



Tax on split income and the effect on estate planning

Tax alert

While the recent tax changes affecting private corporations were presented as a means of targeting high income individuals looking to shift income to family members in lower tax brackets, the true impact of the rules extends much further than simply income splitting and actually affects the way Canadians transfer wealth between generations and engage in estate planning.



New rules

Both the extension of the tax on split income (TOSI) rules and the new rules limiting passive income earned inside a private corporation have impacted common estate planning practices in Canada.

TOSI

The TOSI rules work to remove the benefits of income sprinkling by imposing tax at the highest marginal rate on amounts that would be considered split income—such as dividends from private corporations—when they are paid to certain related individuals. The specific details surrounding the rules and the various exclusions can be found [here](#), but the intention is to link the contribution that a person makes to a business—either through labour, capital or risk—to the return the individual takes from the business. As a result, income earned from share ownership may not be taxed at the shareholder's personal tax rate, which, from an estate planning standpoint, is a shift that is highly important.

A few of the specific provisions that are relevant from an estate planning perspective are as follows:

Inherited property

In determining how income and gains earned on inherited property will be treated for TOSI purposes, the legislation has outlined specific rules that will differ depending on the age of the recipient, as well as the relationship between the recipient and the deceased.

A general exclusion exists if an individual is under 25 years of age and is inheriting property from a parent (or anyone if the individual in question is a full-time student or eligible for the disability tax credit). Income or gains on such property will be fully excluded from TOSI. For all other individuals who are at least 18 years or older and do not meet the criteria mentioned above, income or gains earned on inherited property are not generally excluded in any way. Instead, the recipient of the property will inherit the contributions of the deceased with respect to the property, and those specific contributions will be used to assess whether TOSI will apply on any income or gains, based on the specific criteria.

For example, in the case that parent worked an average of 20 hours per week in Opco for at least five years—criteria that would exempt the parent from TOSI under the “excluded business” test—and the parent passes away and leaves his/her Opco shares to a 30 year-old adult child, dividends received by the adult child from Opco would also be excluded from TOSI as the adult child would have inherited the labour contributions made by the parent during his/her lifetime with respect to Opco.

65 years

Income splitting with a spouse becomes easier once a taxpayer reaches 65 years of age. TOSI will not apply on an amount received by an individual from a related business if the individual's spouse has attained the age of 65 during the year and the amount itself would have been excluded from TOSI had it been received by the spouse directly.

Gains on death

One helpful addition to the new rules, from an estate planning perspective, is that any capital gain incurred as a result of a taxpayer's death will be excluded from TOSI. This was a necessary addition to ensure that taxpayers were not being unnecessarily punished for circumstances out of their control and it is a helpful exclusion to keep in mind when going through the estate planning process.

Passive income

The new rules around passive income earned inside a private corporation work by restricting a corporation's access to the small business deduction when passive income earned exceeds a certain threshold. For a corporation with active business operations that is relying on the small business deduction, losing even a portion of this deduction could result in a significant increase in taxes payable due to the large spread that can exist between the small business tax rate and the general corporate rate in certain provinces. The impact here is that it becomes less advantageous for a taxpayer to save for retirement within their private corporation. From an estate planning perspective, this, again, represents a shift.

Estate planning strategies

The major goals of estate planning are to transfer family assets to future generations in a tax effective manner. While the new rules on income splitting and passive income have limited the

effectiveness of certain estate planning strategies, there are still many options available for those looking to shift assets to their children.

Maintaining QSBC status

One of the major exclusions to the TOSI rules is the exemption for gains incurred on the sale of shares of a qualified small business corporation (QSBC). This general exclusion will apply to any such gains, as long as the gain is not incurred by a minor on a sale to a non-arm's length person.

Because of this general exclusion, there is value in ensuring that business owners maintain QSBC status of their private corporations. This is especially true if a sale is anticipated in the near future, as one of the criteria for being considered a QSBC is that at least 50 percent of the fair market value of the assets held by the corporation must have been used principally in the active business of the corporation for the 24 months immediately preceding the sale.

If a corporation that would otherwise be considered a QSBC is holding more than 50 percent of its total asset value in passive assets, and a sale is anticipated, it may be effective to transfer the passive assets to a holding company so that QSBC status may be achieved by the time the sale takes place.

Planning for contribution inheritance

Where a parent is looking to pass shares of a private corporation to adult children, and those children will have varying levels of involvement in the business, it is worth considering the contributions associated with the parents' shares, in combination with the anticipated contributions of the adult children. This consideration is especially valuable if a corporate structure has multiple corporate entities.

For example, consider a parent who has been working full time in a family business for the past 20 years and is now looking to pass this wealth to his/her two children (Child A and Child B). If Child A has expressed interest in taking over the family business, while Child B is pursuing other career alternatives, depending on the full portfolio of wealth to be divided among the two children, it may be most effective to leave Child B the shares in the family business, simply because Child B will not be making any contributions to the business in his/her own right, and to provide Child A with other assets of similar value. This could be done in combination with an estate freeze that would allow Child A to purchase common voting shares of the

family business at a nominal amount, while allowing the parent to freeze the current value of his/her existing common shares into preferred shares.

This concept of contribution inheritance, as it relates to shares of a private corporation, will greatly increase the recordkeeping required with respect to a share, especially for family businesses that grow and span multiple generations.

Completing regular estate freezes

Another helpful planning tactic that can continue to be used for estate planning purposes is the practice of completing regular estate freezes to ensure the common shares of a private corporation do not hold a large amount of value. This becomes increasingly beneficial where common shares are held by inactive family members, as ensuring that they are of low value will minimize any gain on sale, as well as any high rate tax that may result due to TOSI.

Estate freezes also provide a relatively low cost way for a founder to bring future generations into the business while still exercising a certain level of control. A [family trust](#) can be an especially effective way of facilitating this process.

Saving for retirement in a private corporation

As mentioned above, the rules around passive investment income earned inside a private corporation have limited the ability for business owners to save for retirement inside of their corporations—most notably where the business is earning active business income eligible for the small business deduction. While this may have limited certain retirement planning strategies for business owners, there are still ways to structure your retirement planning using a private corporation in ways that comply with the new rules.

First, if your private corporation is holding a portfolio of investments, it may be effective to shift the contents of the portfolio so the investments are growth focused as opposed to income focused. This will provide the business owner with capital growth as opposed to yearly dividend income, minimizing any reduction to the small business limit. This will also give the business owner control over when the passive investment income is realized as they can sell shares and earn capital gains in years where active business income is lower and there is less need for the small business deduction.

Another alternative is to invest excess corporate earnings in an exempt life insurance policy or an Individual Pension Plan (IPP). These two investments in particular are excluded from the rules as the income earned within does not meet the definition of adjusted aggregate investment income (AAII), a definition integral to the application of the new rules.

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