SMALL BUSINESS ADVISOR

Limits on income sprinkling cut into family businesses

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Financial planner Douglas Nelson and his family are concerned about new income splitting rules and how they will affect small business taxation. 'They've made it harder to be successful,' he says. 'There are all of these hoops we have to jump through now and the question is why? Is the country really better off?'

JOHN WOODS/THE GLOBE AND MAIL

In the nearly three decades that Douglas Nelson has been running his financial consulting company, never once has he considered the awkward task of writing a job description for his wife, a shareholder in the business, until now.

It’s just some of the additional paperwork Mr. Nelson will need to do thanks to Ottawa’s changes to income-splitting legislation for private corporations that took effect Jan. 1. The rules limit the ability for business owners to split or “sprinkle” income with family members who aren’t considered active in the business.

Mr. Nelson is also considering how he could eventually employ his children, now teenagers, since the new legislation removed the ability to pay them a dividend when they turn 18, through a family trust structure. He says the ability to pay a family member a legitimate dividend, once they turned 18, helped business owners contribute to their children’s postsecondary education.

Mr. Nelson says it’s not always about saving some taxes, but also giving an entrepreneurial family some flexibility in managing both the cash flow of the business with the cash flow needs of the family.

“For us to make things work from a family point of view, we are going through the process of figuring out how we restructure our own affairs so that we can have the income we need when we need it and continue to have a successful and growing business,” says Mr. Nelson, whose father Vernon started the Winnipeg-based company in 1966. Mr. Nelson has been in the family business for 26 years and his wife has been involved for about a decade.

The recent changes are forcing many business owners such as Mr. Nelson to reconsider their family’s financial planning strategies, as well as how they staff their businesses, including potentially replacing existing or any additional employees with family members. Mr. Nelson is also advising his clients about making similar changes.

“Myself and my clients need to think of our family’s economic situations first,” says Mr. Nelson, who believes the new rules are unfair and create more work and red tape for business owners. “They’ve made it harder to be successful. There are all of these hoops we have to jump through now and the question is why? Is the country really better off?”

Out with the old

In the past, business owners would sprinkle income to family members in lower tax brackets through dividends as a way to lower the family’s overall tax bill. For many business owners, this was considered a perk for a spouse’s involvement in the daily operations, even if they weren’t a paid employee, or to help pay for a child’s education.

The federal government cracked down on income splitting as part of a broader set of tax changes for private corporations. Some of those changes were removed or scaled back amid a countrywide business backlash, but income-splitting changes remained largely intact.

“Income splitting, for the most part, is dead when it comes to private companies,” says Jamie Golombek, managing director of tax and estate planning at CIBC Financial Planning and Advice.

Exceptions to the changes

There are exceptions under the new rules for family members who can prove they're active in the company, which means contributing an average of 20 hours per week throughout the year, or in any five prior years.

Another exception is for family members 25 years or older holding shares with more than 10 per cent of the votes and value of the company, he says. However, this exception doesn't include owners of professional corporations such as doctors, dentists and lawyers. For corporations that do qualify, the new rules won't apply to 2018 dividends as long as the company is properly restructured by the end of 2018.

Still, for many businesses, restructuring the company to take advantage of this exemption is neither practical nor desirable, Mr. Golombek says.

One of the more useful exemptions, according to Mr. Golombek, is paying dividends to a spouse or partner of a business owner who is age 65 or older, which is known as the "retirement exception."

Mr. Golombek says there are other income-splitting strategies that private corporation owners may consider to lessen their tax burden such as setting up prescribed-rate loans between spouses, where funds are lent to a lower-income spouse or partner to invest; setting up a family trust to income-split interest or dividend income with children; or for seniors, splitting eligible pension income with a spouse or partner.

Rules still vague

A concern is the rules are still vague, Mr. Nelson says. For example, he says there's no definition of a service business to help corporations better understand whether they're eligible or not.

"If you are considered to be a service business, you can't pay a dividend to another family member. Why does the government differentiate between a service business versus a non-service business when it comes to tax policy?" he asks. "You want to do the right thing, but the rules are vague and subjective. It keeps getting harder. And so if someone comes to me to say they want to be an entrepreneur, it's a very sobering discussion to say, 'It ain't easy to be successful in Canada today.'"

Dan Kelly, president and CEO of the Canadian Federation of Independent Business (CFIB), says business owners and tax professionals are still sorting through the implications, and exceptions, while some are still unaware of the changes. "The real kicker will be in about two years when the audits of the 2018 tax year start," Mr. Kelly says. "That's when a lot of businesses will find out for the first time whether what they've been doing … is kosher."

Mr. Kelly says a problem is that it's difficult to quantify the role of a spouse in a family business to the Canada Revenue Agency. Even if they're not involved on a daily basis, they’re part of the risk-taking. “A family business really doesn’t stop at the one principal that may be in the business,” he says.

The CFIB has been calling on Ottawa to exempt spouses from the new rules, as well as to delay the start of them until the 2019 tax year, giving family businesses more time to prepare.