Is Income Splitting Still Possible with Private Corporations?

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Background on Income Splitting

- Income splitting allows families to *allocate* income to different family members to take advantage of their respective low marginal tax brackets. This effectively reduces overall taxes for the family.

- "Tax on split income" ("TOSI") rules were previously implemented in the tax legislation to limit the ability to income split with *minors*. If the TOSI rules applied, any split income to minors were taxed at the highest marginal tax rate.

- Conversely, *spouses* and *adult children* that held shares in the company could previously receive discretionary amount of dividends to utilize their respective low marginal tax rates.

Recent Income Splitting Rule Changes

- On July 18, 2017, the Department of Finance proposed amendments to expand the existing TOSI rules involving *adult* individuals. The intention was to ensure all Canadians paid their fair share of taxes.

- On December 13, 2017, Finance released revised draft legislative proposals on the TOSI rules.

- On June 21, 2018, Bill C-74 received Royal Assent. This bill implements the new TOSI rules, among several other measures that were announced in the 2018 federal budget.

Expansion of TOSI Rules

- New changes to the TOSI rules include:
  - Expanding the individuals subject to the TOSI rules to include *any* Canadian resident individual that receives income from a business of a *related individual*. That is, spouses and adult children can now potentially be subject to the new TOSI rules.
  - Providing various exceptions to the new TOSI rules (based on the age of the individual).
  - The new TOSI rules would apply to the 2018 and later taxation years.

Expansion of TOSI Rules

- In this context, “split income” will generally include dividends or interest paid by a private corporation directly or indirectly to an individual from a related business unless the amounts fall within certain exceptions.

- “Related Business” of an individual is any business of a corporation where another individual *related* to the former owns either shares of the corporation or property the value of which is derived from shares of the corporation and their fair market value is *not less than 10%* of the fair market value of all of the shares of the corporation.

- A Related Business in respect of an individual can also include a business of a sole proprietorship, corporation, partnership, or trust where another individual related to the former is *actively engaged* in the operation of the business.

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Exceptions to New TOSI Rules

- Under the *Income Tax Act*, the following will be exceptions to the new TOSI rules:

  1) Special Situations (e.g. death, marital breakdown);
  2) Excluded Business (for all adult individuals);
  3) Excluded Shares (for ages 25+);
  4) Reasonable Return (for ages 25+);
  5) Safe Harbour Capital Return (ages 18-24);
  6) Arm's Length Capital (ages 18-24); and
  7) Spouse Over 65 Years Old (for ages 65+).

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Exception – Special Situations

- There are exceptions to the new TOSI rules in the following special situations:
  - Income was received from property acquired as a result of the *death of a parent* when the recipient was under 25 years old.
  - Income was received from property acquired as a result of the death of any other person when the recipient was under 25 years old, and the recipient was enrolled in full time studies or was entitled to the disability tax credit.
  - Income was received from property as a settlement upon a *marital breakdown*.
  - The income was a capital gain arising from the deemed disposition of property upon the individual's death.
  - The income was a capital gain from QSBC shares or QFP (except for gains of a minor arising from the disposition to a related person).

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Exception - Excluded Business

- Income received from an Excluded Business will not be subject to the new TOSI rules. This exception can apply to *all* adults.

- “Excluded Business” = a business if the specified individual is **actively engaged** on a regular, continuous and substantial basis (i.e. average of 20 hours per week) in the activities of the business in either:
  - the current taxation year; or
  - in any five prior taxation years.

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Excluded Business - Issues

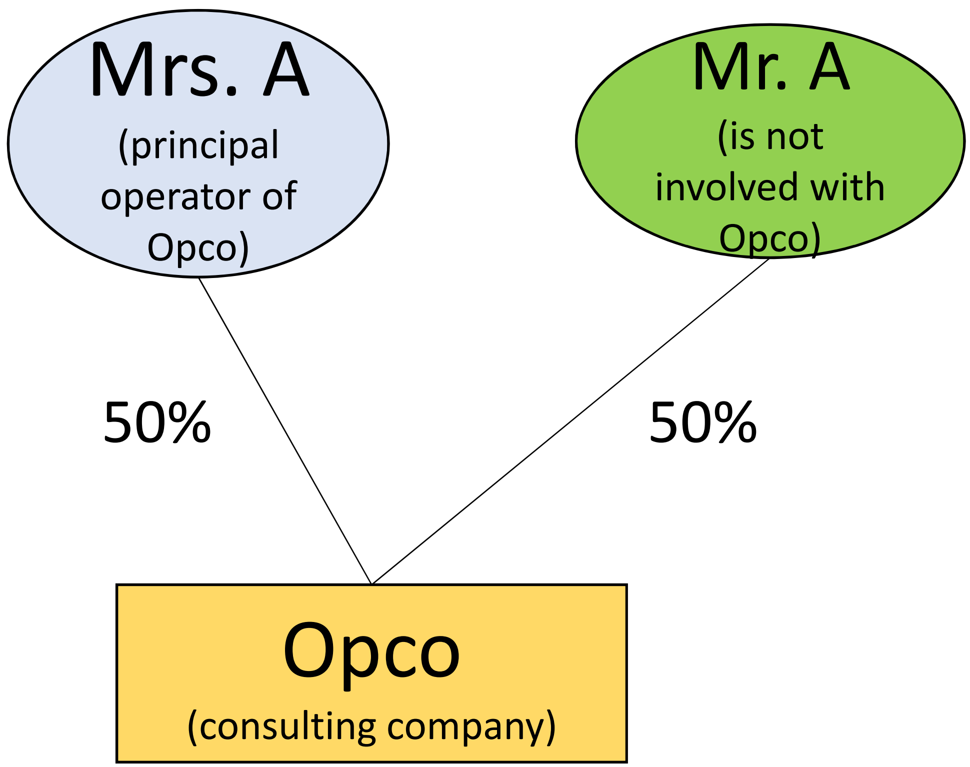
- CRA has indicated records such as payroll reports, timesheets, schedules, or logbooks retained by either an individual or a business will be sufficient to establish the number of hours the individual worked in a given year.

- Obtaining records for prior years may be difficult where an individual was not on payroll. The CRA said they will consider all information that may be available related to the history of the business.

- Going forward, it will be even more important to maintain records, or even put the individual on payroll to substantiate being actively engaged in the business.

Excluded Business Issue

Dividends paid to Mr. A would not meet the criteria in the Excluded Business exception as he is not actively engaged in Opco.



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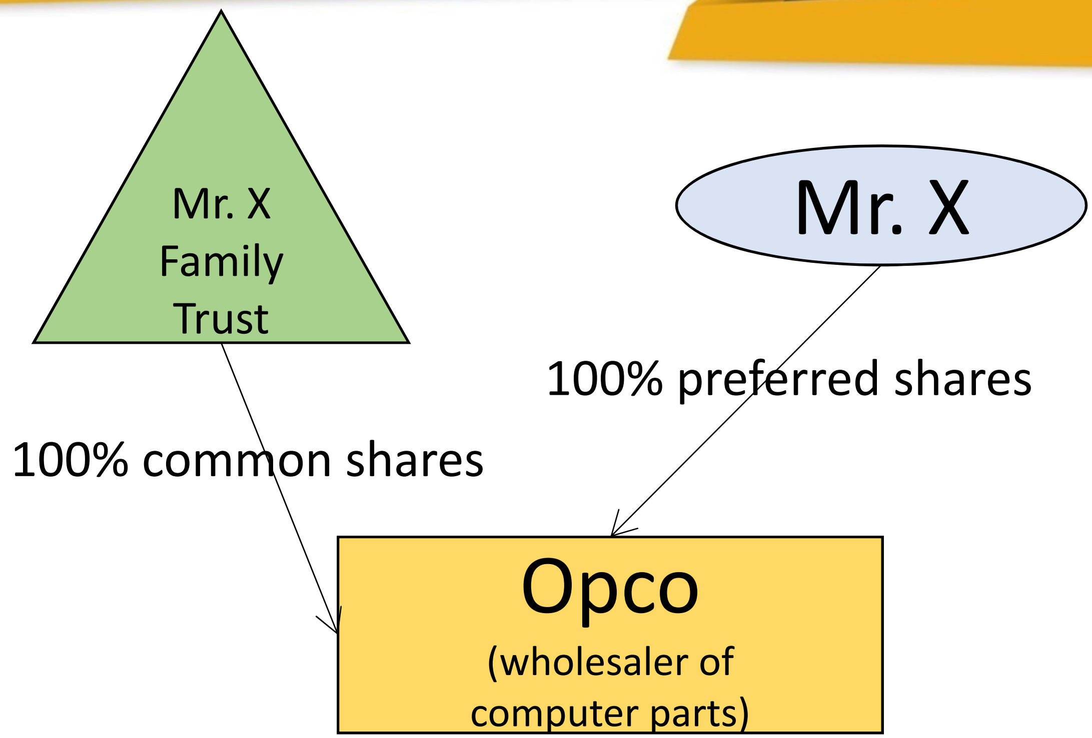
Example – Excluded Business



Mr. X stopped working in Opco during the current year but he has worked in the business at least an average of 20 hours per week during each previous taxation year since Opco was incorporated more than 20 years ago. He will be redeeming his preferred shares over time.

Application of TOSI rules:
The dividends deemed to be paid by Opco on the repurchase of the freeze shares held by Mr. X **will be an Excluded Amount** as the dividend is received from an **Excluded Business** in respect of Mr. X.

Exception - Excluded Shares

- Income received from Excluded Shares will not be subject to the new TOSI rules. This exception can only apply to individuals aged 25 and older.

- Excluded Shares are shares of a corporation where all of the following conditions are met:
  - less than 90% of the corporation's business income was from the provision of services (i.e. at least 10% of the income is from sources other than services revenue);
  - the corporation is not a professional corporation;
  - the individual holds shares representing 10% or more of the votes and value of the corporation; and
  - all or substantially all of the income of the corporation is derived from a non-Related Business in respect of the individual.

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Excluded Shares - Issues

- A “professional corporation” is a corporation that carries on the professional practice of an accountant, dentist, lawyer, medical doctor, veterinarian, or chiropractor. Accordingly, if the corporation carries out any of these practices, the Excluded Share exception will not be an option to avoid the TOSI rules.

- Given that the Excluded Share exception only applies to a specified *individual,* a family trust that directly holds the shares of Opco will be problematic. A special transitional rule allows corporations until the *end of 2018* to complete corporate reorganizations to meet the “votes and value test” in the Excluded Shares exception (e.g. roll out Opco shares to beneficiaries of the trust).

- Business structures with a holding company that owns all Opco shares will also be problematic in meeting the Excluded Share exception since all of Holdco’s income (e.g. Opco dividends) may be considered to be received from a related business (i.e. Opco).

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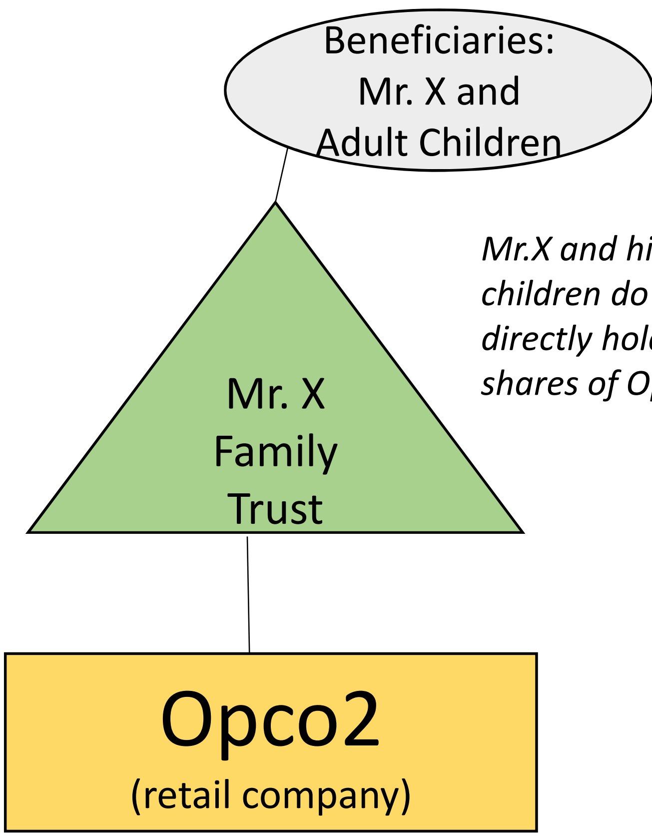
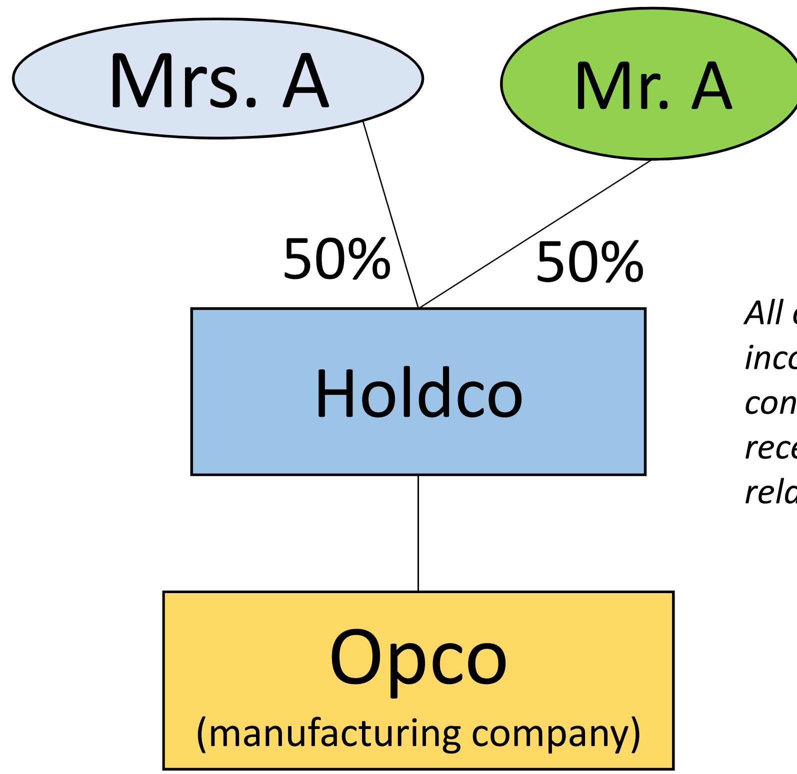
Excluded Shares Issue

Problems with these two types of structures for the Excluded Share *exception:*



Mr.X and his children do not directly hold shares of Opco2



All of Holdco's income may be considered to be received from a related business

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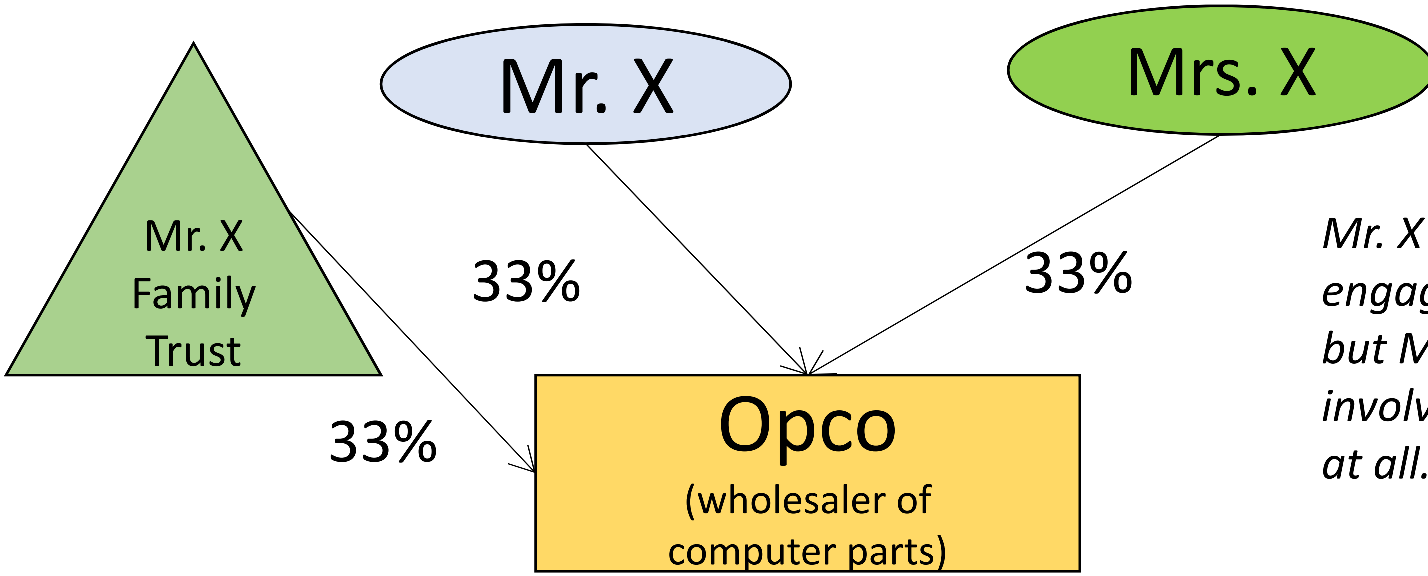
Example – Excluded Share



Mr. X is actively engaged in Opco but Mrs. X is not involved in Opco at all.

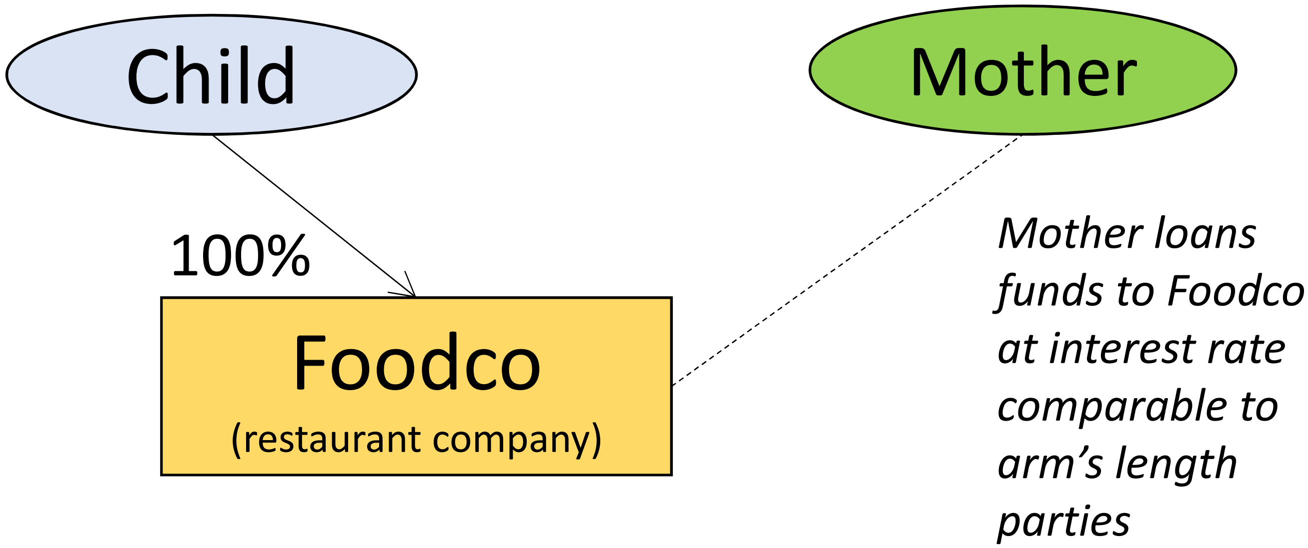
Application of TOSI rules:
Where dividends are paid by Opco to Mrs. X, this will be split income unless it is an Excluded Amount. Mrs. X holds shares that qualify as **Excluded Shares**. As such, the dividend received by Mrs. X **will be an Excluded Amount**.

Exception – Reasonable Return

- Income that does not exceed a Reasonable Return will not be subject to the new TOSI rules. This exception can only apply to individuals aged 25 and older. A reasonable return is based on one or more of the following criteria:

  - **Labour Contribution:** the work performed in support of the Related Business;
  - **Property Contribution:** the property contributed directly or indirectly in support of the Related Business;
  - **Risk Incurred:** the risks assumed in respect of the Related Business;
  - **Historical Payments:** the total amounts paid or payable by any person or partnership to or for the benefit of the individual in respect of the Related Business; and
  - Such other factors that may be relevant.

Example – Reasonable Return



Application of TOSI rules:

The interest paid to Mother from Foodco on the loan by Mother will be split income unless it is an Excluded Amount. In the circumstances, the interest charged by Mother on the loan will be an Excluded Amount because it is a Reasonable Return based on the property contributed and the risk assumed by Mother by lending money to Foodco.

Exception– Safe Harbour Capital Return

- Income that does not exceed a Safe Harbour Capital Return will not be subject to the new TOSI rules. This exception applies to individuals aged 18-24. This exception applies to individuals who have contributed capital to a related business but allows only a reasonable return up to a prescribed rate.
- A safe harbour capital return is determined as the return on property contributed by the individual to the related business. The formula to make this determination is the product of A x B, where:
  - A – is the highest prescribed rate of interest in effect for a quarter in the year; and
  - B – the fair market value of the property contributed by the individual in support of the business, pro-rated for the number of days the property was used in the related business in the year.

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Exception – Arm's Length Capital

- A similar reasonable return exception applies to individuals aged 18-24. However, it only applies to contributions of *arm's length capital*.

- Therefore, the amount subject to TOSI can be reduced or eliminated if the individual is able to justify that the amount received represents a reasonable return on his or her own property contributed to the business, meaning that the property is *not*:
  - transferred to him or her by any means from a related person (other than as inheritance);
  - derived from income, gains or profit from a related business; and
  - borrowed from any source (including from arm's length sources).

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Exception – Over 65 Years Old

- Certain exception applies to individuals aged 65 or older.

- The new TOSI rules will not apply on income received by a specified individual, if the following conditions are met:
  - The same income would not be subject to the TOSI rules, if it was received by the specified individual's spouse; and
  - The spouse is at least 65 years old in the particular year.

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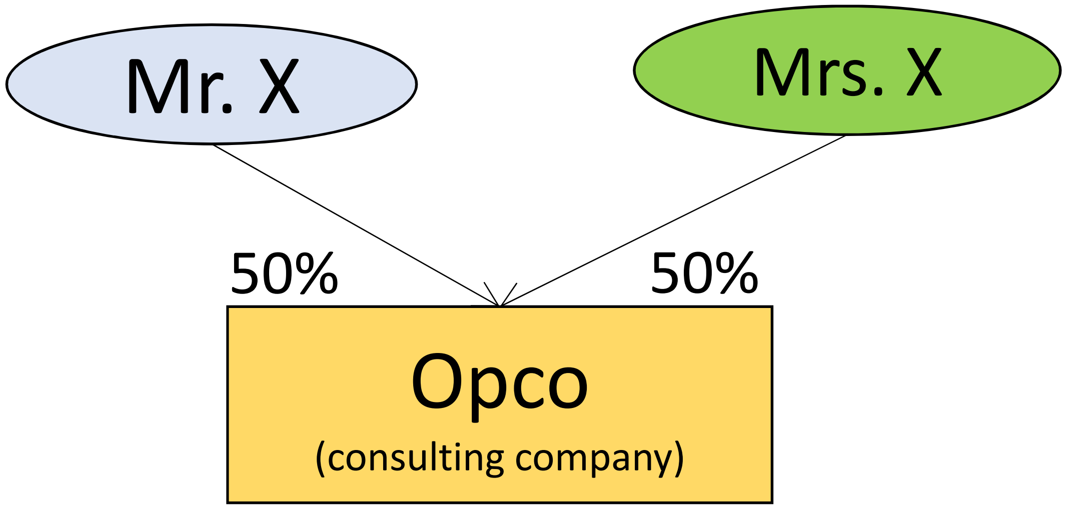
Example – Over 65 Years Old



Mr. X (65 years old) is actively engaged in Opco but Mrs. X (60 years old) is not involved in Opco at all.

Application of TOSI rules:

Where dividends are paid by Opco to Mrs. X, this will be split income unless it is an Excluded Amount. Mrs. X will meet the 65 years old/retirement exception as Mr. X's dividends would meet the Excluded Business exception (i.e. he is actively engaged in Opco) and he is over 65 years old. As such, the dividend received by Mrs. X **will be an Excluded Amount**.

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Summary

- Don’t ignore the TOSI issue – the rules have been enacted and are no longer “proposed”.

- Review corporate structure to determine if the new TOSI rules will apply to your situation:
  - Which TOSI exceptions will be met, if any?

- Consider if any changes need to be made to operations or structure to meet the TOSI exceptions:
  - Using timesheets to substantiate being “actively engaged” for Excluded Business exception
  - Transfer of Opco shares held by holding company or trust to the individual’s hands to meet the “Excluded Share” exception
  - Wait for business owner to reach 65 years old

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