, Jim's wife, who is already receiving a small salary for administrative work, Jim may not be able to pay any additional amounts if she has no other capital contributed to the business. For his two kids in university, he will be limited to paying them for actual labour performed in the business. Overall, Jim will need to have a higher personal income to get the same amount out of his company without splitting income. This will mean an increase to his personal tax bill each year.

Capital Gains Deduction

The capital gains deduction allows entrepreneurs to shelter a lifetime maximum of capital gains on the disposition of qualified small business corporation shares from taxation.

There are new limitations on the ability to access the capital gain deduction of qualified small business corporation shares for dispositions after 2017. These include:

- The capital gains deduction will no longer be available to minors. If the individual held the shares while they were a minor, any portion of the capital gain accruing during that time is not eligible.
- If the taxable capital gain is considered split income under the new TOSI rules, it will not be sheltered and could be taxed as high rate income.
- If a personal trust holds the shares, any capital gain accruing while the shares were held by the trust will not be eligible for capital gains deduction.

Photo: iStock

Case Scenario Example: Implications to Jim

Jim will still be able to utilize his personal Capital Gains Exemption (CGE) should someone offer to buy either of his operating company's shares (if he structures his business correctly). However, he will run into issues trying to use

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his family members' exemptions, which was possible under the old rules. This will result in an increase in tax paid on the sale of his businesses.

Planning Opportunity

Jim will have an opportunity to create a deemed disposition in 2018 of his qualified small business corporation shares and shelter the capital gain with the deduction. This will allow Jim and his family to use their capital gains exemptions before this opportunity is lost. They will be deemed to re-acquire the property at this stepped-up cost base, therefore reducing future capital gains on sale.

This election must be made before the due date of the personal or trust tax return for 2018.

Holding Passive Investments Inside a Private Corporation

The government has discussed changing the rules to prevent the use of the corporate tax deferral to hold passive investments inside a corporation.

Currently, the shareholder can decide when they receive dividends, thus can control when the personal taxes are paid. As such, there is a potential deferral of tax. This tax deferral was originally intended as an incentive for Canadian-controlled private corporations to invest in their businesses. However, some have made all necessary capital and labour investments and are left with significant after-tax cash inside their corporate structures which is being invested passively (e.g. bonds, shares, rental properties).

The government believes this tax deferral provides an advantage to business owners that is not available to employees.

In their paper, the Department of Finance indicates that the corporate tax deferral should not be used to accrue passive investments inside a corporation. The paper proposes several options to eliminate this perceived benefit and speculates on various options to mitigate the deferral.

Unlike the other issues addressed in this paper, the government has not released any draft legislation related to the passive investment income proposals, indicating that they will begin drafting legislation once the consultation period is complete. They have however, commented that they intend to tax investment income earned in a corporation at a higher rate to remove the benefit that they believe business owners are taking advantage of.

The measures introduced, will have a significant impact on tax planning for your contracting business. To minimize your tax exposure, it's important to talk to your accountant or business advisor about how these changes could impact you and your business going forward.

Learn More: The TLA hosted a webinar in late September to help its members understand these proposed tax changes and give feedback on them to the federal government. To learn more about this issue, watch the recorded webinar on the TLA website, www.tla.ca.

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