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On October 16, 2017, federal Finance Minister Bill Morneau announced that the government would simplify the July 18, 2017 draft proposed Tax on Split Income (“TOSI”) legislation.

On December 13, 2017, Minister Bill Morneau released new draft legislation relating to income sprinkling. These revisions represent substantial changes to the July 18, 2017 draft proposed TOSI rules.

The purpose of this tax alert is to summarize these new revised income splitting measures and how they compare to the July 18, 2017 draft proposal.

What has changed?

1. 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 deduction, regardless of whether the income from, or gain on, the shares otherwise would be subject to TOSI.

   This is a very important change as it allows the continued use of family trusts in corporate structures as a way to multiply the capital gains deduction on the eventual sale of an incorporated business. Furthermore, minor-aged family members remain eligible to claim the capital gains deduction, regardless of whether the shares are held directly or indirectly through a family trust.

2. Inclusion of additional “bright-line” tests. This change addresses some of our previous concerns about how a reasonableness test would be enforced in evaluating whether TOSI is applicable.

   Adult family members of a business owner who fall into any one of the following categories will automatically qualify for exclusion from the TOSI:
   a. The business owner’s spouse, if the business owner is aged 65 or over and is or has been actively engaged in the business or owns 10% or more of the equity in the corporation carrying on the business (the “Seniors exemption”);
   b. Adults aged 18 or over who have made a substantial labour contribution to the business (generally at least 20 hours on average per week) during the year or any cumulative five prior years (the “Excluded business exemption”);
   c. Adults aged 25 or over who:
      i. Directly owns shares that carry a minimum of 10% of votes and value of the corporation;
      ii. The business income of the corporation is derived less than 90% from the provision of services;
      iii. The corporation is not a professional corporation; and
      iv. No more than 10% of the income of the corporation for the particular year is derived directly or indirectly from one or more other related businesses (the “Excluded shares exemption”).

3. Capital gains realized as a result of death will not be subject to TOSI.

   This change addressed our previous concerns about how TOSI gains realized on death may have been recharacterized into high rate dividends and not capital gains.

4. Definition of “related persons” no longer includes aunts, uncles, nieces or nephews.

5. 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 a breakdown in their relationship.

6. Reinvestment of income that was subject to TOSI will generally not be subject to TOSI again.

What has not changed?

1. Effective date remains January 1, 2018.

2. Where a minor child does not meet any of the proposed exclusions, capital gains on the non-arm’s length disposition of shares by the minor child will be re-characterized as ordinary dividends taxed at the top marginal tax rate.

3. Where the proposed exclusions are not met, individuals will be subject to a reasonableness test and will be subject to the TOSI to the extent the amounts exceed a “reasonable return”.

4. Individuals ages 18-24 are still limited to a prescribed rate of return on capital contributed to a related business.
5. Do not have clarification of what is meant by “capital contributed”.

What do the changes mean to your family?

We have provided below some common situations where TOSI may, or may not, apply based on the age category of the specified individual:

Under 18 (Minors)

- Unless property has been inherited as a consequence of the death of a parent, any income or gains that meets the definition of “split income” will be subject to TOSI (with the exception noted above on capital gains realized from disposition of QSBC shares to arm’s length parties).

18 to 24 (Return on Capital Contributed)

- Generally, income on capital contributed to a related business can be paid to the individual but it must be limited to the prescribed rate of interest (currently 1%).

18 and Over

- “Excluded business exemption” as described above

25 and Over

- “Excluded shares exemption” as described above
- Reasonable return from the related business, considering factors such as labour efforts, capital contributed, risks taken, other payments already received from the business, and other case specific relevant factors.

65 and Over

- “Seniors exemption” as described above

What concerns or uncertainties do we have with the revised proposed TOSI legislation?

Partnerships

Unlike for corporations, there is no 10% equity ownership exclusion. As a result, income allocated from a partnership will have to rely on any one of the other exclusions noted above. If none of the exclusions are applicable, then the income allocated from a partnership would be subject to the reasonability test.

Family Trusts

If an individual is relying on the “excluded share” exclusion from the application of TOSI, a direct holding of shares by the specified individual is required. Family trusts may consider reorganizing its shareholdings and distributing shares on a rollover basis to its beneficiaries to meet the “Excluded shares exemption”. Various other considerations are also required.

Please note that we will be providing a letter with specific Trust considerations to our Trust clients in the near future.

Holding Companies

Based on the interacting definitions of “excluded shares” and “related business”, it is possible that dividends flowed from a wholly owned operating company to a holding company cannot, in the same year, be paid to an otherwise excluded 10% shareholder without attracting TOSI. This is because the dividend would indirectly be derived from a related business.

Investment Companies

It appears that investment earnings of a holding company funded from an operating subsidiary’s dividends may be deemed to be related business income, making distributions of the holding company’s investment income potentially ineligible for the “excluded share exclusion”.

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