FR Dollars and Sense

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REVISED INCOME SPLITTING PROPOSALS

By Ian V. MacInnis

On July 18, 2017, the Department of Finance released a series of controversial tax proposals aimed at closing perceived tax "loopholes" that involve the taxation of private corporations and their shareholders. These proposals included measures that would severely curtail income splitting, which is the practice of paying income to family members in a lower tax bracket using certain arrangements such as dividends on private corporation shares, or trust or partnership distributions. The current tax law imposes a special tax – called the "tax on split income" ("**TOSI**") – which applies to certain types of income paid to minor children. The TOSI applies at the top personal tax rate on non-salary income or gains derived from a private business. The proposals would extend the TOSI to individuals over age 18.

On December 13, 2017, the Department of Finance released revised draft legislation that addresses tax planning involving income splitting and the application of the TOSI. See attached. These proposed measures will apply to the 2018 and subsequent taxation years and respond to certain concerns that were raised during the public consultation process. The Canada Revenue Agency (the "**CRA**") also released guidance respecting these measures.

Beginning in 2018, the TOSI will be extended to apply in respect of certain amounts received by adult individuals. These amounts will include dividends or interest paid by a private corporation, directly or indirectly, to an individual from a related business, certain distributions of trust and partnership income, as well as capital gains from the disposition of certain property, subject to specific exclusions.

Exclusions from the TOSI

Under the revised rules, the TOSI will not apply to amounts received in a year in the following situations:

- Income received by a business owner's spouse where the business owner is 65 years of age or older;

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- Amounts received by a person aged 18 or older who works more than 20 hours a week in the business in the year or in any 5 prior years (which need not be consecutive);
- Amounts received by persons aged 25 or older who own at least 10% of the votes and value of the shares of the corporation carrying on the business, provided the corporation earns less than 90% of its income from the provision of services and the corporation is not a professional corporation (e.g. legal, accounting, medical and dental practices);
- Capital gains from the sale of qualified small business corporation shares and qualified farm or fishing property (i.e. property that would be eligible for the lifetime capital gains exemption), regardless of whether or not such exemption is claimed.
- Capital gains arising on an individual's death; and
- Income or gains from property received as a settlement upon marriage breakdown.

Individuals who do not meet any of the above exclusions will be subject to a reasonableness test to determine how much income, if any, would be subject to the TOSI. If an amount received is unreasonable, then the income will be taxed under the TOSI rules at the top personal tax rate. In certain cases, adults aged 18 to 24 who have contributed capital to a family business will be able to avoid the TOSI up to amounts which represent a prescribed return on their capital.

The CRA has issued guidance as to how it will interpret the reasonableness test through a series of examples. It might be expected, however, that the reasonableness test will be difficult to interpret with certainty in many cases.

The proposed rules will be effective for the 2018 and subsequent taxation years. However, the amendments include a transition provision that will allow the 10% ownership exclusion test to apply in 2018 provided the 10% ownership level has been is achieved by the end of 2018.

Other Changes

The December 13, 2017 proposals contain additional changes from what was proposed in July. These changes include the following:

- The TOSI will not apply to compound income (i.e. income earned from the investment of income that was subject to TOSI or other attribution rules);

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- Aunts, uncles, nieces and nephews will not be considered to be related individuals for purposes of the TOSI rules.

The Department of Finance also confirmed its intention to proceed with proposals that will limit tax deferral opportunities involving passive investments in private corporations. The details of these proposals will be included in the 2018 Federal Budget.

Please contact any member of our Tax Group to discuss how these proposed changes may impact you.