
WEBINAR:
NEW CHANGES TO SMALL BUSINESS TAX

AGENDA:

- Introduction
- Income Sprinkling
- Family Trusts
- Passive Investment Income
- Q&A

Introduction

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Income Sprinkling

- <u>Definition:</u>
  - Tax strategy used to distribute income among family members of a family business. When income is sprinkled among many family members, the overall tax burden decreases.

Income Sprinkling Cont'd.

	Father	Mother	Adult Child #1	Adult Child #2	Total:
Dividends split	$100,000	$100,000	$80,000	$80,000	**$360,000**
Taxes Payable	$14,986	$14,986	$8,293	$8,293	**$46,378**

	Father	Mother	Adult Child #1	Adult Child #2	Total:
Dividends not split	$360,000	$0	$0	$0	**$360,000**
Taxes Payable	$126,461	$0	$0	$0	**$126,461**

Taxes are lower with income splitting

New Restrictions on Dividends

- New rules restrict dividends paid to family members of the principal owner
  - Dividends paid are reasonable based on work performed.
    - Time sheets and job description required.
    - **Ex.** *$100,000 dividend to 18-year old son for data entry is not fair*
    - 18 to 24 year olds – actively engaged on a regular, continuous basis (not part time)
    - 25 years and older – involved in the business (part time is okay)

New Restrictions on Dividends Cont'd.

- Dividends paid are reasonable based on amounts invested.
  - **Ex.** *Child making $100 investment in family business cannot receive $10,000 dividend.*
  - Subject to judgment and can create uncertainty.
  - 18 to 24 – rate of return (%) determined by CRA on amount invested
  - 25 years and older – rate of return (%) determined by market risk (e.g. start-up could have high ROI %).

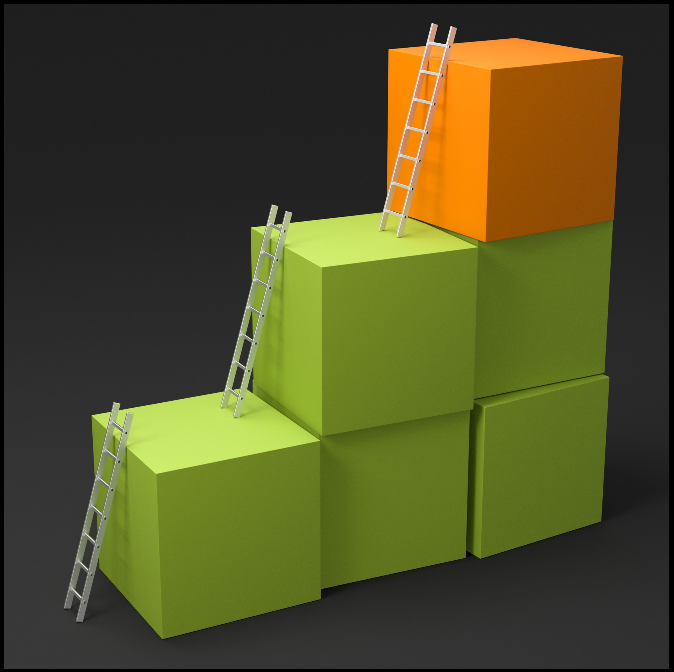
New Framework for Dividends (October Update)

- <u>October 16 Update – New Framework for Measuring Reasonableness</u>
  - Less restrictive
  - Clear and meaningful contributions by spouses, children and other family members – not impacted
  - Reasonableness tests pending for adult family members aged 18-24 and for those 25 and older.
  - <u>Four basic principles:</u>
    - Labour contributions;
    - Capital or equity contributions to the business;
    - Sharing the financial risks of the business, such as co-signing a loan or other debt; and/or
    - Past contributions in respect to previous labour, capital or risks.

Tax on Split Income (TOSI)

- Dividends paid in excess of reasonable amount subject to TOSI
- ***Ex.*** *John receives a salary of $50,000 for working in his mother's company. He also receives a corporate dividend from Mom Inc. at Christmas for $30,000, unrelated to his work.*
    - TOSI = 45% x $30,000 = $13,500
    - John will pay tax at 45% on the dividend received

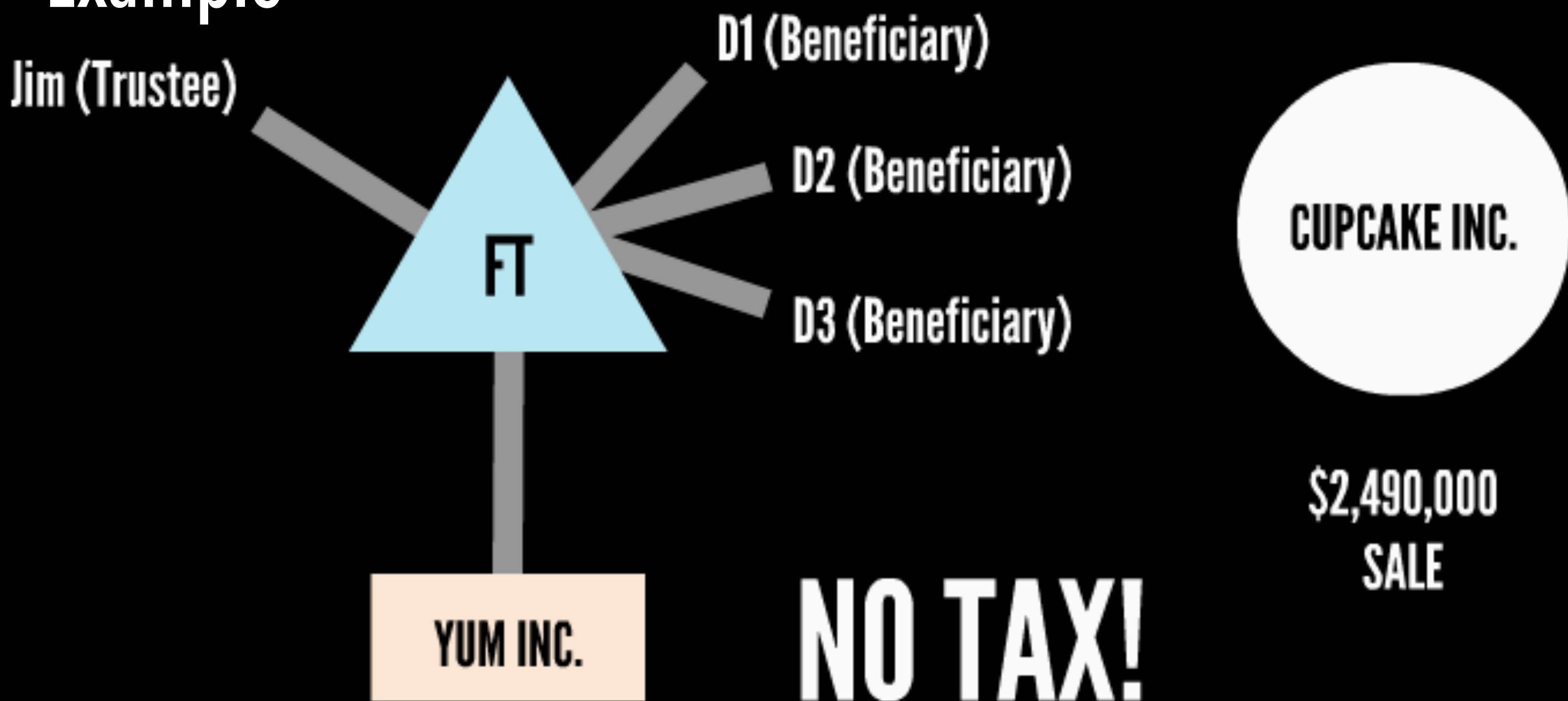
Family Trusts



- Family trusts are used to ‘multiply the lifetime capital gains exemption’ on the sale of a family business. The proposed rules meant to stop this multiplication.

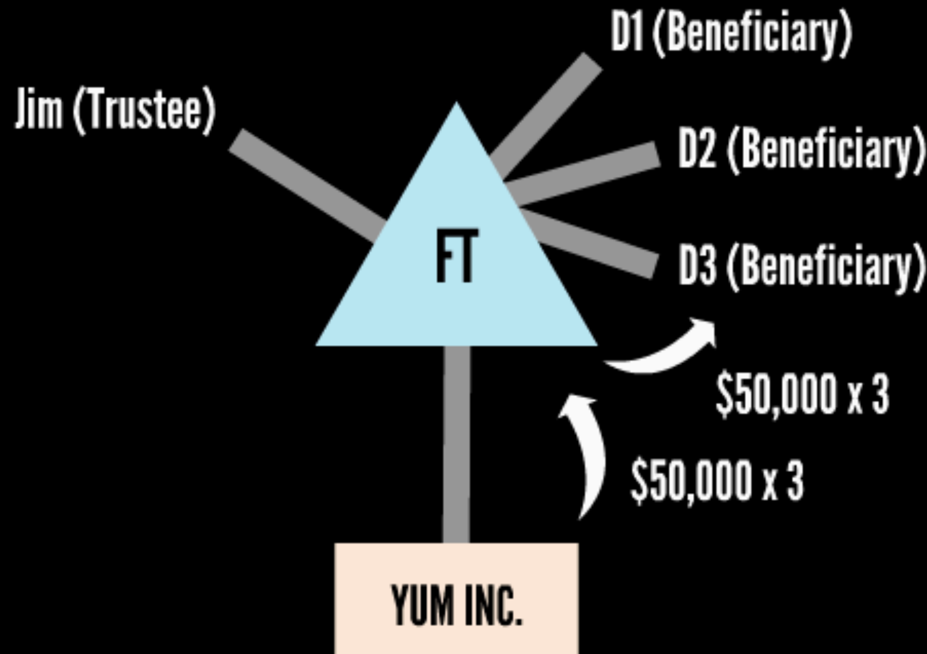
Family Trust Cont'd. 1

- Example



$0 tax is paid by daughters on the sale because they each claim the lifetime capital gains exemption of $830,000 / beneficiary

Family Trust Cont'd. 2



- **<u>Tax on Split Income (TOSI) applies to beneficiaries of a family trust.</u>**
  - All of Jim's daughters receive a $50,000 yearly dividend from the family trust.
  - They do not work or contribute to the business.
  - The $50,000 is classified as "TOSI" and taxed at 45%, or $22,500

As of October 2017, the government reversed its decision, so that the lifetime capital gains exemption can still be multiplied through a FT.

Passive Investment Income

- Canadian business owners save money within their corporate bank accounts in order to avoid paying high personal tax.
- The government is upset – dead money that's not creating jobs.
- To discourage corporations from hoarding their money, the government will now tax investment income at a higher rate, up to 73%

Passive Investment Income Cont'd. 1

	Corporate	Personal	Total:
Investment Income (rents, royalties, dividends)	$100,000		
Corporate tax rate (current) - 50%	($50,000)		
After tax corporate savings	**$50,000**		
Dividend paid to shareholder		$50,000	
Personal tax paid on dividend – 45%		**$22,500**	
Total Tax Burden (corporate tax + personal tax)			**$72,500**

Passive Investment Income Cont'd. 2

- **<u>Backlash</u>**
  - Many business owners upset – Government backtracked somewhat
  - Investment Income more than $50,000 in a year subject to higher rate of tax
  - Investment Income below $50,000 still taxed at 50% (combined personal + corporate tax)
  - Existing investments not affected by new rules

Passive Investment Income Cont'd. 3

- **<u>Capital gains explained</u>**
  - Capital gain can occur on the sale of corporate investments (stocks, mutual funds, real estate)
  - Capital gains are half taxable to a corporation
  - Corporate tax rate on capital gains is 50%
  - ½ of the capital gain is added to the 'capital dividend account'
  - Capital dividends paid to shareholders are non-taxable
  - Government proposes to eliminate capital dividend account on sale of capital property

Passive Investment Income Cont'd. 4

- **Capital dividends example:** Existing rules

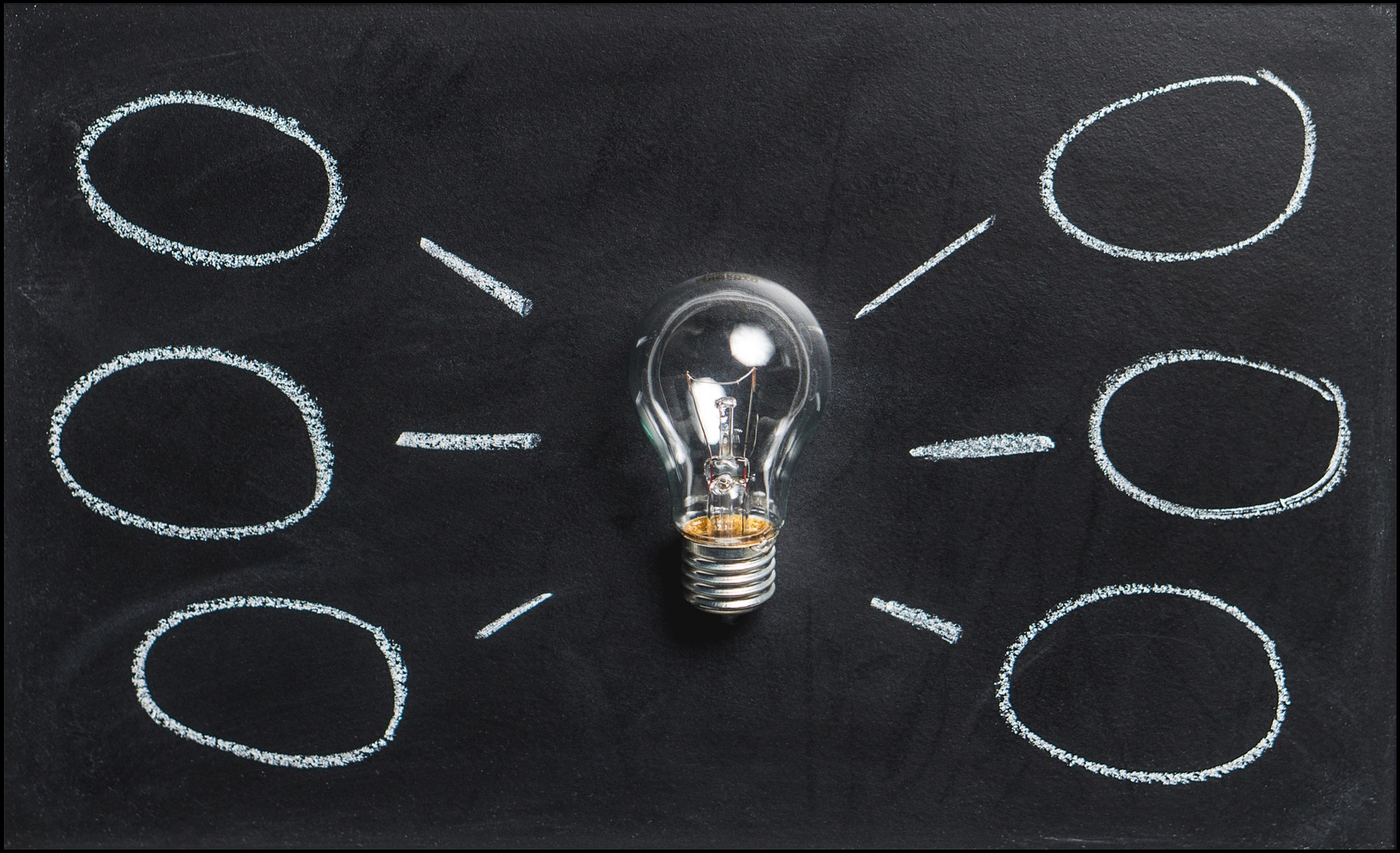
	Corporate	Personal	Total:
Gain from sale of property	$100,000		
Taxable portion of gain	$50,000 (1/2)		
Corporate taxes (50% rate)	$25,000		
RDTOH	($15,333)		
Net corporate tax paid	**$9,667**		
Taxable dividend paid – owner		$40,333	
Non taxable dividend (CDA Account)		$50,000	
Personal Tax paid on dividend (41.64%)		**$16,795**	
TOTAL TAX PAID			**$26,462**

Passive Investment Income Cont'd. 5

- **Capital dividends example:** New Rules

	Corporate	Personal	Total:
Gain from sale of property	$100,000		
Taxable portion of gain	$50,000 (1/2)		
Corporate taxes (50% rate)	$25,000		
RDTOH	($15,333)		
Net corporate tax paid	**$9,667**		
Taxable dividend paid – owner		$90,333	
~~**Non taxable dividend (CDA Account)**~~		~~$50,000~~	
Personal Tax paid on dividend (41.64%)		**$37,615**	
TOTAL TAX PAID			**$47,282**

Q&A



Feel free to ask any questions