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# 8 Highlights from the New Income Splitting Rules

Crowe Soberman's Tax Group

The story began on July 18, 2017, when the Liberal Government announced proposed tax changes that intended to fundamentally and adversely alter the taxation of income derived from private corporations. A 75-day consultation period followed (in the peak of summer) and practitioners rushed to submit their comments to the Department of Finance expressing their concerns regarding the proposals.

This consultation period ended on October 2, 2017, and it is reported that the Department of Finance received more than 21,000 submissions. Only 10 days later, during the week of October 16, the Department of Finance announced that they would not be moving ahead with the proposals that would have curtailed the multiplication of the capital gains exemption and surplus stripping transactions. At that time, the Department of Finance also announced that it

would be moving forward with the proposals relating to limiting income “sprinkling” opportunities currently available to private company shareholders and that these measures would take effect on January 1, 2018.

Fast forward to 1:00 p.m. on December 13, 2017 when the Department of Finance released updated draft legislation in connection with the income

sprinkling provisions. Specifically, these provisions deal with the Tax on Split Income (“TOSI”), also known as the “kiddie tax.”

The updated draft legislation provides new exclusions from the TOSI rules in certain situations and provides guidelines with respect to the reasonability tests that are to be applied in determining whether an individual is actively engaged in a private corporation’s business.

Below is a high-level summary of the updated draft legislation. In our opinion, the rules continue to be complex and as such, we will be studying these drafts closely and analyzing their impact on our clients' specific circumstances.

Highlights of the December 13, 2017 updated draft legislation:

1. The updated proposed TOSI rules are applicable to the 2018 and subsequent years.
2. In the following situations, amounts received by individual family members will be excluded from the punitive TOSI rules if:
  - a. The amount is received by an individual aged 25 or over who owns at least 10 per cent of the votes and value of an operating private corporation that derives less than 90 per cent of its revenue from the provision of services and is not a professional corporation.
  - b. The amount is received by an individual aged 18 or over who has made a "meaningful direct labour contribution" to the corporation in the year,

or in any five previous tax years. A meaningful labour contribution is defined to be 20 hours per week of active engagement in the business. For seasonal businesses, the 20-hour threshold applies only to the relevant time of the business.

- c. The amount is received by a business owner's spouse if the business owner meaningfully contributed to the business and is aged 65 or over.
- d. The gain is received by an individual and results from the disposition of "qualified small business corporation" shares or farm property regardless of whether or not the capital gains exemption is claimed by the individual to shelter all or a portion of the gain.
- e. The gain is realized by an individual on his or her death.
- f. The amount is received by an individual from property received as a settlement upon a marriage breakdown.

3. Taxpayers who are 25 years of age or older who do not meet the above exclusions would be subject to a reasonableness test to determine whether any of the amount received would be subject to TOSI.

4. Taxpayers will have until the end of 2018 to structure the ownership of their corporations to meet the above test. This appears to mean that a family member who is 25 years of age or older would be required to pay fair market value ("FMV") for a 10 per cent (of votes and value) interest in the company to enable him/her to receive dividend income that is not subject to TOSI. The undertaking of a freeze transaction (to freeze the current FMV of the company in the hands of the existing shareholders) and then having the individual buy-in for 10 per cent newly issued shares of the corporation for nominal value will not meet the test.

5. TOSI will not apply to dividends that represent a reasonable return on an individual's capital contribution. An amount will not be reasonable if it

is disproportionate to the contributions to, and amounts received from, the business by the individual and other family members.

6. Compound income (i.e., second generation investment income) will not be subject to TOSI as initially proposed.
7. The proposals to apply TOSI to capital gains between related individuals by deeming the gain to be a taxable dividend will not be moving forward.

8. Income items derived from the relationship with aunts, uncles, nieces and nephews will not be affected by the TOSI rules.

It is interesting to note that the Standing Senate Committee of National Finance yesterday issued a report criticising the Government's proposed tax measures and recommended that the Government drop all of its proposed tax changes impacting Canadian-controlled private corporations. We shall see what happens when the draft legislation is formally introduced as a bill in the House of Commons and is eventually

forwarded to the Senate. It is quite possible that we have not heard the end of the possible changes to these rules.

In addition, it was announced that the Government still intends to move forward with the passive income tax changes for Canadian-controlled private corporations and will provide the details as part of the 2018 Federal Budget. Once introduced, these rules will apply on a prospective, not retroactive, basis.

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For more information regarding the tax changes and other measures discussed here, please contact your Crowe Soberman advisor today.

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