

# “New Income Tax Rules – Income Sprinkling”

Toronto Chapter of ICAI

September 29, 2018

**Manu Kakkar**

**CPA, CA, TEP, MTax, BSc(Hons)**

Manu Kakkar CPA Inc.

# Disclaimer

This material is for educational purposes only. As it deals with technical matters which have broad application, it is not practical to include all situations. As well, the course material and the references contained therein reflect laws and practices which are subject to change. For this reason a particular fact situation should be reviewed by a qualified professional.

Although the course material has been carefully prepared, none of the persons involved in the preparation of the material accepts any legal responsibility for its contents or for any consequences arising from its use.

# Table of Contents

Topic	Slide(s)
What is Income Splitting	4 – 5
December 13, 2017 Income Splitting Proposal	6 - 69
- TOSI	
- Related Business	
- New Rule (Relieving Provision)	
- Excluded Amounts	
- Excluded Business	
- Safe Harbour Capital Return	
- Arm's Length Capital	
- Excluded Shares	
- Reasonable Return	
- Reasonableness Criteria	
Conclusions	70 - 71
Questions	72
Contact Information	73

# Basically What is Income Splitting ?

- Tax planning arrangements
- Income is taxed as income of a lower-income individual
- Where instead, it should have been taxed as income of a high-income individual
- Why do this ?
  - Lower marginal tax rates
  - Personal tax credits
  - Deductions (Example : Lifetime capital gains deduction)
- Supreme Court of Canada Decision *Neuman v Queen*
  - Income splitting was accepted

# Other Current Legislative Limits in ITA – Income Splitting

- Section 67 – Deduction from income must be reasonable.
- Sections 56, 74.1 to 75.1 – Income attributed back to transferor.
- Sections 15, 246 and subsection 56(2) – Tax benefit conferral
- Section 74.4 – Imputes income where attribution done indirectly through corporations.
- Sections 74.1 and 60.03 – explicit permission for seniors to split CPP and eligible pension income.
- December 13, 2017 proposal significantly expands the scope of the TOSI rules.

# The First Order Strikes Back . . . Sprinkle No More

- Darkness now surrounds the following age groups:
  - Minor Children
  - 18 – 24 years of age
  - 25 years of age and older
  - Lightness surrounds the following age group:
    - Certain adults 65 years of age and under
- TOSI is now extended to individuals over the age of 17
- Kiddie Tax evolved = does not target just Kids (Minors) anymore !

# COMPARISON - Who is Subject to TOSI?

- Only individuals (but not trust) who are “specified individuals” are subject to TOSI.

OLD RULES – 2017 AND PRIOR	NEW RULES – 2018 AND AFTER
<ul style="list-style-type: none"><li>• Canadian resident throughout the year</li></ul>	<ul style="list-style-type: none"><li>• Canadian resident at the end of the year</li></ul>
<ul style="list-style-type: none"><li>• Under 18 for the entire year</li></ul>	<ul style="list-style-type: none"><li>• Any age</li></ul>
<ul style="list-style-type: none"><li>• Parent resident in Canada at any time in the year</li></ul>	<ul style="list-style-type: none"><li>• If under 18, parent resident in Canada at any time in the year</li></ul>

- Generally speaking, all Canadian resident individuals other than minors with non-resident parents will be a “specified individual”.

# EXAMPLE 1 - To Sprinkle or Not to Sprinkle – Kiddie Tax

- Mr. BoBo has a son, Mr. BoBoFett
- Mr. BoBoFett is 16 years of age
- Mr. BoBo has a private corporation, BoBo Inc.
- Mr. Bobo is resident in Canada
- It is a private corporation that qualifies as a Canadian Controlled Private Corporation
- BoBo Inc. paid Mr. BoBoFett \$15,000 in Dividends in 2017
- Does TOSI – Kiddie Tax apply ?



# EXAMPLE 1 - To Sprinkle or Not to Sprinkle – Kiddie Tax

- TOSI – Kiddie Tax applies
- This is the standard application of The Kiddie Tax
- Mr. BoBoFett will be taxed at the highest marginal rate (47%) on this Income received
- Does Kiddie tax apply in 2018 on the \$15,000 dividend?
- Yes it does, because Mr. BoboFett is still a specified individual
- As will be seen later, none of the exceptions for work done by Mr. BoboFett apply as he is under 18 years old (unfair result).

# TOSI – Tax on Specified Individuals

- 120.4(2) “Split Income” ITA
  - Where a specified individual earns split income, there will be a tax applied at the top marginal rate
    - Split Income X Top Marginal Tax Rate
- 120.4(3) “Split Income” ITA
  - When TOSI applies, an individual can only claim certain tax credits to offset TOSI
    - Credit for mental or physical impairment **(New)**
    - Dividend tax credit
    - Foreign tax credit
- 20(1)(ww) ITA
  - Eliminates double taxation
  - Removes the amount of split income from net income

# Comparison - Types of Income Subject to TOSI (“Split Income”)

OLD RULES – 2017 AND PRIOR	NEW RULES – 2018 AND AFTER
<ul style="list-style-type: none"><li>• (a)(i) taxable dividend from corporation (other than listed shares or MFC)</li></ul>	<ul style="list-style-type: none"><li>• (a)(i) taxable dividend from corporation (other than listed shares on designated stock exchange or MFC)</li></ul>
<ul style="list-style-type: none"><li>• (a)(ii) 15(l) income from corporation (other than listed shares)</li></ul>	<ul style="list-style-type: none"><li>• (a)(ii) 15(l) income from corporation (other than listed shares on designated stock exchange)</li></ul>

# Comparison - Types of Income Subject to TOSI (“Split Income”)

OLD RULES – 2017 AND PRIOR	NEW RULES – 2018 AND AFTER
<ul style="list-style-type: none"><li>• (b) income from partnership for services provided to a business carried on by:<ul style="list-style-type: none"><li>i. a related person</li><li>ii. a corporation where a related person is a specified shareholder</li><li>iii. a professional corporation where a related person is a shareholder or rental income</li></ul></li></ul>	<ul style="list-style-type: none"><li>• (b) income from partnership derived directly or indirectly from a related business or rental income</li></ul>

# Comparison - Types of Income Subject to TOSI (“Split Income”)

OLD RULES – 2017 AND PRIOR	NEW RULES – 2018 AND AFTER
<ul style="list-style-type: none"><li>• (c) income from trust that is:<ul style="list-style-type: none"><li>• Taxable dividends as per (a)(i)</li><li>• 15(l) as per (a)(ii)</li><li>• Service income as per (b)</li><li>• Rental income</li></ul></li></ul>	<ul style="list-style-type: none"><li>• (c) income from trust that is:<ul style="list-style-type: none"><li>• Taxable dividends as per (a)(i)</li><li>• 15(l) as per (a)(ii)</li><li>• Service income derived directly or indirectly from a related business</li><li>• Rental income</li></ul></li></ul>

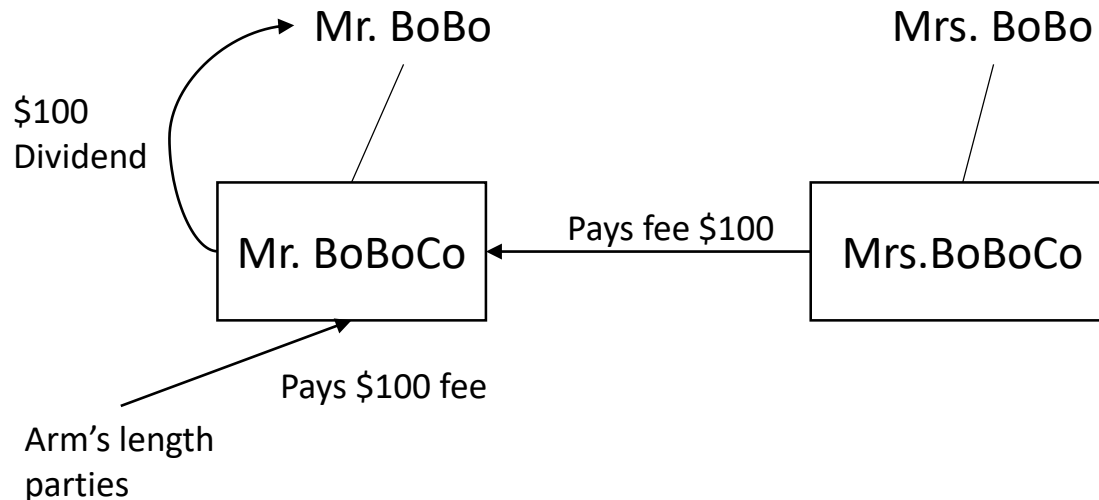
# Related Business

Only direct reference to related business found in split income is in (b)(ii) in respect of partnership allocations and (c)(ii)(C) in respect of trust distributions.

However, the related business concept also impacts (inter alia) dividends received by shareholders of private corporations by virtue of (e)(i) in excluded amount.

## (e)(i) Amendment to Excluded Amount

“Not derived directly or indirectly from a related business in respect of the individual for the year”



- Where was the source of the dividend to Mr.BoBo coming from Mrs. BoBoCo or arm's length parties?

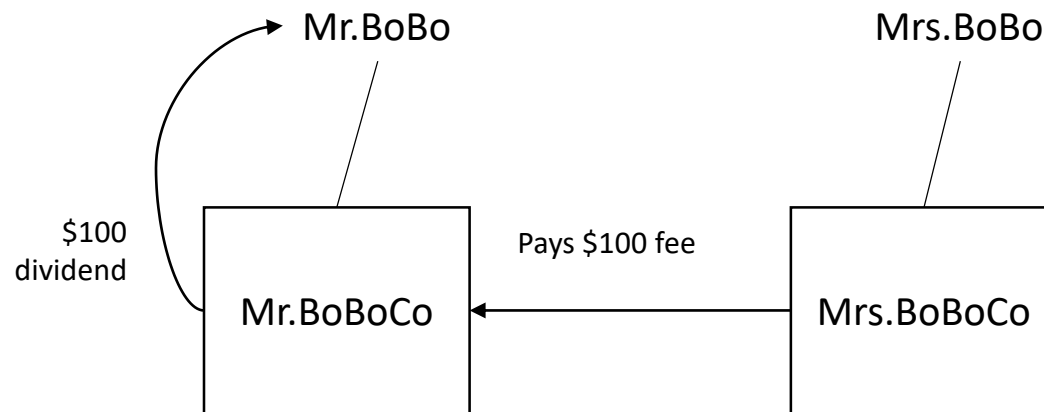
It is a question of fact.

- Cash damming techniques to determine tracing for interest deductibility may be needed to defend against “related business” argument for TOSI



## (e)(i) Amendment to Excluded Amount

“Not derived directly and indirectly from a related business in respect of the individual for the year”



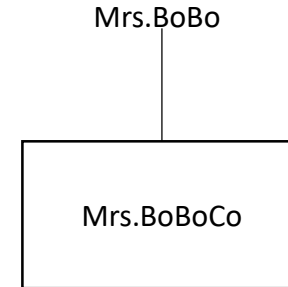
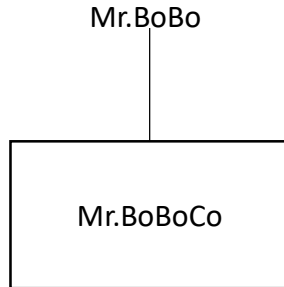
Likely that \$100 dividend to Son derived indirectly from Mrs.BoBoCo will be subject to TOSI (assuming it is not otherwise an excluded amount).

Mrs. BoBoCo is a related business to Mr.BoBo (specified individual) as Mrs.BoBo (source individual) is actively engaged on a regular basis in the business of Mrs.BoBoCo.

- March 20, 2018 NWMM clarified
  - That related business is in respect of the specified individual for the year.
  - Clarified that there does not exist a historical related business for the TOSI

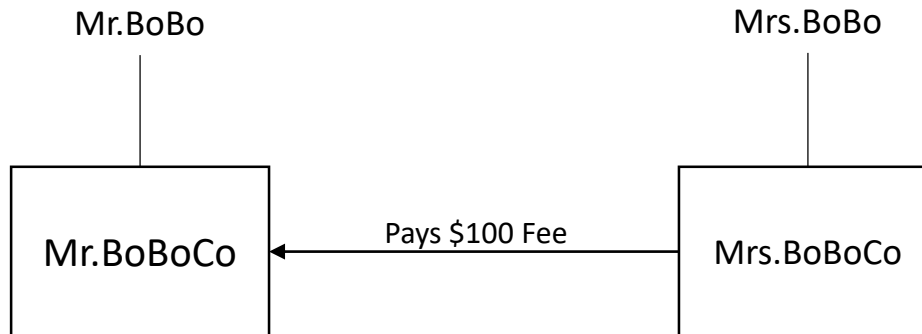
# Previous Example

- Historical retained earnings of Mr. BoBoCo are from fees paid from Mrs. BoBoCo in the past.

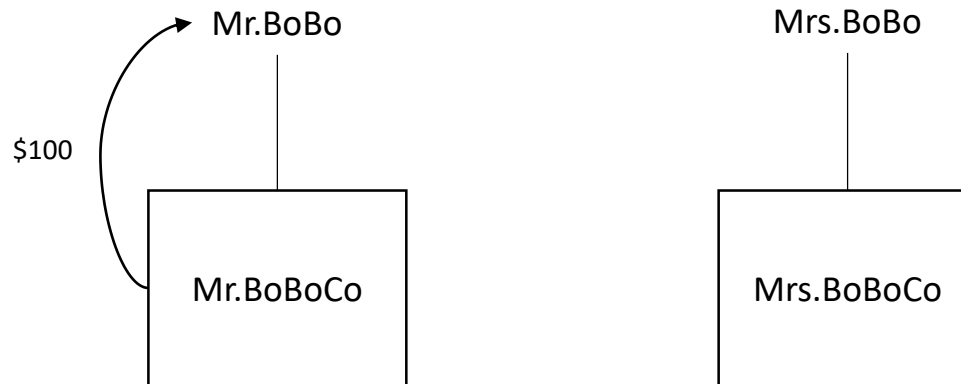


- Current year there is no income from Mr. BoBoCo that is derived from related business of Mrs. BoBoCo.
- Any dividend in the current year paid from Mr. BoBoCo to Mr. BoBo not subject to TOSI
- Planning opportunities?

# 2017 Calendar Year



# 2018 Calendar Year



- In 2018 dividend did not come from related business; (if it is from historical related earnings that comes from related business)
  - Therefore no TOSI for Mr. BoBo.
  - Then , repeat the cycle.....

# Definition of “Related Business”

In respect of a specified individual for a taxation year, means any one of the following:

- (a) A business carried on by
  - i. A source individual in respect of the specified individual at any time in the year, or
  - ii. A partnership, corporation or trust if a source individual in respect of the specified individual at any time in the year is actively engaged on a regular basis in the activities of the partnership, corporation or trust related to earning income from the business;
- (b) A business of a particular partnership, if a source individual in respect of the specified individual at any time in the year has an interest – including directly or indirectly through one or more partnerships – in the particular partnership; and

# Definition of “Related Business”

- c. A business of a corporation, if the following conditions are met at any time in the year:
  - i. A source individual in respect of the specified individual owns
    - A. Shares of the capital stock of the corporation, or
    - B. Property derives, directly or indirectly, all or part of its fair market value from shares of the capital stock of the corporation, and
  - ii. It is the case that

$$0.1A \leq B + C$$

Where

**A** is the total fair market value of all of the issued and outstanding shares of the capital stock of the corporation,

**B** is the total fair market value at that time of property described in clause (i)(A), and

**C** is the portion of the total fair market value of property described in clause (i)(B) that is derived from shares of the capital stock of the corporation

[source individual owns at least 10% of value of corporation]

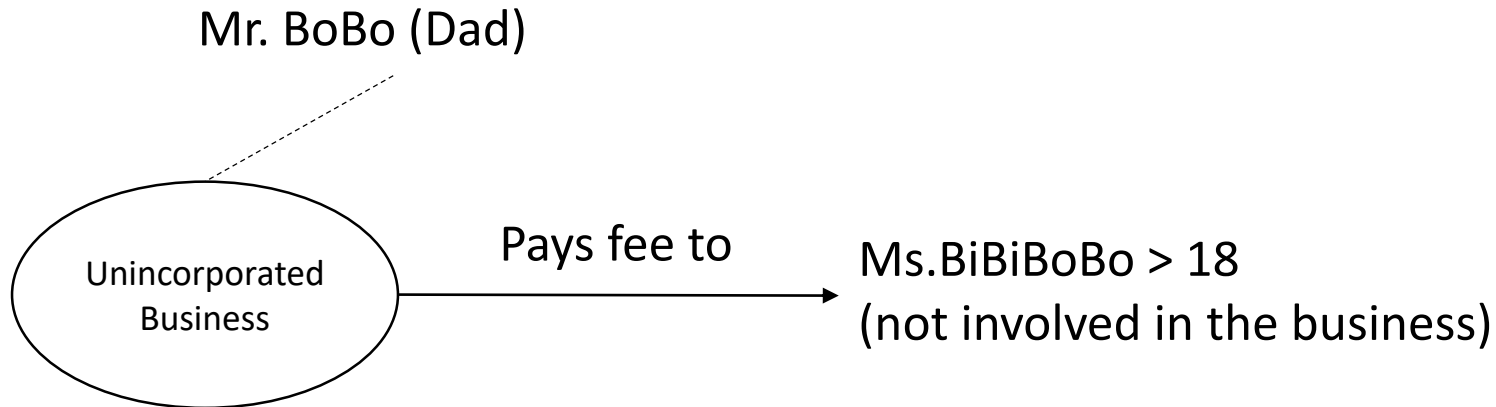
# Source Individual

In respect of a specified individual for a taxation year, means an individual (other than a trust) who at any time in the year is:

- a) Resident in Canada; and
- b) Related to the specified individual



# New Definition a(i) of Related Business

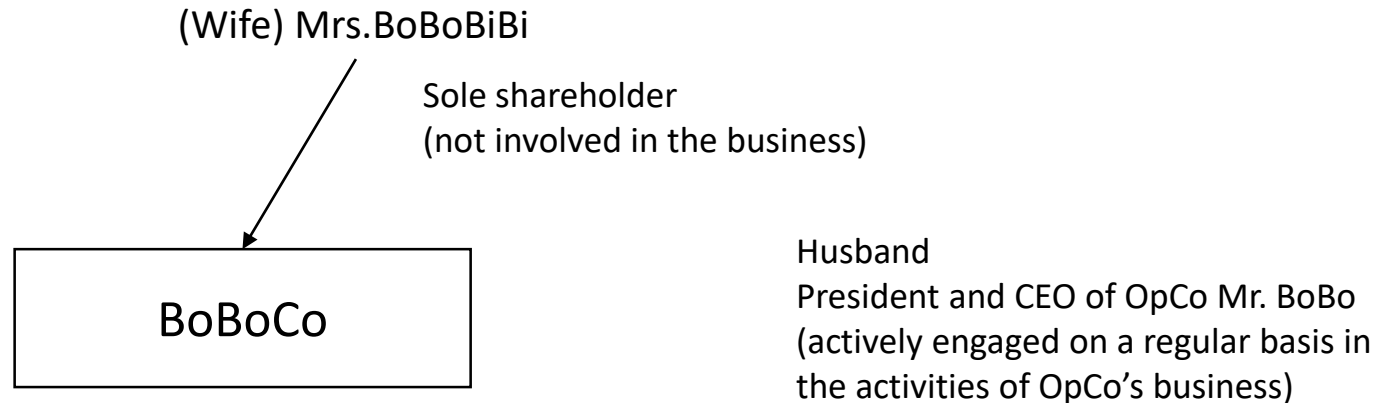


## Analysis

- 1) Is daughter (Ms. BiBiBoBo) a specified individual? Yes, resident in Canada.
- 2) Is Mr. BoBo a source individual? Yes, resident in Canada and related to daughter (specified individual).
- 3) Is unincorporated business a related business in respect of the daughter? Yes, Mr. BoBo (source individual) in respect of the daughter Mrs. BiBiBoBo (specified individual) is carrying on an unincorporated business.

**Conclusion: Unincorporated business is a related business but fee is not split income (as long as not recharacterized as partnership income)**

# New Definition of a(ii) of Related Business

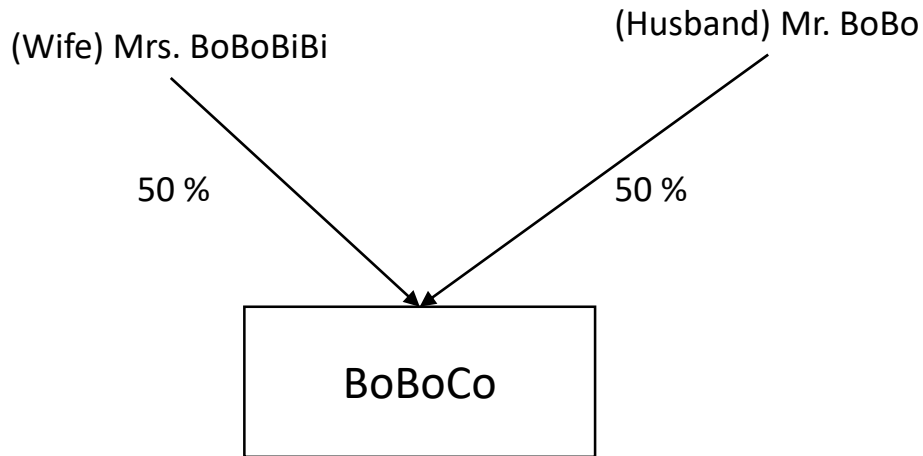


## Analysis

- 1) Is wife Mrs.BoBoBiBi specified individual? Yes, resident in Canada.
- 2) Is husband Mr. BoBo source individual? Yes, resident in Canada and related to wife.
- 3) Is BoBoCo a related business of wife (specified individual)? Yes, husband Mr BoBo is actively engaged on a regular basis in the activities of the business of BoBoCo in respect of the wife Mrs.BoBoBiBi (specified individual).

**Conclusion:** OpCo is a related business. Husband needs only to be actively engaged on a regular basis, and does not need to be involved in the business on a full-time basis. Any dividend to wife is split income (unless it is an excluded amount)

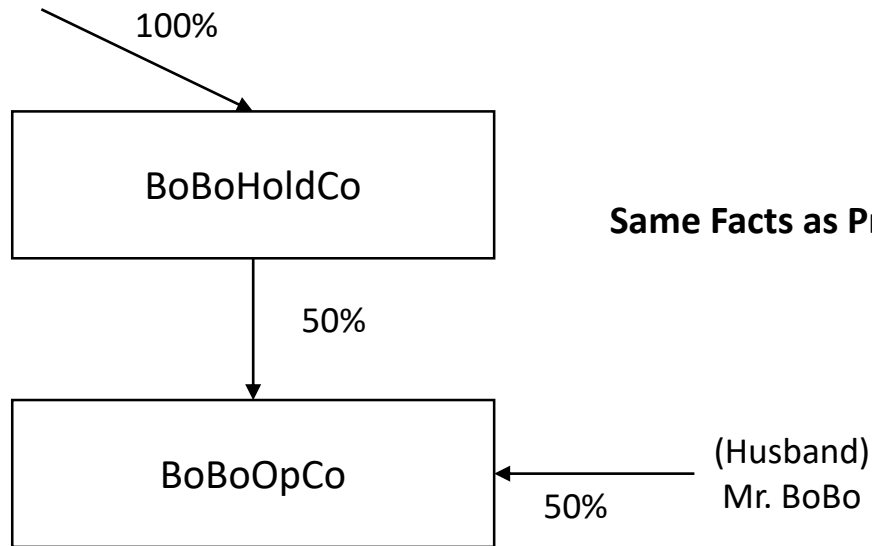
# New Definition of (c) of Related Business



Both resident in Canada and over 25 years old and not active in the business of BoBoCo

- Husband Mr. BoBo is a specified individual .
- Wife Mrs. BoBoBiBi is source individual and she owns 50% of FMV of issued shares (at least 10% of FMV of issued shares).
- BoBoCo is a related business in respect of husband Mr. BoBo.
- Any dividends, paid to husband Mr. BoBo will be split income (unless it is an excluded amount). Same analysis for wife

(Wife)  
Mrs. BoBoBiBi



**Same Facts as Previous Example Except...**

Wife Mrs. BoBoBiBi holds HoldCo shares which derives all or part of its value from BoBoOpCo's shares

- In this example 50% represents the portion of the value attributable to BoBoOpCo shares
- Again 10% or more of BoBoOpCo shares FMV is held by the wife

**Conclusion:** OpCo is a related business of husband, any dividend paid to husband is split income (unless it is an excluded amount). Same analysis for the wife

# New Rule

**New!** March 20, 2018 NWMM introduced new 120.4(1.1)(e) that states that an individual is deemed not to be related to their spouse at any time in a year if, at the end of the year, the individual is separate and apart from their spouse or common law partner because of a breakdown of their marriage or common law partnership.

Welcome relieving provision...

# Types of Income Subject to TOSI

## OLD RULES – 2017 AND PRIOR

## NEW RULES – 2018 AND AFTER

- (d) interest income from loans to:
  - Corporation (other than MFC or listed shares)
  - Partnership or trust (other than MFT)
- and not
  - Fully exempt interest
  - Publicly traded securities
  - Deposit at a bank or a credit union

# Types of Income Subject to TOSI

## OLD RULES – 2017 AND PRIOR

## NEW RULES – 2018 AND AFTER

- (e) taxable capital gain directly or indirectly through a trust from disposition after 2017
  - i. of shares of a corporation (other than MFC or listed shares)
  - ii. of non-share property (including partnership interest, beneficial interest of a trust or a debt obligation) if
    - an amount was included in split income of the individual for the year or a previous year
    - or
    - all or part of the fair market value was attributable to a share of a corporation (other than MFC or listed shares).

# Exclusions . . . The Force Awakens . . .

- If TOSI
  - applies if a specified individual earns income or makes a gain that is qualified as split income
- Therefore, if split income, then TOSI applies
  - Split income X Top Marginal Tax Rate
- UNLESS, Exclusions can apply
- Exclusions
  - Excluded Amounts
    - Specific Exclusions according to age categories
- If Excluded Amounts = No TOSI !



# Excluded amount paragraph (a)

- (a) If the individual has not attained the age of 24 years before the year, is from a property that was acquired by, or for the benefit of, the individual as a consequence of the death of a person who is,
  - (i) a parent of the individual, or
  - (ii) any person, if the individual is
    - (A) enrolled as a full-time student during the year at a post-secondary educational institution (as defined in subsection 146.1(1)), or
    - (B) an individual in respect of whom an amount may be deducted under section 118.3 in computing a taxpayer's tax payable under this Part for the year;

# Excluded amount paragraph (b)

(b) is from a property acquired by the individual under a transfer described in subsection 160(4);

# Excluded amount paragraph (c)

(c) is a taxable capital gain that arises because of subsection 70(5)

# Excluded amount paragraph (d)

(d) is a taxable capital gain for the year from the disposition by the individual of property that is, at the time of the disposition, qualified farm or fishing property of the individual or qualified small business corporation shares of the individual, unless the amount would be deemed to be a dividend under subsection 120.4(4) or (5) if this definition were read without reference to this paragraph;

- Would be excluded if eligible for capital gains exemption (not required to be claimed)
- NAL disposition by minors will not qualify – no crystallization (same as existing rules)
- Proposed paragraph 104(21.2)(b) will apply for the purposes of section 120.4 to deem a beneficiary to have a taxable capital gain but unclear if condition for property to be that of the individual is met.

# **New Definition of Excluded Amount Found in (e)(i)**

(e)(i) Not derived directly or indirectly from a related business in respect of the (specified) individual for the year.

# Derived Directly or Indirectly

- 120.4(1) “Excluded Amounts” ITA for Age Categories
- Paragraphs (e), (f), (g)
- Uses expression “derived directly or indirectly”
- 120.4(1.1)d) ITA definition of “derived directly or indirectly”
  - Derived from the provision of property or services to, or in support of, the business
  - Arises in connection with the ownership or disposition of an interest in the person or partnership carrying on the business, or
  - An amount derived from an amount described in paragraph (d); second generation income.
- March 20, 2018 NWMM has limited the original December 13, 2017 draft legislation infinite iterative rule of “derived directly or indirectly” to only second generation income.

# New Definition of Excluded Business Found in Excluded Amount (e)(ii)

(e)(ii) derived directly or indirectly from an excluded business of the (specified) individual for the year;

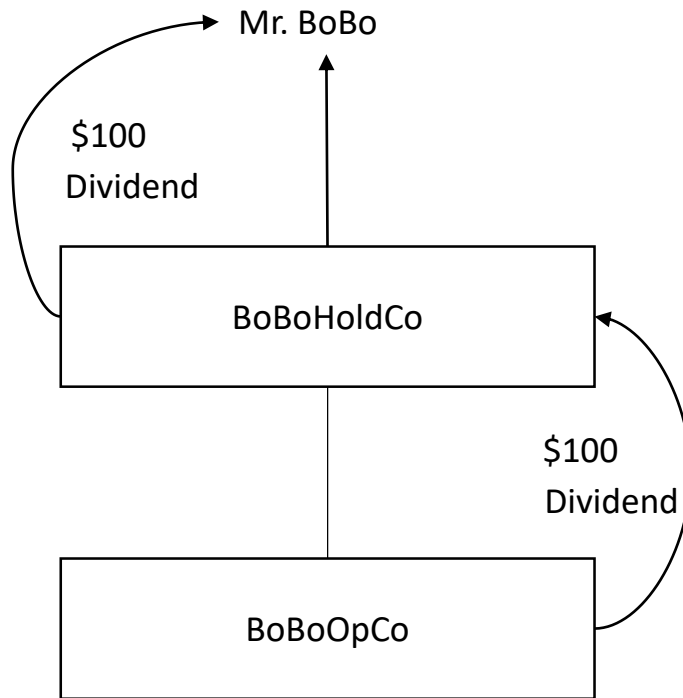
**Conclusion:** Excluded business is a good thing to avoid split income/TOSI!

# Excluded Business

Excluded business of a specified individual for a taxation year, means a business if the specified individual is actively engaged on a regular, continuous and substantial basis in the activities of the business in either:

- a. The taxation year, except in respect of an amount described in paragraph (e) of the definition *split income*; or
- b. Any five (5) prior taxation years

# Examples of Excluded Business



- BoBoOpCo is the excluded business and not BoBoHoldCo
- However, the dividend from BoBoHoldCo to Mr. BoBo is derived from BoBoOpCo (indirectly)
- BoBoHoldCo dividend qualifies as income from excluded business – avoid TOSI as an excluded business; therefore an excluded amount.

Mr. BoBo actively involved on a regular, continuous and substantial basis in OpCo and not HoldCo



# What is “Actively Involved”?

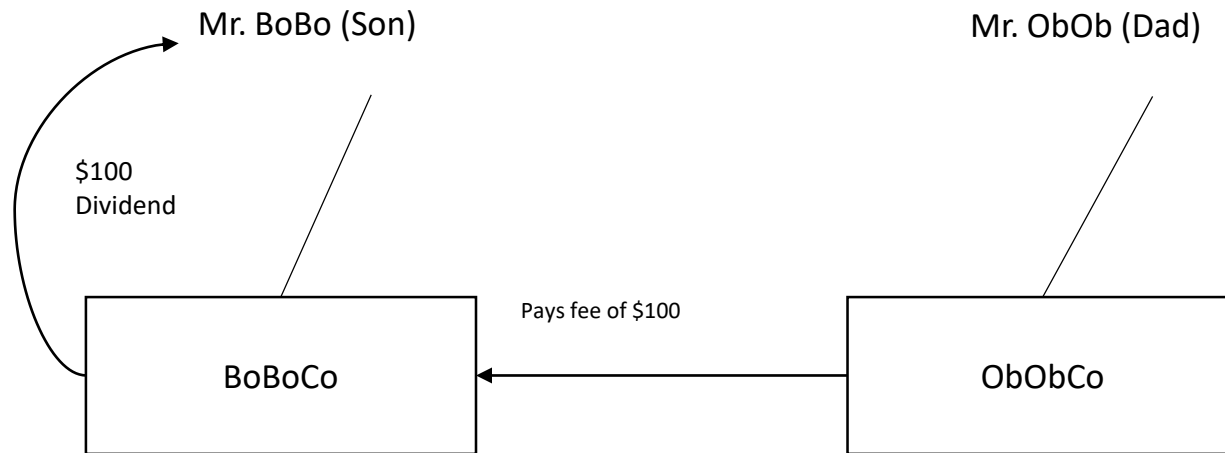
120.4 (1.1)(a) states that an individual is deemed to be actively engaged on a regular, continuous and substantial basis in the activities of a business in a taxation year of the individual if the individual works in the business at least an average of 20 hours per week during the portion of the year in which the business operates.

If the above deeming rule does not apply, then it is a “facts and circumstances” test. Specified individual more involved in the management/current activities of the business, more likely to be actively involved in the business.

# About those 5 years

- Not necessary that 5 preceding years are continuous.
- 5 year test meant to ensure that a specified individual who was actively involved in the business in prior years but has since retired from or stepped back from the business still can be exempt from TOSI in later years.

# Per the Technical Notes of “Excluded Business”



Both BoBoCo and ObObCo are professional corporations

- Mr. BoBo is active on a regular, continuous and substantial basis in BoBOCo, but not ObObCo,
- ObObCo is a related business of Mr. BoBo, however BoBoCo is still an excluded business for Mr. BoBo.
- \$100 dividend derived from BoBoCo is exempt from TOSI because BoBoCo is “excluded business”
- BoBoCo shares are not excluded shares because it is a professional corporation.

# Excluded Business – Technical Notes

Per technical notes, if a person was working 30 hrs/week on a year-round basis up to the start of July and then could not work the rest of the year because of illness. Even though the person fails to meet the deeming rule test of 20 hours per week on an average basis, Finance indicated that this person will still meet the factual test of “actively engaged on a regular, continuous and substantial basis in the activities of the business”.

# **EXAMPLE - To Sprinkle or Not To Sprinkle - Seasonal Family Business - Inspired from 4A of CRA Guidance Documents**

- Mr. BoBo (Child) is a shareholder of BoBoOpCo
- BoBoOpCo has a seasonal family business of 40 weeks
- Mr. BoBo works 40 hrs/week over 20 weeks
- Mr. BoBo would be deemed to be actively engaged in the business because he worked an average of 20 hrs/week during the portion of the taxation year that the farming business operated

**Conclusion:** Dividends can be paid to Mr. BoBo without attracting TOSI as they are an excluded amount because BoBoOpco is an excluded business.

# Safe Harbour Capital Return & Arm's Length Capital (Reasonable Return) - 18 to 24 years old

- If 18-24 years of age (Exclusions) :
- “Safe Harbour Capital Return” 120.4(1) paragraph f ITA
  - Return on property contributed by the individual in support of the Related Business
  - Return cannot exceed a prescribed capital return
  - Return on contributed capital up to the prescribed rate currently 2%
- “Arm's Length Capital” 120.4(1) ITA (“Reasonableness Return”) 120.4(1) ITA
  - Property of an individual that is inherited or earned by the individual (salary)
  - Excludes 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
  - Disregard contributions of labour
- Reasonableness Test here is : Reasonableness with regards to contributions of Arm's Length Capital to the business
  - Amount will be excluded if it does not exceed a reasonable return on arm's length capital contributed by the individual

# New Definition of Safe Harbour Capital Return found in Excluded Amount f(i)

## Safe Harbour Capital Return

$$A \times B$$

Where

A - Lowest prescribed rate (currently 2%) (Attention: the law says highest prescribed rate)

B - FMV of property contributed in support of a related business prorated based on days used.

- Technical notes referred to prescribed rate set out in paragraph 4301(c)
- FMV determined at time of contribution
- Gives minimum reasonable amount

# Reasonable return on Arm's Length Capital is Excluded Amount f(ii)

- Exception applies only to a reasonable return having regard only to the contributions of arm's length capital by the individual.
- No exclusion for other contribution such as labour or assumption of risk.



# New Definition of Arm's Length Capital

- Not acquired as income from or a taxable capital or profit from disposition of, another property derived directly or indirectly from a related business
- Not borrowed under a loan or other indebtedness
- Not transferred directly or indirectly from a related person (otherwise than as a consequence of death)
- Salary earned from a related business will qualify

# “Excluded Shares”

- Only available to individual who is  $\geq$  age 24 in the PY (25 and over in the current year).
- A very generous carve-out for the businesses not in the service business.
- Shareholders of “excluded shares” does not have any contribution requirement, never need to be active in the business, and will not need to substantiate anything other than that the shares qualify as “excluded shares”.
- TOSI will not apply.

# “Excluded Shares”

Excluded shares, of a specified individual at any time, means shares of the capital stock of a corporation owned by the specified individual if

(a) the following conditions are met:

(i) less than 90% of the business income of the corporation for the last taxation year of the corporation that ends at or before that time (or, if no such taxation year exists, for the taxation year of the corporation that includes that time) was from the provision of services, and

(ii) the corporation is not a professional corporation;

(b) (March 20, 2018 NWMM change in legislation) immediately before that time, the specified individual owns shares of the capital stock of the corporation that:

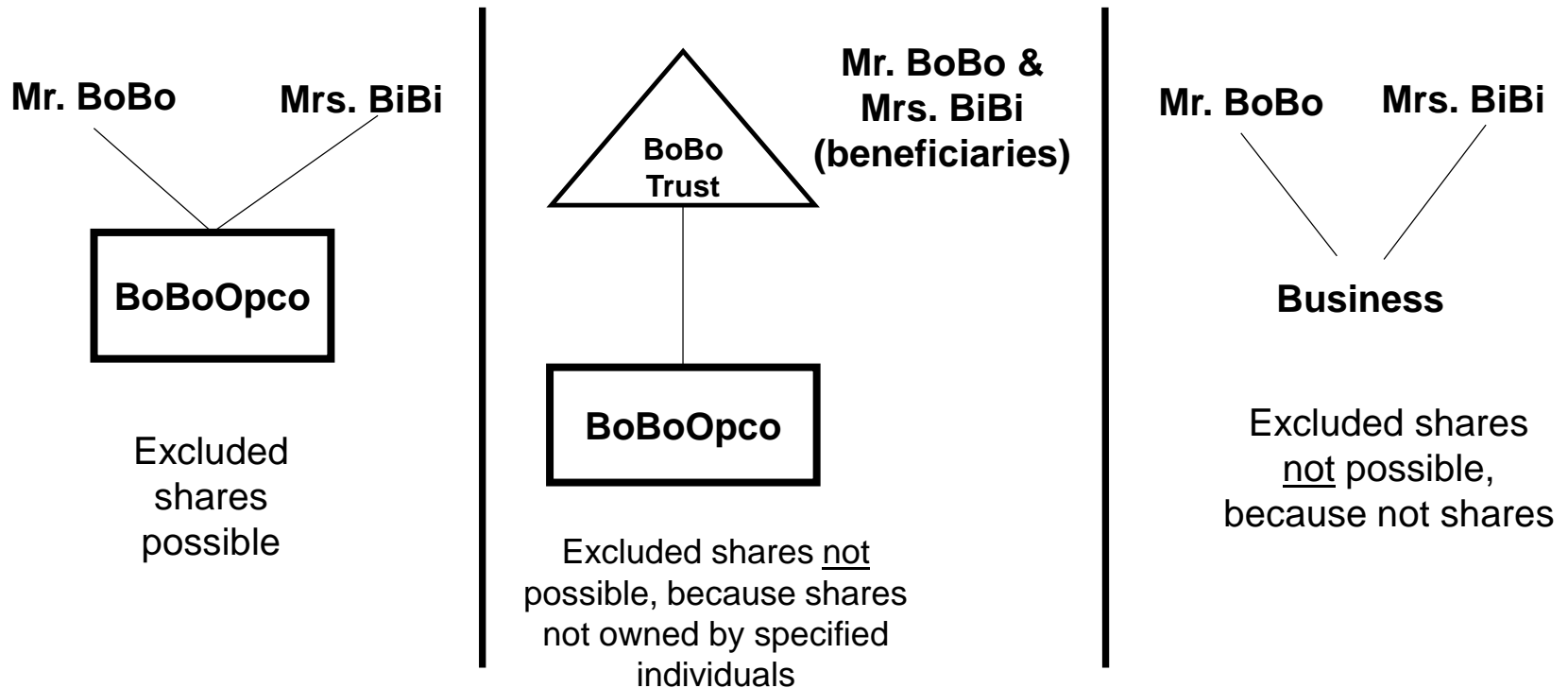
(i) give the holders thereof 10% or more of the votes that could be cast at an annual meeting of the shareholders of the corporation, and

(ii) have a fair market value of 10% or more of the fair market value of all of the issued and outstanding shares of the capital stock of the corporation; **and**

(c) all or substantially all of the income of the corporation for the relevant taxation year in subparagraph (a)(i) is income that is not derived, directly or indirectly, from one or more other related businesses in respect of the specified individual, (March 20, 2018 NWMM change in legislation) other than a business of the corporation.

# Direct Ownership Criteria

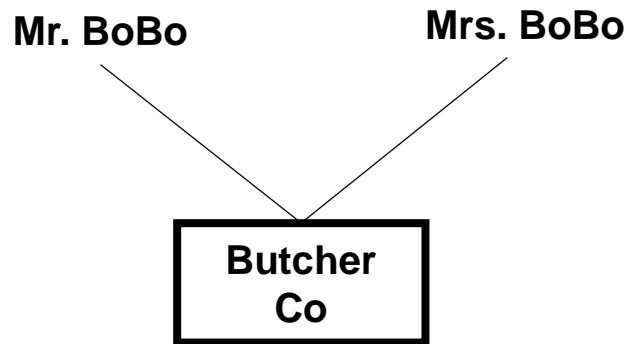
- Shares “owned by the specified individual”.
- Requires direct ownership. Trust beneficiaries must rely on other exclusions



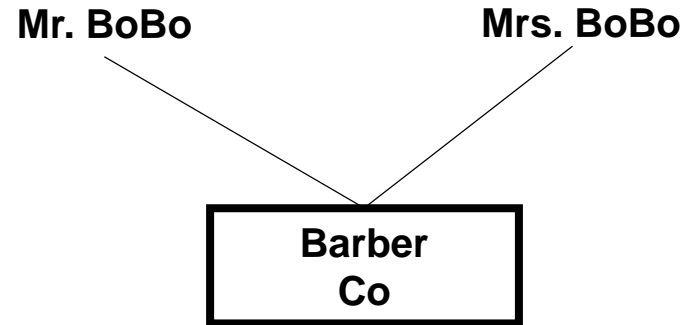
# Excluded Shares Paragraph (a)

- Paragraph (a):
  - Professional corporation automatically disallowed, e.g. doctor, dentist, lawyer, etc.
  - Less than 90% of the business income of the corporation for the last taxation year of the corporation that ends at or before that time (or, if no such taxation year exists, for the taxation year of the corporation that includes that time) was from the provision of services.
- The second part is presumably to prevent businesses that are 'professional-like' from assessing this generous exclusion. However, it is worded extremely broadly.
- Note that this test does not require the corporation to operate a business.

# Excluded Shares – Paragraph a) – Cont’d



“Excluded  
shares” possible;  
Can income split



Unless <90%  
business income from  
service, Can never be  
“excluded shares”.

# The 90% Test – Business Income

- Issue : Less than 90% of Business Income comes from services
- Business Income is not a defined term in ITA
  - Likely includes Investment Income (Specified Investment Business)
- Possible for services business to be loaded with investment + carry out sufficient activities to constitute a business
  - Ability then to qualify for Excluded Shares Exception
- Gross Income VS Net Income
- Services business can sometimes justify income from sale of materials
  - Sale of Materials = Business Income
- Internal accounting methods
  - Separate Materials vs Services
    - Potential ability then to qualify for Excluded Shares Exception

# The 10% Test of Votes and Value

- Paragraph (b)
- Immediately before that time, the specified individual owns shares of the capital stock of the corporation that:
  - (i) give the holders thereof 10% or more of the votes that could be cast at an annual meeting of the shareholders of the corporation, and*
  - (ii) have a fair market value of 10% or more of the fair market value of all of the issued and outstanding shares of the capital stock of the corporation;*
- Food for thought ?
- Similarity as the Part IV Tax “connected” test in s.186(4)(b).
  - 120.4(1) Excluded Shares paragraph (b) : now does not require the same class of share to have both votes and value (March 20, 2018 NWMM change);
  - 186(4)(b) ITA : the votes and value can reside in two different share class?
    - Describes characteristics required of these shares



# 10% Requirement: Timing and Transition Period

- Point in time test.
  - Example: from Jan to June, Mr. A owned 10% votes and value of Opco, and from July to Dec, ownership dropped to 5%. Dividend and capital gain arising between Jan and June may be protected by “excluded shares” exclusion.
- As a transitional measure, for the 2018 taxation year, the 10% threshold may be met at the end of 2018.
- Important to structure shareholders to meet the 10% threshold during 2018 where possible.
  - For Corporations that could meet the other criteria of Excluded Shares

# Related Business Income Prohibition

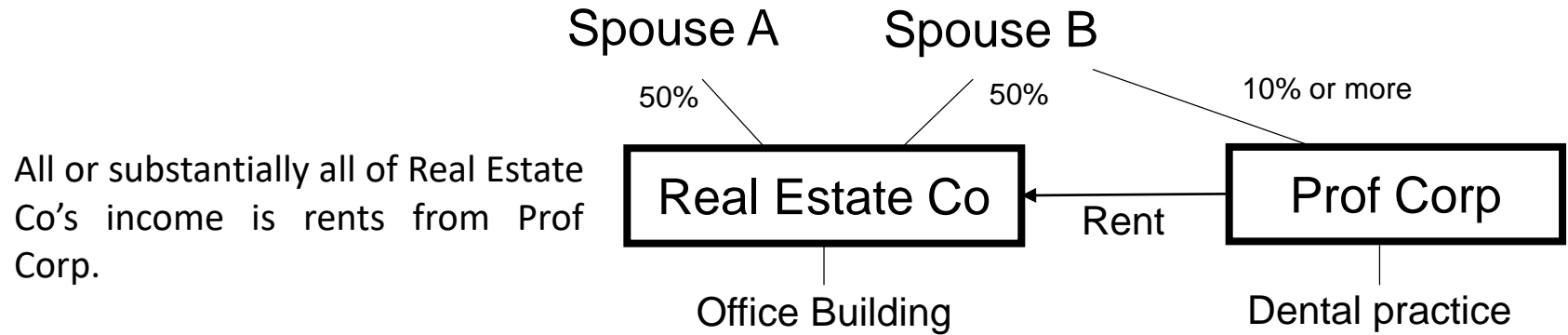
- Paragraph (c): *all or substantially all of the income of the corporation for the relevant taxation year in subparagraph (a)(i) is income that is not derived, directly or indirectly, from one or more other related businesses in respect of the specified individual, other than a business of the corporation.*

- From the Explanatory notes:

*“This limitation is intended to prevent the circumvention of the TOSI rules by splitting a services business into services and non-services parts. For example, this would apply to the use of holding companies and so-called “side car” structures (e.g., where property used in a service business is leased to a corporation carrying on the services business by another corporation in which the specified individual has an interest).”*

*Per “other than a business of the corporation” wording, the March 20, 2018 NwMM wishes to clarify that excluded shares will not be disqualified by a related business of the same corporation but of a different corporation.*

# Related Business Income Prohibition: “Other” Related Business



- The “excluded shares” is not allowed for professional or service corporations. Can shareholders plan around this by diverting income, such as rent, to a separate corporation owned by family member?
- No. All or substantially all of Real Estate Co's income is derived directly or indirectly from the Prof Corp's dental practice, which is a “related business”. Because this related business is owned by Prof Corp, it is an “other” related business to Real Estate Co.
- Therefore, shares in Real Estate Co cannot be “excluded shares” and Spouse A/B cannot income split relying on the “excluded shares” exclusion.
- This is referred to in Finance's Explanatory Notes as the rationale for paragraph (c).

# Reasonable Return

- 120.4(1) ITA
- Reasonableness Test
  - Criteria the same
  - Applied differently, if 18 to 24 OR 25 and over
    - 18 to 24 : Reasonableness with regards to “Arm’s Length Capital” and “Safe Harbour Capital Return” 120.4(1) ITA
    - 25 and over: Reasonableness with regards to “Reasonable Return” 120.4(1) ITA
- What is acceptable is based on whether Reasonable Amount
  - If Reasonable Return = No TOSI
  - If exceeds Reasonable Return = TOSI applies
- Reasonableness Criteria to determine the amount that exceeds a reasonable amount (based on relative contributions and no longer any arm’s length standards imposed by the July 18, 2017 proposals)

# Reasonableness Criteria

- Reasonableness Return
- Labour Contribution :
  - The work performed by the individual in support of the Related Business before the amounts became paid
- Property Contribution :
  - The property contributed by the individual in support of the Related Business
- Risk Incurred :
  - The risks assumed by the individual in respect of the Related Business
- Historical Payments :
  - The total amounts paid by any person or partnership to or for the benefit of the individual in respect of the Related Business
- Other relevant factors

# Reasonableness Criteria

- Labour Contribution
- Factors that will be taken into consideration :
  - Nature of the tasks performed
  - Hours required to complete the tasks
  - Competitive salary & wage for the tasks in relation to businesses of similar size and industry
  - Education, training and experience
  - Degree of activities and nature of activities in relation to those of a business of a comparable nature and size
  - Time spent on the activity in comparison to time spent in other activities or undertakings
  - Particular knowledge, skills or know-how that the individual possessed
  - Business acumen
  - Past performance of functions

# Reasonableness Criteria

- Property Contribution
- Factors that will be taken into consideration :
  - Amount of capital contributed to the business
  - Amount of loans to the business
  - FMV of property (tangible and intangible property) transferred to the business; including technical knowledge, experience, skill, know-how
  - Whether the individual has provided property as collateral for loans or other undertakings
  - Whether other sources of capital or loans are readily available
  - Whether comparable property are readily available
  - Whether property are unique or personal to the individual
  - Opportunity costs
  - Past property contributions

# Reasonableness Criteria

- Risk Assumption
- Factors that will be taken into consideration :
  - Whether the individual is exposed to the financial liabilities of the business; through guarantees of mortgages, loans or lines of credit or otherwise
  - Whether the individual is exposed to statutory liabilities related to the business
  - Extent of the risk that contributions made by the individual to the business may be lost, whether in whole or part
  - Whether any risk is indemnified or otherwise limited in the circumstances, whether by agreement or otherwise
  - Whether the individual's reputation or personal goodwill is at risk
  - Past or ongoing risk assumption



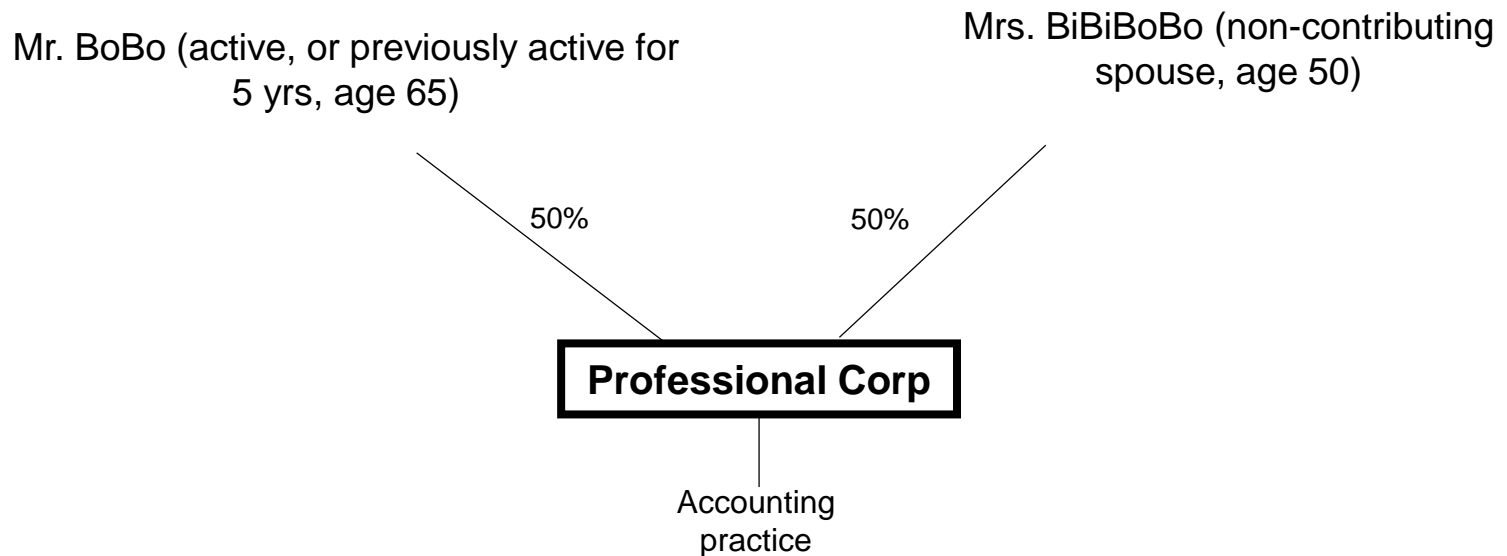
# Reasonableness Criteria

- Historical Amounts (Total Amounts Paid)
- Take into account any other amounts previously paid to the individual
- Includes :
  - Payments of any kind (salary, other remuneration, compensation, dividends, interest, proceeds, and fees)
  - Benefits
  - Deemed payments (as reasonably required in the circumstances)

# Excluded Amounts – Age 65 Years Old

- 120.4(1.1)c) ITA
- Unlimited Income Splitting allowed
  - Individual with a contributing spouse age 65 or over in the present year OR has died
- S.120.4(1.1)(c): An individual's income or taxable capital gain for the year is deemed to be an "excluded amount" if
  - A. the amount would have been an excluded amount in the hands of the individual's spouse or CL partner, if it had been received by the spouse or CL partner in the year, and
  - B. the spouse/CL partner was  $\geq$  age 64 in the PY (65 years or over in the current year).
  
- Be Careful :
- Attained 65 years old
  - Contributing spouse of the specified individual
  - The income or taxable capital gain to be Excluded Amount
- The age 65 rule only applies to permit income when a contributing spouse turns 65 years old in the present year

# Example #1 – To Sprinkle or Not To Sprinkle- Contributing Spouse Age 65 Years Old

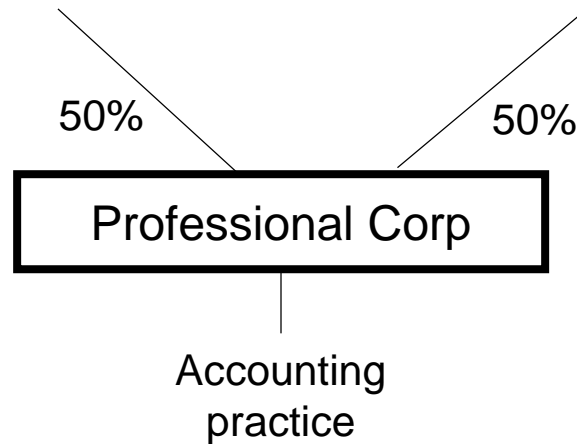


- Prior to Mr. BoBo reaching age 65, any income received by Mr. BiBiBoBo subject to TOSI since none of the exceptions can be met (not “excluded business” or a “reasonable return” because Mrs. BiBiBobo (spouse) never active, cannot be “excluded shares” since it is a prof corp).
- Once Mr. BoBo attains age 65 in the current year, unlimited ability to income or capital gain split with Mrs BiBiBoBo, because if the income or gain were earned by Mr. BoBo it would have been an “excluded amount”.

# Example #2: Non-Contributing Spouse Age 65

Spouse A (active, or previously active for 5 yrs, age 50)

Spouse B (non-contributing, age 65)



- Spouse B does not meet any of the exclusions. TOSI applies to Spouse B.
- Spouse B attaining age 64 in the PY does not entitle Spouse B to the age 65 rule. The age 65 rule only applies to permit income when a contributing spouse turns 65 in the current year.

# Excluded Amounts – By Age Categories

- Steps to follow for the new age categories :
- 1<sup>st</sup> step, apply paragraph (e) first
  - Applies to INDIVIDUAL who is 18 or 18 years old and older = Not a Minor
  - Check Exclusions : Related Business and Excluded Business
- 2nd step, apply EITHER paragraph (f) or (g)
  - Depends if the specified individual is between 18 to 24 or 25 years old and over
  - OR
  - If a contributing spouse has attained 65 or has died, apply 120.4(1.1)c)

# Sprinkle Sprinkle - Conclusions

- Income is Split Income unless Exceptions
  - If Split Income : TOSI applies the highest marginal tax rate 47 %
- The Exceptions in order of analysis where applicable :
- For adult individuals, 18 and over - Excluded Business and not a related business
- Where possible, always use an Exclusion concept that is applicable before using Reasonableness
- Failing which, proceed by age category :
  - If age 25 or over - Excluded Shares or Reasonableness Test
    - Was there Reasonableness with regards to a reasonable return ?

# Sprinkle Sprinkle

## Conclusions

- If 18-24 years of age – Safe Harbour Capital Return, or, Arm's Length Capital Reasonableness
  - Reasonableness Test here is : Reasonableness with regards to contributions of Arm's Length Capital to the business
- If spouse aged 65 + or deceased and would be excluded amount to spouse
  - Attention : Attained 65 in present year
- Always check Reasonableness Criteria, this is dependent on facts and circumstances
- Under 18 years old kids actively involved in the business cannot pay dividends as they are specified individuals and no exclusions are applicable to < 18 years old.
- Can only pay reasonable (unreasonable) salaries to minors.

**Questions ?**





For More Information

Manu Kakkar

CPA, CA, BSc.(Hons), TEP, MTax

**Manu Kakkar CPA Inc.**

Tel: 1-877-988-4600

Email: [info@kakkar.com](mailto:info@kakkar.com)

[www.Kakkar.com](http://www.Kakkar.com)