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Income splitting rules are changing—are you ready?

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Unfortunately for Canada's private business sector, perception is everything. The perception at hand, held by Canada's current government, is that "tax planning strategies involving corporations are being used to gain unfair tax advantages." As a result, major changes are coming to the Income Tax Act to put a stop to it. While purportedly cracking down on "wealthy" Canadians that are trying to "avoid" paying their fair share through the use of "loopholes" is laudable, the result of these proposed changes is in reality a hit on the entrepreneurial middle class of the Canadian economy. Some of the changes may be unduly onerous—even unfair in some cases – and represent significant policy revision to the underlying theory embedded in the Canadian tax system that has existed for decades. Although the proposed changes will have an impact on truly wealthy Canadians, the impact will be far greater on middle class business owners.

Income splitting is one tax strategy that private business owners have long used to manage their overall family tax position. In one common scenario, a corporation will pay dividends to family members who own shares in the company, which may be taxed at a lower marginal rate.

These equity-based payments have not been scrutinized in the past, but going forward, recipients will be subject to a "reasonability" test to assess if their contribution to the company's success justifies the dividend paid. If not, tax will be applied at the highest marginal rate rather than normal marginal rates. A similar reasonability test will apply to any income splitting strategy involving non-salary payouts, including the ability of family member to use their personal capital gains exemption on a disposition of the shares.

Overall, the strategy of having multiple family members legally own shares of a private corporation will be dramatically restricted from a tax perspective, and families of private business owners will have less after-tax cash at hand. The ostensible goal is to target businesses that are piling up wealth by manipulating rules, but in fact, it's the average middle class business owing family that will be most impacted. For instance, if a contractor's spouse, who indirectly contributes to the family business by managing the home and family cannot receive dividends as a shareholder and leverage their otherwise available marginal tax rates, how does this create tax fairness in the tax system? Or what about the incorporated plumber with a few vans on the road and several employees who uses a family trust to split income by distributing dividends? The lost tax savings will be significant, and we're talking about a small company, not a national chain.

The point is – in family businesses, family members often contribute to the functioning and success of the business in ways not quantifiable by a "contribution-to-earnings" test. Of course, a further issue is that "reasonability" hasn't been defined yet, and the overall rule changes are unclear and create significant uncertainty. What does seem clear is that private businesses and their owners will probably have to pay more tax, have a bigger administrative burden and in many cases adjust their tax structure.

Companies will want to prepare for this change, but until further specifics are released, detailed advice would be premature. What business owners can do is speak to their local MP to explain how these rules may negatively affect them, and consult with your Grant Thornton advisor to understand the proposals so they can avoid making precipitous decisions.

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