Federal Government Partially Retreats from July 2017 Income Sprinkling Tax Proposals

December 15, 2017

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On December 13, 2017, the Department of Finance ("Finance") released revised draft legislation, together with a technical backgrounder, simplifying the income sprinkling proposals first announced on July 18, 2017. At the same time, the Canada Revenue Agency ("CRA") provided guidance on how it intends to administer the new rules. Although the legislation will be enacted later in 2018 as part of the 2018 Budget process, it is intended to apply as of January 1, 2018.

The original income splitting proposals from July met with significant opposition from business owners. Details of the original proposals can be found in our bulletin, *Impact of the Proposed Private Corporation Tax Changes*.

The draft legislation released on December 13 attempts to address concerns relating to the complexity, compliance burden, subjectivity and unintended tax consequences (including with respect to intergenerational business succession) of the original proposals. Some of the key highlights of the new proposals are discussed below.

Highlights of the Revised Draft Legislation

1. **Consistent with the original proposals, the tax on split income ("TOSI") will be extended to individuals over 18 (referred to as specified individuals) on amounts that are received directly or indirectly from private business arrangements** . The rules are designed to capture income, whether in the form of dividends, trust distributions, partnership distributions or certain capital gains derived from a business in which a related individual is actively engaged or is a significant equity owner. Such a business is referred to in the draft legislation as a related business. Fortunately, Finance has decided not to expand the class of related individuals to include aunts, uncles, nieces and nephews.
2. **Amounts derived from excluded businesses are exempted from TOSI.** An excluded business is a business to which the specified individual contributes labour on a regular continuous and substantial basis (a bright-line test of at least

20 hours per week has been included) during the year or in any five previous years. For businesses with seasonal operations, the labour contribution requirement will be applied for the part of the year in which the business operates. If the bright-line 20 hour per week test is not met, it will be a question of fact as to whether the specified individual contributed labour on a regular continuous and substantial basis.

3. **For specified individuals over age 24, TOSI will not apply to income derived from excluded shares**. To qualify, the individual must own shares representing at least 10 per cent of the votes and value of the corporation. Further, the corporation must meet one of the following conditions: (i) it must earn less than 90 per cent of its income from the provisions of services; (ii) in must not be a professional corporation; and (iii) no more than 10 per cent of its income can be derived directly or indirectly from related businesses. Under a transition rule, the condition that the specified individual own shares having at least 10 per cent of the votes and value must be met by the end of 2018. Special rules permit specified individuals under age 25 who inherit shares that qualified as excluded shares to the deceased, to continue to benefit from the excluded share exemption.
4. **If none of the exclusions apply, specified individuals aged 25 and older will be subject to a reasonableness test to determine how much income should be subject to TOSI.** Reasonableness will be determined based on a number of enumerated factors, including labour contribution, capital contribution, risks assumed, and any other relevant factors. As this is essentially a subjective determination, the CRA guidance released contemporaneously provides a list of criteria it will consider in assessing these reasonableness factors.
5. **More restrictive rules apply to specified individuals aged 18-24 who cannot meet the labour contribution requirements**. The reasonable tests will not provide a safe harbour. Such individuals will generally only be entitled to a prescribed rate of return (currently 1 per cent) on capital contributed to a related business.
6. **TOSI will not apply to dividends paid to a business owner's spouse provided that the business owner contributed to the business in an important way and has reached age 65 (with relieving rules applicable where the contributing business owner dies before age 65).** This approach is consistent with the existing pension income splitting rules and addresses concerns raised about the adverse impact of the July 18th proposals on existing retirement planning arrangements of business owners. It is intended to ensure that business owners are not disadvantaged in retirement.
7. **Specified individuals over the age of 18 who receive shares by way of inheritance will be able to "step into the shoes" of the deceased such that the contributions of the deceased will be deemed to be those of the specified beneficiary**. The intention is that the adult beneficiary will not be in a less favourable position than the deceased would have been under the TOSI rules.
8. **To facilitate inter-generational business succession, taxable capital gains arising from disposition of property that would be eligible for the lifetime capital gains exemption (such as qualified farming or fishing property and small business corporation shares) will be excluded from TOSI.** Consistent with existing anti-avoidance provisions, these rules do not apply to non-arm's length dispositions of property by individuals under 18, or by trusts for the benefit of individuals under 18.
9. **Several additional announcements are a welcome change.** TOSI will not apply to taxable capital gains arising because of the deemed disposition of property at death. TOSI will also not apply to property acquired by reason of a settlement on

the breakdown of a marriage or common-law partnership. Finally, TOSI will not apply on income from reinvested split income (*i.e.* secondary income).

Comments and Planning Tips:

- Although the proposed rules are narrower in scope than the original proposals and address several of the concerns raised, the Department of Finance has retained its differentiation between young adults (aged 18-24) and older adults (aged 25 and over) as well as singling out businesses engaged in services, including but not limited to professional corporations, by imposing more restrictive rules. Businesses owners engaged in service businesses may have difficulty avoiding TOSI.
- For non-service businesses, some restructuring in 2018 may be necessary to ensure specified individuals own shares representing at least 10 per cent of the votes and value of the corporation. Where an estate freeze has occurred, the shares owned by specified individuals may not reach this value threshold for a period of time, if ever. In addition, the CRA guidance suggest that ownership through a family trust would not be sufficient and that the shares would need to be owned directly by the adult individual. Restructuring share ownership may require a review of other non-tax issues, such as governance and control, to ensure appropriate arrangements are in place to protect the business. If restructuring is not possible or desirable, it may not be possible to avoid TOSI.
- The rules are still very complex and rely on subjective criteria. Even with the changes from the original proposals, the compliance burden on business owners is still significant and should not be underestimated.
- It may be difficult to avoid TOSI for the 2018 tax year if structures cannot be changed before the end of 2018. With only days until the effective date of these rules, many business owners will find it difficult to determine whether they are affected, and if so, adjust their business arrangements in time to avoid the impact of TOSI.
- The government faced significant backlash on manner in which it released the original proposals in the middle of summer – with a very short consultation period, and with a tone that suggested business owners were deliberately flouting tax rules. The new proposals have been released during the busy holiday period, with only 18 days before their stated effective date and with no further consultation planned. Notwithstanding calls from the business community for a more respectful dialogue and meaningful consultation, the tone from the government has not changed. We anticipate the business community will continue to pressure the government for future changes. It is interesting to note that several hours before the release of the revised proposals, the Senate's Standing Committee on National Finance released a report on the July 18th proposals which recommended that the proposed changes be withdrawn and a comprehensive review of Canada's tax system conducted, or, alternatively, that implementation be delayed until the 2019 tax year so that meaningful consultations and further study on the impact of the proposals on Canada's economy, gender and health care system could be conducted.

The government also confirmed its commitment to introducing in the 2018 Federal Budget the proposed passive investment rules to limit tax deferral opportunities for private corporations.

BLG's [Tax Group] is closely following the legislation and how it may impact our clients. If you have questions, please contact Pamela Cross, Natasha Miklaucic, Lindsay Holmes, Peter Wong or Joseph Takhmizdjian.

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