The Institute™ for Advanced Financial Education

COMMENT

Edition 325 - July/August 2021

A newsletter for CLU designation holders focusing on risk management, wealth creation, and preservation.

How New TOSI Rules Affect Maximizing Retirement Income for Shareholders of Canadian-controlled Private Corporations

by Frank DiPietro

Since 2018, incorporated business owners have had to navigate the new Tax on Split Income (TOSI) rules to effectively shift income to lower-taxed family members. This has created a need for business owners to re-evaluate their corporate structure and family involvement in the business, amongst other things. While this has significantly impacted the planning for a business owner in their working years, TOSI may continue to apply to business owners and their families in retirement.

As a refresher, since 2018, dividends — as well as other amounts paid by private corporations directly or indirectly to an individual from a related business — may be taxed at the top marginal tax rate, also known as TOSI. A related business, generally, is a business in which a Canadian resident family member is actively involved in or has a significant capital interest in at any time during the year. However, the Department of Finance has carved out several exclusions from TOSI (i.e., excluded amounts), which if met, would allow for payments made to the adult family member to be taxed at their (lower) marginal tax rate, and not subject to TOSI.

While several exclusions may be available, let's discuss specific exclusions available to the business owner who may have sold their business, ceased operations, built up investment assets, or reached age 65, and have a desire to income split with family members to maximize after-tax retirement cash flow from their corporation.

Retirement Exclusion

One of the simplest exclusions available to a business owner is the retirement exclusion. The retirement exclusion is available when the business owner reaches age 65. TOSI will no longer apply on amounts paid to the business owner's spouse or common-law partner, so long as the business owner has reached age 65 during the year and the amount would have been excluded from TOSI had it been received by the business owner directly, by virtue of the fact that they would have otherwise met another exclusion. While it is known as the retirement exclusion, there is no requirement for the business owner to retire or for the business to end.

Tommy and his spouse, Gina, respectively own 95% and 5% of all the issued and outstanding shares of their corporation. The corporation carried on an active business for more than 30 years where Tommy was involved on a full-time basis. Gina was never involved in the business. In 2015, they sold the assets of the corporation, wound down the business, and have invested the proceeds of the sale in a portfolio of passive investment assets for the past several years. This year, Tommy is age 65 and Gina is age 62. The corporation pays all its net investment income as taxable dividends to both Tommy and Gina to augment their retirement income.

Any taxable dividend paid to Tommy is considered an excluded amount and not subject to TOSI since he meets the excluded share exception. This exception is available for those age 25 and older where the following conditions have been met:

1. The family members directly own at least 10% of the shares in votes and value of the corporation
2. The corporation earns less than 90% of its business income from the provision of services
3. The corporation is not a professional corporation, and
4. All or substantially all (i.e., 90%) of the corporation's income is not derived directly or indirectly from one or more related businesses in respect of the family member, other than the business carried on by the corporation itself.

Any dividend paid to Gina is also an excluded amount and will not be subject to TOSI. For her, she meets the retirement exclusion since Tommy has reached age 65 this year. Therefore, regardless of her ownership or (lack of) involvement in the active business in the past, dividends are not subject to TOSI because her spouse, Tommy, the primary business owner, has reached age 65. Any dividends she may have received prior to Tommy reaching age 65 may be subject to TOSI unless she is eligible for another exclusion.

The retirement exclusion would be the de facto exclusion to rely on for retirees. However, many business owners may sell or retire from their business prior to age 65 and may need to rely on other exclusions to income split with family members and increase after-tax cash flow in retirement. Two other exclusions from TOSI may apply (as discussed farther down in this article) and could effectively be incorporated into the business owner's retirement income plan.

Second-Generation Exclusion

Passive income earned on the profits of an operating company, also known as second-generation income, may be split with family members without the application of TOSI. One of the triggering factors for whether second generation income may be excluded from TOSI is determining if that income is derived, directly or indirectly, from a related business.

Consider Meghan and Harry, both 45 years old, who respectively own 100 Class A and 100 Class B common shares of Holdco. Holdco owns all the shares of Opco. Meghan is actively engaged in the Opco business on a regular, substantial, and continuous basis; Harry isn't. Historically, Opco paid taxable dividends to Holdco from its retained earnings, all of which were used to invest in dividend-paying stocks of publicly traded companies. Holdco pays all the dividends from the investment portfolio (i.e., second-generation income) to Harry, the non-active shareholder.

The dividends received by Harry from the investment portfolio is second-generation income and would be considered an excluded amount, and not subject to TOSI,[1] assuming Holdco is not carrying on a business. If Holdco is viewed as carrying on a business, the dividends Harry received would be considered derived directly or indirectly from a related business and thus TOSI would apply.[2] In either case, any distributions to Harry representing the capital that originated from the profits of Opco would be subject to TOSI.

Therefore, it is imperative to track the cash flows by perhaps maintaining separate bank accounts for capital and for second-generation income, to determine whether the distribution represents the original capital (subject to TOSI), or the second-generation income (not subject to TOSI assuming there is no business). This strategy to create second-generation income and distribute it out to the non-active shareholder is a way to shift income into the hands of the lower income spouse (or any other family member shareholder). As an additional benefit, this strategy may also have the effect of extracting passive assets from the corporation, and thus protecting the small business limit from being ground down under paragraph 125(5.1)(b) of the *Income Tax Act*.[3]

Income Splitting in Years after the Business Ceases to Exist (Sale or Dissolution)

For business owners who have discontinued or wound up their business, there may be an additional opportunity to distribute not only the second-generation income as described earlier to a non-active shareholder, but also the remaining capital within the Holdco.

Using the example above with Harry and Meghan, let's assume the business is wound up this year with the resulting sale proceeds and retained earnings invested in marketable securities in Holdco. Beginning in the 2nd fiscal year following the year the business has ceased its operations, it may be possible to distribute all funds from Holdco, including income as well as capital, to Harry (i.e., non-active shareholder) without triggering TOSI. That is, any amounts (excluding second-generation income as discussed earlier) paid to Harry this fiscal year (i.e., the year the business ceased operations) as well as next fiscal year may result in the application of TOSI, since these amounts are considered derived directly or indirectly from a related business (Opco). Any amounts, including capital originating from Opco's retained earnings paid out in fiscal year three or afterwards may be considered excluded amounts, and not subject to TOSI.

This is possible because TOSI does not apply to amounts received by adults that are "not derived directly or indirectly from a related business" for the relevant taxation year.[4] The amounts received by Harry (and Meghan) from Holdco would not be derived directly or indirectly from a related business for the year because there is no longer any business in year three. That is, Opco's business was the only "related business" that could apply; however, it no longer exists.[5] In addition, the Canada Revenue Agency has stated that it may deny this benefit to taxpayers under GAAR if they believe a series of transactions took place to primarily obtain this benefit.[6]

These three illustrations highlight important strategies and considerations for business owners who have ceased operations, built up capital in their business for retirement, or simply reached age 65 (whether the business remains a going concern or not). By navigating these challenging TOSI rules effectively, business owners and their families have an opportunity to draw income in retirement in a very tax efficient manner. ©

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[1] *Subparagraph (e)(i) of the definition in s. 120.4(1) of the* Income Tax Act *provides that second-generation income is an "excluded amount" because it is an amount that is not derived directly or indirectly from a related business. Technical Interpretation 2018-0771861E5.*

[2] *Whether the corporation is carrying on a "business" is a question of fact that is dependent on a number of factors. The term "business" is not defined in the* Income Tax Act.

[3] *Paragraph 125(5.1)(b) grinds down the $500,000 federal small business limit by five dollars for every dollar of adjusted aggregate investment income (i.e., passive income) above $50,000.*

[4] *Paragraph (c) of the excluded share definition in subsection 120.4(1) requires that all or substantially all the income of the corporation (Holdco) for the relevant taxation year must not be derived directly or indirectly from one or more related business. The relevant taxation year is defined as the taxation year ending at or before the time the dividend is paid.*

[5] *Technical Interpretation 2019-0792011E5 states that two years should pass after the sale of business for the excluded share exception to apply. If a business is sold in year three, dividends paid in year five may meet excluded share definition (as the test is based on prior year's income). After this time, no sale proceeds or accumulated earnings would be derived directly or indirectly from the previous operating business.*

[6] *Technical Interpretation 2018-0779981C6 (E).*

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