CANADIAN TAX FOUNDATION
FONDATION CANADIENNE DE FISCALITÉ

ESTATE PLANNING & TRUSTS

Tax on Split Income

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TOSI: The Old ‘‘Kiddie Tax’’ Regime

Framework of the old “Kiddie tax” rules

If a **specified individual** …

… receives an amount that is **split income** …

… and that is not an **excluded amount,** …

… tax will be payable by the specified individual on this split income at the highest individual percentage.

Background

- Since Canadian federal and provincial income tax is levied at progressive rates, taxpayers often attempt to find ways to income split with lower-income family members in order to reduce the overall amount of income tax payable by the family unit as a whole.

- To discourage this type of income splitting, several attribution rules have been introduced into the Act over the years.

- A tax on split income was introduced to combat income splitting with respect to certain types of dividends and business income between parents and their minor children.

The "Kiddie Tax" rules

- Subsection 120.4(2) : "there shall be added to a specified individual's tax payable under this Part for a taxation year the highest individual percentage [33% in 2017] for the year multiplied by the individual's split income for the year."

- The terms "specified individual" and "split income" are defined in subsection 120.4(1).

- A "specified individual" is an individual <u>under 18</u> who is a Canadian resident throughout the year with at least one Canadian resident parent at any time in that year.

Split Income – Old Rules

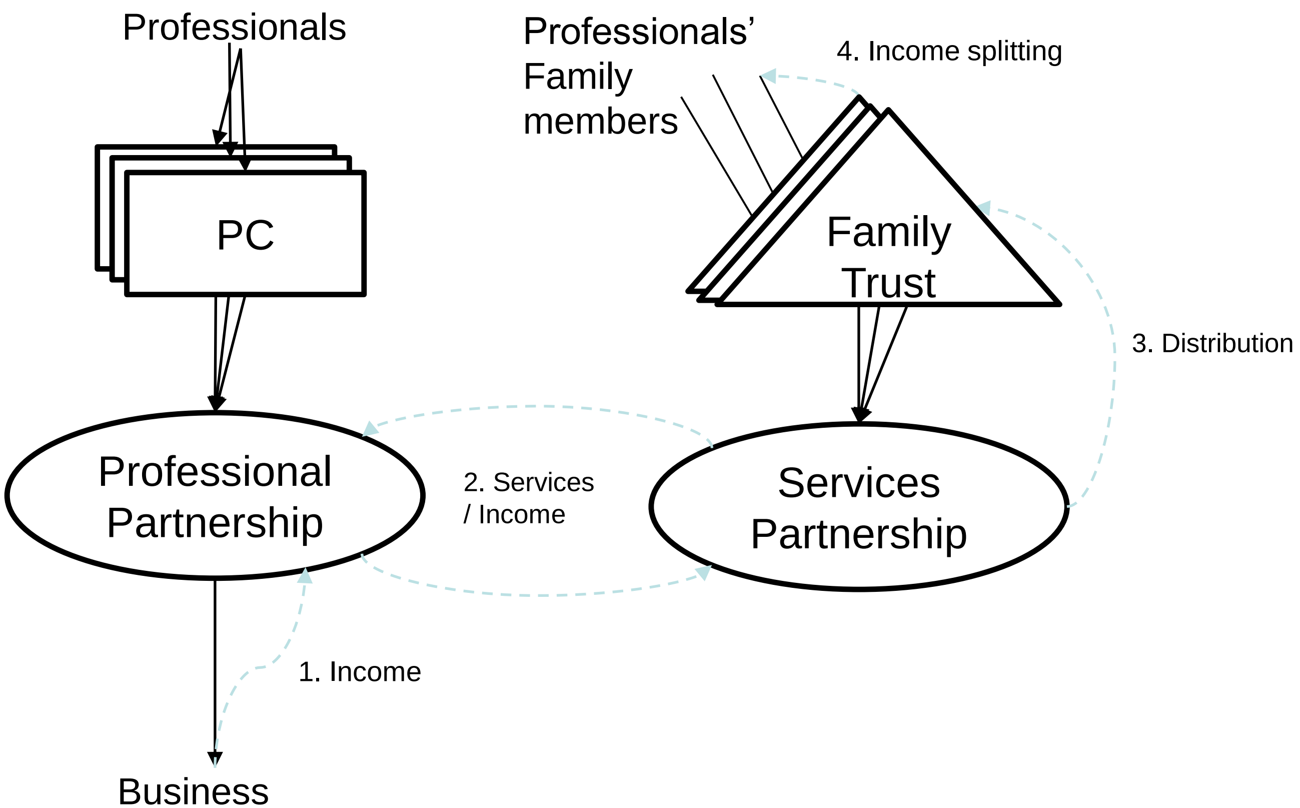
> "Split income" of a specified individual is the aggregate of the following types of income:

1. Taxable dividends received directly or indirectly on a class of shares of a Canadian or foreign corporation that is not listed on a designated stock exchange or shares of an MFC;

2. Section 15 income received directly or indirectly in respect of shares described in 1);

3. Income received from a trust or partnership that is income derived from the provision of property or services by the trust or partnership to or in support of a business carried on by:
   - a person related to the specified individual;
   - a corporation of which a person who is a specified shareholder of the corporation is related to the specified individual; or
   - a professional corporation of which a shareholder of the corporation is related to the specified individual;

Example of split income #3 (Old Rules)



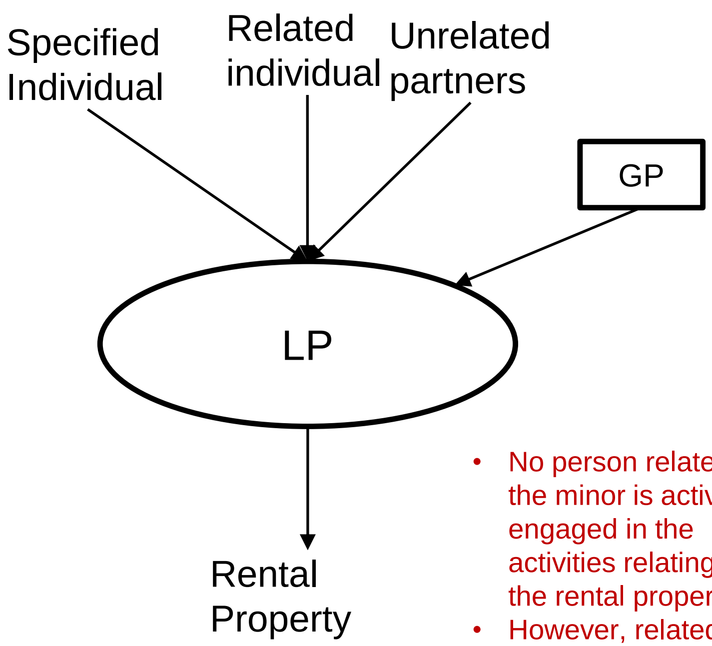
Split Income – Old Rules (cont'd)

4. Income received from a trust or partnership that is income derived from a source that is a business or a rental property, <u>and</u> a person related to the minor:
   - is actively engaged on a regular basis in the activities of the trust or partnership to earn income from any business or rental property, or
   - has, in the case of a partnership, an interest in the partnership (whether held directly or through another partnership).

5. Taxable capital gains of the specified individual from a non-arm's length disposition of unlisted shares (twice the amount of the taxable capital gain is recharacterized as taxable dividend of the specified individual).

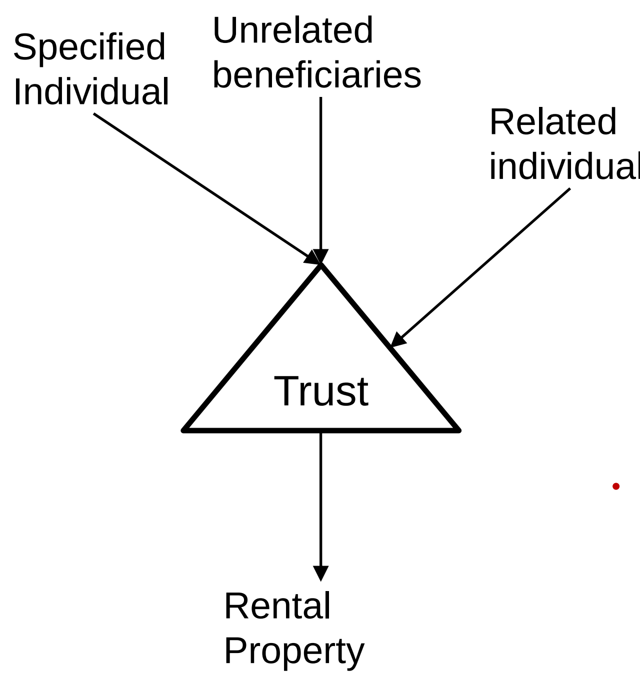
Example of income #4 (Old Rules)

Scenario 1 – Split income



- No person related to the minor is actively engaged in the activities relating to the rental property
- However, related person owns an interest in the LP

Scenario 2 – No split income



- No person related to the minor is actively engaged in the activities relating to the rental property

Exceptions to Split Income

- Taxable dividends received on publicly-listed shares;
- Employment income; and
- Any income received by a specified individual (minor) that is an “excluded amount”.

Excluded Amount

- Income or taxable capital gain from a property acquired by the specified individual (or for his or her benefit) as a consequence of the death of
  - a parent of the individual, or
  - any other person if the individual is a full-time student at a post-secondary institution during the year or is eligible to claim the disability tax credit in the year.

The New TOSI rules

Framework of the new TOSI rules

If a **specified individual** …

… receives an amount that is **split income** …

… and that is not an **excluded amount,** …

… tax will be payable by the specified individual on this split income at the highest marginal tax rate.

Specified Individual

An individual is a **specified individual** if the following conditions are met:

- Not a trust;
- A Canadian resident at the end of the year (or immediately before death);
- If the individual has not attained the age of 17 before the year,
  - The individual has a parent resident in Canada at any time in the year.

Split Income

1. Taxable dividends from a corporation (other than publicly-listed or MFC shares) received directly or indirectly;

2. Section 15 income received directly or indirectly in respect of shares described in 1);

3. Taxable capital gains of specified individual under 18 from a non-arm's length disposition of unlisted shares;

4. Income received from a partnership that is income derived directly or indirectly from:
   - one or more related businesses, or
   - the rental of property by a partnership or trust if a related person is actively engaged on a regular basis in its activities, or, in the case of a partnership, has a direct or indirect interest in the partnership;

5. Income received from a trust that is income derived:
   - directly or indirectly from one or more related businesses, or
   - from the rental of property by a partnership or trust if a related person is actively engaged on a regular basis in its activities of the partnership or trust in relation to the rental of property.

Split Income (cont'd)

5. Amounts in respect of a debt obligation of a corporation (other than a publicly listed corporation or a mutual fund corporation), partnership or trust (other than a mutual fund trust), other than :
   - certain debts of, or debts guaranteed by, governments, that are described in paragraph (a) of the definition "fully exempt interest" in subsection 212(3);
   - publicly-listed or traded debt; and
   - a deposit standing to the individual's credit at a bank or credit union.

6. Taxable capital gains and income from the disposition of property, received directly or through a trust, to the extent the property is :
   - a share of the capital stock of a corporation (other than from publicly traded shares or from mutual fund corporation), or
   - A debt obligation or an interest in a partnership or trust (other than MFT or 143(1) trust), in respect of which (i) an amount was included in the individual's split income for the year or earlier year, or (ii) all or part of its FMV immediately before the disposition was attributable to a share of a corporation.

Excluded Amount

> The definition provides many exceptions which apply (or not) depending on:

- the characteristics of the individual receiving the amount;
- the source of the income;
- the circumstances under which it arises.

> To this effect, the definition incorporates a number of key notions that are discussed below.

Excluded Amount (cont'd)

- Briefly, the exceptions are income or gain that are:
  - from inherited property (certain individuals only but - 24);
  - from subsection 160(4) property (matrimonial settlements);
  - a subsection 70(5) gain;
  - a gain from qualified farm/fishing property or QSBC shares (certain circumstances only)
  - not from a **related business** (17+);
  - from an **excluded business** (17+)
  - a **safe harbour capital return** (17+ - 24);
  - a **reasonable return** with respect to **arm's length capital** only (17+ - 24);
  - from **excluded shares** (24+);
  - a **reasonable return** (24+).

Excluded Amount – From Inherited Property

- Who?
  - Individuals who have not attained the age of 24 before the year.
    - If the individual is over 24 years old, the exclusion will not apply, even if the individual inherited the property before he or she attained the age of 25 years.
- What?
  - Income or gain from property inherited from <u>a parent</u>, OR
  - property inherited from <u>any person if</u> the individual is during the year:
    - a full-time student (post-secondary educational institution), or
    - An individual to whom 118.3 applies (mental or physical impairment).

Excluded Amount – Gain from QSBC shares (+ farm/fishing property)

- Who?
  - Any individual;
    - (The gain can be realized through a trust)
- What?
  - Taxable capital gain from qualified farm/fishing property or QSBC shares, **UNLESS**
    - Subsection 120.4(4) or (5) applies to the disposition.
- Subsections 120.4(4) and (5) apply to a capital gain realized by an individual who has not attained the age of 17 before the year and that is from a <u>disposition to an non-arm's length person</u>.

Excluded Amount – Not Derived from a Related Business

- Who?
  - Individuals who have attained the age of 17 before the year.
- What?
  - Income or gain not derived directly or indirectly from a **related business**.
- Related Business: a business, or the provision of property or services to such business, to which a **source individual** (*i.e.* an individual, other than a trust, resident in Canada that is related to the specified individual) has a "sufficient connection".
- A "sufficient connection" is established by either:
  - the source individual carrying on the business;
  - the source individual being actively engaged on a regular basis in the activities of the entity carrying on the business;
  - the source individual having an interest in a partnership that carries on the business;
  - the source individual owning, directly or indirectly through other properties, more than 10% of the FMV of the shares of a corporation carrying on the business.

Excluded Amount – From an Excluded Business

- Who?
  - Individuals who have attained the age of 17 before the year.
- What?
  - Income or gain derived directly or indirectly from an **excluded business**.
- Excluded Business:
  - A business if the specified individual is actively engaged on a regular, continuous and substantial basis in the activities of the business in either the taxation year, or in any five prior taxation years.

Excluded Amount – Safe Harbour Capital Return

- Who?
  - Individuals who have attained the age of 17, but not 24, before the year.
- What?
  - Income or gain that is a **safe harbour capital return**.

- Safe harbour capital return:
  - A return up to a prescribed rate (regulation 4301(c)) based on the FMV of property contributed by the specified individual in support of a related business (pro-rated according to the number of days in the year the property (or property substituted) was contributed).
  - Prescribed rate is currently 2%.

Excluded Amount - Reasonable Return on Arm's Length Capital

- Who?
  - Individuals who have attained the age of 17, but not 24, before the year.
- What?
  - Income or gain that is a reasonable return in respect of the individual having regard only to the contributions of arm's length capital by the individual.
    - Contributions of labour and other contributions not taken into consideration
- <u>Reasonable return</u>: Taking into consideration the relative contributions made to the business by the individual and persons related to the individual.
- <u>Arm's length capital</u>: property inherited or earned by the individual, such as salary. Specifically excluded are the following property :
  - Acquired as income/taxable capital gain derived directly or indirectly from a related business;
  - Amount borrowed by the individual;
  - Transferred directly or indirectly by any means whatever from a related person.

Excluded Amount – From Excluded Shares

- Who?
  - Individuals who have attained the age of 24 before the year.
- What?
  - Income or gain from **excluded shares**.
- Excluded Shares: shares of the capital stock of a corporation that are owned by the individual if all of the following conditions are met:
  1. less than 90% of the business income of the corporation is from the provision of services;
  2. the corporation is not a professional corporation, as defined in subsection 248(1);
  3. the individual owns shares that represent 10% or more of the votes that could be cast at an annual meeting of the shareholders and 10% or more of the FMV of all the shares of the corporation; and
  4. all or substantially all of the income of the corporation is not derived directly or indirectly from one or more other related businesses other than a business of the corporation. (You cannot split a services business into services and non-services parts (*e.g.*, lease of the property used in carrying on the service business).
- When? At the time a dividend is being paid or the shares are being sold.

Excluded Amount – Reasonable Return

> Who?
- Individuals who have attained the age of 24 before the year.

> What?
- Income or gain that is a **reasonable return** in respect of the individual.

> Reasonable Return: Reasonable having regard to a number of factors. What is relevant is the relative contributions to the business of the specified individual and each **source individual**. The factors are the following:
- the work they performed in support of the related business;
- the property they contributed, directly or indirectly, in support of the related business;
- the risks they assumed in respect of the related business;
- the total of all amounts that were paid or that became payable, directly or indirectly, by any person or partnership to them, or for their benefit, in respect of the related business; and
- such other factors as may be relevant.

Additional Rules – 120.4(1.1)(a)

> Deems an individual to be actively engaged on a regular, continuous and substantial basis in the activities of a business in a taxation year if the individual works, on average, 20 hours per week or more in the business during the portion of the taxation year that the business operates.

> No need to work every week – Is the mathematical average for the year (or part of year) higher than 20 hours per week?

> Relevant for the **excluded business** exception for individual over 17;
  - "regular, continuous and substantial basis"

> Relevant for the **related business** definition?
  - "regular basis"

> Relevant for the qualification of income from the rental of property as split income?
  - "regular basis"

Additional Rules – 120.4(1.1)(b)

- Provides a continuity rule for inherited property.
- Applies to amounts that would be split income of an over-17 specified individual in respect of property that was acquired by or for the benefit of the specified individual as a consequence of the death of another person.
- In these circumstances, the results are that:
  - If the income or gain would have been a **reasonable return** for the deceased, it will be a reasonable return for the specified individual;
  - If the income or gain would have been from an **excluded business** for the deceased, it will be from an excluded business for the specified individual;
  - If the deceased was aged 24+, the specified individual is deemed to be over 24 for the purposes of the **excluded shares** and **reasonable return** exception.

Additional Rules – 120(1.1)(c)

- Applies to amounts received by a specified individual in a taxation year, if the spouse or common law partner of the specified individual attained the age of 64 years before the year, or died before the end of the year.

- Where it applies, an amount will be an **excluded amount** in the hands of a specified individual if the amount would have been an excluded amount in the hands of the specified individual's spouse or common law partner, if it had been received by the spouse or common law partner as income in the year (or in their last taxation year, if applicable).

Additional Rules – 120.4(1.1)(d)

> Clarifies that certain amounts are included, for the purposes of the TOSI rules, in what is an amount derived, directly or indirectly, from a business.

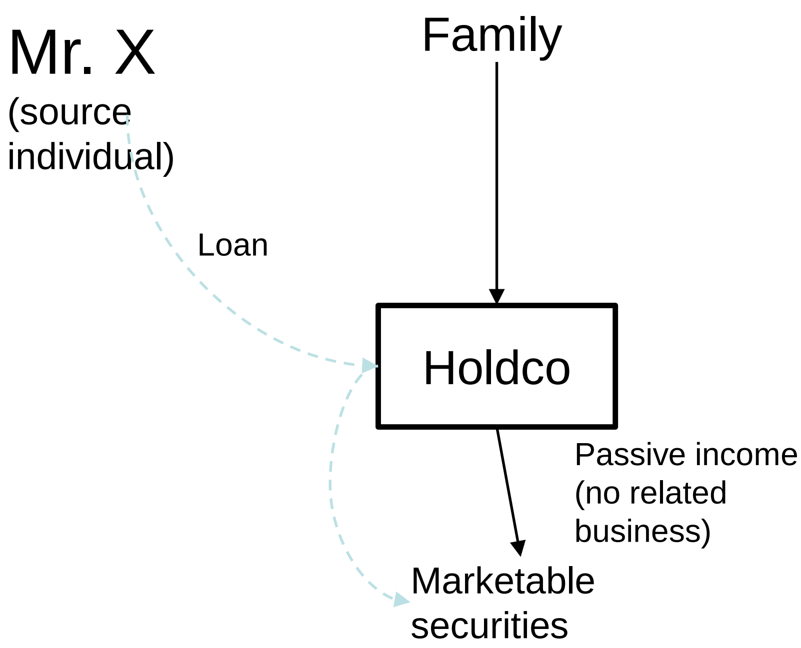
- An amount will be considered to be derived from a business where it is derived from the provision of property or services to, or in support of, the business.
- An equity return on an interest in a partnership, corporation or trust carrying on a business will also be considered to be an amount derived from that business.
- Lastly, subparagraph (ii) contains an iterative rule so that income derived from income described in the two first points above is income derived, directly or indirectly, from the business.

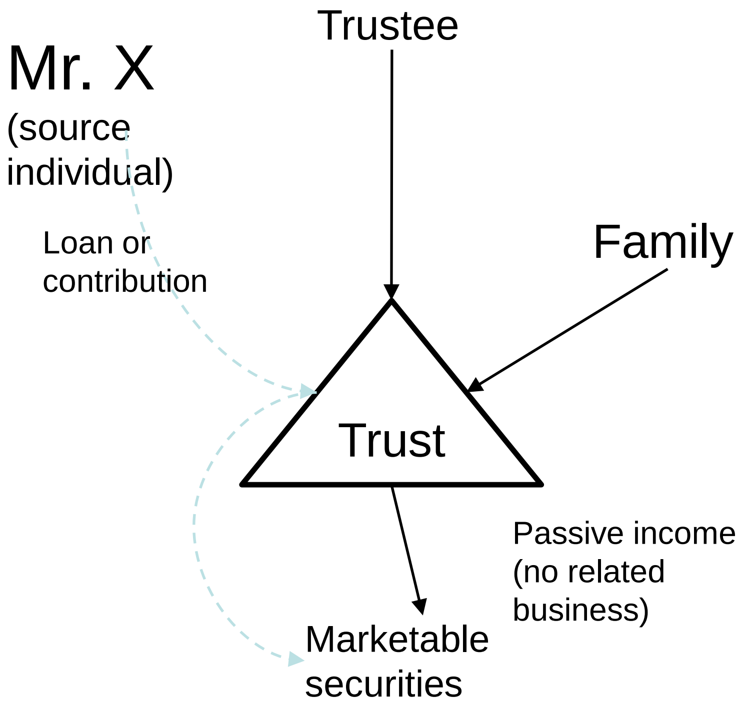
Additional Rules – 120(1.1)(e)

- Clarifies that, for the purposes of the TOSI rules, an individual is deemed not to be related to their spouse or common-law partner at any time in a year if at the end of the year, the individual is living separate and apart from their spouse or common-law partner because of a breakdown of their marriage or common-law partnership.
  - Relevant for the definition of “source individual”

TOSI Rules
Practical Applications

Income splitting with passive income

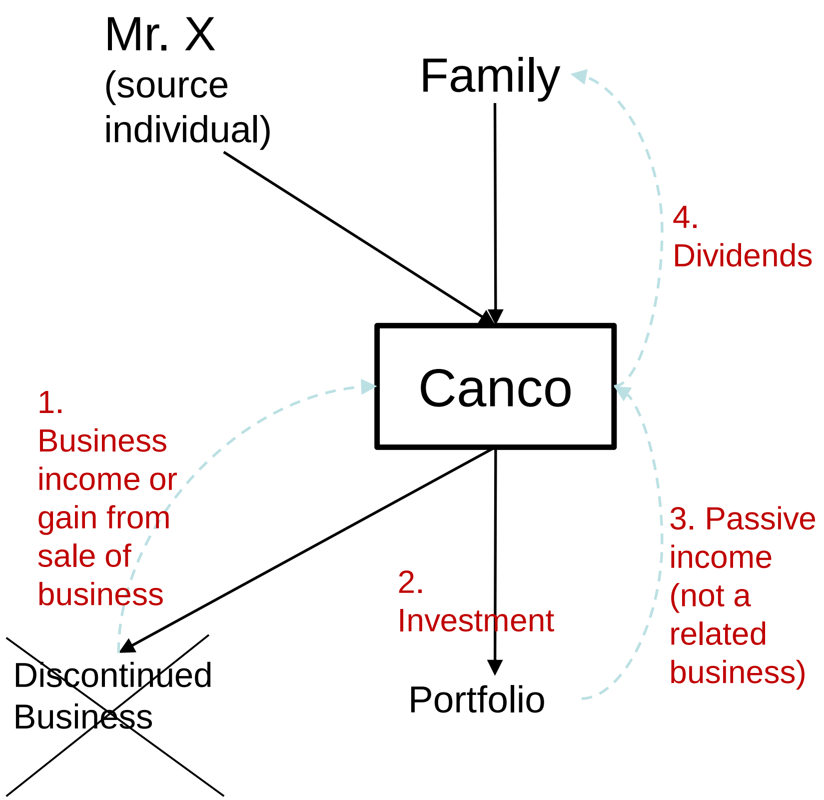




- Other relevant rule(s): 74.4
- TOSI: Dividends from Holdco is split income unless it is an excluded amount (no applicable exception for minors)

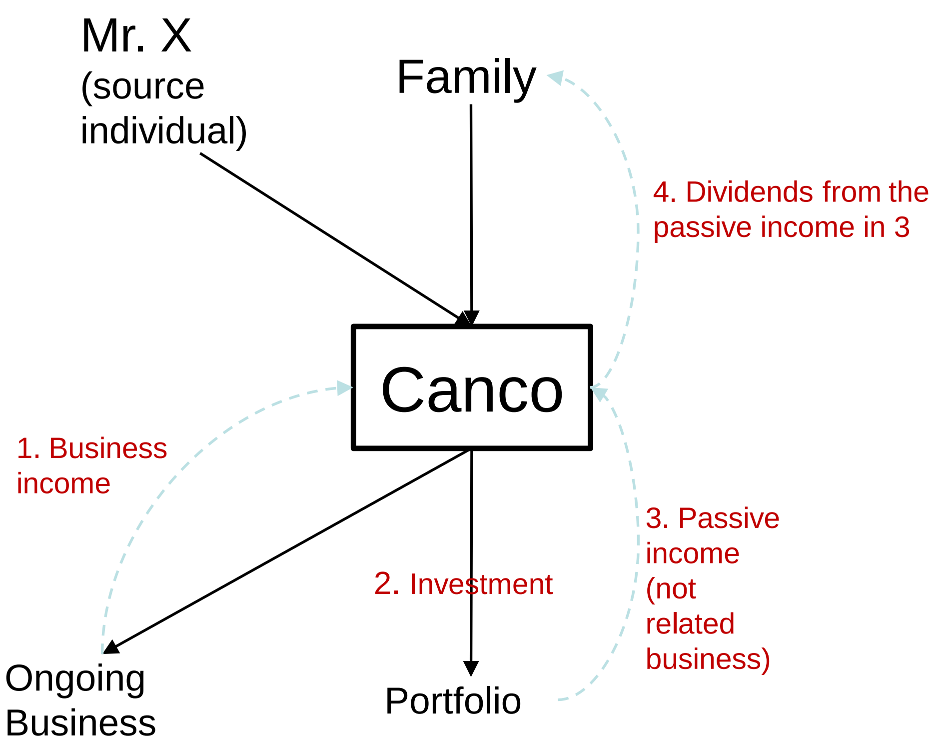
- Other relevant rule(s): 74.1(2), 74.5(2), 75(2), or 56(4.1)
- TOSI: Income from Trust is not split income (even for minors)

Income splitting with passive income (cont’d)



- Minors: split income (taxable dividend)
- For 18+ individuals: Is there income derived from a related business?
  - Not following year of sale
  - Q. 9, 11 and 13 Roundtable 45, APFF Congrès 2018

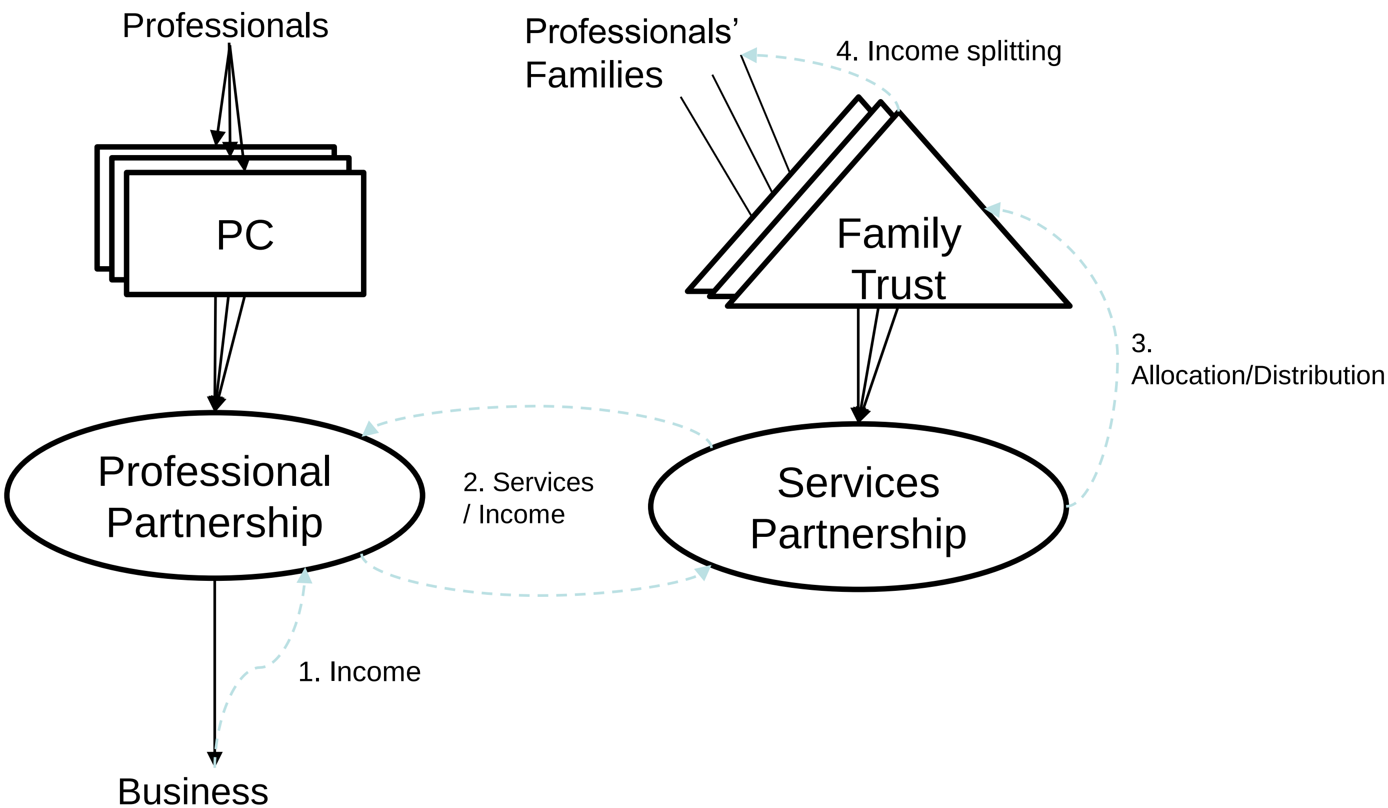
Income splitting with passive income (cont'd)



- Minors: split income (taxable dividend)
- For 18+ individuals: Does the analysis differ from the preceding example because there is now an ongoing business? Yes
- For 24+ individuals, the excluded shares exception might help

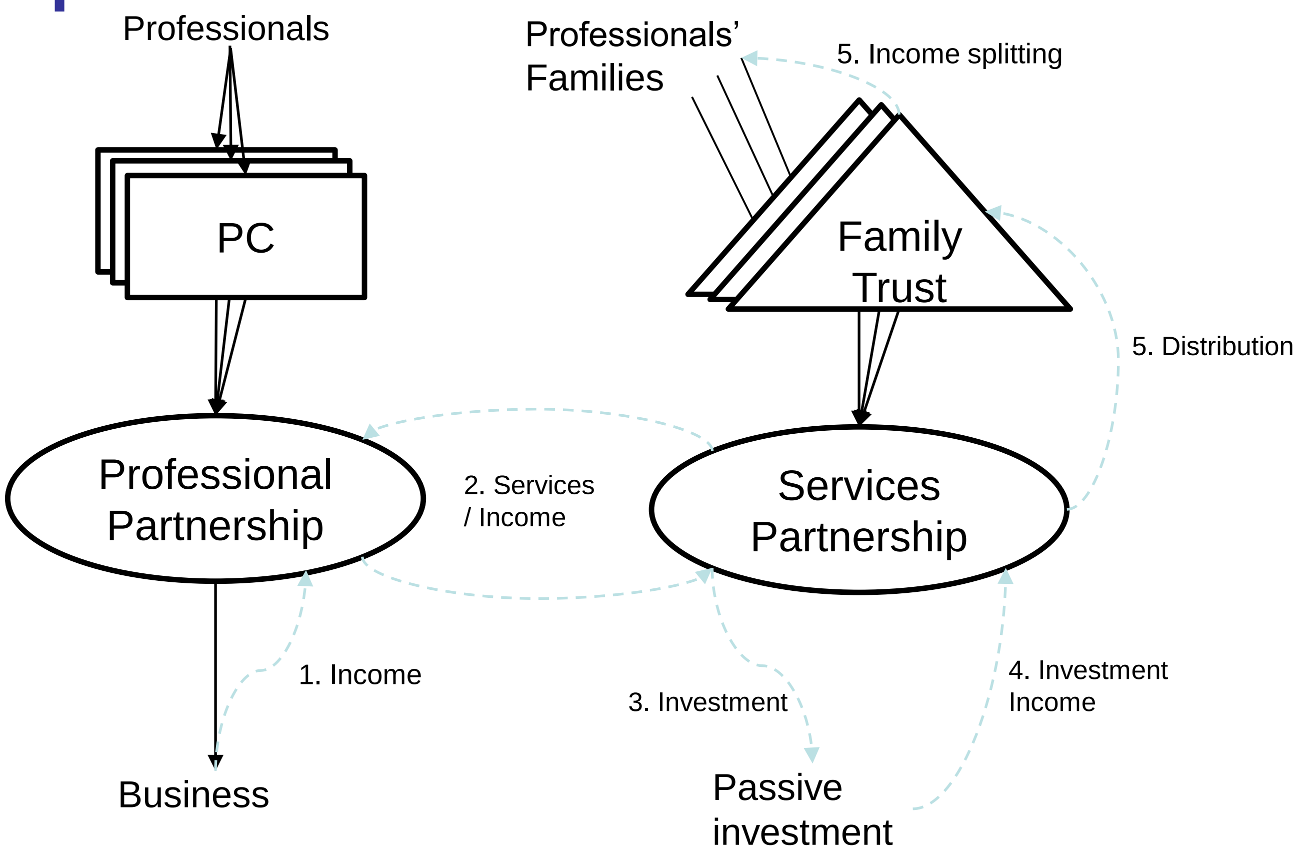
- Tracing approach suggested by the CRA – Q. 11 Roundtable 45 APFF Congrès 2018
- Would the approach still apply if both types of income earned directly in the same entity (i.e. no Holdco-Opco structure)

Example – income derived from a related business

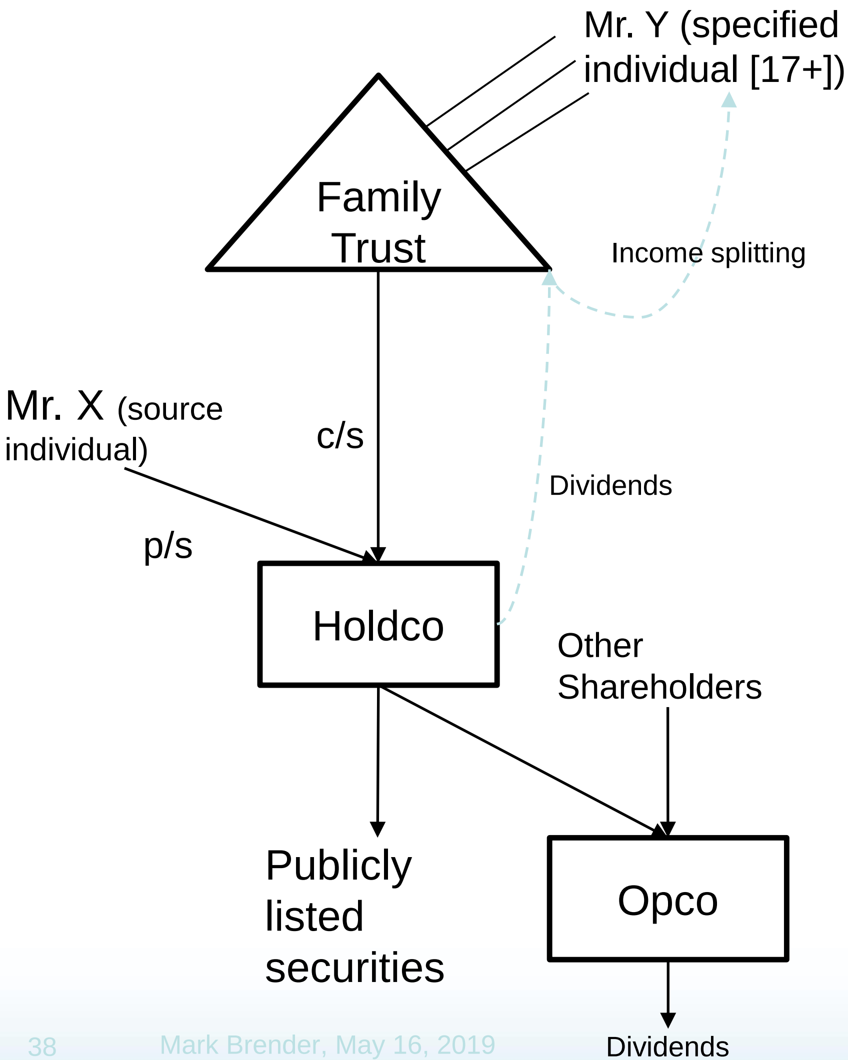


The old "kiddie tax" rules would have only applied to the minor children – see slide 7

Example – derivative rule



Related Business

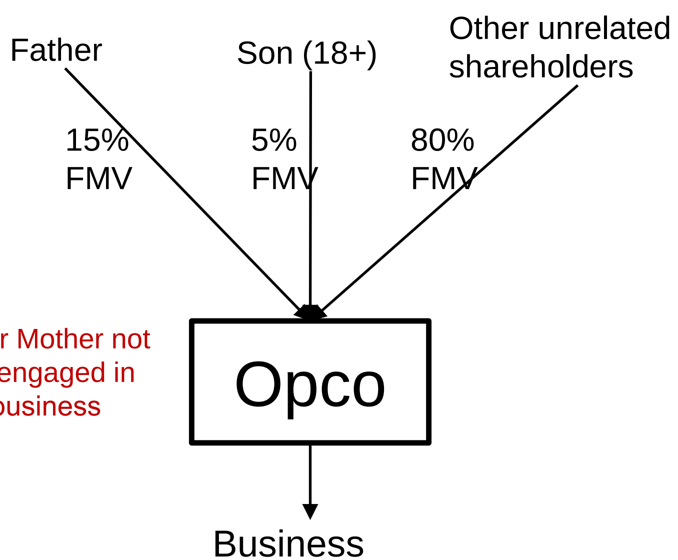


<u>Relevant Questions:</u>

- Is Holdco carrying on a business?
- Is Mr. X actively engaged in Opco's business?
- Is the portion of the FMV of the preferred shares owned by Mr. X in Holdco that is derived from the shares of Opco equal to 10% or more of the FMV of all the shares of Opco?
  1. What is the participation of Holdco in Opco?
  2. What is the participation of Mr. X in Holdco?
- Does Mr. X or a related individual to Mr. Y own any other property that derives its value from Opco shares?

Related Business – No aggregation

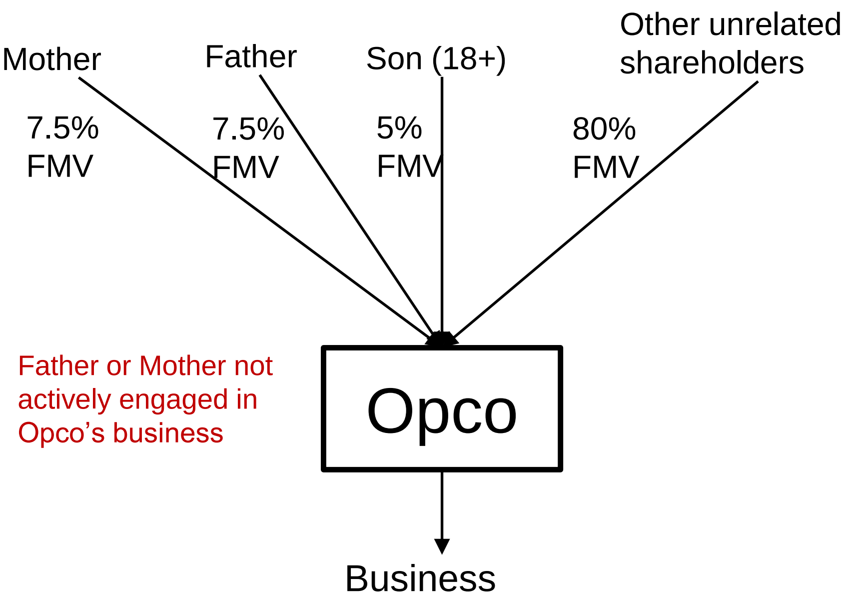
Scenario 1



- Father or Mother not actively engaged in Opco's business

TOSI rules should apply on a dividend to Son as there is a related business

Scenario 2

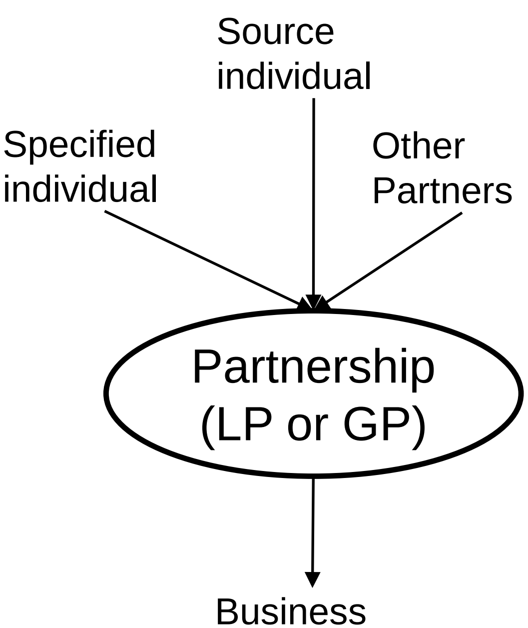


- Father or Mother not actively engaged in Opco's business

TOSI rules should not apply on a dividend to Son as there is a no related business

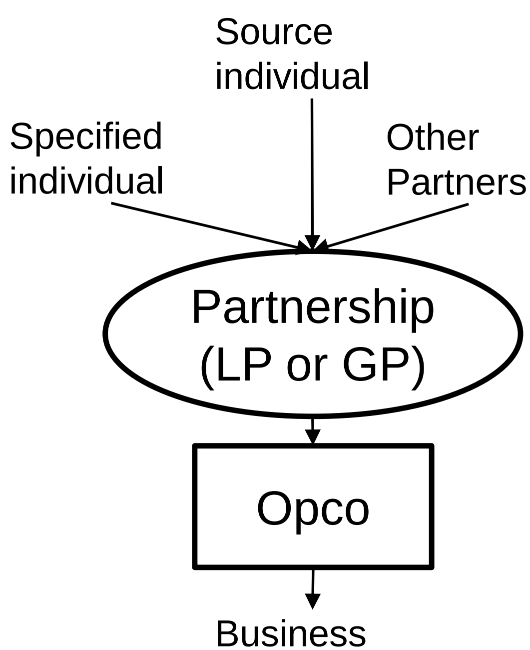
Examples of related business

Scenario 1



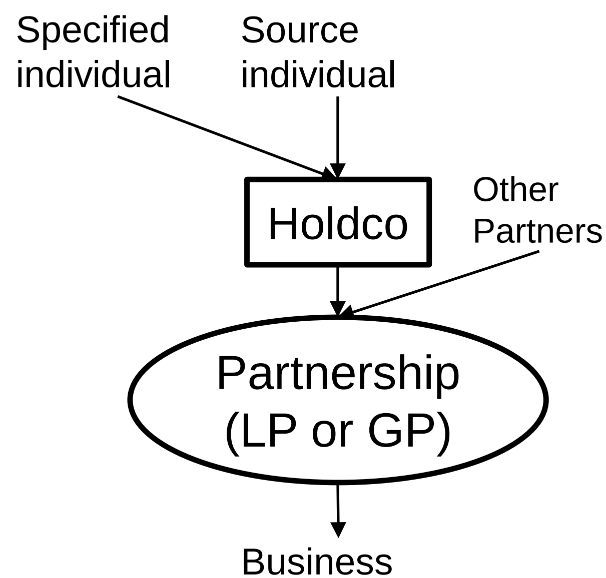
No source individual actively engaged in the business

Scenario 2



No source individual actively engaged in the business

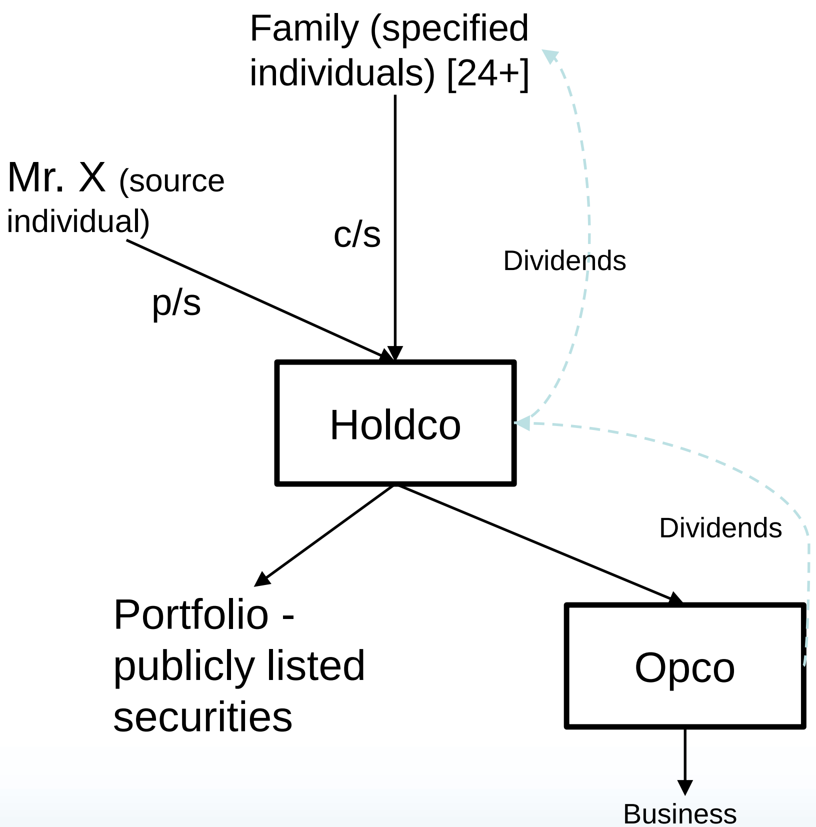
Scenario 3



No source individual actively engaged in the business

However, query whether the *reasonable return* exception applies if the specified individual is over 24

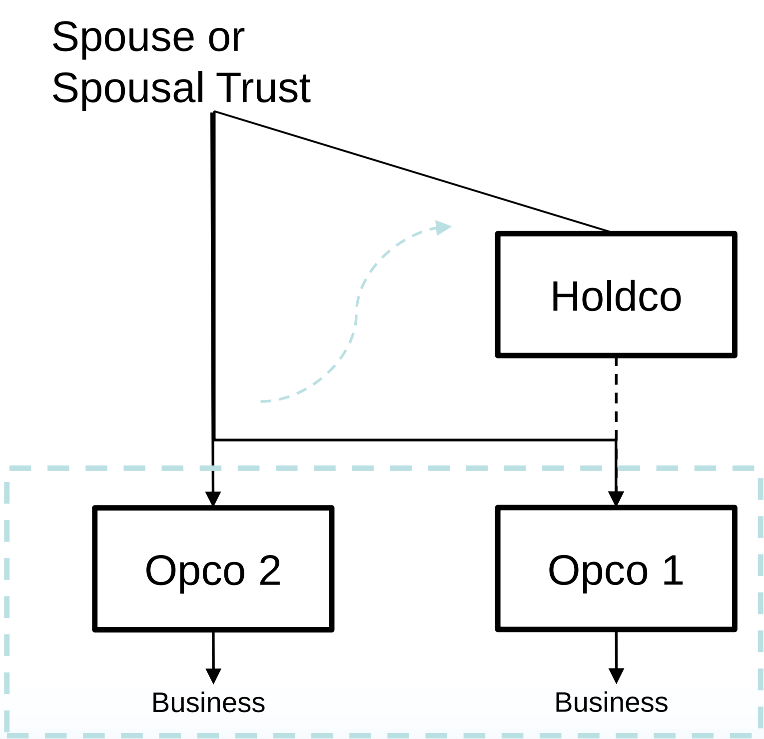
Is Existence of Business Preferable?



- Excluded Share exception requires, *inter alia*, that shares be directly owned by specified individual
- Distribution to Family intended to be funded by Opco's business profits
- Portfolio capital intially funded by Opco
- If Holdco does not carry on a business, excluded share exception not available – second generation income on Portfolio capital should however not be TOSI, although tracing approach required
- If Holdco carries on a business, not more than 10% of Holdco's income of the prior taxation year should be derived from Opco
- GAAR?

Continuity Rules for Spouse

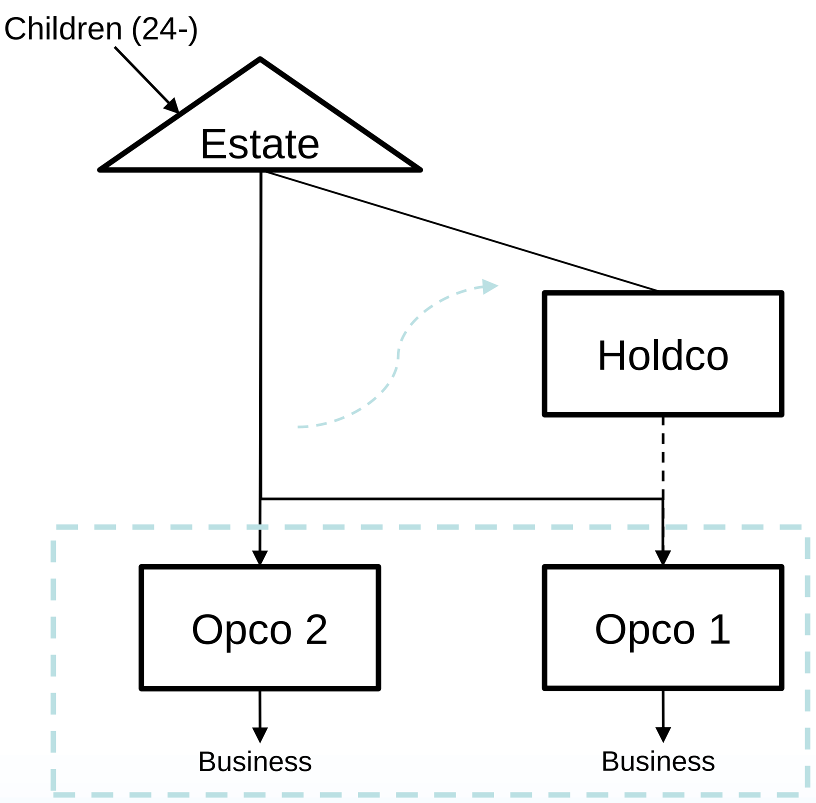
Amalgamation or Rollover



- Deceased individual was involved in the businesses carried by Opco 1 and Opco 2
- Spouse (or Spousal Trust) inherits all the shares – year of death vs subsequent years
- Is there a source individual?
  - no family members involved in business
  - Family members involved in business
- Impact of transfer to Holdco?
- 120.4(1.1)(c)(ii) links to "excluded amount" for the deceased

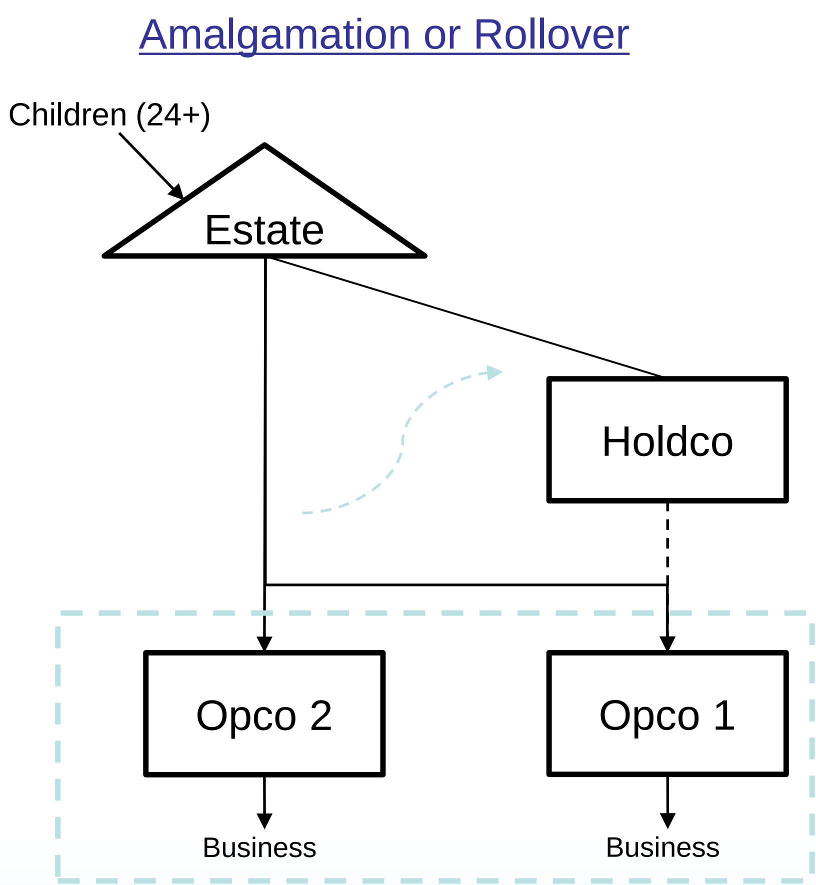
Continuity Rules and Substituted Property

Amalgamation or Rollover



- Spouse dies – Children (under 24) inherit directly from Spouse or from Spousal Trust and they are not involved in the businesses
- Excluded shares exception could apply if shares owned directly by children – 120.4(1.1)(b)(iii)
- Exceptions for inherited property (120.4(1)(a)) and reasonable return (120.4(1.1)(b)(i) and (iii)) should apply regardless of ownership (ie. directly or in trust)
- Impact of post-mortem planning, i.e. transfer to Holdco/Amalgamation
  - No "substituted property" rule in inherited property exception or 120.4(1.1)(b), as opposed to the definition of arm's length capital
  - No continuity rule in subs. 87(2) for the property
- Legislative intent?

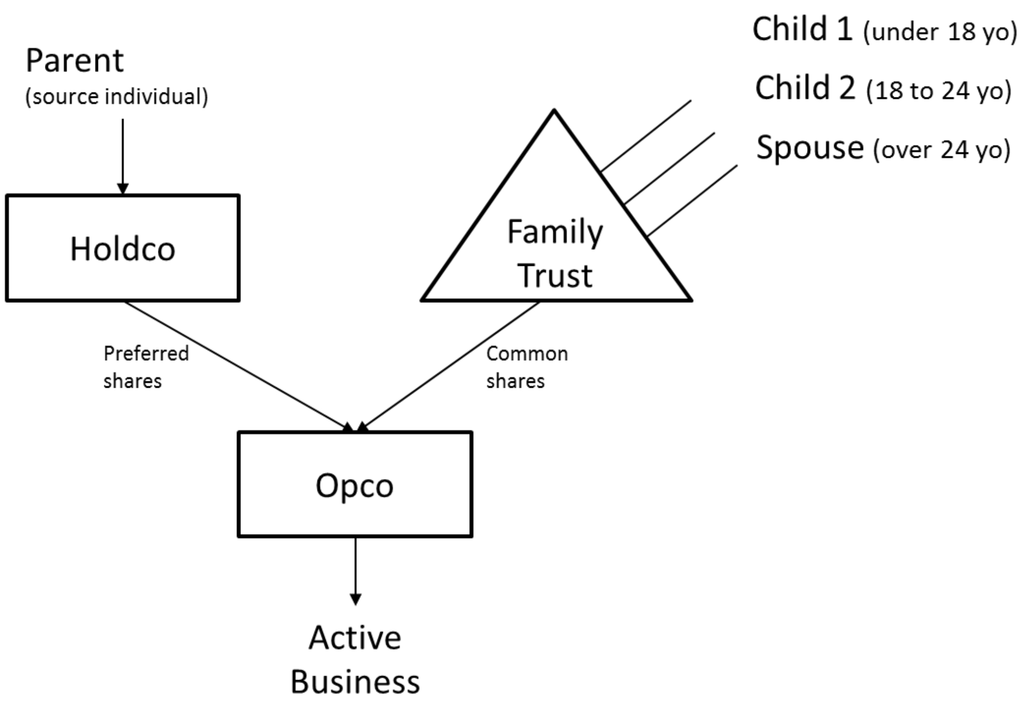
Continuity Rules and Substituted Property



- Spouse dies – Children (over 24) inherit directly from Spouse or Spousal Trust and they are not involved in business
- Exception for excluded shares and reasonable return could apply if shares owned directly by Children
- Exception for inherited property (120.4(1)(a)) does not apply (ie. children over 24)
- Impact of post-mortem planning, i.e. transfer to Holdco/Amalgamation
  - Excluded shares: is Holdco carrying on a business? If not, amalgamation?
  - Reasonable return: no substituted property rule in 120.4(1.1)(b)
- Legislative intent?

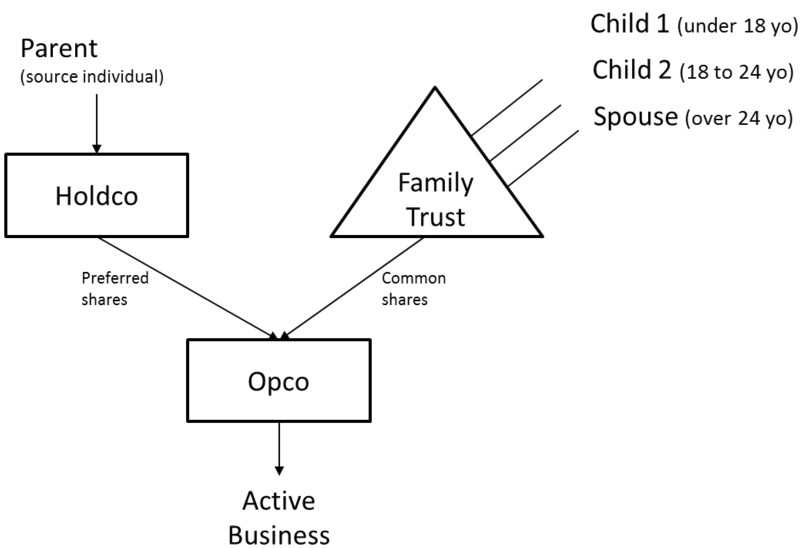
TOSI Rules
Estate Freeze

Classic Estate Freeze: Example 1 (Family Business)



- Typical structure to multiply lifetime capital gains exemption (LCGE);
- Parent triggers gain within LCGE limit on freeze and future gains accumulate to Common Shares held by the trust;

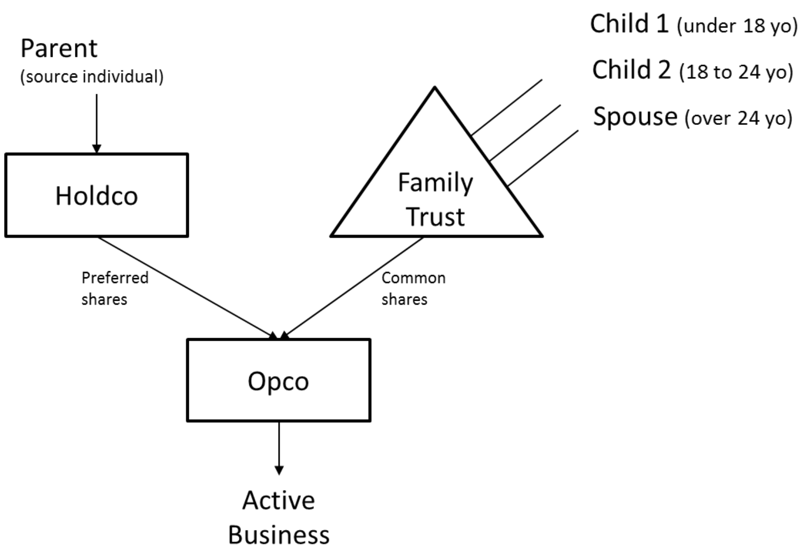
Classic Estate Freeze: Example 1 (cont'd)



<u>Child 1 (under 18 yo)</u>

- Law unchanged for minor children, except for the 2 new types of split income (interest income and capital gain)
- TOSI will apply to any income received by Child 1 from Opco
  - Mere fact that Child 1 receives a taxable dividend from a corporation triggers the TOSI rules (exception for public corp. and MFC)
- For capital gains:
  - any gain from a non-arm's length disposition will be recharacterized as a taxable dividend (120.4(5))
  - On an arm's length disposition, the taxable capital gain is subject to TOSI (*i.e.* highest marginal tax rate), unless Opco shares qualify as QSBC shares

Classic Estate Freeze: Example 1 (cont'd)



<u>Child 2 (18 to 24 yo)</u>

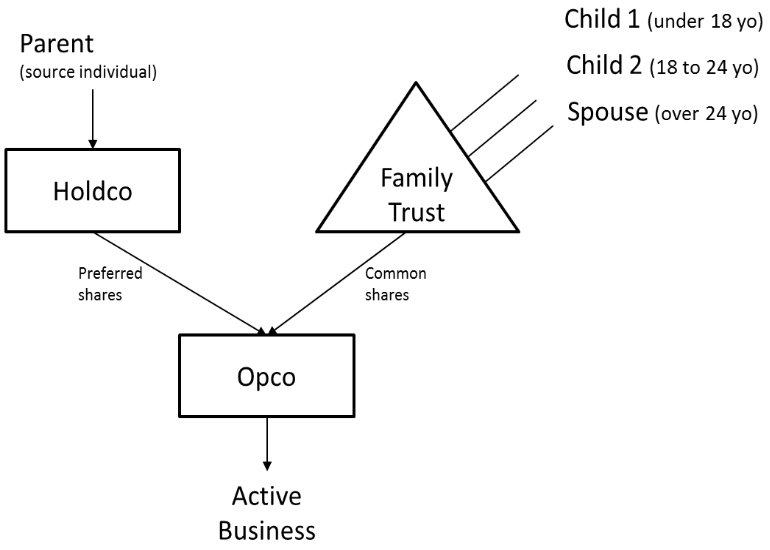
•TOSI rules will likely apply to income or gain received by Child 2 and derived from Opco, unless Child 2 is sufficiently engaged in Opco (*excluded business* exception)

•Child 2 deemed to be sufficiently engaged if works in the business at least an average of 20h/week

•The "safe harbour capital return" and the "reasonable return on arm's length capital" exceptions do not apply as Child 2 did not contribute any capital or property to Opco

•If Opco shares qualify as QSBC shares, the TOSI rules will not apply to the gain attributed to Child 2; otherwise, need to rely on the *excluded business* exception

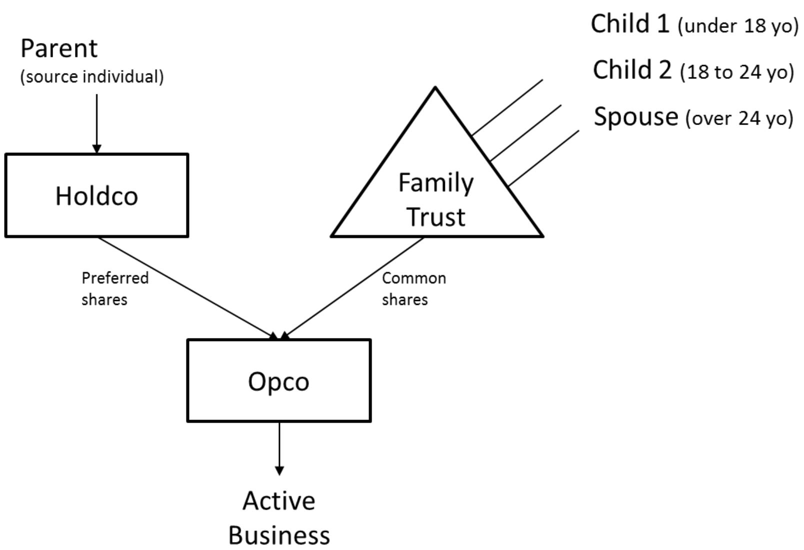
Classic Estate Freeze: Example 1 (cont'd)



<u>Spouse (over 24 yo)</u>

- TOSI rules likely apply to income/gain derived from Opco, unless Spouse is sufficiently engaged in Opco (*excluded business* exception) or the amount is a *reasonable return*
- Spouse deemed to be sufficiently engaged if works in the business at least an average of 20h/week (average for the whole year or the part of the year in which the business operates)
- A *reasonable return* – analyze relative contributions by Spouse to the business vs each *source individual* regarding the following factors:
  - The work performed
  - The property contributed
  - The risk assumed
  - The total of all amounts previously paid to Spouse from Opco
  - Such other factors as may be relevant
- "excluded shares" exception does not apply as Spouse does not own Opco shares directly
- If Opco shares qualify as QSBC shares, TOSI rules will not apply to gain; otherwise, need to rely on the *excluded business* or *reasonable return* exceptions

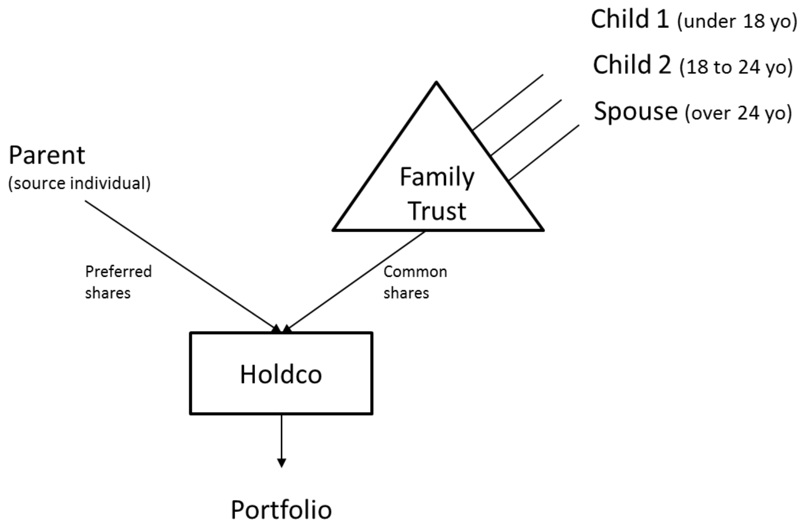
Classic Estate Freeze: Example 1 (cont'd)



Takeaways

- For minor children, not much of a change
- For 18 and over individuals, the TOSI rules will generally apply unless the individual is sufficiently engaged in the business (question of fact + deeming rule) or the amount received is a *reasonable return*
- The use of a trust in this structure prevents the application of the *excluded shares* exception (10% vote and value) for individuals 25 and over
- However, this typical estate freeze still allows for the multiplication of the capital gain exemption (even for minors, if it is realized on an arm's length disposition)

Classic Estate Freeze: Example 2 (Passive Holding Company)

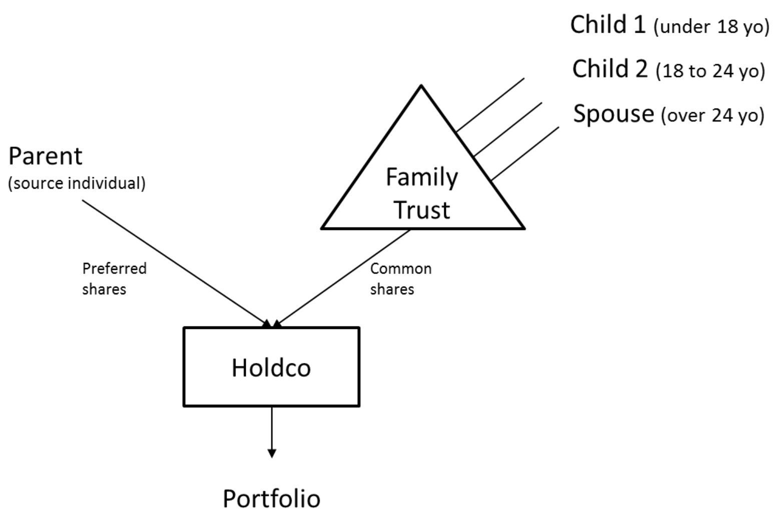


Child 1 (under 18)

- The law has not changed for minor children with respect to the TOSI rules, except for the 2 new types of split income (interest income and capital gain)
- The highest marginal tax rate will apply to any income received by Child 1
- Given the restrictions on distribution to minors, TOSI not relevant

*Trust deed includes restrictions against distribution to “designated persons”, to satisfy subsection 74.4(4) and avoid attribution rule;

Classic Estate Freeze: Example 2 (cont'd)



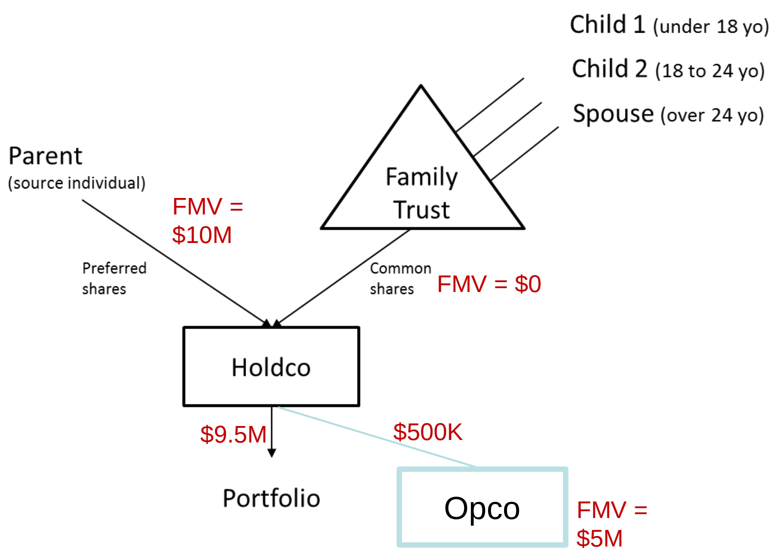
<u>Child 2 (18 years old or more) and Spouse</u>

- The TOSI rules will not apply if the income or gain is **<u>not</u>** derived directly or indirectly from a *related business*
- No *related business* in Holdco… passive investment of Holdco not a business
- Is there a *related business* in the underlying investments of Holdco?
- Of particular relevance: is a source individual owning, directly or indirectly through other properties *(e.g.* Holdco shares), more than 10% of the FMV of the shares of a corporation carrying on a business? If so, the derivative rule will be applied down the corporate chain.
- The new TOSI rules should not have any impact on an estate freeze of a passive holding company for individuals who have attained 17 years of age before the year

Classic Estate Freeze: Example 2 (cont'd)

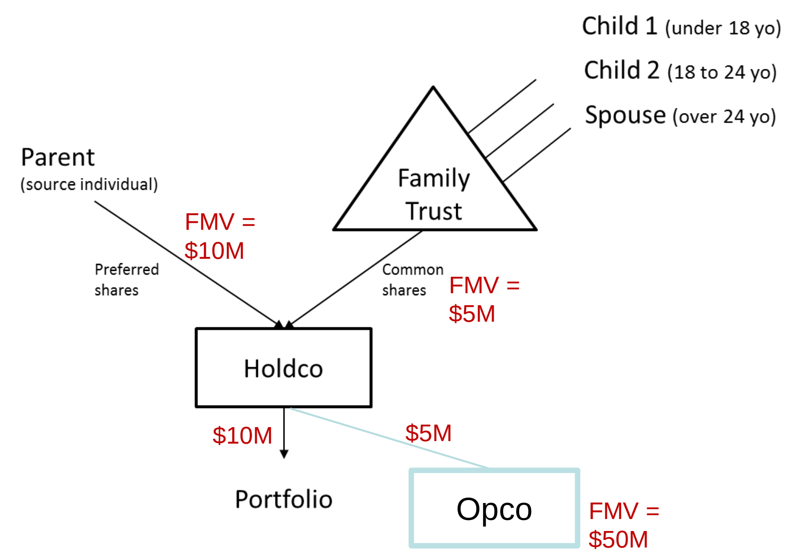
Example (Parent is not engaged in the activities of Opco)

At the Time of the Freeze



- The 10% threshold is met – there is a related business
- Child 2 and Spouse would need to rely on another exception

Five Years Later



- The 10% threshold is **not** met – there is a **no** related business
- The TOSI rules would not apply to Child 2 and Spouse
- The 10% threshold for the related business exception must not be satisfied throughout the year ("at any time")

Cheat Sheet

Under 18 years old

- Nothing changed, except for the 2 new types of split income (interest income and capital gain)
- Capital gain on non-arm's length disposition of shares recharacterized as taxable dividend
- Exception for **inherited property** from a parent or any person if full-time student or entitled to the 118.3 credit
- Exception for capital gain realized on the **deemed disposition on death**
- Exception for capital gain realized on arm's length disposition of **QSBC shares**

18 to 24 years old

- TOSI rules now apply to "split income" of those individuals, unless an exception applies ("excluded amount")
- Exception for **inherited property** from a parent, or any person if full-time student or entitled to the 118.3 credit
- Exception for capital gain realized on the **deemed disposition on death** or disposition of **160(4) property**
- Exception for gain realized on any disposition of **QSBC shares**
- Exception for income or gain not derived from a **related business**
- Exception for income or gain derived from an **excluded business**
- Exception for income or gain that is a **safe harbour capital return**
- Exception for income or gain that is a **reasonable return** having regard only to **arm's length capital**

Over 24 years old

- TOSI rules now apply to "split income" of those individuals, unless an exception applies ("excluded amount")
- Exception for capital gain realized on the **deemed disposition on death** or disposition of **160(4) property**
- Exception for capital gain realized on any disposition of **QSBC shares**
- Exception for income or gain not derived from a **related business**
- Exception for income or gain derived from an **excluded business**
- Exception for income or gain from **excluded shares**
- Exception for income or gain that is a **reasonable return**

Thank You

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