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COMMENT

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## "Kiddie" Tax Net Continues To Expand

One of the more popular tax planning strategies is "income splitting." To the extent income can be shifted within a family unit from a higher income earner to a lower income earner, less income tax is paid and more after-tax income is retained within the family unit.

As one might guess, the government has a wide array of tax laws to maintain fairness and ensure tax revenues are not inadvertently stifled through income shifting. The shifting of income among family members within the context of family-owned businesses was commonplace in the 1990s. To curtail the common strategy of paying dividends to minors on shares of private non-arm's length companies owned by a trust, a new tax referred to as "kiddie tax" (or more formally, "tax on split income") was introduced in the 1999 federal budget, beginning with the 2000 taxation year. Rather than attribute the dividends to the parent, kiddie tax was structured to tax the dividend income in the hands of the minor child, but at the highest marginal tax rate.

The kiddie tax rules were expanded in the 2011 federal budget to include capital gains realized by minors on the sale of private company shares to a non-arm's length person. The rules deem that the capital gain realized is re-characterized as a taxable dividend. Effectively, this prevents the ability to make use of the preferred rate of taxation available for capital property, and to access the capital gains exemption when the shares are disposed of in a non-arm's length situation.

The 2014 federal budget proposes to expand the kiddie tax rules even further. It states that, to the extent a minor realizes business or rental income from certain partnerships or trusts, the income will be treated as "split income."

In simple terms, the kiddie tax rules identify situations where income is earned by a minor from private company shares, and redefines that income as "split income." Split income is removed from the calculation of regular taxable income for the minor, and is instead taxed at the top federal marginal tax rate plus the top marginal tax rate for the province of residence. The tax on split income and the tax on regular taxable income are added together to determine the minor's overall income tax liability for the year.

In general terms, split income is defined as:

- Taxable dividends received by a minor from a private corporation;
- Capital gains realized on the disposition of shares of a private corporation to a non-arm's length party;
- Shareholder benefit amounts realized by the minor from private corporations;
- Partnership income allocations derived from the provision of goods, services or property rental to a non-arm's length entity (i.e., sole proprietorship, corporation, partnership);
- Allocations of income from a trust that can reasonably be considered taxable dividends or shareholder benefits from a private corporation; or
- Income derived from the provision of goods, services or property rental to a non-arm's length entity.

It should be noted that the kiddie tax rules do not apply to income received on property inherited by the minor as a consequence of the death of a parent, or as a consequence of the death of any person, if the minor is enrolled during the year as a full-time student at a post-secondary educational institution, or the minor qualifies for the federal tax credit for mental or physical impairment.

I/R 7401.00

## Shareholder Loans: Beware Of Taxable Events

In general terms, a shareholder is subject to tax on the value of any assets withdrawn, whether directly or indirectly, from his or her company. This would include physical assets or money, such as dividends, a draw or a loan. Some of the exceptions to this general rule include a withdrawal of paid-up capital, payment of an amount owing to the shareholder by the corporation, and capital dividends. There are unique tax consequences depending upon the nature of the withdrawal.

Salaries and bonuses are taxable as income to the shareholder in the year received, and would be subject to source deductions (also known as tax withholding) by the corporation. The requirement for the corporation to withhold income tax and other payroll deductions creates a prepayment of some or all of the resulting tax. Later, when the shareholder files his or her tax return, the amount of income tax withheld can be applied as a credit to offset the individual's income tax liability.

Dividends paid to the shareholder are taxable in the year received and are subject to the gross-up and dividend tax credit rules. While dividends are not subject to source deduction withholding, they can trigger an obligation for the shareholder to make income tax instalments. Overlooking required income tax instalments can result in interest charges to the shareholder.

When a shareholder draws money from the corporation, and it is not labelled as salary or dividends, the withdrawal is often treated as a loan to the shareholder. The general rule is that any outstanding balance of the loan is taxable to the shareholder one year after the end of the corporate year-end in which the loan was made.

For example, a shareholder makes several draws totalling $200,000 over the course of the corporation's fiscal year ending June 30, 2013. This means the shareholder owes the company $200,000 at year-end. The shareholder would be taxable on the $200,000 loan if it is still outstanding on the company's June 30, 2014, year-end.

From a planning perspective this shareholder could repay the entire loan and avoid the income inclusion. Either he could repay some of the loan, and reduce the income inclusion, or the corporation could declare a bonus or a dividend equal to the outstanding balance of the loan, use the amount to offset the loan, and include the applicable dividend or bonus amount in his 2014 income. This allows the shareholder some control over the tax consequences; a dividend receives special tax treatment, and a bonus would be tax-deductible to the corporation.

Where a withdrawal from a corporation is not appropriately categorized and tax-reported (for example, in the corporate accounting books, board resolutions and any applicable tax slips), the Canada Revenue Agency (CRA) is likely to treat the amount as a shareholder benefit. In other words, the amount will be fully included in the shareholder's income, and no deduction will generally be allowed to the corporation. This creates double taxation that could have been avoided through appropriate documentation and reporting.

In situations where the shareholder is also an employee, there are exceptions with respect to how loans are treated if the loan is made to the individual in his capacity as an employee rather than as a shareholder. To satisfy the CRA that the loan was made because of employment, all employees within the particular class of employees to which the shareholder belongs must be eligible for similar loan benefits. Employee loans that are advanced under the following circumstances will not be treated as income to the recipient:

1. Shareholders who own less than 10 per cent of the issued shares of the company;
2. Loans received from the company to buy shares of the company;
3. Loans received from the company to buy a home; and
4. Loans received from the company to buy a car used in the performance of employment duties.

However, at the time the funds are advanced, there must be a bona fide plan in place outlining the terms for repayment within a reasonable timeframe, and an imputed interest benefit will be included in the employee's income.

Shareholders cannot treat the company property as their own, but rather must recognize the income tax consequences that arise with most types of asset withdrawals. It is important to know before the issue arises when strategies can be deployed to avoid unnecessary tax consequences.

I/R 2101.00

## Canadian Farm Operations

Agriculture is an important industry for Canada, with over 200,000 farms averaging approximately 800 acres currently in operation. Farm performance remains strong, and asset values, particularly land, continue to grow. Like other business owners, farmers need to carefully plan for succession of their business operations.

Important considerations include:

- Funding any income tax liability that arises with the deemed disposition of the farm property upon death;
- Estate distribution among heirs, particularly where not all heirs inherit the farm; and,
- The financial needs of surviving family members.

The government provides a number of tax rules of benefit to farmers, including:

- A deduction from capital gains realized on the disposition of qualified farm property. The farm may be incorporated, in which case the shares of the farm corporation may qualify for the capital gains exemption. Alternatively, the farmer may be a sole proprietor, in which case the assets of the farm operation may qualify.
- A tax-deferred rollover of farm property and/or shares of a farm corporation to a child. This provision allows farmers to defer the payment of income tax on accrued gains embedded in the farm property indefinitely, so long as the farm stays an active farm in the family. In addition, an election can be made so that the transfer occurs at an elected price, which would allow the parent to crystallize his or her capital gains exemption, and the child to increase the adjusted cost base of the farm property received.

It is important to note that the definition of what qualifies is different for these two provisions.

### Income Tax Rollover

For farm property to qualify for the rollover, the property must have been used principally in a farming business carried on in Canada. The rollover will be allowed on an inter vivos or testamentary basis between a parent and his or her "child." In addition, one of the parents, grandparents or a child of the transferor must be actively engaged in farming on a regular and continuous basis at the time of the transfer of property. The word "principally" is generally defined to mean more than 50 per cent.

The provision uses the extended definition of child, which includes a natural or adopted child, a grandchild and an individual married to, or in a common-law relationship with, a

child or grandchild. In addition, the child receiving the property must be resident in Canada at the time of receipt, and in the case of a transfer on death, property must vest in the child within 36 months of the death of the transferor.

The shares of a farm corporation can qualify for the rollover if they meet the definition of "capital stock of a family farm corporation." In general terms, the definition requires that "all or substantially all of the fair market value of the property owned by the corporation was used principally in a farming business in Canada where the person, spouse, common-law partner, child, parent, or a partnership that itself meets the definition of a family farm partnership was actively engaged on a regular and continuous basis."

**Capital Gains Exemption**

Farm property that qualifies for the capital gains exemption is generally property owned by the individual that is used in the course of carrying on the business of farming in Canada by the individual, a spouse, common-law partner, child or parent. It is important to note that it does not matter who is acquiring the farm property in order for the transferor to qualify for the capital gains exemption.

For farm property purchased before June 18, 1987, the term "used in the business of farming" means the property was used in at least the 24 months prior to the disposition in the farming business, or was used at least five years during the entire period of ownership in the business of farming.

For farm property purchased after June 17, 1987, the term "used in the business of farming" means the property was owned for at least 24 months before the disposition, used mainly in the business of farming, and in any 24-month period the gross income from the farming operation was greater than the business income from all other sources.

Shares of a farm corporation that qualify for the capital gains exemption are generally defined as follows:

1. The shares were owned by the individual at the time of disposition;
2. Throughout the immediate 24-month period, more than 50 per cent of the fair market value of the property owned by the corporation was used principally in a farming business carried on in Canada by the individual, spouse, common law partner, child; and
3. At the time of disposition, all or substantially all of the property of the corporation was attributable to a farming operation carried on in Canada.

A farmer therefore has two valuable income tax provisions that could apply in his/her situation, and it is important to comply with the criteria of each provision in order to qualify for the income tax benefit.

Note: Similar provisions for fishermen permit rollovers similar to those available to farmers.

I/R 2500.17

## Cottage Succession

Family cottages often represent great memories. The cottage can be an important retreat where families congregate in a relaxed environment, developing close relationships with successive generations. Alternatively, the cottage may be an economical vacation spot that families count on year after year. The cottage could be a simple structure on a remote lake, or a compound covering an entire island.

Ownership of a cottage generally begins with the parents holding joint ownership, and assuming responsibility for annual expenses and property upkeep. As families grow, adult children typically help maintain the cottage, and look forward to sharing the cottage experience with their own children. But as the parents age, families need to decide how best to ensure future generations enjoy the cottage.

In order to retain the family cottage through future generations, a number of issues should be considered in advance to ensure a long and enjoyable family experience. The first generation — the parents — could address the cottage as part of their overall estate transition by designing a plan for long-term retention. Alternatively, the parents could bequeath the cottage to the adult children jointly, requiring the children to determine how the cottage would be shared among all siblings.

The most prevalent of these issues is the long-term ownership, and annual and periodic expenses. Expenses include not only the cost of maintenance and annual property taxes, but also the income tax liability that could arise upon the disposition of the property at the time of the parent's death, and when the property passes between family members in the future.

**Ownership**

Different ownership options have different advantages and disadvantages; a great deal of thought is needed as to the long-term structure that best meets the needs of the individuals involved. The following is a list of the typical types of ownership structures.

| Structure | Description | Some Considerations |
|---|---|---|
| **Joint tenancy**<br><br>(option not available in Quebec) | Property registered in joint tenancy with the right of survivorship means that when one of the registered owners dies, the remaining individuals share ownership of the property. The last person alive and on title of the property has personal control, and can decide how to deal with the property. This person can transfer the property as he or she chooses, while alive or through a last will and testament. | This works well in some situations upon registering the initial joint tenancy as the parent chooses. However, the passing of an adult child could preclude that individual's children and successive generations from accessing the cottage — they will be reliant on their aunts and uncles. The last surviving owner makes the decision about future ownership.<br><br>Subject to the principal residence rules, the death of each family member on title of the property triggers an income tax liability based on that individual's interest in the cottage property. The income tax liability rests with deceased's estate, not the continuing owners. |

| Structure | Description | Some Considerations |
|---|---|---|
| **Tenants in common** | As tenants in common, each family member owns a share of the cottage, in the proportion initially registered. Each owner has the right to pass the interest in the cottage according to his or her wishes, either while alive or through the last will and testament. Typically, each owner would name the children who stand to inherit the parent's interest in the cottage as tenants in common. | Again subject to the principal residence rules, the death of each family member on title to the property triggers an income tax liability, creating a tax bill for the deceased's estate.<br><br>The number of tenants in common listed on title will increase as each owner passes and bequeaths the interest to his or her children as tenants in common. |
| **Family trust** | The cottage could be transferred into a trust with all of the children and (future) grandchildren listed as beneficiaries of the trust. The trustees would be responsible for managing the cottage property and adhering to the rights of the beneficiaries. | A trust is deemed to sell its capital property every 21 years, which means there could be a large income tax liability in the trust every 21 years unless the cottage is transferred from the trust to one or more beneficiaries. |
| **Patriarchal or matriarchal approach** | Title to the property would pass to the oldest child in the next generation, and it would be up to that adult child to hold the property for the entire extended family. | This could be considered a bare trust. |
| Although additional alternatives are available, the extra complexity necessitates exploration beyond the scope of this article. Additionally, issues such as claims against the cottage property by creditors of a bankrupt family member, rights of estranged spouses under provincial family law, and numerous other issues must be considered. Professional legal guidance should be sought. | | |

## Agreements with respect to expenses

After a family has reached agreement as to the sharing of expenses and the use of the property, it is helpful to document the decisions in a cottage constitution. The purpose is to clearly specify how expenses and use of the cottage will be shared, with the intention of minimizing conflicts and emotional reactions that might arise from misunderstandings. Agreements are advantageous as they allow the participants to anticipate, in advance, fair and equitable rules that everyone knows and agrees with.

*Expense considerations to be addressed:*

- What expenses are shared equally?
- How is "equally" defined, now and in the future?
- What expenses are shared by usage?
- What expenses are paid by the user?
- How are maintenance and repairs determined? Who determines what is necessary and/or desirable?
- Who is responsible for paying the expenses?
- Are funds gathered in advance (i.e., at the beginning of the year)?
- Do family members recover funds not spent at the end of the year?
- What if financial difficulties or strained family relations result in non-payment?

*Considerations for establishing usage of the cottage:*

- How is cottage time shared across each participating family? (e.g., Should each family take turns picking one week?)
- When do subsequent generations step into the picture for picking times?
- Are there common times when all families share time together?

*Is there a mechanism for dispositions of ownership interests?*

- Families may relocate and no longer be close enough to enjoy the cottage; they may find after some time that they do not enjoy cottage life; family harmony may no longer exist; or some family members may desire a different type of cottage or location.

*Making an agreement work*

- Consider establishing a timeframe for regularly updating the constitution to reflect changing family circumstances.
- Consider establishing annual family meetings to process decisions and address issues.
- Consider rotating the appointment of one sibling to chair family meetings.

When the family cottage holds great sentimental value to one or multiple family members, addressing the long-term plan for succession is essential to family harmony.

I/R 2500.00

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