



TAX NOTES

December 2017

Revised Income Splitting Proposals Released (Happy Holidays!)

On December 13, 2017, the Department of Finance released revised legislative proposals for the extension of tax on split income (“TOSI”) to certain adults. Concurrent with the release from the Department of Finance, the CRA released guidance on how it would apply the proposed TOSI rules, and in particular the proposed rules that feature reasonableness criteria.

Tax Policy Concerns

As discussed in our July 2017 Tax Notes, the Department of Finance is concerned with the ability of private corporations (and particularly professional corporations) to distribute pre-tax or after-tax profits to shareholders or creditors who are not actively involved in the corporation’s business. Since these non-active shareholders or creditors are likely not subject to tax at the top marginal rate, the overall result of these distributions is a reduction in tax payable versus an either unincorporated business or a corporation with no non-active shareholders.

Proposed Legislation

Like the original July 18, 2017 proposals, the Department of Finance’s December 13, 2017 proposals would address the tax policy concerns by extending TOSI to adults. However, the December 13, 2017 proposals are significantly narrower in scope than the July 18, 2017 proposals, and are drafted in a much more concise manner.

Extension of TOSI to Adults

TOSI is currently imposed on the “split income” of a “specified individual”, and causes that split income to be taxed at the highest marginal rate. A corresponding deduction is claimed by the specified individual so as to avoid double taxation. No personal tax credits, other than dividend tax credits and foreign tax credits, can be claimed to reduce TOSI.

The proposed amendments simplify the definition of specified individual so that it encompasses every adult resident in Canada at the end of a taxation year and any minor resident in Canada at the end of a taxation year with a parent resident in Canada at any time during the year. This definition is complemented by the new definition of “source individual”, which is defined as an individual resident in Canada at any time in the year who is related to a specified individual.

Split income will continue to include taxable dividends and shareholder benefits from private corporations, as well as certain partnership and trust distributions. Under the proposals, interest on

certain debt obligations issued by private corporations, partnerships or trusts will be included in split income, as will capital gains realized on the disposition of shares of private corporations or certain interests in partnerships, trusts and debt obligations.

Split income does not include any amount that is an “excluded amount” received by a specified individual. All of the following items are examples of excluded amounts for specified individuals age 18 and over:

- For specified individuals over age 24, income from a share or a capital gain realized on a disposition of a share if:
 - The corporation is not a professional corporation and less than 90% of the income of the business from its last taxation year is from the provision of services;
 - The specified individual owns shares with 10% or more of the votes and value attached to all of the shares of the corporation; and
 - All or substantially all of the non-services income of the corporation is not derived, directly or indirectly, from a business in which a source individual is involved.
- For specified individuals age 18-24, income that is a return on capital (dividends, interest, etc.) that either does not exceed the prescribed rate of interest (currently 1%) or is a reasonable return on capital obtained otherwise than from a business carried on by a source individual, a loan or an *inter vivos* gift from a related person.
- For specified individuals over age 24, income derived directly or indirectly from a business in which a source individual is engaged if the income is reasonable, having regard for work performed, property provided, risks assumed, prior returns and remuneration, and any other potentially relevant factor.
- Any capital gain realized by an adult on a disposition of a qualified farm or fishing property or a qualified small business corporation share, and any capital gain realized by a minor on an arm’s length disposition of a qualified farm or fishing property or a qualified small business corporation share. This exception applies even if the capital gains deduction is not claimed.
- Income received directly or indirectly from, among other things, a business in which the specified individual was employed for an average of 20 hours per week in the current year or any five prior years, or a business – whether carried on directly, through a partnership or through a corporation – in which a source individual is not active or does not own shares.
- Income or capital gains from certain property inherited by an individual under age 24.
- Income or capital gains from property obtained as part of a qualifying matrimonial property division.
- Capital gains realized on the death of the specified individual.

Supporting rules clarify that, in determining whether a return is reasonable in relation to property that was acquired by an individual or by a trust maintained for the benefit of an individual upon the death of another individual, the recipient individual is placed in the same position as the deceased individual. Furthermore, the spouse or common-law partner of an individual age 65 or older will not be subject to TOSI if the individual's spouse or common-law partner would not be subject to TOSI had the spouse or common-law partner received the income or realized the capital gain.

It is still proposed that these amendments will come into force on January 1, 2018. However, for the purpose of determining if a capital gain from the disposition of a share of a private corporation is an excluded amount, the requirement that the specified individual must own 10% or more of the votes attached to all of the shares of the corporation will not come into effect until January 1, 2019. TOSI will potentially apply to any other post-2017 capital gains realized on a disposition of private corporation shares that are not qualified small business corporation shares and that are not excluded shares.

CRA Administrative Guidance

The CRA has provided guidance on how it anticipates that the proposed TOSI rules will apply to real-world situations. This guidance includes examples of when split income will or will not arise, as well as examples of what the CRA will consider in determining whether a return is reasonable.

Much of what is contained in the CRA's administrative comments is a non-controversial explanation and application of the proposed legislation. More usefully, the CRA has addressed many of the concerns previously raised by practitioners in a practical manner. For example:

- Interest received by parents investing in a child's start-up business will be reasonable if the rate charged by the parents is similar to the rate charged by other investors;
- The reasonability test will not apply to a dividend paid on a share if another exclusion applies, regardless of the quantum of the dividends paid to each shareholder and the relative value of the work performed by each shareholder;
- A spouse will assume risks in relation to a business if the spouse guarantees the business debt, and a reasonable return on the risks assumed will approximate an arm's length guarantee fee;
- Dividends paid to a spouse who provides part-time services to a professional corporation will satisfy the reasonability test if the dividends approximate amounts that would be paid for similar services, even if the dividends slightly exceed market prices;
- If a business is a seasonal business, specified individuals working in the business need only meet the 20 hour per week threshold during the times that the business is active;
- Deemed dividends arising on a repurchase of shares issued as part of a "freeze" transaction may not be subject to TOSI; and

- If no shareholder is active in a business, then TOSI will probably not apply to dividends paid rateably to all shareholders if all shareholders have assumed similar risks.

In assessing whether a return is reasonable, the CRA is willing to consider a broad, non-exhaustive list of factors. For all intents and purposes, if a factor would be considered by arm's length parties in negotiating a return on capital or the remuneration of a contractor or employee, it is likely that the CRA will consider that factor in determining reasonability.

Implications for Taxpayers

The December 13, 2017 proposed TOSI rules are far simpler than the July 18, 2017 TOSI rules, and are far narrower in their scope. While there may be little practical change from the earlier draft legislation for the shareholders of professional corporations or members of professional partnerships, the reduction in the scope of the TOSI proposals means that the shareholders of many other private corporations will be able to avoid the application of the TOSI rules without taking any further action.

If the spouse and adult children of a controlling shareholder of a private corporation do not own voting shares and the corporation carries on a business other than a services business, it would be prudent for the capital of the corporation to be reorganized to ensure that all shareholders related to the controlling shareholder own 10% of the votes and value attached to the outstanding shares. By doing so, the controlling shareholder can ensure that dividends paid to the related shareholders and capital gains realized by the related shareholders will be excluded from the TOSI rules, regardless of whether or not those other shareholders are involved in the business in any way.

For corporations carrying on services businesses, professional corporations, or corporations where it is not possible to issue voting shares to non-controlling shareholders, there are a number of bright-line tests that can be met in order to avoid TOSI. For example, non-controlling shareholders could ensure that they work at least 20 hours per week in the business, or the corporation could be regularly "purified" in order for shares to qualify as qualified small business corporation shares, thereby permitting capital gains strips. In the latter case, advisors will have to be proactive in helping clients maintain the asset thresholds for operating corporations.

In any other case, it will likely be necessary for specified individuals to rely on the reasonableness test in order to avoid having dividends or capital gains classified as split income. The revised draft legislation makes the reasonableness test more intelligible and addresses issues with the application of the test, including permitting returns on property transferred to testamentary spousal trusts to be tested using the testator's activities, investments and risks. At the same time, the CRA's administrative statements allow for optimism that reasonability should be determined in a commercially sound, common-sense manner.

Some professional corporations or corporations carrying on services businesses will have non-professional and non-active shareholders who will not be able to acquire 10% of the voting shares, work 20 hours per week in the business or satisfy the reasonableness test. It may be advantageous for those corporations to undertake additional tax planning before the end of 2017 in order to allow the non-professional, non-active shareholders to receive dividends or realize capital gains without attracting TOSI.