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Tax Alert — Canada

Finance releases revised income splitting measures

On 13 December 2017, federal Finance Minister Bill Morneau released new draft legislation relating to income sprinkling. Consistent with the 18 July 2017 proposals, the new draft legislative proposals will extend the Tax on Split Income (TOSI) to individuals aged 18 and over. The revisions contain simplifications and address certain feedback concerns associated with the 18 July 2017 proposals, but parts of the revised draft legislation are quite complex. As the proposals take effect 1 January 2018, a detailed review of existing income splitting arrangements with an EY professional is highly recommended. Some existing or proposed arrangements may continue to be effective, while others are now restricted.

Background

On 16 October 2017, federal Finance Minister Morneau announced that the government would simplify the draft TOSI legislation proposed on 18 July 2017. Over 21,000 submissions were made by Canadians in response to the July proposals, many including concerns over how the expanded TOSI proposals could apply to disadvantage families engaged in ordinary commercial arrangements.

On 13 December 2017, federal Finance Minister Morneau released new draft legislation addressing TOSI. These revisions represent an overhaul of the proposed TOSI rules. Certain aspects of the revised rules are complex and subject to interpretation. The revised rules will generally apply effective 1 January 2018. The Canada Revenue Agency (CRA) also released guidance on how they would apply the revised TOSI rules.

Of particular concern is that certain exclusions to the application of TOSI specifically target and preclude service-based businesses and professionals from accessing the exclusions. Neither the *Income Tax Act* (the Act) nor the proposed legislation contains a definition of what constitutes "the provision of services." It is yet to be seen how these aspects of the rules will be interpreted by CRA and what impact this will have on the large number of private service-based companies in Canada.

Concerns addressed by the revised legislation

The revised legislation addresses some of the issues that may have resulted from the 18 July 2017 proposed TOSI legislation, particularly:

- Capital gains on the arm's length disposition of shares that are qualified small business corporation (QSBC) shares, or qualified farm or fishing property, will be eligible for the Capital Gains Exemption (CGE Property), despite income from, or gains on, the shares otherwise being subject to TOSI. Family trusts that dispose of CGE Property and allocate the gains amongst beneficiaries will also be able to access this TOSI exclusion, assuming the various other criteria are met. Minor-age related family members remain able to access this exclusion, whether the shares are held directly or indirectly via a family trust. Non-arm's length dispositions of shares that generate capital gains will be re-characterized as ordinary dividends consistent with the existing TOSI legislation.

- Any capital gains realized as a consequence of death will not be subject to TOSI. This change is a welcome relief, as TOSI gains realized on death may previously (under the 18 July 2017 proposals) have been converted into high-taxed ordinary dividends and not half-taxed capital gains.

- A "bright line" test deeming individuals working at least an average of 20 hours per week to be actively engaged on a regular and continuous basis has been included. This rule addresses previous concerns about how a reasonableness test would be applied in determining whether income would, or would not, be subject to TOSI, and is supplementary to the reasonable facts and circumstances tests still contained in the revised legislation.

- The extended definition of "related persons" has been narrowed and no longer includes aunts, uncles, nieces or nephews.

- Property transferred as a consequence of a breakdown in a marriage or common-law relationship will not be subject to TOSI, where the spouses or common-law partners were separated and living apart as a result of the relationship breakdown.

- Reinvestment of income that has been subject to TOSI will generally not be further subject to TOSI in and of itself and will generally form part of the available capital of a family member to reinvest (subject to certain restrictions for individuals aged 18 to 24).

Who and what are impacted by the revised TOSI proposals?

Both the July and December proposals expanded the income streams that could be subject to TOSI, particularly to interest income generated on indebtedness, and income or gains from the disposition of property. This is in addition to the existing definitions in the Act for split income, being private company dividends, and certain trust and partnership income allocations.

The revised structure of the TOSI legislation is that all Canadian residents (and in the case of minors, an individual having a parent resident in Canada) fall within the definition of "specified individual" and within the ambit of TOSI.

A recommended approach to understanding whether the revised legislation will impact arrangements is to identify whether a particular amount is "split income", and thereafter whether the amount could qualify as an "excluded amount". Split income that is not otherwise an excluded amount will be subject to tax at the highest marginal rate. Split income generally arises when the income stream is connected directly or indirectly to a "related business", defined as when a related person is active in a business or owns 10% or more of the shares in a corporation that carries on the business.

A comprehensive analysis of all potential TOSI scenarios is beyond the scope of this Tax Alert; however, the following are common situations where TOSI may, or may not, apply based on the age category of the specified individual:

Minors

- Unless property has been inherited as a consequence of the death of a parent, any income or gains meeting the definition of "split income" will be subject to TOSI (with the exception described above on capital gains realized from direct or indirect dispositions of QSBC shares).

Individuals age 18 to 24 (returns on capital contributed)

- Income on capital contributed to a related entity, for example shares, debt or a partnership interest, can be paid to the individual but must be limited to the prescribed rate of interest (currently 1%).
- A higher than prescribed rate of return can be paid on capital contributed to a related entity; however, it must be reasonable, taking into account certain interpretive and judgmental factors, and must be from "arm's length capital". Generally speaking, the only source of arm's length capital will be from earnings or gains associated with non-related sources. The arm's length capital test precludes the individual from using loans or indebtedness (regardless if the borrowing is from an arm's length source such as a bank), property acquired directly or indirectly from a related person, and earnings or gains generated from a related business.

Individuals age 18+

- To the extent the individual is actively engaged on a regular, continuous and substantial basis in either the current year, or any cumulative five prior years, income generated from the business can be paid to the individual without the application of TOSI. As discussed above, it is a question of fact whether the individual is working a sufficient amount to meet this test, but they will be deemed to meet the test if they work an average of 20 hours per week while the business is operating. Once the five years of active/regular work threshold has been met (regardless of whether the years are consecutive), there are no TOSI restrictions on receipt of income by the individual. It should be noted that this exclusion will not apply to restrict TOSI on direct or indirect capital gains realized by the individual on property connected with the business.

Individuals age 25+

- Income or gains can be realized by the individual to the extent it is a reasonable return from the related business, taking into account judgmental factors such labour efforts, capital contributed, risks taken, other payments already received from the business, and other factors that may be deemed relevant. There is no requirement that the capital contributed by the individual be from an arm's length source.

- Income or gains can be realized by the individual to the extent they are from "excluded shares", regardless of whether the individual is active (or not) in the related business. As discussed in "Unanswered questions" below, the required criteria to meet the excluded share definition may have unintended consequences or ambiguous outcomes that will preclude access to the TOSI exclusion. The requirements for excluded shares are that:

  - The individual directly owns shares carrying 10% of the votes and value of the corporation;

  - The business income of the corporation is derived less than 90% from the provisions of services;

  - The corporation is not a professional corporation; and

  - All or substantially all of the income of the corporation for the particular year is not derived directly or indirectly from one or more other related businesses.

Individuals age 65+

- To the extent an amount of income, profit or gain would not be subject to TOSI in the hands of a spouse aged 65 or older, the other spouse may receive income from the related business independently of any TOSI exclusions. This rule is intended to align the TOSI rules with existing pension income splitting legislation.

Unanswered questions

Family trusts

There may be ambiguity on whether any of the TOSI exclusions will apply to income allocated from a family trust where the property generating the income within the trust is a debt or loan instrument. This problem arises because the TOSI exclusion criteria require the amount of income or gain be from property held by the specified individual. While trusts that allocate capital gains and dividends have specific rules in the Act that deem the receipt of these amounts to be directly by the individual trust beneficiary, no comparable rule exists for the allocation of ordinary income by a trust (such as interest on debt instruments). It is unclear whether the TOSI legislation will be further updated to address this ambiguity.

Additionally, and if using the TOSI exclusion "excluded shares" definition, a direct holding of shares by the specified individual is required. One planning consideration to address the direct ownership requirement may be that a family trust reorganize its shareholdings and distribute shares on a rollover basis to a beneficiary. Monitoring the value of the shares will be required to ensure they meet the 10% test (for example, typical growth shares in an estate freeze may not qualify for some time). Families will also need to balance and weigh governance, family law, probate and commercial issues associated with direct shareholdings of a family member versus the benefits of holding assets in a trust.

Holding companies

One of the more anticipated TOSI exclusions to be relied upon is the "excluded shares" definition. As described above, the definition of "excluded shares" requires that all or substantially all of the income of the corporation for the particular year not be derived directly or indirectly from one or more other related businesses; the definition of related business includes a business carried on by any corporation where a related person owns more than 10% of the shares, or where the related person is active in the corporation's business.

Based on these interacting definitions, it is possible that dividends flowed from a wholly owned operating corporation to a holding company cannot, in the particular year, be paid to an excluded 10% shareholder without attracting TOSI; this is because the dividend would indirectly be derived from a related business. On the other hand, if the operating company were directly owned by the 10% excluded shareholder, the amount would not be subject to TOSI. Additionally, it would appear that delaying the holding company dividend payment to the specified individual/excluded shareholder to another year (where no other operating company dividend payments are received) may exempt the dividend from TOSI. It is unclear whether these anomalous outcomes were unintended in the drafting of the legislation.

Investment companies

The draft legislative proposals include an iterative deeming rule stating that "an amount derived directly or indirectly from a business includes an amount that is [itself] derived from an amount that is derived directly or indirectly from the business". It is possible that this proposal may deem investment earnings of a holding company funded from an operating subsidiary's dividends to be related business income (where a related person is active in the operating subsidiary), making distributions of the holding company's investment income potentially ineligible for the "excluded share" criteria. The Department of Finance's explanatory notes appear to confirm this interpretation, in that they state the provision is "an iterative rule so that income derived from income derived from a business is income derived, directly or indirectly, from the business."

It also possible that the general TOSI principles may extend to income generated by an investment company within a corporate structure, as the Act defines a "business" to include an undertaking of any kind and therefore could also potentially extend the "related business" definition to investment companies, where applicable.

Tax planning considerations

Certain historic and commonly used tax planning arrangements are affected by the revised TOSI legislation, while other arrangements have been left unaddressed in both the 18 July 2017 and 13 December 2017 TOSI proposals. The following tax planning considerations should be considered in light of the new rules:

- Any amounts that will be subject to TOSI on or after 1 January 2018 should be evaluated to see if an accelerated payment could be made on or before 31 December 2017. While a prepayment of tax may result, the marginal tax rate benefits would generally outweigh the opportunity cost of the tax prepayment. Additionally, and as discussed in EY's Tax Alert #51, the tax rates associated with non-eligible dividends will increase on 1 January 2018 and further enhance the benefits of accelerating dividend payments in the 2017 calendar year.

- Prescribed rate investment loans: individuals or family trusts may borrow at a fixed prescribed-rate, currently 1%, and use the borrowed funds to invest in a portfolio of marketable securities. Any income or gains earned in excess of the interest expense will be taxed in the hands of the individual borrowers (or beneficiaries of the family trust), regardless of age. Certain substantial private placements and investments in related family companies may also be permissible, but subject to a more complex analysis of the current TOSI proposals as described above.

- Reasonable salaries paid to family members for services performed will be deductible to the payer of the wage and taxable in the hands of the recipient. The TOSI proposals do not address employment income and remuneration.

- Eligible pension income continues to be eligible for splitting amongst married and common-law couples. The TOSI proposals do not address the splitting of pension income.

Other considerations

The Finance Minister's TOSI announcement was preceded on the same day by a Report of the Standing Senate Committee on National Finance, which was critical of the 18 July 2017 proposals, particularly recommending that:

- the Finance Minister withdraw the proposed 18 July 2017 tax changes;
- the government undertake an independent and comprehensive review of Canada's tax system; and
- if the Finance Minister proceeds with changes to the Act, the application of any proposed changes be delayed to at least 1 January 2019.

It is yet to be seen what impact the Senate committee report will have on the proposals, given that some of the July proposals have already been withdrawn by the government.

Learn more

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