Tax Changes Affecting Private Corporations: Tax on Split Income (TOSI)

As outlined in our previous publication **Tax Proposals Affecting Private Corporations – Initial Government Response Following Consultation Period**, the federal government released a tax consultation paper in July 2017 affecting private corporations. The consultation paper outlined proposed policy responses (along with original draft legislative proposals) for certain tax planning strategies involving private corporations that it perceives unfairly reduce personal taxes of high income earners through a variety of tax reduction strategies unavailable to other Canadians. Ultimately, final legislation regarding one of these targeted strategies, income sprinkling, was released and enacted with new tax rules taking effect as of January 1, 2018.

Background

In October 2017 (after the consultation period expired), the government made several announcements with respect to these proposals affecting private corporations, including that it would not move forward with some measures outlined in the consultation paper, namely measures to limit access to the Lifetime Capital Gains Exemption (LCGE) and measures relating to the conversion of income into capital gains. On the other hand, the government also announced at that time that it would be proceeding with measures to limit tax deferral opportunities related to passive investments, the details of which were ultimately included with legislative proposals in the 2018 federal budget and subsequently enacted into law. Please see our **Federal Budget Review – 2018** for a summary of these new rules.

In addition, the consultation paper addressed income sprinkling, a strategy which can reduce income taxes by causing income (such as dividends and capital gains) that would otherwise be realized by an individual facing a high personal income tax rate to instead be realized by family members who are subject to lower personal tax rates. At the time of the October 2017 announcements, the government acknowledged the complexity and the potential impact of the original draft legislative proposals on small family businesses. It noted that the measures could create uncertainty as to how amounts received from a family business would be taxed. As a result, while it reiterated that it intended to move forward with these measures to limit income sprinkling using private corporations, it indicated that it would simplify the income sprinkling proposals and ensure that the rules would not impact businesses to the extent there are clear and meaningful contributions by spouses, children and other family members. In December 2017 the government released revised draft legislative proposals, and subsequently added some further minor amendments, ultimately leading to final legislation which received Royal Assent in 2018. This final legislation regarding the measures limiting income sprinkling involving private corporations is the subject of this publication.

Income Sprinkling

Income sprinkling is a tax strategy designed to shift income that would otherwise be taxed in the hands of one individual (often a principal shareholder of a private corporation) subject to high tax rates, to another individual (often family members of the principal

business owner) subject to lower tax rates, in an effort to achieve a reduction in the overall family tax burden. This is commonly achieved using private corporations by structuring family members of the principal business owner as shareholders (either directly or through a family trust) so that they can receive income, such as dividends, from the corporation. Previous tax legislation, known as "kiddie tax" or tax on split income (TOSI), eliminated the ability to achieve any benefit of income splitting by imposing the highest marginal tax rate on certain income received by minors under the age of 18. Under the previous rules, TOSI was narrow in its application as it only applied to certain income (commonly dividends), and only to minor children. The tax proposals initially released by the government in July 2017 contained draft legislation that would significantly expand the TOSI rules to capture income splitting strategies involving private companies and family members **of any age**. The original proposals sought to expand the types of income subject to the TOSI rules and introduced a "reasonableness" test to determine their applicability. Specifically, the expanded draft TOSI rules released in July 2017 originally sought to tax distributions from a private corporation at the top marginal rate, where such income received by an adult family member was not "reasonable" taking into account the individual's labour and capital contribution to the business and previous returns/remuneration, in light of appropriate compensation commensurate with what an arm's length individual would receive for comparable contributions. These reasonableness tests would be stricter for individuals aged 18 to 24 years.

As noted above, concerns were raised during the consultation period in the fall of 2017 about the complexity of these originally proposed measures and how they would create uncertainty in relation to how amounts received from a family business would be taxed. The government's subsequent amendments to the final legislation are aimed at simplifying and better targeting its goal of limiting the ability of owners of private corporations to lower their personal income taxes by sprinkling their income to family members who do not contribute to the business.

Summary of Revised Income Sprinkling Rules Enacted

The final enacted legislation to address income sprinkling maintains the overall structure of the original proposals released on July 18, 2017, but with important changes to simplify and better target the rules, and to reduce the potential compliance burden in their application. Consistent with the original July 2017 proposals, the new legislation extends the TOSI rules to potentially apply to individuals aged 18 and over in respect of amounts that are received either directly or indirectly, from a related business. Moreover, these tax changes (which are effective for the 2018 and subsequent taxation years) are intended to clarify the process for determining whether a family member is significantly involved in a business, and thus is excluded from potentially being taxed at the highest marginal tax rate under the TOSI rules outlined previously. The final enacted legislation further seeks to simplify and clarify the reasonableness test, address potential unintended consequences and ensure that the TOSI rules do not limit access to the LCGE.

Specifically, the final legislation includes clear, "bright-line" tests to automatically exclude from the potential application of TOSI, individual members of a business owner's family who (among other exclusions) fall into any of the following categories:

- The business owner's spouse, provided that the owner meaningfully contributed to the business and is aged 65 or over – in an approach similar to the existing pension income splitting rules.
- Adults aged 18 or over who have made a substantial labour contribution (generally an average of at least 20 hours per week) to the business during the year, or during any five previous years.
- Adults aged 25 or over who own 10 per cent or more (of the votes and value) of a corporation that earns less than 90 per cent of its business income from the provision of services and is not a professional corporation.

- Individuals who receive capital gains from qualified small business corporation shares and qualified farm or fishing property, if they would not be subject to the highest marginal tax rate on the gains under the previous TOSI rules (regardless of whether or not the LCGE is claimed in respect of the taxable capital gain arising from the disposition). This exclusion parallels the October 2017 announcement by the government that it will not be moving forward with proposed measures that would have limited access to the LCGE.

Reasonableness test

Individuals aged 25 or over who do not meet any of the exclusions described above are subject to a reasonableness test to determine how much income, if any, would be subject to the highest marginal tax rate. Specifically, the TOSI on amounts derived directly or indirectly from a related business will only apply to the extent that the amounts exceed a "reasonable return", which is defined as an amount that is reasonable having regard to the contributions of the individual to the related business relative to other family members who have contributed to the business. It is intended that an amount will not qualify as a reasonable return from a related business only in cases where it is clearly evident that the amount received from the business is disproportionate relative to the contributions made – including labour contributions, capital contributions, and risks assumed – in light of any previous compensation.

In addition, special rules apply to individuals aged 18 to 24 who do not meet the above "bright-line" tests. Specifically, for these individuals who have contributed their own capital to a family business, a prescribed rate of return will be allowed (or in certain cases, a "reasonable return" on the contribution).

CRA Guidance

For additional clarity, the Canada Revenue Agency (CRA) has released guidance, along with continuing and evolving technical interpretations, with respect to these expanded TOSI measures. The CRA's guidance is intended to help businesses and family members understand the operation of the measures and correspondingly reduce their compliance burden in relation to these new rules.

Summary

As these new and expanded TOSI rules are very complex and wide-ranging, and may have significant implications to your particular tax situation, you should consult with your tax advisors for specific advice and direction on how your particular situation may be affected by these recent changes in the tax law.

Please consult with your external Tax Advisor for further information regarding these important income tax changes.

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