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Analysis of Revised Income Sprinkling (TOSI) Rules – December 13, 2017

Background

On December 13, 2017 the anxiously awaited revised rules for TOSI were released in the form of revised draft legislative proposals. These proposals revise the previous proposals released on July 18, 2017. The revised proposals maintain the underlying tax policy of extending the TOSI rules to adult family members, however there are a number of new changes that will reduce the impact on existing structures and future planning.

Additional information on this topic can be found on the Government of Canada, Department of Finance website at www.fin.gc.ca/n17/17-124-eng.asp including the actual amendments to the Income Tax Act and Regulations as well as CRA guidance on the proposed measures.

We continue to monitor interpretations and news releases related to the TOSI proposals. It is our expectation that these proposals are in fact going to be effective January 1, 2018.

In general terms for the average small business earning under $100,000 to $200,000 very little has changed from the original proposals, and in fact the rules have been made even tighter by the "Actively Engaged" test. Larger businesses make out slightly better and the capital gains exemption appears to be intact for qualified farm and fishing properties and qualified small business corporation shares.

There are a number of traps in the legislation and given the complexity level professional advice will continue to be very important in structuring and restructuring corporations.

Summary

In general terms, the draft legislation confirms the government's intention to proceed with an expansion of the TOSI rules that currently apply to those aged 17 and under. The main difference with the new proposal is that certain amounts will be "Excluded Amounts" for the purposes of the new rules and hence not subject to the TOSI. At the end of this document we also include a number of additional comments for the reader's consideration.

What is an "Excluded Amount"

The following amounts will be "Excluded Amounts":

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- All adult individuals – amounts received from, or capital gains realized on a disposition of an "Excluded Business" will not be subject to TOSI. A related business will be an "Excluded Business" where the individual was actively engaged on a regular, continuous and substantial basis "Actively Engaged" in the activities of the business in the taxation year or in any five prior taxation years of the individual.

  An individual will be "Actively Engaged" if they work in the business at least an average of 20 hours per week during the portion of the taxation year that the business operates, or meets that requirement for any five prior years. In any other case, whether an individual is "Actively Engaged" will depend on the facts and circumstances of that case.

- For individuals age 25 or over – income from or taxable capital gains from the disposition of "Excluded Shares" or payments that qualify as a "Reasonable Return" will not be subject to TOSI.
  - "Excluded Shares" are defined as follows:
    - Less than 90% of the corporation's business income was from the provision of services, and the corporation is not a professional corporation,
    - The shares represent 10% or more of the votes and value of the corporation, and
    - All or substantially all of the income of the corporation is not derived from another related business in respect of the individual.
    - Note that shares held in a trust for the benefit of an individual will not be "Excluded Shares".
    - Note that for 2018 only, the share ownership test can be met at the end of 2018 whereas after 2018 the exclusion must be met at the time of earning income or realizing capital gains on the shares.
  - "Reasonable Return" is defined as:
    - Payments that represent a reasonable return based on the following criteria:
      - The work performed in support of the related business,
      - The property contributed directly or indirectly in support of the related business,
      - The risks assumed in respect of the related business,
      - 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 as may be relevant.

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- For individuals between the ages of 18 and 24 – a return on property contributed in support of a Related Business that is a "Safe Harbor Capital Return" or a reasonable return having regard only to contributions of "Arms' Length Capital" to the business.
    - "Safe harbor Capital Return" is defined as a return on property contributed by the individual in support of the Related Business provided that such return does not exceed a prescribed capital return determined by formula.
    - "Arms' Length Capital" is defined as property of an individual, other than property that is derived from property income in respect of a Related Business, that is borrowed under a loan, or that is transferred from a related person, other than by way of inheritance.

- For any individual – taxable capital gains realized on death or from the disposition of qualified farm or fishing property and qualified small business corporation shares.

Additional Comments:

- The revised proposed legislation was released on the same day that the Standing Committee on National Finance recommended that the Finance Minister withdraw the July 18, 2017 proposals or at least delay the implementation of the proposals until January 1, 2019. In addition, the committee proposed the government undertake an independent and comprehensive review of Canada's tax system. It remains to be seen if these proposals will have any impact.
- The rules are complex and difficult to understand. Although less individuals in total are impacted by the revised proposed legislation, the complexity level remains high.
- Any capital gain realized as a consequence of death will not be subject to TOSI.
- The extended definition of "related persons" has been narrowed and no longer includes aunts, uncles, nieces or nephews.
- Property transferred as a consequence of marital or common-law relationship breakdown will not be subject to TOSI so long as the spouses or partners are separated and living apart.
- Second generation income, or income on income that has been subject to TOSI will not be further subject to TOSI, subject to certain restrictions.
- For individuals aged 65 and older, the proposed rules will allow the person's spouse to receive income, profit or gain and not be subject to TOSI as long as the amount would not be TOSI to the individual. This rule is intended to align with existing pension income splitting legislation.

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- Family trusts – although there is no longer a prohibition from obtaining the Lifetime Capital Gains Exemption through a family trust structure, the TOSI rules related to income require a direct ownership interest in the company involved to meet the 10% test described previously.
- As written, the definition of "Excluded Shares" does not allow for a dividend to flow through a holding company to an excluded 10% shareholder and not be subject to TOSI. It is not clear if this is intentional or not in the legislation as a dividend on share ownership meeting the 10% test held directly by an individual, so long as all other qualification criteria are met, would not be subject to TOSI.
- Regardless of the revised proposals, no share in a Professional Corporation (PC) or a service corporation, or a corporation providing goods/services to a PC or service corporation owned by a related party, will be able to be structured as an excluded share unless the individual owning the share is actively engaged in the business.
- The revised proposed TOSI rules would apply to a capital gain on the sale of shares that were not eligible for the capital gains exemption as Farm, fishing or qualified small business shares unless the individual could meet the "Actively Engaged" test and hence the business be an "Excluded Business" under that criteria. The result of this conversion is punitive.
- Reasonable salaries paid to family members for services performed will be deductible to the payer and taxable to the recipient as is the case now and prior to January 1, 2018. The revised TOSI proposals do not address employment income and remuneration.
- Prescribed rate investment loans appear to be permissible such that individuals or family trusts may borrow at the fixed prescribed rate, currently 1% and use the funds for portfolio investments with income net of interest costs taxed in the hands of the individual borrower regardless of age.

To discuss the impact of these new rules on your corporation please contact your regular engagement partner, or a member of the tax group, Garth Howes, Derek Michell, Jim Frederick or Bill Luyks by phone or email.