TOSI AND ALTERNATIVE REMUNERATION STRATEGIES

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I. INTRODUCTION

On July 18, 2017, the Department of Finance proposed several significant amendments to the *Income Tax Act* (Canada) (the "Tax Act"),[4] with the stated goal of "improving fairness in the tax system by closing loopholes and addressing tax planning strategies".[5] After a brief period of consultation with stakeholders, the proposed changes were revised and reformulated over the following year, and ultimately the "Tax on Split Income" ("TOSI") regime was implemented effective as of January 1, 2018.

The TOSI regime is set out in section 120.4 of the Tax Act. Its purpose, as described by the Department of Finance, is "to limit the ability of owners of private corporations to lower their personal income taxes by sprinkling their income to family members who do not really contribute to the business."[6]

I. INCOME SPLITTING

As noted above, the TOSI rules are intended to limit the practice of "income splitting" (sometimes also referred to as "income sprinkling"). In its simplest form, income splitting involves diverting income away from a high income-earning family member (i.e. income that might otherwise be taxed at a high (or, most likely, the top) marginal tax rate) into the hands of a lower-income-earning family member, where it will be subject to a lower tax rate or possibly no tax.

See, for example, the following illustration of the approximate amount of additional tax payable by a family member resident in British Columbia who is now subject to the TOSI regime on dividend income from the family's privately-held corporation:

	$50,000 in dividends	$100,000 in dividends
Eligible dividends – additional taxes under TOSI*:	$17,000	$26,000
Non-eligible dividends – additional taxes under TOSI*:	$18,000	$28,000

*Assumes BC tax rates; compares tax paid on dividends by individual at highest tax rate to tax paid by individual with no other sources of income

Common Income Splitting Structures

Historically, income splitting has been a driving motivation behind the implementation of an estate freeze. Under the estate freeze, an owner-operator of an incorporated business might "freeze" her present value in the operating company by exchanging her common shares into fixed-value preferred shares, and then have the intended income splitting beneficiary (or a trust

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[4] Income Tax Act (Canada) RSC 1985, c.1 (5th Supp), as amended (the "Tax Act"). Unless otherwise stipulated, all statutory references herein are to the Tax Act.

[5] Department of Finance News Release, July 18, 2017.

[6] Department of Finance News Release, December 13, 2017.

of which such person is a beneficiary) subscribe for new common shares at nominal value. From the date of the freeze transactions, the growth in value of the operating company will accrue to the new common shares, and dividends can be declared on those common shares (out of corporate value over and above the value of the preferred shares) such that income from the business flows to the freeze beneficiary and is taxed in his hands at his applicable marginal rate.

Under the 2018 TOSI regime, the freeze beneficiary may be subject to the highest rate of tax on the dividends received from the operating company in the above example, unless one of the exclusions to TOSI applies.

II. HISTORICAL INCOME SPLITTING LIMITATIONS

As noted above, a key policy rationale raised by the Department of Finance in announcing the TOSI rules is the goal of restricting or preventing income splitting. Historically, several rules in the Tax Act limit income splitting in specific circumstances[7], but there has been no general policy against income splitting where those rules are successfully navigated – this was effectively confirmed by the courts in the context of family-owned corporations in *McClurg v the Queen*[8] and *The Queen v Kieboom*[9].

Kiddie Tax – The Original TOSI

The original section 120.4, commonly referred to as the "kiddie tax" regime, came into effect on January 1, 2000. The kiddie tax is the direct predecessor of the TOSI regime, and as such it is worth indulging in a brief review of the kiddie tax before discussing the new TOSI regime.

The kiddie tax regime was aimed at restricting dividend-sprinkling and management services structures used to split income with minor children. The kiddie tax differed from other income splitting limitations in that instead of imputing or attributing income to the high-tax-paying family member, kiddie tax was an additional top-rate tax imposed on the individuals who received the split income, if certain conditions were met.

The pre-2018, kiddie tax was applicable to "specified individuals" and resulted in the additional tax at the highest marginal rate on any "split income" received by such an individual, unless an "excluded amount" exception applied.[10] As discussed in further detail below, the concepts of

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[7] Existing pre-TOSI restrictions on income splitting include attribution rules for both minors (for income – subsection 74.1(2)) and spouses (income and gains - subsections 74.1(1) and 74.2(1)), the corporate attribution rule (subsection 74.4(2)), the reversionary trust rules (subsection 75(2)), attribution and deeming rules respecting loans (subsection 56(4.1)), conferral of benefits (subsections 56(2) and 246(1)) and non-arm's length transfers not at fair market value (section 69).

[8] [1990] 3 SCR 1020.

[9] 92 DTC 6382 (FCA).

[10] "Specified individual", "split income" and "excluded amount" all as defined in then-subsection 120.4(1) of the Tax Act.

"specified individual", "split income" and "excluded amount" have been carried forward in the expanded TOSI regime.

Under the original kiddie tax regime:

(1) A "specified individual" meant any person who was a Canadian resident and under 18 throughout the applicable taxation year, and had at least one parent resident in Canada at any time in the year;

(2) "Split income" meant any of the following:

- Dividends received from a private corporation (including if received through a trust);

- Shareholder benefits received from a private corporation (including if received through a trust);

- Income from a partnership or trust derived from the provision of property or services to a business carried on by a "related person", within the meaning of the Tax Act, or by a corporation of which a related person was a "specified shareholder"[11] in the year; or

- Business or rental income from a partnership or trust where at any time in the year a related person was regularly and actively engaged in the activity of the partnership or trust that generated the income; and

(3) "Excluded amount" meant any income from, or taxable capital gains on the disposition of, property acquired by or for the benefit of the specified individual as a consequence of the death of either (a) a parent of the specified individual, or (b) any person, if the specified individual was eligible for the disability tax credit or was enrolled in full-time post-secondary studies during the year.

These three definitions have carried through to the new TOSI regime, though all have been significantly expanded.

III. 2017-2018 TOSI PROPOSALS

The TOSI rules were initially announced, with the release of draft legislation, on July 18, 2017, with many differences from the ultimate regime recently enacted.

On December 13, 2017, the Department of Finance published a new set of draft amendments to the Tax Act, setting out a revised TOSI regime. These draft amendments were accompanied by

[11] "Specified shareholder", as defined in subsection 248(1), refers to a person who holds more than 10% of the shares of any class of a particular corporation or a corporation related thereto, either directly or indirectly and with the shareholdings determined in accordance with certain deeming rules.

revised explanatory notes and several examples detailing how the new proposed legislation would apply in particular circumstances.

On March 27, 2018, a slightly revised version of the December 13, 2017 proposals was introduced in the House of Commons in Bill C-74.[12] This revision did incorporate some changes as a result of practitioner feedback, including changes to the definition of excluded shares (discussed below), but the December 13, 2017 proposals remained largely unchanged.

After some further minor modifications, Bill C-74 received royal assent on June 21, 2018. In accordance with subsection 13(8) of Bill C-74, the TOSI regime is effective as of January 1, 2018.

IV. THE CURRENT TOSI REGIME

The new TOSI regime, as implemented by Bill C-74, maintains the existing provision in subsection 120.4(3) that a specified individual will pay tax at the highest marginal rate on any split income received in the applicable taxation year.

The new TOSI regime maintains the same key concepts as the previous kiddie tax regime: *specified individuals* are subject to tax at the highest marginal rate on their *split income* (being 'tax on split income', or 'TOSI') and an amount will not constitute split income if it is an *excluded amount*. However, the scope of each of these terms has been significantly expanded under the new regime.

A. Specified Individual

The term "specified individual", defined in subsection 120.4(1), effectively means any individual (other than a trust) who is resident in Canada at the end of the taxation year in question or was resident in Canada immediately prior to their death, if they died during the taxation year. Where the individual is under age 18 throughout the taxation year, there is an additional requirement that the individual had a parent resident in Canada at any time in the year.

There is only one definition of "specified individual" in the new section 120.4. However, in light of the newly framed excluded amounts (discussed below), most of which are applicable only to taxpayers in a specific age range, there are in effect four categories of "specified individual": (1) those under age 18; (2) those between ages 18 and 24; (3) those over age 24; and (4) those with a spouse over age 64. As discussed below, these groupings are relevant to the determination of whether an exception to the definition of "split income" is available, such that TOSI will not apply to the income in question.

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[12] *Bill C-74*:An Act to implement certain provisions of the budget tabled in Parliament on February 27, 2018 and other measures. (2018). First reading, March 27, 2018, 42nd Parliament, 1st session.

B. Split Income

The types of "split income" have also been significantly expanded in the new TOSI regime. "Split income", defined in subsection 120.4(1), now includes all of the following types of income:

- Taxable dividends received by the individual (including through a trust) in respect of shares of a private corporation (i.e. not shares of a class listed on a designated stock exchange or shares of a mutual fund corporation);[13]

- Shareholder benefits pursuant to section 15 in respect of the ownership by any person of such shares (including if received through a trust);[14]

- Income from a partnership or trust derived directly or indirectly from a "related business";[15]

- Income from a partnership or trust derived from the rental of property, where a person related to the specified individual is actively engaged on a regular basis in the activities of the partnership or trust relating to the rental of property;[16]

- Income from a partnership derived from the rental of property, where a person related to the specified individual holds a direct or indirect interest in the partnership;[17]

- Income from a debt obligation of a private corporation, partnership or trust, if the debt obligation is not publicly traded, CDIC debt or within paragraph (a) of the definition of "fully exempt interest" in subsection 212(3) (i.e. not a government bond) (essentially, this means a debt obligation of a private corporation, partnership or trust if income from such corporation, partnership or trust would otherwise be split income of the individual);[18] and

- Taxable capital gains or profit on the disposition (including through a trust) of (a) shares in a private corporation; or (b) a debt obligation or an interest in a trust or a partnership where (i) income in respect of such debt obligation or interest is included in the individual's split income for the year or a prior year, or (ii) part of value of

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[13] Subparagraph (a)(i) of the definition of "split income" in subsection 120.4(1).

[14] Subparagraph (a)(ii) of the definition of "split income" in subsection 120.4(1).

[15] Clause (b)(ii)(A) and clause (c)(ii)(C) of the definition of "split income" in subsection 120.4(1).

[16] Subclause (b)(ii)(B)(i) and clause (c)(ii)(D) of the definition of "split income" in subsection 120.4(1).

[17] Subclause (b)(ii)(B)(ii) of the definition of "split income" in subsection 120.4(1).

[18] Paragraph (d) of the definition of "split income" in subsection 120.4(1).

property derives from private company shares (incl. gains/profit received through a trust).[19]

Many of the receipts that constitute split income under the new TOSI regime already fell within the definition of split income under the kiddie tax regime, but there have been some adjustments to pre-existing types of split income and the last two bullets represent new additions to the definition.

Income on Indebtedness & Capital Gains

Income on indebtedness and capital gains are new additions; these amounts did not constitute split income under the old kiddie tax regime.

Capital gains were a notable exclusion from the kiddie tax regime, such that it was generally still possible to divert capital gains to minor children. Under the TOSI regime, capital gains may now constitute split income, though there are exceptions in place to preserve the lifetime capital gains deduction in most cases (as discussed in further detail below).

Related Business

The introduction in subsection 120.4(1) of the defined term "related business" is also new to the TOSI regime. The term is defined to mean, "in respect of a specified individual for a taxation year":[20]

a) a business "carried on by" a (i) "source individual" in respect of the specified individual at any time in the year, or (ii) a corporation, partnership or trust, if a "source individual" at any time in the year is actively engaged on a regular basis in the activities of the corporation, partnership or trust related to earning income from the business;

b) a business of a partnership, if a "source individual" in respect of the individual at any time in the year has a direct or indirect interest in the partnership; or

c) a business of a corporation if at any time in the year a "source individual" in respect of the specified individual owns at least 10% of the value of the corporation, either through shares in the particular corporation or shares in a corporation that derives any of its value from the corporation (either directly or indirectly).

A "source individual" is defined in subsection 120.4(1) as an individual who at any time in the year is a Canadian resident and "related" to the specified individual. Related parties are defined in section 251 of the Tax Act.[21]

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[19] Paragraph (e) of the definition of "split income" in subsection 120.4(1).

[20] Definition of "related business" in subsection 120.4(1).

[21] The original July 2017 draft legislation extended the concept of related parties for purposes of the TOSI amendments to include less closely-connected family members (aunts, uncles, nieces and nephews), but this was abandoned.

Due to paragraph (c) of the definition, a related business can accordingly include a business in which a person related to the specified individual merely holds an indirect interest, even if they are – and always have been – a completely passive investor.

It is uncertain how the phrases "for a taxation year" in the opening line of the definition and "in the year" throughout the definition are to be interpreted from a timing perspective. The inclusion of the phrase "for a taxation year" (and also the phrase "for the year" in subparagraph (e)(i) of the definition of "excluded amount") may suggest that if the business was discontinued in a prior year, then the lingering corporation, partnership or trust may no longer have or carry on a "related business".

The extent to which investment activities and the management of rental properties will constitute a business for purposes of the "related business" definition is unclear. For a discussion of the meaning of "business" see Trista Gallant, "TOSI Rules – How they now work and practical applications."[22]

Deeming Rules: Amounts Derived From Business Income

Paragraph 120.4(1.1)(d) contains deeming rules that expand the scope of what constitutes income derived directly or indirectly from a business. The deeming rules provide that an amount derived directly or indirectly from a business includes all of the following:

a) Amounts derived from the provision of property or services to the related business (clause 120.4(1.1)(d)(i)(A));

b) Amounts arising in connection with the ownership or disposition of an interest in the person or partnership carrying on returns on the business (clause 120.4(1.1)(d)(i)(B)); and

c) Amounts derived from the above amounts (subparagraph 120.4(1.1)(d)(ii)).

Note that this is an inclusive provision rather than an exhaustive provision. These deeming rules effectively extend the reach of the "related business" category of split income beyond the direct earnings of a business carried on by a related family member. The extent of application is uncertain. Consider the following examples:

1. Pursuant to the deeming rule in clause 120.4(1.1)(d)(i)(A), income derived from the rental of property to a particular business would be deemed to be income derived directly or indirectly from that business.

   Parent A owns and operates Business A, a small clothing repair business. Son B is an adult with an independent income, and has recently acquired a commercial property as an investment. Parent A and Son B decide that Son B will rent his property to Business A so that it can expand its clothing repair business. The decision to rent the property to Business A is made for business reasons and is not driven by a desire to shift income

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[22] Trista Gallant, "TOSI Rules – How They Now Work and Practical Applications", in *2018 Prairie Provinces Tax Conference*, (Toronto: Canadian Tax Foundation, 2018).

from Business A into Son B's hands. However, under the deeming rule in clause 120.4(1.1)(d)(i)(A), when Business A pays Son B rent in exchange for the use of Son B's property, Son B has likely received split income (income from a related business).

2. Pursuant to the deeming rule in clause 120.4(1.1)(d)(i)(B), a gain on the sale of a partnership interest would be deemed to be income derived directly or indirectly from the business carried on by the partnership.

   Since under clause 120.4(1.1)(d)(i)(C) an amount derived from an amount described in clause 120.4(1.1)(d)(i)(B) is considered income from a business, if the after-tax sale proceeds from the sale of the partnership interest are invested in publicly traded securities, does the investment income therefrom constitute income from the business?

   The Department of Finance Explanatory Notes to 120.4(1.1)(d) provide some limited, fact-specific examples of the application of the derivative rule. Example 3 thereof suggests that once the income from the related business has been received, investment returns on the funds are not connected to the business.

C. Excluded Amounts

Since the concepts of specified individuals and split income have been expanded significantly, presumably most tax advisors will adopt the practice of assuming that a given individual is a specified individual receiving split income, and look for an exclusion to avoid the application of TOSI. The exclusions are found in the definition of "excluded amount" in subsection 120.4(1) and the definition of "split income" – an amount cannot be "split income" if it is an "excluded amount".

Excluded amounts may be income from a property or a taxable capital gain or profit from the disposition of the property in the particular taxation year. In some cases, exceptions apply differently depending on whether the amount received is in the nature of income or a capital gain.

There are now effectively ten categories of exceptions under which a particular receipt may constitute an excluded amount:

(1) "Excluded business";

(2) Spousal (over age 65) deeming rule;

(3) "Excluded shares";

(4) Income that is not from a "related business";

(5) "Reasonable return";

(6) "Safe harbour capital return";

(7) Dispositions on marital breakdown;

(8) Deemed dispositions on death;

(9) Property subject to the lifetime capital gains deduction; and

(10) Inherited property.

Each of these exceptions is discussed in detail below. Some exceptions are applicable to taxpayers of all ages, while some are either only available to taxpayers of a certain age or apply differently depending on the age of the specified individual.

Some of the exceptions involve bright line tests, but many require subjective analysis; as a result, it will often require detailed consideration of the facts in a given situation in order to determine whether an exception is applicable. The CRA has stated that it will interpret the major exceptions of "excluded business" and "excluded shares" as simply approximating a determination of reasonableness (as that concept was originally expressed in the July 18, 2017 proposals), and that the safe harbour exclusions for an "excluded business" or "excluded shares "provide a bright line test and are intended to act as a proxy for situations that would have otherwise met" that reasonableness test.[23]

1. Excluded Business Exclusion

For specified individuals 18 and over, income and capital gains derived directly or indirectly from an "excluded business" of the specified individual do not constitute split income.[24]

"Excluded business" of a specified individual for a taxation year means a business if the specified individual was "actively engaged on a regular, continuous and substantial basis in the activities of the business", either (a) in the taxation year in question (except in the case of capital gains), or (b) in any five prior taxation years.[25] In order for capital gains to be sheltered under the excluded business exception, the individual must meet the second requirement (five prior taxation years); meeting the test in a single current-year is insufficient.[26] In other words, for the exclusion to apply in respect of a gain on a disposition of a business, long-term active involvement in the business is necessary. Further, note that (1) a disposition within the fifth active year is not sufficient, as the test requires five prior years, and (2) the years relevant for the purposes of the definition of "excluded business" are the taxation years of the specified individual, not of the underlying business.

The phrase "actively engaged on a regular, continuous and substantial basis" is not defined. However, the legislation does contain a bright line deeming rule, in paragraph 120.4(1.1)(a), which provides that this requirement will be met if the specified individual works in the business

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[23] CRA Technical Interpretation No. 2018-0761601E5, May 25, 2018.

[24] Subparagraph (e)(ii) of the definition of "excluded amount" in subsection 120.4(1).

[25] Definition of "excluded business" in subsection 120.4(1).

[26] See carve-out in paragraph (a) of the definition of "excluded business" in subsection 120.4(1).

for at least an average of 20 hours per week during the period of the year in which the business operates.[27]

This deeming rule does not supersede the general test, and it is still possible to satisfy the broader excluded business definition without meeting the 20-hours-per-week average, but this rule at least provides some comfort to taxpayers working full-time or even part-time for a related business.

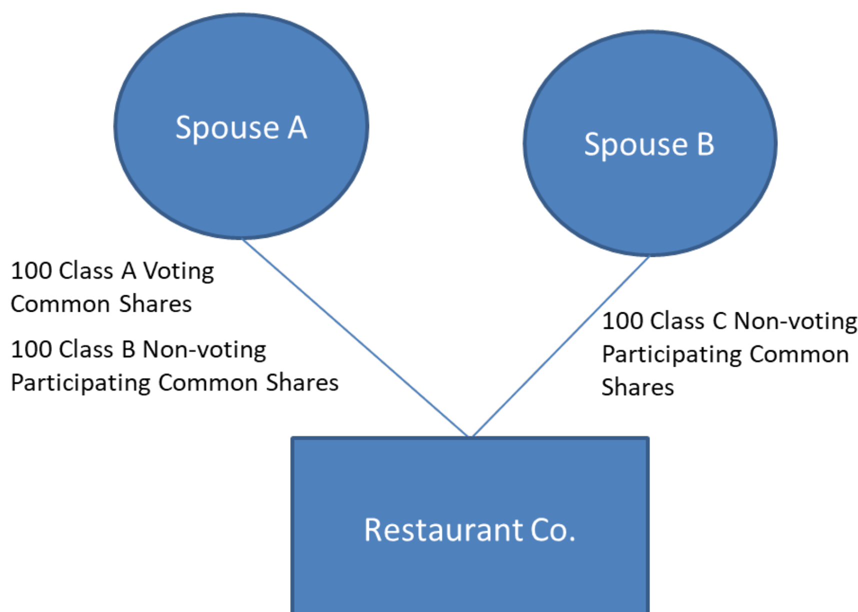
The bright line test accommodates seasonal workers by referring to “the portion of the year in which the business operates”, and accommodates specified individuals who work full time for part of the year: as long as the average is met over the entire operating year of the business, the bright line test is satisfied and the individual will be deemed to satisfy the excluded business requirement.

The Department of Finance explanatory notes to the definition of excluded business specifically note that reorganizations of a business are not intended to impact the five-year test. So, for example, where a business was originally operated as a sole proprietorship and was later incorporated, the years in which it operated as a sole proprietorship can be counted for purposes of determining the proprietor’s years of sufficient active engagement.

[27] Paragraph 120.4(1.1)(a).

Excluded Business Examples:

Example I: Excluded Business – One Business



Additional Facts: *Spouse A and Spouse B are both over age 18 and under age 65. Spouse B has worked in the business of Restaurant Co. for an average of 30 hours per week for the past two years. Spouse B did not work in the business in any other years.*

Example I: Is the business of Restaurant Co. an "excluded business" of Spouse B?

Yes. The bright line test set out in paragraph 120.4(1.1)(a) is met as Spouse B works more than the minimum 20 hours per week in the current taxation year. Accordingly, dividends paid to Spouse B will be an excluded amount.

And also No. Since Spouse B has only worked in the business for the last two years, a gain on Spouse B's sale of share in Restaurant Co. will not be income from an excluded business. Spouse B should consider whether such gain might be eligible for one of the other exclusions (for example, the lifetime capital gains deduction exclusion (discussed below) might apply in this circumstance).

In a May 2018 Technical Interpretation,[28] the CRA provided the following guidance on what records will be sufficient for an individual to establish the number of hours worked in a given year:

> In general, records such as timesheets, schedules, or logbooks retained by either an individual or a business will be sufficient to establish the number of hours the individual worked in a given year. Where the individual also receives a salary or

[28] CRA Technical Interpretation No. 2018-0761601E5, May 25, 2018.

wages from the business, we would also consider information contained in payroll records that supports the number of hours the individual worked.

After the rules first come into effect, the CRA recognizes the challenges presented where family members continue to derive income from a business in which they had been actively involved (or could be deemed to be so under the proposed amendments) during years for which records were not required and which may no longer be available or were not formally maintained.

In such situations, the CRA will consider all information that can be made available related to the history of the business, in particular in relation to the involvement of family members.

Where such information is provided in support of assertions that the 20 hour per week threshold was met in prior years, the CRA will if necessary, consider whether the assertions are reasonable having regard to such factors as

* The type of business and duties performed as they relate to the main activities of the business

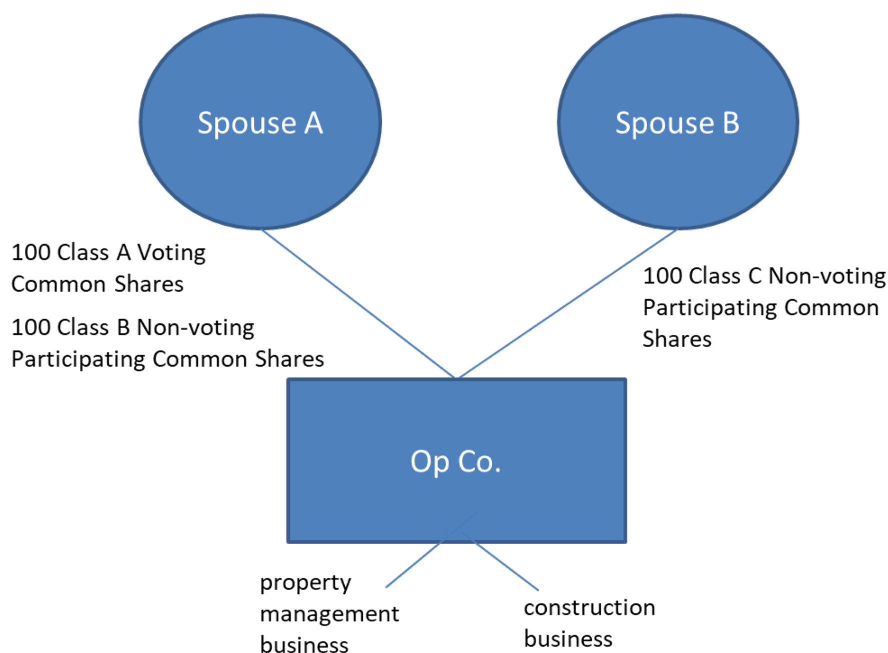
* The individual's education, training and experience

* Any particular knowledge, skills or know-how that the individual possessed

Going forward, the ongoing maintenance of such records in respect of any family members involved in the business will ensure that businesses are able to comply with the new rules and obtain the benefits of available exclusions, even as family members leave the business.

Needless to say, family business operators should now increase their efforts in documenting the contributions to the business by family members.

Example II: Excluded Business – Two Businesses



Additional Facts:

- *Spouse A and Spouse B are both over age 18 and under age 65.*
- *Spouse A runs the property management business, and works more than 20 hours per week in that business, but does not do any work for the construction business.*
- *Spouse B runs the construction business, and works more than 20 hours per week in that business, but does not do any work for the property management business.*

Example II: How does TOSI apply to the multiple businesses in Op Co.?

In Example II, two businesses are being operated through the same company. Because each spouse satisfies the bright line test in paragraph 120.4(1.1)(a) in respect of the business he or she works in, the property management business should be an excluded business in respect of Spouse A, and the construction business should be an excluded business in respect of Spouse B. However, the property management business will not be an excluded business in respect of Spouse B, and the construction business will not be an excluded business in respect of Spouse A.

The CRA considered a similar example in its May 2018 Technical Interpretation, and confirmed that it would expect Op Co. to track the income of each business so as to trace the funds appropriately from each particular excluded business to the particular spouse.[29]

2. Spousal ("age 65") Exclusion

Subparagraph 120.4(1.1)(c)(i) sets out a deeming rule that essentially permits taxpayers over age 64 to share exclusions with their spouses and common-law partners. Where an amount would be

[29] CRA Technical Interpretation No. 2018-0761601E5, May 25, 2018.

an “excluded amount” if it were received by a particular person who attained age 64 prior to the applicable taxation year, the amount is deemed to be an “excluded amount” in the hands of the particular person’s spouse or common-law partner (regardless of the age of the spouse or partner).

Similarly, under subparagraph 120.4(1.1)(c)(ii), an amount is an “excluded amount” to an individual if the spouse of such individual has died and the amount would have been an “excluded amount” to such deceased spouse in his or her last taxation year.

For example, applying these rules to Excluded Business – Example II above and CRA’s comments regarding tracking the income of separate businesses, it would not be necessary to track the income from the property management and construction business separately if both Spouse A and Spouse B were over age 64; in that case, income from either business division could be an excluded amount to each spouse. Similarly, if Spouse A died at age 55, income from the property management business could thereafter be an excluded amount to Spouse B.

3. Excluded Shares Exclusion

Income from, or a capital gain realized on the disposition of, “excluded shares” of a specified individual, is not split income.[30]

The term “excluded shares” is defined in subsection 120.4(1), and means at a particular time shares in the capital stock of a corporation “owned” by the specified individual;[31]

a) In the previous taxation year (or in the current one if there is no previous taxation year), the corporation derived less than 90% of its “business income” from the provision of services;[32]

b) Immediately before the time, the specified individual owns shares in the corporation that give the individual at least 10% of the votes of the corporation and have a fair market value of at least 10% of the value of all issued shares of the corporation;[33]

c) All or substantially all of the corporation’s income is not derived, directly or indirectly, from one or more “other” related businesses in respect of the specified individual;[34]

d) The corporation is not a professional corporation;[35] and

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[30] Subparagraph (g)(i) of the definition of “excluded amount” in subsection 120.4(1).

[31] Preamble to the definition of “excluded shares” in subsection 120.4(1) – this presumably means the specified individual must own the shares directly, and shares held in trust will not qualify.

[32] Subparagraph (a)(i) of the definition of “excluded shares” in subsection 120.4(1).

[33] Subparagraph (b)(i) of the definition of “excluded shares” in subsection 120.4(1).

[34] Paragraph (c) of the definition of “excluded shares” in subsection 120.4(1). Note that the CRA’s longstanding administrative position is that the phrase “all or substantially all” means 90% or more. See e.g. CRA Documents No. 2013-0495631C6, 2009-0305501E5 and 6M12570.

e) The specified individual is 25 or older in the year.[36]

In the December 13, 2017 draft legislation, the definition of excluded shares required that the 10% votes and value test be met in respect of the particular shares from which the income derives (i.e. the excluded shares themselves). Under the final version of the definition as enacted in Bill C-74, the votes and value can be aggregated across all classes of shares held by the specified individual. There is some uncertainty, however, as to the application of this favourable amendment in the 2018 taxation year, due to an apparent error in the wording of the transitional rule in subsection 13(8) of Bill C-74. The transition rule provides that for the 2018 taxation year, the opening of paragraph (b) in the definition of "excluded shares" is to be read as "immediately before that time or at the end of 2018, the shares". The intent of the transitional rule is to give taxpayers time (expiring December 31, 2018) to reorganize the shareholdings of the corporation so that the recipient of income in the year holds shares that meet the definition of "excluded shares". However, the words "the shares" in the transition rule suggests that for 2018 the "excluded shares" themselves meet 10% votes and value test (i.e. the requirement from the draft legislation seems to have been maintained, and it is not clear that whether the rights can be aggregated over various classes). Hopefully this is recognized as a simple drafting error and it is not necessary to meet the 10% votes and value test in this manner for 2018.

The CRA interprets that the reference to the company's deriving value from any "other" related business means any related business in respect of the specified individual other than a business carried on by the company itself. Accordingly, the CRA's position is that shares in holding companies that derive substantially all of their income from the underlying operating company will never qualify for the "excluded shares" exception.[37]

A "professional corporation" is defined in subsection 248(1) as "a corporation that carries on the professional practice of an accountant, dentist, lawyer, medical doctor, veterinarian or chiropractor." Accordingly, the excluded shares exception is not available in respect of these types of incorporated professionals.

Where a business makes more than 10% of its income from the sale of goods, as opposed to services, it will not be prevented from accessing the excluded shares exception. Unfortunately, it is not clear what types of income qualify as "income from the provision of services", and this term is not defined anywhere in the TOSI regime. In a question posed at the 2018 CALU Roundtable, the following observations were made on this point:

> Without a definition, a taxpayer is presumably left with interpreting the term under general business principles. From an economic perspective, there is a relatively clear delineation between the provision of "goods" versus "services". It is understood that goods are physical objects whereas services describe the performance of work for others. Services often lack physical identity and cannot

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[35] Subparagraph (a)(ii) of the definition of "excluded shares" in subsection 120.4(1).

[36] Paragraph (g) of the definition of "excluded amount" in subsection 120.4(1).

[37] 2018 CALU Roundtable, Question 6(b), CRA Document No. 2018-0745871C6.

> be distinguished from the service provider. Commonly cited examples of service businesses include banking, insurance, transportation and communications. There may also be some businesses which offer a mix of goods and services. One example is a restaurant business, where food is prepared for consumption (a good), and services are also provided (waitering, valet parking, etc.).
>
> Many businesses will be considered to be engaged in the provision of services. In fact, Statistics Canada data indicates that at the end of 2015 over 75% of small businesses were categorized as being in the service producing sector. For these businesses to qualify under this exemption, they will need to demonstrate that more than 10% of their income in any given year arises from the provision of goods. Also, looking at the types of businesses that are in the service producing sector (financial services, retail trade, healthcare, scientific and technical services), it can be expected that most of these businesses will not qualify for the "excluded shares" exemption as they will not be able to satisfy the "10% test."
>
> For example, a building contractor may otherwise meet the "excluded shares" definition, because its business involves the provision of goods, whereas a technology consulting firm (even if it has multiple offices employing a number of full time staff) will not, because its business involves the provision of services. Of particular concern may be the impact on technology-based businesses in Canada who are typically involved in the provision of services and are also the subject of specific government initiatives designed to encourage the growth of a robust innovation-based economy.[38]

The CRA was then asked to comment on, *inter alia*, what types of business might be considered to be engaged in the provision of services. The response on that issue was as follows:

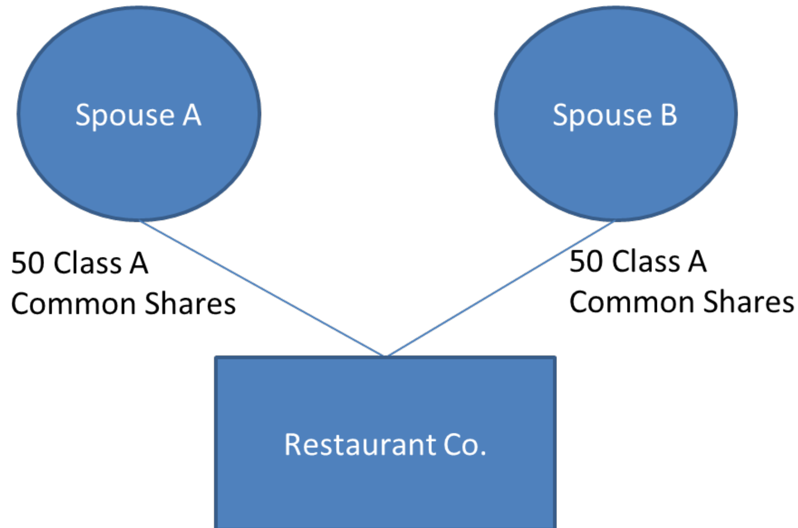
> Whether a business will be considered to be engaged in the provision of services will depend on the facts and circumstances of the businesses. The CRA expects that in most cases, the distinction between whether income is from the provision of services or is other income should be clear. In cases of uncertainty, we will be prepared to provide guidance as required based on a review of all of the relevant circumstances and our understanding of the rationale for the safe harbour exclusions. The interpretation of the requirements for the excluded shares and other issues relating to TOSI will develop over time.

In summary, there is minimal guidance and many unanswered questions in respect of what may constitute the provision of services.

[38] 2018 CALU Roundtable, Question 6(a), CRA Document No. 2018-0745871C6.

Excluded Shares Examples

Example III: Excluded Shares – Direct Interests



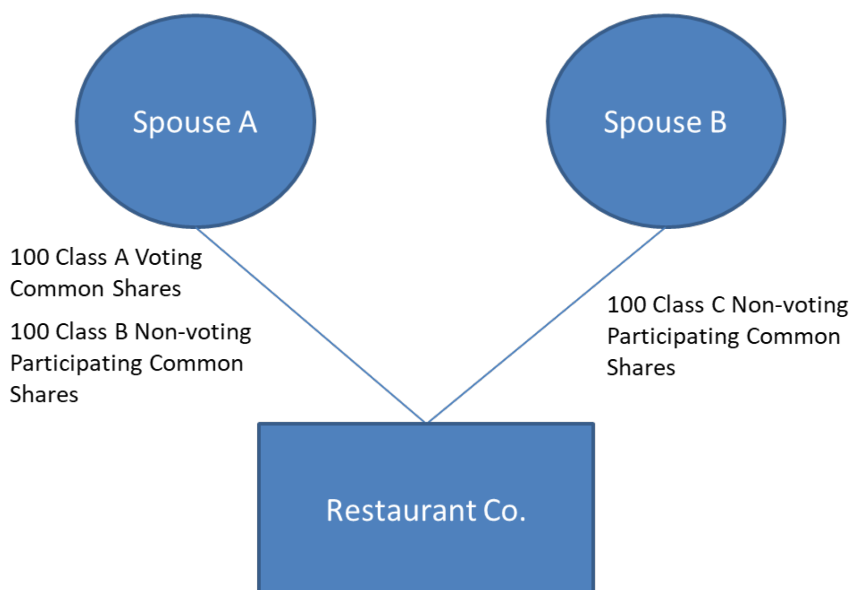
Additional Facts:

- *Spouse A and B each own 50 Class A voting, participating common shares*
- *Spouse B is not active in the business of Restaurant Co.*
- *Each spouse is over age 24*
- *Restaurant Co carries on active business and is not a professional or a services corporation*

Example III: Will Spouse B be subject to TOSI on dividends from Restaurant Co?

Since Spouse B is not involved in the business of Restaurant Co, the business is not an excluded business to Spouse B. However, the excluded shares definition is met: Spouse B is over 24 and holds more than 10% of the votes and value of Restaurant Co, which is not a professional corporation, does not earn more than 90% of its income from services, and does not derive any income from other related businesses.

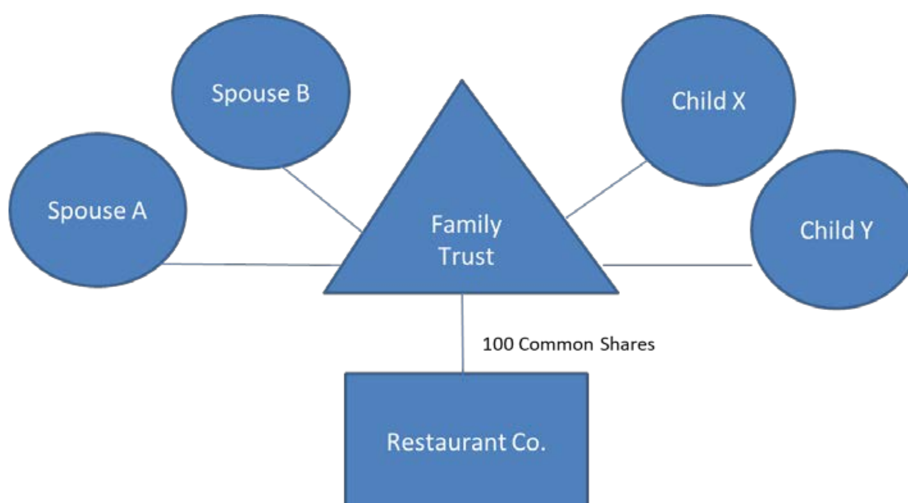
Example IV: Excluded Shares – Direct Interests Multiple Classes



Example IV: Same facts as Example III except Spouse B's shares are non-voting – what changes?

Since Spouse B's shares are non-voting, Spouse B does not hold excluded shares. Spouse B's tax advisors will need to consider whether any other exclusions are available, otherwise TOSI may apply.

Example V: Excluded Shares – Indirect Interests



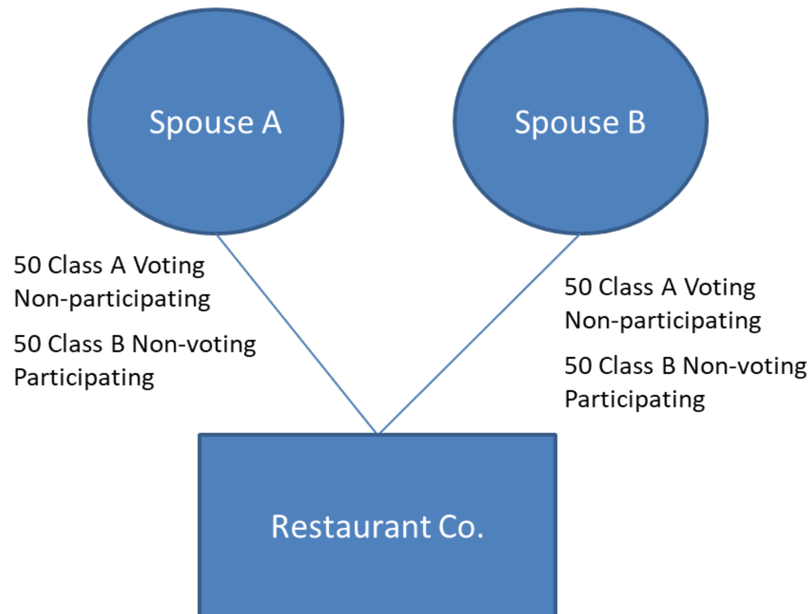
Example V: What if shares are held indirectly? Can the excluded shares test be met?

If shares are held indirectly, they cannot qualify as excluded shares. The legislation is clear that the term "specified individual" does not include a trust. Further, aspecified individual seeking to

rely on the excluded shares exception must "own" the shares, so presumably must hold the shares in question directly.

It is possible that certain beneficiaries in Example V will meet other exceptions, but the excluded shares exception is not available in this case.

Example VI: Excluded Shares – Multiple Share Classes & 2018 Transitional Rules

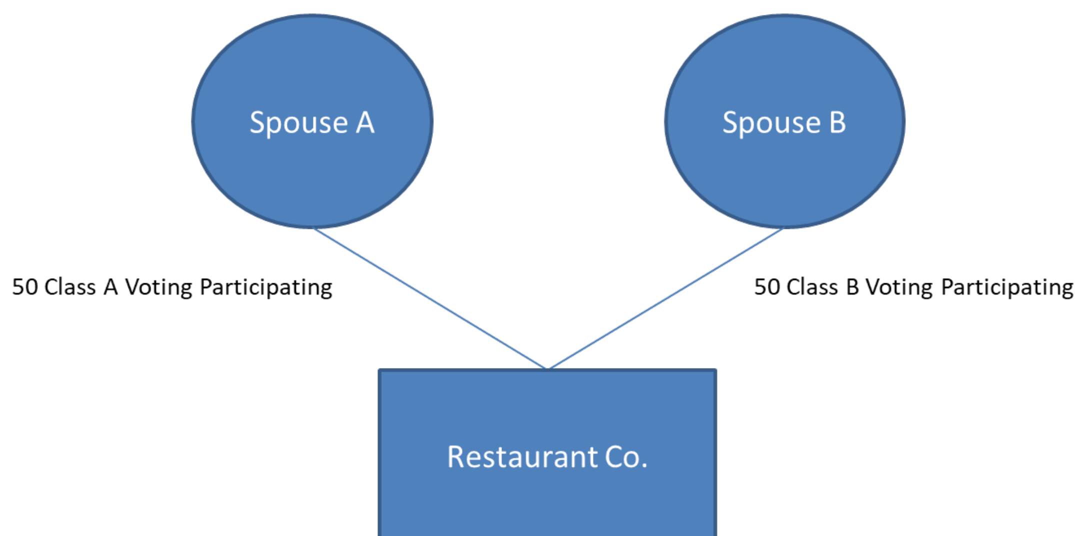


Example VI: What are the implications of multiple share classes, before and after the end of 2018?

As of January 1, 2019, the shares held by each of Spouse A and Spouse B should both constitute excluded shares, because each Spouse holds more than 10% of the votes and value across their two classes of shares.

However, in 2018 votes and value across multiple classes of shares may not satisfy the excluded shares definition. As discussed above, the wording of the transitional rule for 2018 in subsection 13(8) of Bill C-74 uses the words "the shares" referring to the shares on which the dividend is received. It is not clear if this was intentional or perhaps it was just an oversight in the transitional rule for 2018.

Example VII: Excluded Shares – Dividend Sprinkling Shares



Additional Facts:

- *Class A and Class B are dividend sprinkling shares*
- *Class A and Class B shares are identical in all other aspects*
- *Spouse B is not active in the business*

Example VII: What are the implications on the votes and value test for dividend sprinkling shares?

The CRA has provided some guidance and examples on the application of the split income rules (the "CRA TOSI Examples");[39] In Example 3 of the CRA TOSI Examples, the shareholders hold dividend sprinkling shares

Each of Spouse A and Spouse B will meet the excluded shares definition if they hold separate classes of shares that are the same in all aspects with the exception of dividend sprinkling. Both spouses would have more than 10% of the votes and value of Restaurant Co. in this example.

For structures that are in place with dividend sprinkling shares you may wish to review the share attributes to ensure they are the same in all material aspects such that the 10% votes and value test can be met.

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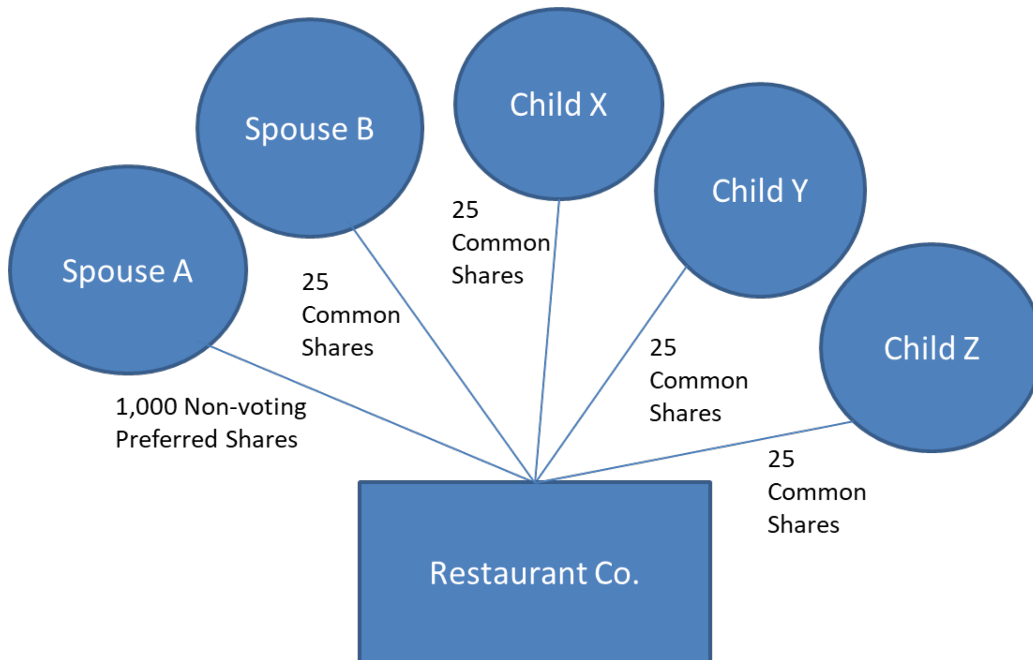
[39] "Guidance on the application of the split income rules for adults", Canada Revenue Agency Website, December 13, 2017, https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/federal-government-budgets/income-sprinkling/guidance-split-income-rules-adults.html.

Example VIII: Excluded Shares – Wasting Freeze



Additional Facts:

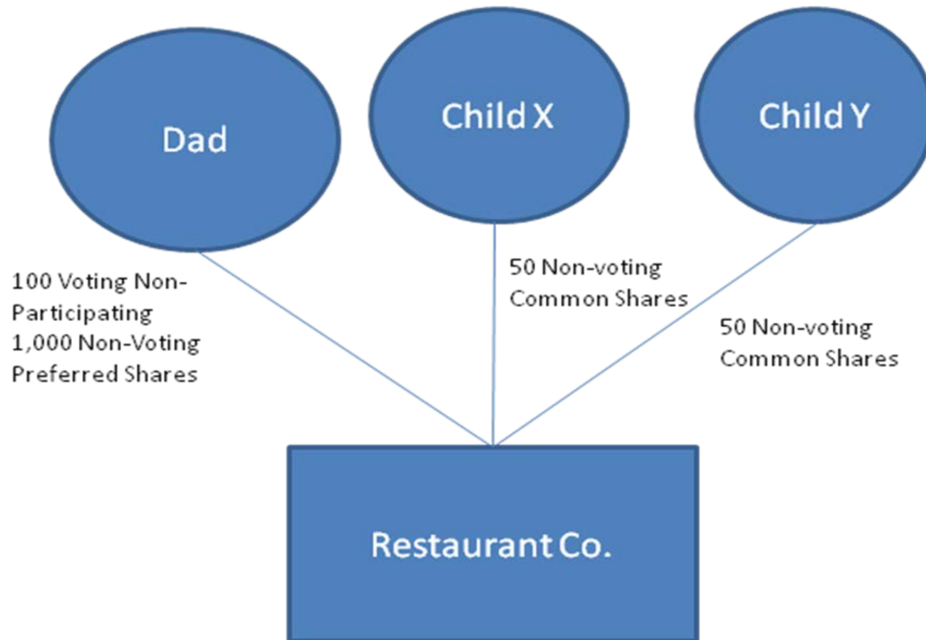
- *Spouse A has undertaken an estate freeze, and no longer has voting shares*
- *Children X, Y and Z are all over age 24*
- *Spouse B and the children have the voting shares and the future growth*

Example VIII: What needs to be considered with respect to TOSI after an estate freeze?

As Spouse A no longer has any voting shares, Spouse A would need to rely on another exclusion from the TOSI rules such as the reasonable return or excluded business exceptions when redeeming their shares.

For Spouse B and the Children, they would each have more than 10% of the votes in this example; however, it becomes a timing question for them as to when 10% of the value has accrued to their shares to enable them to meet the excluded shares definition. In the short term, Spouse B and the Children may need to rely on other exclusions until such time as the Company has grown in value and/or redeemed preferred shares belonging to Spouse A.

Example IX: Excluded Shares – Skinny Votes – Post-Freeze



Additional Facts:

- *Child X and Child Y are both over age 24*

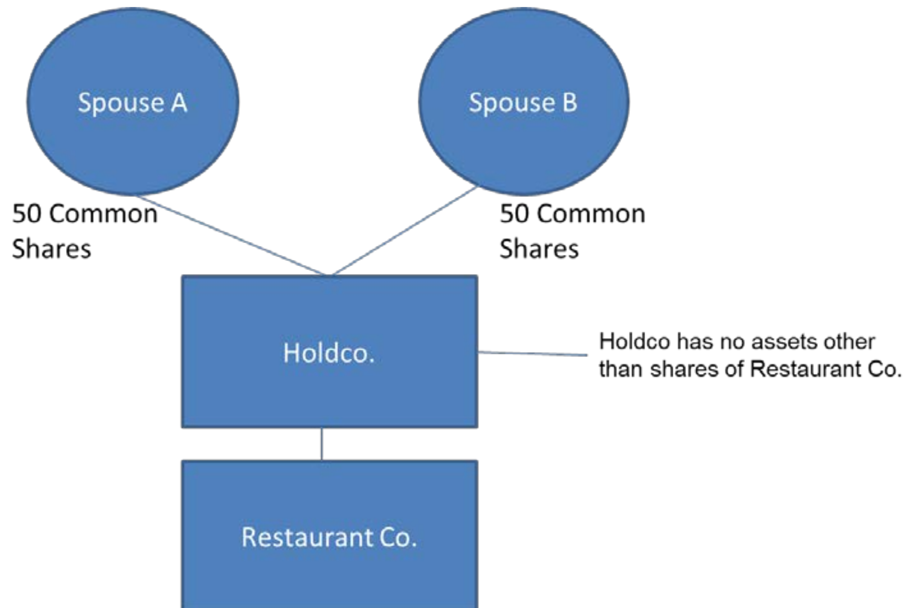
Example IX: What needs to be considered with respect to TOSI in this type of structure?

It is common that parents wish to retain voting control post freeze for various reasons.

As the children in this example don't have 10% of the votes (assume they get to 10% of the value one day), their shares won't be excluded shares. Therefore, the kids would need to rely on another exception for the TOSI rules to not be applicable.

In this example you may wish to consider either freezing out Dad's voting rights or issuing the kids a voting class of shares to ensure the kids get more than 10% of the votes each in order to meet the excluded shares test if another exception cannot be found.

Example X: Excluded Shares – Common Holdco Structure



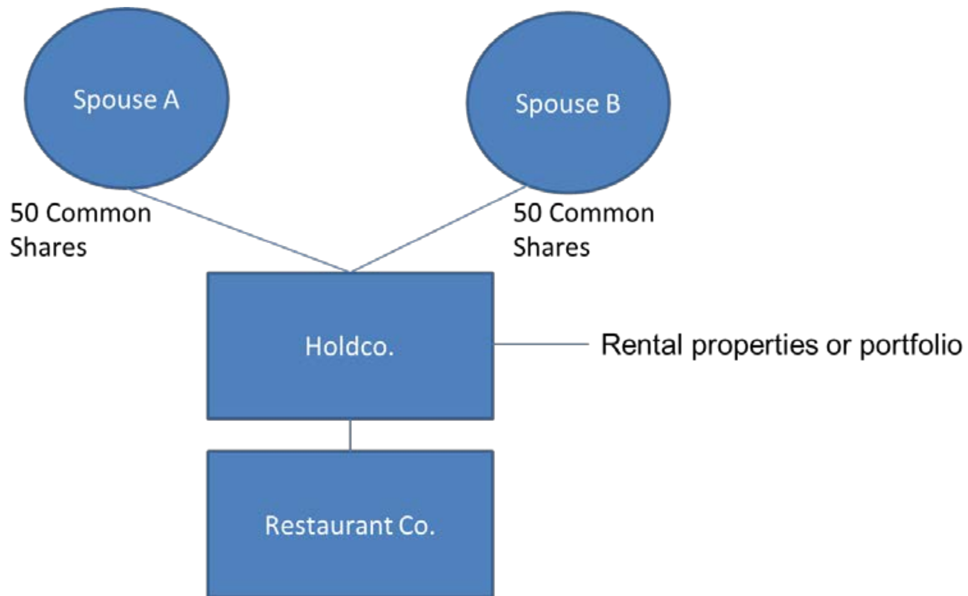
Example X: Can holding company shares be excluded shares?

The way the definition of excluded shares reads, holding companies will generally not meet the excluded shares test. This is because a holding company generally derives all or substantially all of its income from a related business, such that it will fail to meet the requirements in paragraph (c) of the definition of excluded shares.[40]

However, the shareholders of Holdco may meet another exception to the TOSI rules.

[40] See STEP Roundtable, May 29, 2018 (“2018 STEP Roundtable”), Q.6.

Example XI: Excluded Shares – Common Holdco Structure #2

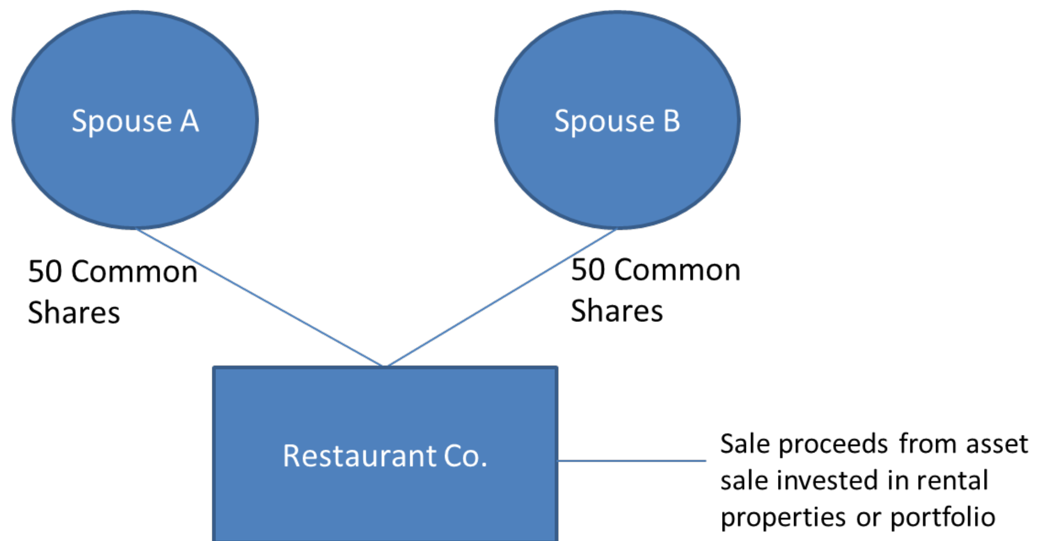


Additional Facts:

- *Holdco receives no dividends in the taxation year or prior year from Restaurant Co., but has investment and/or rental income*

Example XI: Even though Holdco does not have income from the other related business of Restaurant Co for the purposes of paragraph (c) of the definition of excluded shares, it also may not have "business income" for the purposes of subparagraph (a)(i) of the definition of excluded shares. CRA takes the position that the company must have "business income" in order for the excluded shares definition to apply.

Example XII: Excluded Shares – Post-Sale of Business



Additional Facts:

- *Spouse A and Spouse B were the original shareholders from incorporation*
- *Restaurant Co carried on an active business for 20 years*
- *Spouse A and Spouse B were active during this period*
- *Investment income paid to Spouse A and Spouse B as dividends*

Example XII: Are the shares of Restaurant Co. still excluded shares?

As Restaurant Co. is only earning investment income now, it has no business income. Therefore, if Restaurant Co. has no business income can it meet paragraph (a) of the excluded shares definition?

In Example 8 of the CRA TOSI Examples, with a virtually identical fact pattern, they indicate the shares of Restaurant Co. would be excluded shares.[41]

However, at the 2018 STEP Roundtable, CRA answered a question about whether a corporation with no business income can qualify as excluded shares. They answered in the negative, with the rationale being that mathematically if both services income and business income are zero, then the condition in paragraph (a) can't be met. [42]

There is a contradiction in their illustrative example and how they answered the question at STEP so it remains to be seen how CRA will assess these situations, although in the example, a taxpayer may still be able to meet an exception to the TOSI rules other than the excluded shares exception.

4. Not Derived from Related Business Exclusion

Pursuant to subparagraph (e)(i) of the definition of excluded amount, if an amount is not derived directly or indirectly from a related business in respect of the specified individual "in the year", it does not constitute split income to a specified individual who is over 18 years old.

One result of this exclusion is that where a taxpayer is aged 18 or older, dividends from a private company will only be subject to TOSI if the company derives its income from a related business.

If relying on the non-related business exclusion, it is important to be aware of the deeming rules in paragraph 120.4(1.1)(d), discussed above. Although an amount may not appear on its face to be derived from a related business, between the broad definition and the deeming rules in paragraph 120.4(1.1)(d), the scope of what amounts may be derived directly or indirectly from a related business is expansive. Further, as noted above, it is not clear (1) the extent to which investment or rental activities will be considered a business, or (2) how the rules will be applied where a business has been sold or wound-down.

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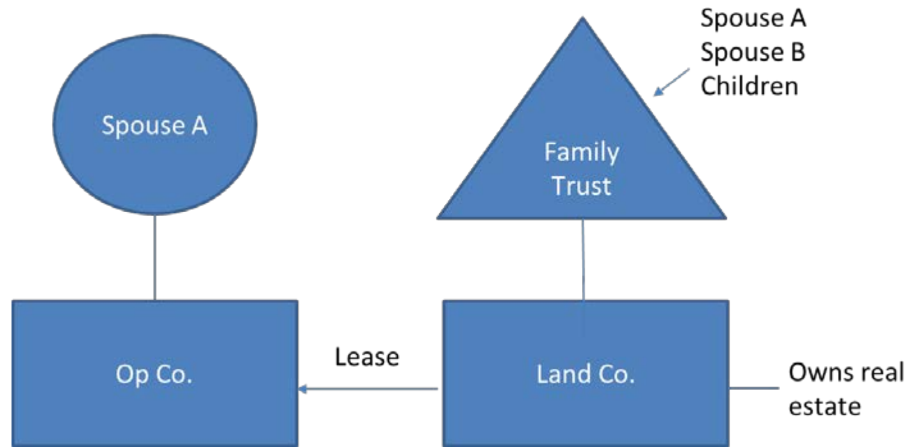
[41] CRA TOSI Examples, *supra* note 39, Example 8.

[42] 2018 STEP Roundtable, *supra* note 40, Question 7.

Related Business Examples

Example XIII: Related Business – Sidecar Structure



Additional Facts:

- *Op Co carries on active business in which Spouse A is actively engaged and Spouse B is not actively engaged*
- *Land Co leases land to Op Co and receives rental income in return*

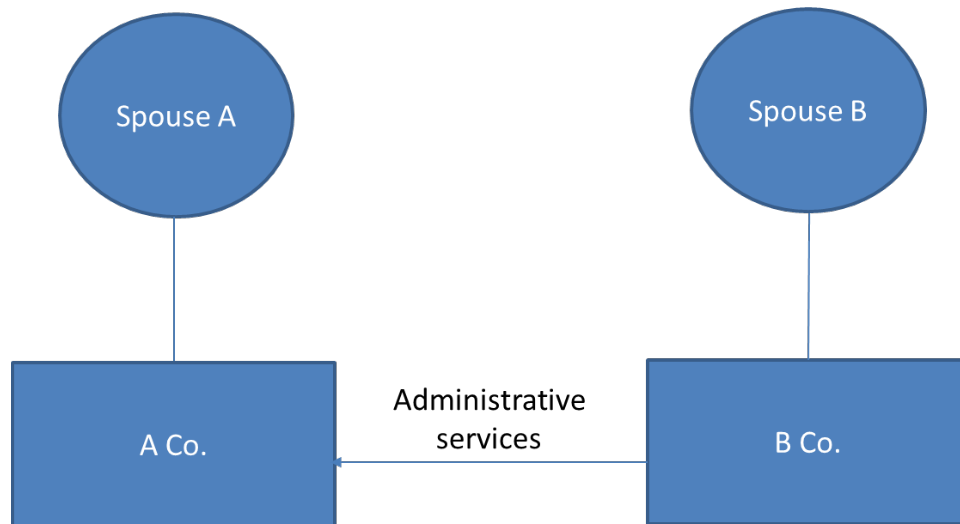
Example XIII:

Op Co is a related business in respect of Spouse B and the Children, because Spouse A is a source individual to Spouse B and the Children, and is actively engaged in the business of Op Co. The rental income received by Land Co from Op Co is therefore income derived from a related business, per the deeming rule in clause 120.4(1.1)(d)(i)(A).

Dividends paid by Land Co to the beneficiaries through the Family Trust will be subject to TOSI unless another exclusion applies.

Note that if the Land Co shares were held directly, they would not constitute excluded shares because more than 10% of Land Co's income is derived from the related business of Op Co.

Example XIV: Related Business – Management/Service Co.



Additional Facts:

- *Spouse A is actively engaged in the business of A Co*
- *Assume the excluded business test is met for Spouse B in respect of B Co*
- *B Co provides administrative services to A Co and other parties*

Example XIV:

The income of B Co from the provision of services to A Co is income derived from a related business. But if another exception applies in respect of Spouse B, amounts paid to Spouse B from B Co that derive from B Co's income from A Co should be excluded amounts to Spouse B.

5. Reasonable Return Exclusion

There are effectively two categories within the reasonable return exception: one applicable to specified individuals under age 25, and one applicable to specified individuals aged 25 or older.

The term "reasonable return" is defined in subsection 120.4(1), and means an amount derived directly or indirectly from a related business, which would otherwise constitute split income, but is reasonable having regard to certain factors. The list of factors that may be considered depends on the age of the particular specified individual.

Reasonable Return for Individuals Under Age 25

A specified individual under age 25 is entitled to an exclusion from split income in respect of an amount that constitutes a "reasonable return" to the specified individual having regard only to the individual's contributions of "arm's length capital".[43] The phrase "arm's length capital" is defined in subsection 120.4(1) and means property of a specified individual (or property substituted therefor) that does not fall within any of the following categories:

[43] Subparagraph (f)(ii) of the definition of "excluded amount" in subsection 120.4(1).

- Property acquired as income from or a taxable capital gain or profit from the disposition of another property that was derived directly or indirectly from a related business;
- Property borrowed by the specified individual under a loan or other indebtedness; or
- Property transferred, directly or indirectly by any means whatever, to the specified individual from a related person (unless by way of an inheritance).

Note that the second category includes amounts borrowed pursuant to an arm's length loan; arm's length capital is narrowly defined and appears to be intended to apply to capital owned by the specified individual and not tainted by association with any related business.

Reasonable Return for Individuals Age 25 or Over

In determining whether an amount is a reasonable return to a specified individual over age 24, the following factors relating to the "relative" contributions of the specified individual and any applicable source individuals in respect of the related business are to be considered:

a) The work performed in support of the related business;

b) The property contributed (either directly or indirectly) in support of the related business;

c) The risks assumed in respect of the related business;

d) The total of all amounts paid or payable (whether directly or indirectly) by any person or partnership to or for the benefit of the specified individual in respect of the related business; and

e) Such other factors as may be relevant.[44]

The reference to "property contributed" in support of the related business does not specify any requirement that the property be derived from arm's length capital, unlike the requirement for specified individuals under age 25; however, as the factors for specified individuals over age 24 lead to a more holistic assessment of the specified individual's true contributions to the business (compared to the contributions of all other parties presumably, based on the inclusion of the word "relative"), this omission may not in fact afford any significant advantage.

In the above example described in relation to the deeming rule in clause 120.4(1.1)(d)(i)(A), in which Business A, operated by Parent A, rents property from Son B, it was noted that the rental income would constitute split income to Son B under the deeming rule in clause 120.4(1.1)(d)(i)(A). However, assuming that Son B is 25 or older the rental payments would arguably constitute a reasonable return in consideration of property contributed in support of the related business.

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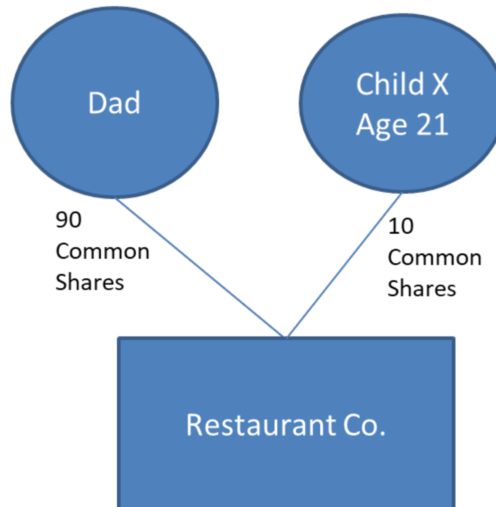
[44] Paragraph (b) of the definition of "reasonable return" in subsection 120.4(1).

Reasonable Return Examples

Example XV: Reasonable Return – Employed Child

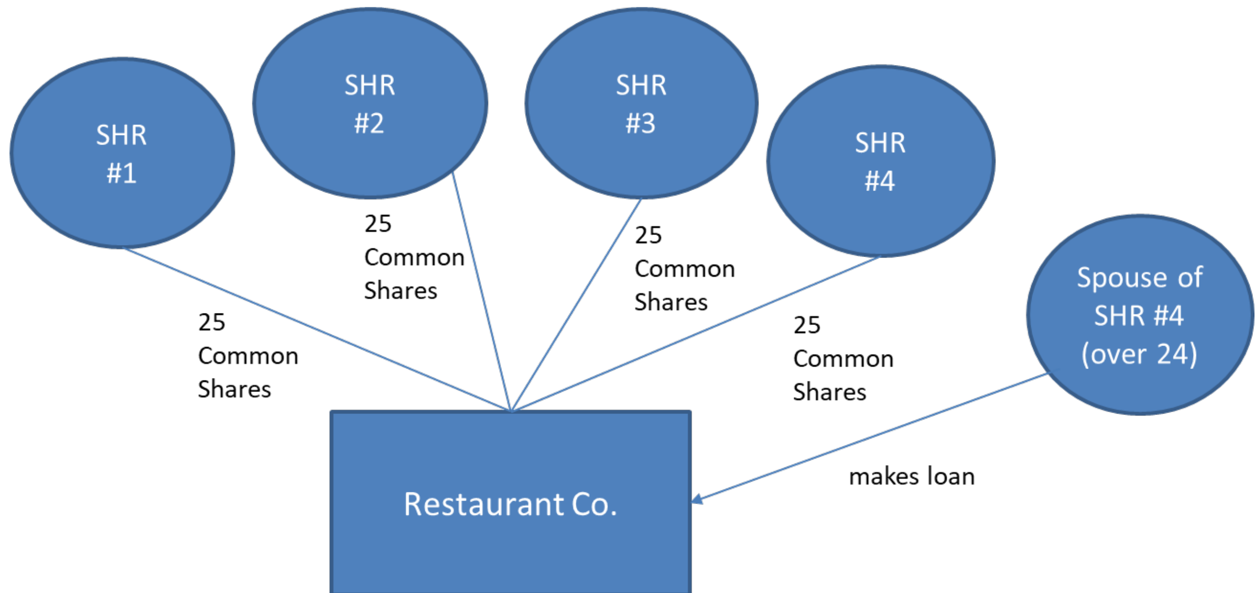


Example XV: Does Child X meet the excluded shares exception?

As Child X is not over the age of 24 the shares are not excluded shares for Child X. Furthermore, a reasonable return for Child X given their age is limited to a safe harbour return of 2% of the amount contributed by Child X to Restaurant Co. In many cases this will likely not be substantial.

Therefore, until Child X is over the age of 24, it would be more prudent to pay Child X salary/bonus to compensate them for their contribution to the business. Or, ideally Child X is active in the business to a sufficient extent such that the business is an excluded business to Child X, and Child X can rely on that exception.

Example XVI: Reasonable Return - Loan



Additional Facts:

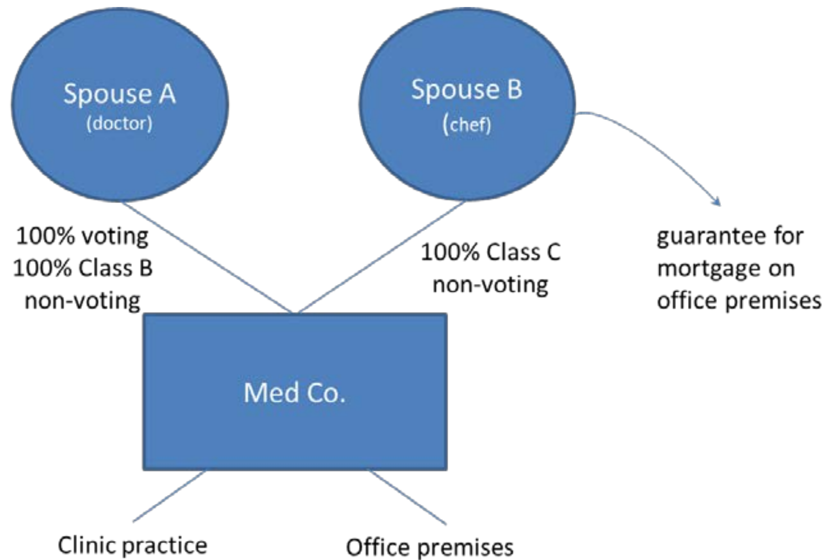
- *Shareholders #1, #2, #3 and #4 all deal at arm's length with each other*
- *All shareholders are over the age of 24*
- *Restaurant Co has a long-term policy of paying 10% interest on unsecured loans from all four shareholders*
- *The Spouse of Shareholder #4 has their own cash on hand*

Example XVI: Can the spouse of Shareholder #4 cycle cash through Restaurant Co and repay Shareholder #4's loan?

The Spouse of Shareholder # 4 has their own funds available and on hand. The Spouse of Shareholder #4 will make a loan to Restaurant Co., which in turn will repay all or a portion of Shareholder #4's existing unsecured loan.

As the shareholders are all dealing at each other at arm's length, and as the shareholders have an established history of paying 10% on unsecured shareholder loans, 10% should be considered a reasonable rate of return on the unsecured loans. Therefore, the Spouse of Shareholder #4 should meet the reasonable return exclusion in respect of the interest received on the loan to Restaurant Co.

Example XVII: Reasonable Return - Guarantee



Additional Facts:

- *Spouse B is not active in the business of Med Co*
- *Spouse B is not permitted to own voting shares in Med Co*
- *However, Spouse B owns the family home and provides a guarantee for Med Co to finance the purchase of office premises*
- *Med Co does not pay Spouse B a fee for the guarantee*

Example XVII: If Spouse B receives a dividend in lieu of a guarantee fee is it subject to TOSI?

The shares owned by Spouse B will not qualify as excluded shares, since Med Co is a professional corporation. Therefore, it is a question of fact as to whether the dividend received by Spouse B in lieu of a guarantee fee can meet the excluded amount exception.

In Example 3C of the CRA TOSI Examples, ,[45] a dividend paid to Spouse B will be an excluded amount as it is a reasonable return based on the risks assumed. This, of course, is contingent on the amount of the dividend approximating what an arm's length guarantee fee would otherwise be.

6. Safe Harbour Capital Return Exclusion

For a specified individual aged 18-24, a "safe harbour capital return" is exempted from split income.[46] This term is defined in subsection 120.4(1) and essentially provides for a small return calculated based on the fair market value of property contributed by the specified individual in support of the related business, up to the CRA's prescribed rate in effect at the time multiplied by

[45] CRA TOSI Examples, *supra* note 39, Example 3(c).

[46] Subparagraph (f)(i) of the definition of "excluded amount" in subsection 120.4(1).

the proportion of the year that the capital was invested in the applicable related business.[47] The capital for this purpose does not need to meet the definition of "arm's length capital".

Since the CRA's prescribed rate is currently 2%, the safe harbour capital return exception does not currently provide significant shelter from TOSI, and is unlikely to be of assistance for most taxpayers seeking to avoid the application of the TOSI regime.

7. Marital Breakdown Exclusion

Pursuant to paragraph (b) of the definition of "excluded amount", income in respect of property received on the breakdown of a marriage does not constitute split income to a specified individual of any age, if the following conditions are met:[48]

1. at the time of the transfer the spouses were living separate and apart as a result of the breakdown of their marriage; and

2. the property was transferred to the specified individual pursuant to either (a) a decree, order or judgment from a competent tribunal, or (b) a written separation agreement.

To fall within this exclusion, the property must have been transferred to the specified individual from the specified individual's spouse or common law partner, as described in subsection 160(4). A transfer to the specified individual of shares directly from a family trust as part of a matrimonial settlement will presumably not meet this exception. Further a division of assets pursuant to paragraph 55(3)(a) inter-corporate transfers may also not meet the exception.

However, there is another avenue under which a separated couple may be able to avoid the application of TOSI: paragraph 120.4(1.1)(e) sets out a deeming rule whereby a couple living separate and apart as a result of the breakdown of their marriage or common-law partnership are deemed not to be related for purposes of the TOSI rules. Accordingly, even though a particular property may not have been transferred in circumstances to which the specific marital breakdown exception applies, a separated spouse may be able to rely on the non-related business exception to avoid TOSI on income derived from, for example, shares in a company whose business is operated by their former spouse or common-law partner.

However, a child of the separated spouse would be a "source individual" of the separated spouse; if the child is actively engaged on a regular basis in the activities of the business, the non-related business exception will not be available and the separated spouse will need to look for another applicable exclusion.

8. Capital Gain on Death Exclusion

Paragraph (c) of the definition of "excluded amount" provides that taxable capital gains that arise as a result of the deemed disposition on death under subsection 70(5) of the Tax Act are

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[47] Definition of "safe harbour capital return" in subsection 120.4(1).

[48] Subsection 160(4) and paragraph (b) of the definition "excluded amount" in subsection 120.4(1).

excluded amounts, and therefore do not constitute split income. This exclusion applies to specified individuals of any age.[49] Does this exclusion make post-mortem loss carryback planning for an estate less attractive? Presumably not, since the dividend arising under the loss carryback plan will be taxed in the hands of the estate, which is a trust and therefore not a "specified individual" and not subject to TOSI[50].

9. Lifetime Capital Gains Deduction Exclusion

Paragraph (d) of the definition of "excluded amount" provides that a taxable capital gain for the year from the disposition by the specified individual of property that meets the definition of "qualified farm or fishing property" or "qualified small business corporation shares" is an excluded amount and therefore not "split income". In other words, capital gains that would be subject to the lifetime capital gains deduction (whether or not the exemption is actually claimed) generally will not constitute split income to a specified individual of any age.[51] This is true even if the gains are allocated to the specified individual as a beneficiary of a trust. The exclusion appears to apply even if the specified individual has already fully used his or her lifetime capital gains deduction, and to the entire gain realized, not just to the amount of the gain up to the deduction threshold applicable in the year.

However, it is important to consider the deeming rules in subsections 120.4(4) and (5), which apply where the specified individual is a minor who has sold shares to a non-arm's length person. The deeming rules recharacterize capital gains on the non-arm's length disposition as non-eligible dividends, which would not be sheltered by this exception.

Subsection 120.4(4) states that where a specified individual who is under 18 throughout the year in question has disposed of private company shares, either directly or indirectly in any manner whatever, to a person with whom the specified individual does not deal at arm's length, then the amount of the capital gain (i.e. twice the amount of the taxable capital gain) that would otherwise arise on the disposition is deemed instead to be received by the specified individual as a non-eligible dividend in the year.

Subsection 120.4(5) contains a similar deeming rule, applicable where a trust allocates a capital gain to a specified individual and the capital gain can reasonably be considered to be attributable to a disposition of private company shares to a person who does not deal at arm's length with the specified individual.

Since there is no provision that deems a dividend to be paid by the corporation (only a provision that deems a dividend to have been received), the deemed dividend does not appear to allow for a refund of RDTOH to the corporation.

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[49] Subsection 70(5) and paragraph (c) of the definition "excluded amount" in subsection 120.4(1).

[50] Presumably most estates meet the definition of "graduated rate estate" and are taxed at marginal rates.

[51] Paragraph (d) of the definition of "excluded amount" in subsection 120.4(1).

10. Inherited Property Rules

There are now two sets of inherited property rules: the original "excluded amount" from the kiddie tax regime remains but is only applicable to taxpayers under 25 throughout the year in question; a new set of inherited property rules applies to taxpayers who are 18 years or older in the year in question.

Inheritances held by (or for the benefit of) young persons

For specified individuals who are 24 or under throughout the year in question, paragraph (a) of the definition of "excluded amount" exempts from split income any income, capital gains or profit in respect of property that was "acquired by, or for the benefit of, the specified individual as a consequence of the death of" (1) a parent of the specified individual[52], or (b) if the specified individual is a full-time post-secondary student or is entitled to the disability tax credit, any person.[53]

The use of the phrase "as a consequence of the death of" suggests that it may not be necessary for the specified individual to inherit directly from the deceased person – if a trust deed stipulates that following the death of a family member, property is to be distributed from the trust to the specified individual "as a consequence of the death of" such family member, will income from the property fall within the exclusion? A close reading of the legislation suggests it will.

The use of the phrase "or for the benefit of" suggests that it may not be necessary for the specified individual to own the property directly – is it sufficient if the property from which the income derives is held in trust for the specified beneficiary, if such trust acquired the property as a consequence of the death of the parent or other person? Again, a close reading of the legislation suggests this will be within the exclusion.

General Inheritance Deeming Rules

For specified individuals who are 18 or older in the year in question, there are several deeming rules for inherited property, which essentially port the characteristics of the deceased person to the specified individual for purposes of applying certain "excluded amount" definitions. For the purposes of these deeming rules, the property from which the income or gains in question is derived must have been acquired by or for the benefit of the specified individual as a consequence of the death of another person (the "Deceased Person"). Where these conditions are met, the following deeming rules will apply:

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[52] A child who inherits from her grandparent because her parent has predeceased would not fit within this exclusion. This unfairness was noted by the March 8, 2018 submission to the Department of Finance by the Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada.

[53] Paragraph (a) of the definition of "excluded amount" in subsection 120.4(1).

A. For purposes of determining a "reasonable return" to the specified individual, the factors as applicable to the Deceased Person in respect of the property in question are deemed to be applicable to the specified individual;[54]

B. For the purposes of determining whether the particular business meets the definition of "excluded business" in respect of the specified individual, if the Deceased Person was actively engaged in the activities of the business on a regular, continuous and substantial basis throughout five previous taxation years, then the specified individual will be deemed to have been actively engaged on a regular, continuous and substantial basis throughout those five years.[55]

C. For the purposes of determining whether the particular inherited property meets the definition of "excluded shares" in respect of the specified individual, if the Deceased Person was aged 25 or older then the specified individual will be deemed to be aged 25 or older.[56]

It is uncertain whether these deeming rules will apply to a subsequent inheritance – in other words, if another family member inherits as a consequence of the death of the specified individual referred to above, will that other family member also pick up the attributes of the Deceased Person for purposes of meeting the "reasonable return" or "excluded business" exclusions?

V. OTHER METHODS OF REMUNERATION TO CONSIDER IN LIGHT OF THE TOSI REGIME

Remuneration from the Business

As illustrated by the foregoing discussion, if a taxpayer cannot meet the specific exceptions to the TOSI rules, alternative forms of remuneration are likely limited. A few things to consider:

- Paying salaries as opposed to dividends for services contributed to the business. Salaries are not subject to the TOSI rules and so long as the salary is reasonable it should be deductible by the payor.

- Consider paying director's fees to those individuals who act as directors but may not meet the exclusions from TOSI. A reasonable market rate director's fee may not provide the full ability to split income as dividends might have in the pre-TOSI era, but there is some value there.

- As noted in examples above, if the facts are right, in cases where historically a guarantee fee could be charged but has not been, consider whether a guarantee fee should be

[54] Subparagraph 120.4(1.1)(b)(i).

[55] Subparagraph 120.4(1.1)(b)(ii).

[56] Subparagraph 120.4(1.1)(b)(iii).

charged. Again, this may not be a significant win from an income splitting perspective but there is some value there.

- Consider employing persons in the business that have not been historically employed such that they can perhaps meet the bright line test of 20 hours/week or make other sufficiently substantial contributions.

- Consider whether preferred beneficiary elections are available, if a family trust has income from the business. CRA has stated that the definition of split income does not extend to amounts included in income because of the application of subsection 104(14).[57]

Prescribed Rate Loan Planning

Where income has been extracted from the business, that income can most likely be used to fund a traditional 'prescribed rate loan' plan.[58] For example, Spouse A could lend funds to Spouse B. If Spouse B pays sufficient interest to avoid the attribution rules in subsections 74.1(1) and 74.2(1) and invests the borrowed funds in publicly traded securities or rental properties, investment income earned by Spouse B should not fall within any of the categories in the definition of "split income".

This should also be the case if Spouse A lends to a trust under which Spouse B is a beneficiary, and the trust invests in publicly-traded securities and allocates investment income to Spouse B.

However, TOSI might not be avoided if such a trust invests in rental properties rather than publicly-traded securities. If Spouse A is actively engaged on a regular basis in the activities of the trust related to the rental of property, then rental income of the trust allocated to Spouse B will be within paragraph (c) of the definition of split income. Query whether the management of rental properties by Spouse A is sufficient business activity to meet the definition of "related business" – if not, then the income realized by Spouse B from the trust should be an excluded amount pursuant to paragraph (e)(i) of the definition of "excluded amount" on the basis that it is "not derived directly or indirectly from a related business". Would Spouse B have a better chance of meeting this exclusion if the trust engages a property management firm to manage the rental properties, and Spouse A merely oversees that firm?

The reason for the potential distinction here between portfolio income and rental income is unclear.

VI. CONCLUDING COMMENTS

The TOSI rules set out a complete code for the taxation of split income. As a general practice, tax advisors may find it appropriate to assume that particular amounts received constitute split income, then consider whether any of the excluded amounts or deeming rules apply. However,

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[57] See CRA document 2018-0759521E5.

[58] This assumes that the derivative rule in paragraph 120.4(1.1)(d) is no longer applicable. See Example 3 of Department of Finance Explanatory Notes for comments in support of this assumption.

practitioners should not ignore the concepts of specified individual and split income, as it will be a much simpler task to determine whether one of these terms applies. In addition, there are various uncertainties within certain of the TOSI provisions and how they will be assessed. It will presumably be several years before we understand CRA assessing practices or see scenarios work their way through the courts and get a clearer picture on some of these uncertainties.

There are several strong policy arguments against the overarching prohibition on income splitting.

In imposing the TOSI rules, the Department of Finance has implied that the ability of a small business owner to income split while a salaried employee cannot is unfair. This comparison misses the importance that income splitting plays in supporting small businesses. Entrepreneurs and small business owners take larger risks and have less stable income than a salaried employee. They have no guaranteed salary or pension, yet they must continue to pay all expenses (both personal and business) as they come due. Accordingly, income splitting previously provided a mechanism for small business owners to lower their tax obligations, thereby easing some of the pressure of expenses up front.

Further, the TOSI rules unfairly target services businesses. There is no difference in value between the contributions to the Canadian economy made by a business that sells goods and one that provides services (and in most cases, arguably no less risk is assumed by the proprietor of a services business[59]).

Finally, the Department of Finance has repeatedly asserted that only a very small number of businesses will be affected.[60] However, this assertion ignores the fact that even businesses to which TOSI does not ultimately turn out to apply may be forced to engage tax advisors at significant expense in order to reach that conclusion.

[59] The CRA does not appear to agree with this statement – see CRA Technical Interpretation No. 2018-0761601E5, May 25, 2018.

[60] See e.g. Department of Finance News Release, Government Simplifies Measures to Restrict Income Sprinkling, December 13, 2017.