

The TaxLetter®

Vol. 36, No. 1

Your Guide to Tax-Saving Strategies

January 2018

TAXSTRATEGY

New and improved

TAX ON SPLIT INCOME

Samantha Prasad

The year 2017 was a crazy one for many taxpayers, what with the new proposals for private corporations, and then various subsequent releases, revisions and backtracks. When I last did a recap, in November, I noted that the government was to still release draft legislation “some-time in the fall” of 2017 related to the tax on split income (TOSI) rules. In fact, I joked that, technically the government had until December 20, since the first day of winter did not start until December 21st. Who knew that my joke was only a week shy of becoming a reality, as the draft rules did not get released until December 13, 2017. Nothing like leaving it to the last minute,

Samantha Prasad, LL.B., is a tax partner with the Toronto-based law firm Minden Gross LLP, a member of Meritas Law Firms Worldwide, and a Contributing Editor of The TaxLetter, published by MPL Communications.
sprasad@mindengross.com

and just in time for the December holiday season.

A Kiddie Tax

As a refresher for those that may have forgotten what the TOSI rules are all about, here we go. On July 18, 2017, it was announced that the current “kiddie tax” rules were to be expanded to apply to all related persons (and not just minors), so that all family members who receive dividends from a family corporation will be subject to the top federal tax rate (unless such amounts paid are reasonable, in light of the services or contributions (including financial) they provide to the company).

On October 16, 2017, the Department of Finance announced that it would make changes to simplify the proposals. Although it did not release amended legislation in October, it did provide examples to show

how it would apply the rules. The government went on to state that it would ensure that the rules will not impact businesses, to the extent that there are “clear and meaningful contributions” by the family members to the business, with certain “reasonableness tests” to be introduced to determine what those contributions were to be. And although the government also announced that it would not proceed with the capital gains exemption proposals, a question still simmered in the tax community: How would the revised legislation for the TOSI rules impact the capital gains exemption proposals, to the extent that such capital gains are caught by the TOSI rules?

Simplified Rules

On December 13, 2017, the government released the draft legislation for TOSI, noting that they were simplifying the proposed tax measures, which would apply as of January 1, 2018. These amended rules were meant to clarify the process for determining when and how a family member would be considered to have made a contribution to the business so as to be exempt from the TOSI rules.

The new rules set out certain exclusions to the TOSI rules for certain “specified individuals”:

1. A business owner’s spouse, where the owner meaningfully contributed to the busi-

ness, and is aged 65 years or older (this is meant to track to the current pension income sprinkling rules in place);

2. Adults aged 18 or over who are engaged on a regular, continuous and substantial basis in the business (i.e. averaging at least 20 hours per week) during the year, or during any given previous years (if the business is seasonal, then the 20 hours per week would be applied to the part of the year the business is operational);

3. Adults aged 25 or over who own 10 per cent or more of the votes and value of the corporation that earns less than 90 per cent of its income from providing services. This specifically excludes professional corporations, such as lawyers, accountants, doctors or dentists.

4. Individuals who realize taxable capital gains from the disposition of qualified small-business corporation shares or qualified farm or fishing property, provided that they would not be subject to the top tax rate on such gains under existing rules. (This is some good news, as the capital gains exemption will still be available under the current rules).

If a family member does not meet any of the above exclusions, then we would look to the new reasonableness tests in order to determine if a family member is considered to have meaningfully contributed to the business.

What's Reasonable?

For individuals aged 25 and over, the reasonableness tests

consider whether such individuals have made contributions to the business through any combination of the following factors:

• Labour contributions: Factors to look at include the nature of the tasks performed, hours required to complete the tasks, education, training and experience, business acumen and particular knowledge, to name a few.

• Property contributed directly or indirectly to, or in support of, the business: This can include amount of capital, loans, fair market value of property (including technical knowledge, skill etc), collateral for loans, etc.

• Risk assumed in respect of the business: Has the individual exposed themselves to the financial liabilities of the business (i.e. guarantees); is their reputation or goodwill at risk; is the risk indemnified?

• Total amounts paid: Are other amounts paid, such as salary, dividends etc., access to benefits or deemed payments;

• Any other relevant factors.

Individuals between the ages of 18-24 will be permitted a prescribed rate of return (i.e. safe harbor capital return) on capital contributed to a related business (if capital is contributed to an unrelated business, the individual will be allowed a reasonable return on the contribution).

There were some notable omissions in this version of the legislation, when compared to the original July 18 proposals. Specifically, the TOSI rules will no longer apply to:

• compound income (i.e.

income earned from the investment of an initial amount of income that is subject to the TOSI or attribution rules)

• aunts, uncles, nieces or nephews

• income derived from property acquired as a result of the breakdown of a marriage or common-law partnership

Moreover, capital gains realized on a transfer of shares by adults aged 18 or over to a non-arm's length person will not be deemed a dividend and taxed as such (However, the current rules, pre-July 18, 2017, will continue to apply for minors, subject to a proposal to provide for an exemption for minors, where a capital gain arises as a consequence of death).

Finance also confirmed that it will not move forward with the measures to limit access to the lifetime capital gains exemption. Additionally, capital gains from property that qualifies for the capital gains exemption will be exempt from the income sprinkling rules.

So, where does all of this leave us? Well, we have a new version of draft legislation that is theoretically in effect as of January 1, 2018. Some of us managed to get some last-minute tax planning between December 13 and the 31, and all of us now are subject to rules that are still in draft form. But the CRA has always taken the position that you should tax plan and file as if draft legislation is the law. So, unless we hear otherwise from the government, it seems like TOSI is here to stay. □