Technical Backgrounder on Measures to Address Income Sprinkling

Draft Legislative Proposals

The revised draft legislative proposals to address income sprinkling maintain the overall structure of the proposals relating to income sprinkling released July 18, 2017 (the July 2017 proposals), but with important changes to simplify and better target the rules, and to reduce the potential compliance burden in their application. Consistent with the July 2017 proposals, the new draft legislative proposals will extend the tax on split income (TOSI) to individuals aged 18 and over (specified adult individuals).

For the Canada Revenue Agency's (CRA's) intended approach with respect to the application of the revised TOSI proposals, please see the CRA guidance released today on the CRA's website. The guidance provided by the CRA and this backgrounder contain general information on how the TOSI proposals will apply in common cases. Taxpayers with questions regarding its guidance can contact the CRA.

The TOSI will potentially apply in respect of amounts that are received by specified adult individuals, either directly or indirectly, from a related business. Generally, a business will be a related business if an individual who is related to the specified adult individual either is actively engaged in the business or owns a significant portion of the equity in the corporation that carries on the business.

While maintaining the general scheme of the July 2017 draft legislative proposals, the revised draft legislative proposals include changes to better target and simplify their application:

- exclusion from the application of the TOSI for specified adult individuals, including those aged 18 to 24, who contribute labour to a related business on a regular, continuous and substantial basis;
- exclusion from the application of the TOSI for specified adult individuals over the age of 24 who have a significant equity investment in a corporation, other than a corporation that carries on a services business or that is a professional corporation;
- simplification and clarification of the reasonableness test;
- relief for spouses that is better aligned with the pension income splitting rules;
- changes to the treatment of capital gains to ensure that the TOSI rules do not limit access to the lifetime capital gains exemption (LCGE); and
- other changes to simplify the TOSI and address potential unintended consequences.

These aspects of the revised draft legislative proposals are discussed below.

What is the TOSI?

A special 'tax on split income' (TOSI), set out in section 120.4 of the *Income Tax Act*, was introduced in 1999 to address sprinkling of certain income to minor children (*i.e.*, individuals under the age of 18 years). The rules apply to income from private business arrangements, such as dividends on unlisted shares, or income in the form of a trust or partnership distribution derived from a business or rental activity of a related individual. The TOSI also denies access to the LCGE in respect of the disposition of shares as part of a non-arm's-length transaction. In cases where the TOSI applies, the income is subject to top flat-rate personal income taxation in the hands of the minor, and personal tax credits (with the exception of the dividend tax credit and foreign tax credit) are denied with respect to the amounts.

Exclusions from the TOSI

Exclusions from the TOSI rules for specified adult individuals will be introduced. Where applicable, these exclusions provide the circumstances in which an individual will not need to consider the potential application of the TOSI rules for amounts received from a related business and, in particular, will not need to determine whether the amounts are reasonable.

Reasonableness test

If none of the new exclusions from the TOSI discussed below apply, then individuals who have attained the age of 25 years in or before the year will be subject to the TOSI on amounts derived directly or indirectly from a related business, but only to the extent that the amounts exceed a “reasonable return.”

The revised income sprinkling legislative proposals define a reasonable return as an amount that is reasonable having regard to the contributions of the specified adult individual to the related business relative to other family members who have contributed to the business. The contributions that are relevant to this analysis include labour contributions, capital contributions, risks assumed, as well as any other relevant factors. What constitutes a reasonable return is also determined with regard to previous amounts received from the business.

It is intended that an amount will not qualify as a reasonable return from a related business only in cases where it is evident that an amount received by an individual from the business is disproportionate relative to the contributions to, and amounts received from, the business by them and other family members. It is not meant to second-guess a *bona fide* exercise of business judgment by the participants in a business.

Excluded business

A specified adult individual will not be subject to the TOSI on amounts received in the year from an “excluded business”. An excluded business is a business in which the individual is actively engaged on a regular, continuous and substantial basis in the taxation year of the individual in which an amount is received or in any five previous taxation years.

The excluded business definition is intended to ensure that the TOSI rules do not apply to individuals who make meaningful direct labour contributions to a business in the year or in any five previous taxation years. The ability to access this exemption will not require individuals to value their labour contributions, but rather to demonstrate an ongoing meaningful contribution to the business. To access the exclusion in respect of five previous years of labour contributions, it is not necessary that the five previous years be consecutive or after 2017. Any combination of five previous years would satisfy the test.

The excluded business definition is intended to be flexible, accounting for differences in businesses and the nature of individuals' contributions to a business. For example, if a business operates only six months of the year, then the determination of whether an individual was engaged on a regular, continuous and substantial basis in a year would be determined with regard to the individual's participation during that six-month period.

To provide greater certainty (but without limiting the generality of the test), an individual who works an average of 20 hours per week during the part of the year that a business operates will be deemed to be actively engaged on a regular, continuous and substantial basis for the year. If an individual does not meet the 20-hour threshold, then it will be a question of fact as to whether the individual was actively engaged in the business on a regular, continuous and substantial basis. However, even if an individual aged 25 or older does not meet the regular, continuous and substantial threshold, the TOSI will apply to amounts derived from a related business only to the extent that they are unreasonable (*i.e.*, only the unreasonable excess will be subject to the TOSI).

Example 1:

Frances worked for her parents' manufacturing business on a full-time basis throughout the year in which she turned 22 to the year in which she turned 28. Frances then stepped back from being involved in the business for three years. Frances received dividend income from her parents' manufacturing business during the years she worked for the business, as well as the three years when she did not participate in the business.

The TOSI would not apply in respect of any of the dividends Frances receives. With respect to the dividends received by Frances in the years she was working full-time, the TOSI would not apply, on the basis that she was actively engaged in the business on a regular, continuous and substantial basis in the year that the dividend was received (she would also satisfy the "bright-line" test of working an average of 20 hours per week). With respect to the dividends received by Frances in the years after she stepped back from the business, the TOSI would not apply as the business would be an "excluded business" on the basis that she was actively engaged in the business on a regular, continuous and substantial basis for at least five prior years.

Example 2:

Jeff and Charles are spouses. Jeff is a doctor practicing family medicine through a professional corporation on a full-time basis. Charles is not a doctor. He runs Jeff's medical clinic and he works four days a week for eight hours a day, taking six weeks of vacation per year (including all of July). The rest of the time, Charles runs a part-time consulting business. Both Jeff and Charles own shares in the professional corporation. Each year, the professional corporation pays Jeff and Charles salaries. The retained earnings in the professional corporation are then paid out as dividends to Jeff and Charles on a 50/50 basis.

Both Jeff and Charles would be considered to be actively engaged on a regular, continuous and substantial basis in the business carried on by the professional corporation. Jeff and Charles would have certainty that they satisfy this condition because they both satisfy the 20-hour deeming rule. Therefore, the TOSI would not apply to Jeff or Charles' dividend income.

Excluded shares

The TOSI will not apply to specified adult individuals over the age of 24 years in respect of income received from "excluded shares" owned by the individual. This exclusion from the TOSI will apply to income received from a share (including from the disposition of the share) if the following conditions are met:

- the individual has attained the age of 25 years in or before the year;
- the individual owns at least ten per cent of the outstanding shares of a corporation in terms of votes and value; and
- the corporation meets the following conditions:
  - it earns less than 90 per cent of its income from the provision of services;
  - it is not a professional corporation (*i.e.*, a corporation that carries on the professional practice of an accountant, dentist, lawyer, medical doctor, veterinarian or chiropractor); and
  - all or substantially all of its income is not derived from a related business in respect of the specified individual. This is intended to prevent a service business from inappropriately accessing this exclusion by interposing a non-service entity between it and the intended recipient of the income (*e.g.*, a professional corporation pays rent for the building in which the professional business is carried on to a corporation owned by the adult children of the professional).

For 2018, taxpayers seeking to rely on this exclusion will have until the end of 2018 to meet the condition of owning at least ten per cent of the outstanding shares of a corporation in terms of votes and value.

If an individual aged 25 years or older receives amounts that are not derived from excluded shares (or from an excluded business, as described above), the TOSI will apply only to amounts derived from a related business to the extent that they are unreasonable. Further information on the reasonableness test is provided below.

Example 3:

Two sisters, Anaya and Saanvi, are seniors. Each of them owns 50 per cent of the common shares of a corporation, which earns investment income and does not have any other source of income. There are no other classes of shares of the corporation. The money in the corporation was originally sourced from the proceeds of a sale of land by their father in the 1970s. Each year, the corporation pays Anaya and Saanvi dividends.

The application of the TOSI would not need to be considered on the dividends received by Anaya and Saanvi because each sister owns capital stock representing at least ten per cent of the value of the corporation, and the corporation neither earns income from the provision of services nor meets the definition "professional corporation" (nor is all or substantially all of the corporation's income derived from a related business).

Retirement and inherited property

Recognizing the special challenges of planning for retirement and managing retirement income, the revised income sprinkling proposals will be better aligned with the existing pension income splitting rules. In particular, the TOSI rules will not apply to income received by an individual from a related business if the individual's spouse made the contributions to the business and has attained the age of 65 years in or before the year the amounts are received. Special rules will apply in respect of a deceased individual, so that the surviving spouse continues to benefit from the contributions made by the deceased individual.

New rules for inherited property will apply to people who have attained the age of 18 and not just those whose spouses have attained the age of 65. For the purpose of applying the exclusions from the TOSI in respect of income from inherited property, the person inheriting the property will generally not face a less favourable treatment than the deceased.

Example 4:

Casey is 70 years old and owns shares of a corporation that carries on a consulting business. Prior to her retirement, she worked on a full-time basis for thirty years in the business. Due to her significant labour contributions over the years, Casey meets the five-year deeming rule and the business is an excluded business for her.

The business would also be an excluded business for Casey's 60-year-old spouse, Charlie, who has not worked in the business.

Example 5:

Gary dies at the age of 50. Immediately prior to his death, he owned a 20 per cent interest in a corporation that operates a restaurant. Gary was not involved in the business. The shares owned by Gary qualified as excluded shares before his death because he owned 10 per cent or more of the shares of the corporation and the corporation does not carry on a services business. Gary leaves all of his shares to his 22-year-old niece, Alex. Alex works full time as a painter and does not intend to work in the business.

The shares can be excluded shares for Alex even though she has not attained the age of 25 (which is a requirement for the excluded shares test) because Gary had attained the age of 25.

Lifetime capital gains exemption

In October 2017, the Government announced that it will not be moving forward with proposed measures that would limit access to the LCGE. As a result of this commitment, the Government will not proceed with amendments to section 110.6 of the *Income Tax Act*.

Consequential to this change, the proposed extension of the TOSI to taxable capital gains from the disposition of property will not apply to the types of property that can qualify for the LCGE (i.e., qualified small business corporation shares and qualified farm or fishing property). This exemption from the application of the TOSI will apply regardless of whether the LCGE is claimed in respect of the taxable capital gain arising from the disposition.

Other changes to the July 2017 proposals

The revised draft legislative proposals also make the following changes to the July 2017 proposals. These changes are intended to simplify the application of the TOSI rules, as well as address potential unintended consequences associated with the July 2017 proposals.

- The Government will not proceed with the proposed measures to apply the TOSI 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).
- The July 2017 proposals had included amendments to extend the application of subsections 120.4(4) and (5) of the *Income Tax Act* (which currently apply to minors and effectively deem twice the amount of a taxable capital gain to be a dividend in certain circumstances) to specified adult individuals. These amendments will not move forward. Furthermore, it is proposed that the existing provision be modified so that it will not apply to a minor in circumstances in which a capital gain arises as a consequence of that person's death.
- The class of related individuals for the purposes of the TOSI rules will not be extended to aunts, uncles, nieces and nephews.
- Income derived from property acquired as a result of the breakdown of marriage or common-law partnership will be exempted from the application of the TOSI rules.
- Generally, individuals aged 18 to 24 will be permitted a prescribed rate of return on capital contributed to a related business. In certain cases, however, such as where the individual earned the capital contributed from an unrelated business, the individual will be permitted a reasonable return on the contribution.

Gender-Based Analysis

Gender considerations previously communicated with respect to the proposed income sprinkling measures are not affected by these revised draft legislative proposals. Data show that men represent over 70 per cent of higher-income earners initiating income sprinkling strategies, and women represent about 68 per cent of recipients of sprinkled dividends (and 58 per cent of recipients of income derived from trust and partnerships). While this income is of benefit for recipients, it also creates incentives that reduce female participation in the workforce. Increased participation of women in the workforce is a source of economic opportunity for individuals and is a major driver of overall economic growth.

Fiscal Impact

The table below shows the revenue estimate of income sprinkling measures by fiscal year, reflecting the draft legislative proposals released today.

$ million	**2017-18**	**2018-19**	**2019-20**	**2020-21**	**2021-22**	**2022-23**
Income Sprinkling (on January 1, 2018)	*(45)*	*(190)*	*(200)*	*(205)*	*(215)*	*(220)*

Next Steps

The revised income sprinkling measures released today are proposed to be effective for the 2018 and subsequent taxation years.