

COALITION FOR SMALL BUSINESS TAX FAIRNESS – Appendix A

Income Splitting:

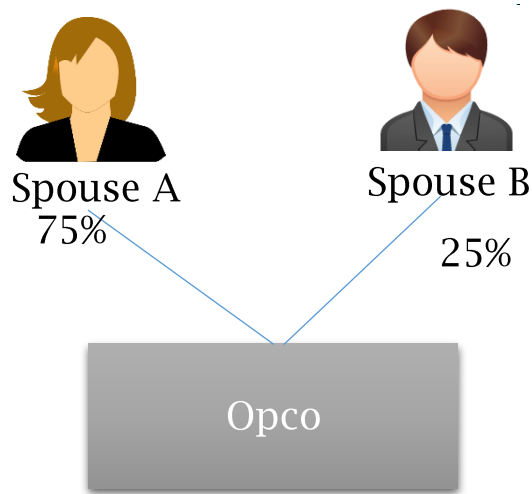
Example – “Excluded Share” exclusion not available to common structures

Facts

- Business is a start-up manufacturing company
- Spouse A is the primary business operator

Spouse B has many informal roles in the business, however, does not meet 20 hours per week bright line test for “excluded business” carve out.

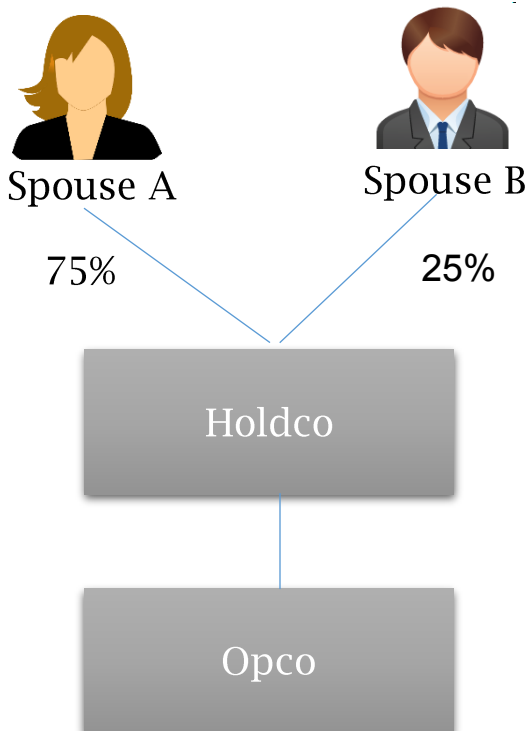
Scenario 1 – Direct Ownership



The shares owned by spouse B meet the definition of “Excluded Shares.” The company does not derive more than 90% of its business income from the provision of services, and the shares owned by Spouse B give him more than 10% of the votes that can be cast, and represent greater than 10% of the fair market value of the company. All or substantially all of the income of the corporation is not from a related business.

Conclusion: New income sprinkling rules do not apply. Dividends can be paid to Spouse B.

Scenario 2 – Ownership through a holding company

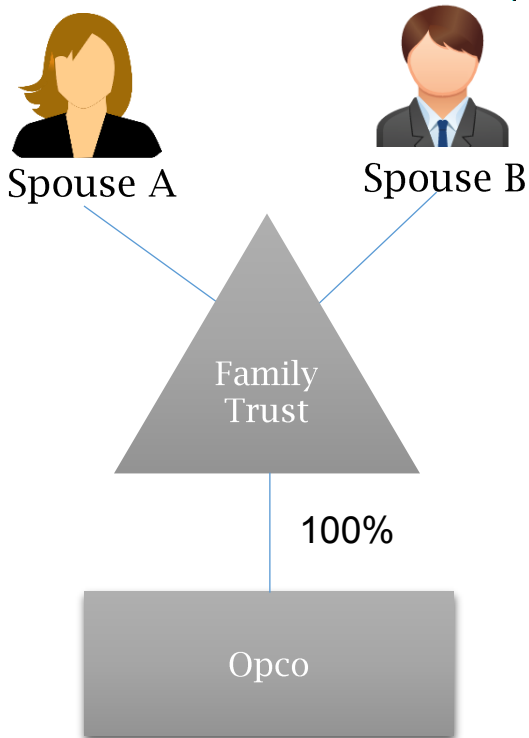


The economic interests are exactly the same as in Scenario 1. However all or substantially all of the income of Holdco is income derived from a related business, Opco. Therefore the shares owned by Spouse B are not excluded shares.

Conclusion: New income sprinkling rules apply. Dividends paid to Spouse B are subject to Tax on Split Income at the highest marginal tax rate.

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Scenario – Ownership through a Trust



The economic interests are exactly the same as in Scenario 1. However, the shares are owned by a trust, not by the specified individual (Spouse B). Therefore, the shares of Opco are not excluded shares

Conclusion: New income sprinkling rules apply. Dividends paid to Spouse B through the trust are subject to Tax on Split Income at the highest marginal tax rate.

Conclusion: Three common structures that exist for both tax and non-tax reasons (i.e. creditor protection, estate planning, etc.) have vastly different results. Any level of complexity introduced to the structure will result in the Exclusions provided for in the legislation not being available to specified individuals.

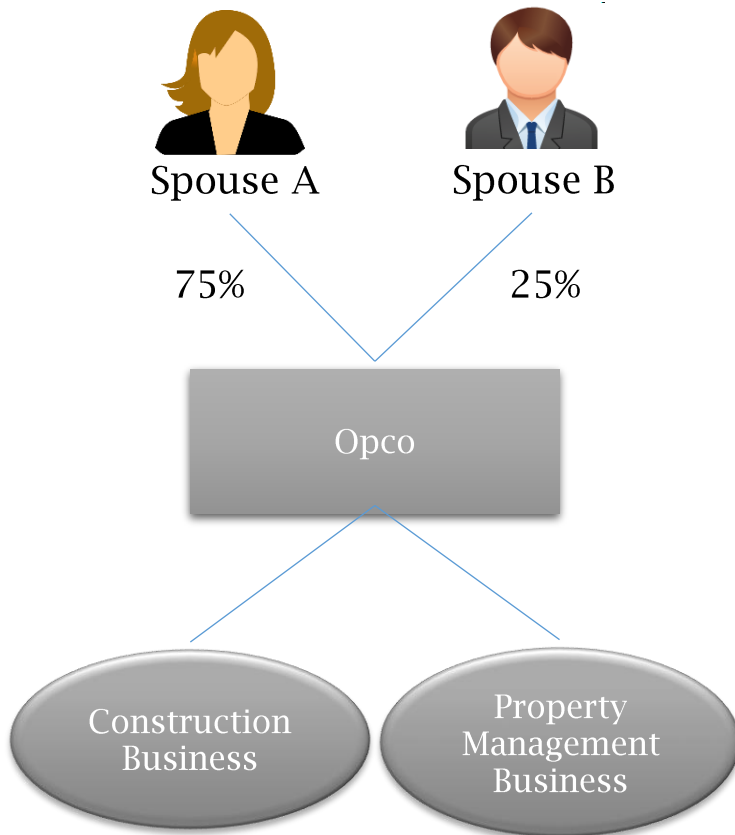
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Example – Excluded Business – Application to Multiple Businesses

Facts

- Spouse A founded and operates a construction business and a property management business.
- Both businesses are operated through a single corporate entity (Opco)
- Spouse B works 25 hours per week as a property manager

Scenario



The “Excluded Business” definition states that where Spouse B works at least 20 hours per week in the business. In this case, Spouse B works 25 hours in the property management business, but not the construction business. Do we now have to trace the flow of funds from the property management business to Spouse B to ensure they are “excluded amounts”?

Conclusion: New income sprinkling introduce significant administrative complexity that may not be possible to manage in ordinary business settings. It may be impossible to trace source of funds that Spouse B receives as dividends. If this isn't possible, dividends to Spouse B will be subject to the Tax on Split Income.

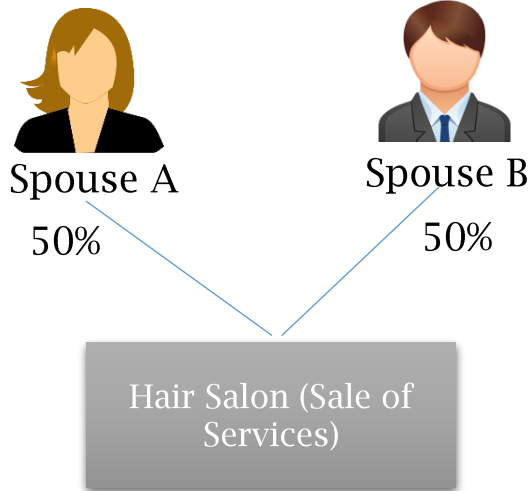
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Example – Excluded Shares – Bias against Services Businesses

Consider the following situation

- 1) Two families start new businesses at the same time
- 2) Family 1 starts a hair salon. Spouse A is active in the business, Spouse B is not.
- 3) Family 2 starts a Pizzeria. Spouse A is active in the business, Spouse B is not.

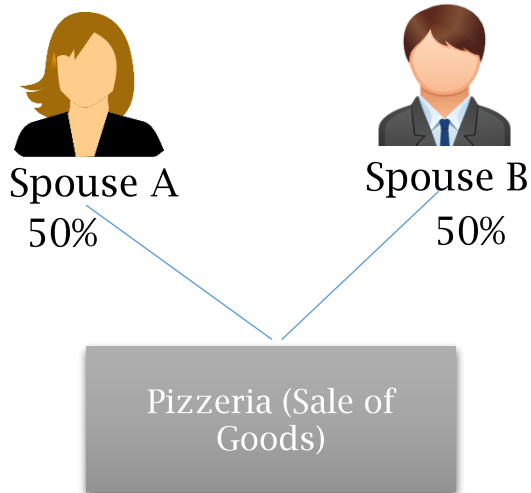
Business 1 – Hair Salon



The company derives more than 90% of its business income from the provision of services. Therefore, the shares do not meet the definition of “Excluded Shares”

Conclusion: New income sprinkling rules apply. Dividends paid to Spouse B are subject to Tax on Split Income.

Business 2 – Pizzeria



The company does not derive more than 90% of its business income from the provision of services. Therefore, the shares do meet the definition of “Excluded Shares”

Conclusion: New income sprinkling rules do not apply. Dividends can be paid to Spouse B.

Conclusion: Significantly different results are applicable to two similar small businesses. Given that 78% of Canadian small businesses are in the service sector, it is unclear why this exclusion should not be available to services businesses.

Examples provided by: MNP LLP

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The proposals provide an exclusion for amounts earned by an individual (over the age of 17), in respect of a property, where the amounts are derived directly or indirectly from an “excluded business”. To qualify for this exclusion, the individual must be actively engaged on a regular, continuous and substantial basis in the activities of this business, either in the current year or in any five prior years. To assist in determining whether this exclusion applies, a bright-line test has been proposed, whereby an individual is considered to be actively engaged in the business if they work at least an average of 20 hours per week in the business during the portion of the year in which the business operates. This will address situations where an individual is not currently working in the business, but did so previously on a basis that meets the bright-line test. However, there is a significant concern about how to prove sufficient hours were worked in the five prior years – in particular, if these five prior years took place a number of years ago. The CRA’s guidance indicates that records such as timesheets, logbooks, schedules and payroll records will be sufficient to establish the number of hours. However, in many family run businesses, family members will not record specific hours worked. Or, if they did have such records, they may not have retained them if it was a number of years ago. As a result, providing records to satisfy this test could be a very onerous or even an impossible task for taxpayers, raising concerns of whether they can rely on this exclusion in situations where TOSI should not apply.

The proposals provide an alternate exclusion for an amount included in the income of an individual (over the age of 24), in respect of a property, where the amount is income from, or a taxable capital gain from the disposition of, “excluded shares”. One condition that must be met for shares of a corporation to qualify as excluded shares is that less than 90% of the business income of the corporation was from the provision of services. Concerns have been raised as to why service companies have been targeted so broadly in the definition of excluded shares. There appears to be an inequity as to why a manufacturing business would likely meet this particular condition, while a business providing housecleaning services or IT consulting services would not? In addition, many businesses may be providing a combination of products and services. Therefore, in order to meet this condition, additional compliance for businesses would be needed in terms of keeping records to distinguish what income is and is not from the provision of services. In fact, this will likely also require a subjective analysis of the business income of the corporation, which introduces uncertainty into applying the tax rules appropriately.

Examples provided by: BDO Canada