The Institute™
for Advanced Financial Education

COMMENT

Edition 308 – Mar/Apr 2018

THE NEW TOSI RULES: COMPLEXITY AND CHALLENGES

In July 2017, the federal government released proposals aimed at limiting opportunities for shareholders of privately held corporations to split income with family members. In response, there was a significant wave of push-back from the business and tax community. The federal government significantly revised their approach and released new proposals in December 2017. The February 27, 2018 federal budget confirmed the government's intent to move forward with the revised proposals and released proposed legislation on March 22, 2018.

For the past 19 years, shareholders of privately held corporations have worked with the split income rules as they relate to minor children (i.e., individuals under age 18). These rules have commonly been referred to by the term 'Kiddie Tax' but, with the extension of the rules to related adults, the new rules have come to be known by the acronym TOSI – **t**ax **o**n **s**plit **i**ncome.

The new TOSI rules are proposed to be effective for 2018 and subsequent years. Higher taxes could apply to dividends and interest paid from privately held corporations to its shareholders and other individuals related to the shareholders. Some capital gains could also be caught. The objective of the new rules is to eliminate income splitting with related individuals who have not contributed significantly to the business.

The complexity of the TOSI rules and their application will create challenges for taxpayers and their professional advisors as everyone begins to interpret and apply the rules to their specific circumstances. Even the Canada Revenue Agency (CRA) has indicated their approach to applying the rules will evolve over time based on their experience and assessment of whether their approach is addressing the tax policy concerns underlying the new rules.

In simple terms, the Department of Finance suggests that where a family member is significantly involved and making a meaningful contribution to a business, the theory is that the individual should be excluded from the new tax on split income rules. They also suggest that about 3 percent of Canadian-controlled private corporations, approximately 45,000 entities, will be affected by these changes.

The challenge is translating the theory into practical terms, which requires an understanding of a series of definitions and the application of the concept of meaningful contribution. Included in the new rules is the phrase "directly and indirectly," which widens the breadth of circumstances subject to TOSI.

The Broad TOSI Rules

In simple terms, the new TOSI rules are designed to apply in all circumstances where dividends or interest are paid and capital gains are realized in respect of a private corporation, unless the circumstances fall within two types of exceptions – definitive and subjective exceptions. The definitive exceptions are clear and can be easily ascertained. The subjective exceptions are far more difficult to ascertain and are based on an assessment of the facts associated with each set of circumstances.

Income meeting the definition of TOSI is removed from the individual's net income and taxed separately at the top marginal tax bracket in his or her province of residence. In addition to paying tax at the top tax rate, the individual may claim only the dividend tax credit, tax credit for mental or physical impairment and foreign tax deduction. As such, there is limited opportunity to offset the tax consequences arising from TOSI using personal tax credits.

The following discussion focuses on the new TOSI rules in respect of adult individuals. There are numerous terms and definitions explained throughout this section because understanding these terms is necessary when applying the TOSI rules.

Let's begin with the term 'Related Business,' which is used throughout the TOSI rules. In general, a 'Related Business' with respect to an individual (Tom) is a corporation where Tom is related to another individual (Alice) who owns shares of the corporation (Opco) and those shares represent 10% or more of the fair market value of the Opco shares. In other words, if Alice and Tom are related (e.g. spouses, common-law partners, parent and child, siblings, etc.) and Alice is a 10% (or more) shareholder of Opco, then Opco is a 'Related Business' to Tom.

In addition, a 'Related Business' in respect of an individual (Shera) could also include a business of a sole proprietorship, corporation, partnership, or trust where an individual (Daniel) who is related to Shera is actively engaged in the operation of the business.

Exceptions Where TOSI Will Not Apply

As noted above, the TOSI rules apply broadly. In simple terms, to escape from the new higher tax consequences that arise, an individual and the amount that the individual receives must fall within an exception under the TOSI rules. Let's look at some of these exceptions:

A) EXCLUDED BUSINESS EXCEPTION

Individuals, aged 18 and over, who contribute labour to a 'Related Business' on a regular, continuous and substantial basis are considered to be 'Actively Engaged' and are not subject to TOSI.

The rules provide that an individual is deemed to be 'Actively Engaged' if the individual works in the business at least an average of 20 hours per week during the taxation year or meets this requirement in any five prior years. The five prior years do not need to be consecutive. For seasonal businesses, the average of 20 hours per week will be measured during the period the business operates in the relevant taxation year.

The 20-hour criteria is a definitive rule that can be easily determined. In any other circumstances, determination of whether the individual is 'Actively Engaged' will depend on the facts and circumstances of each case. The considerations used to determine whether an individual is 'Actively Engaged' from a subjective perspective is similar to the criteria utilized when analyzing the 'Reasonable Return' exception, which is discussed in a subsequent section.

Individuals who meet the definitive 20-hour exception will not be subject to the TOSI rules for amounts received from a 'Related Business' because the amounts will be considered an 'excluded amount.' In addition, when individuals fall within the definitive exception, they do not need to consider the TOSI rules with respect to whether the amounts received were reasonable.

B) EXCLUDED SHARE EXCEPTION

Individuals ages 25 and over who own an 'Excluded Share' of a corporation are not subject to TOSI.

For a share to be considered an 'Excluded Share,' four criteria must be met:

- less than 90% of the corporation's business income was from the provision of services;
- the corporation is not a professional corporation;
- the shares held by the individual represent 10% or more of the votes and value of the corporation; and,
- all or substantially all of the income of the corporation is not derived from another 'Related Business' in respect of the individual.

C) REASONABLE RETURN

Individuals age 25 and over who receive an amount that qualifies as a 'Reasonable Return' are not subject to TOSI. The determination of a 'Reasonable Return' is based on one or more of the following 'Reasonableness Criteria,' as outlined below:

1. *Labour Contribution* - the work performed by the individual in support of the Related Business before the amounts became paid.
2. *Property Contribution* - the property contributed directly or indirectly by the individual in support of the Related Business.
3. *Risk Incurred* - the risks assumed by the individual in respect of the Related Business.
4. *Historical Payments* - the total amounts paid or payable by any person or partnership to or for the benefit of the individual in respect of the Related Business.
5. *Other factors* that may be relevant.

See Figure One, Factor Review, for more details under each of these major categories that the CRA has indicated may be considered in their analysis of 'Reasonable Return.' This analysis is subjective in nature and will be applied based on the facts specific to each situation. As such, while taxpayers may do their own analysis, it will not be a definitive outcome and may be subject to CRA scrutiny.

D) THE GREATER OF A SAFE HARBOUR CAPITAL RETURN AND REASONABLE RETURN BASED ON THE COST OF ARM'S LENGTH CAPITAL

Individuals over age 17 and less than age 24 before the year who receive a return on property contributed in support of the 'Related Business' will not be subject to TOSI on that amount provided that such return does not exceed the greater of a prescribed capital return and a reasonable return based on the contribution of arm's length capital. The prescribed rate is used in determining the safe harbour capital return.

E) OTHER EXCEPTIONS

TOSI will generally not apply in the following situations.

- Dividends or profits received by an individual if their spouse has attained age 64 before the taxation year and the amount would have been an excluded amount, as outlined in the exceptions above, if paid to the recipient's spouse. The suggested rationale for this exclusion is to provide business owners with an income sharing opportunity that parallels pension income splitting afforded to other similar aged individuals.
- Capital gains arising as a result of dispositions, by individuals over age 17, of qualified farm or fishing property or shares of a qualified small business corporation.
- Salary and wages paid to related family members. However, salary and wages may be a consideration if a TOSI reasonableness analysis applies to other types of payments made to that individual. In addition, salary and wages are already subject to reasonableness tests in order to be a deductible expense of the business.
- There are exceptions for amounts received that arise as a result of a parent's death and other death-related scenarios.
- Amounts received by individuals living separate and apart from their spouse or common-law partner because of a breakdown of their marriage or common-law partnership are generally excluded.

Application of the TOSI Rules

The following are a few examples that will help provide guidance in the application of the TOSI rules. In all examples, assume that the taxpayers are residents of Canada. The examples have been developed using straightforward facts as outlined. Changing or adding facts beyond what is noted could change the outcomes.

EXAMPLE ONE

Assume the following facts:

- Opco carries on an active business that is neither a service business nor a professional corporation. Ailin founded Opco several years ago and her eldest child, Sarah, is now active full-time on the management team at Opco. No one else in the family works or has ever worked at Opco.
- The shareholders of Opco are Ailin and a discretionary family trust. Beneficiaries of the trust are Alex (Ailin's spouse), Sarah, and Ailin's son, Johnny, along with four grandchildren under the age of 18. Sarah and Johnny are both over age 24.
- Ailin owns 1,000 fixed-value preferred shares that carry one vote each and are worth about half of the value of the business.
- The trust owns 1,000 common shares that carry one vote each and would be worth about half of the value of the business.

The plan is to systematically redeem Ailin's fixed-value preferred shares, pay Sarah a salary and pay a dividend to the discretionary family trust, which will be allocated equally to Sarah and Johnny.

The deemed dividend realized by Ailin on the redemption of her fixed-value preferred shares will be an excluded amount because of the 'Excluded Business' and 'Excluded Share' exceptions. Ailin is 'Actively Engaged' in the business which means the income meets the 'Excluded Business' exception. As well, the shares that Ailin owns meet the definition of an 'Excluded Share' (at least 10% of the votes and value).

The dividend allocated to Sarah will be considered an excluded amount under the 'Excluded Business' exception because Sarah is 'Actively Engaged' in the business.

The dividend allocated to Johnny does not fall within any of the exceptions under the TOSI rules. Johnny is not currently and has never been 'Actively Engaged' in the business so does not meet the 'Excluded Business' exception. He does not own shares of Opco so does not meet the 'Excluded Share' exception. The payment to Johnny does not meet the criteria for a 'Reasonable Return' when applying the reasonableness criteria to the fact situation. The outcome of this payment to Johnny is that the dividend will be taxed at the top marginal tax rate.

In summary, Ailin and Sarah's dividends will not be subject to TOSI but Johnny's dividend will be.

EXAMPLE TWO

Assume the following facts:

- Chris owns 100% of the Class A common shares of a professional corporation (ProCorp) and Chris's spouse, Pat, owns 100% of the Class B common shares. The common shares are equal in all aspects except the Class A shares are the only voting shares.
- Pat does not currently nor has he ever worked for ProCorp.
- ProCorp makes active use of a line of credit in its ongoing operations. The bank requires both Chris and Pat to sign a guarantee in respect of the line of credit, which is secured by a mortgage on their home. Pat is not paid a guarantee fee for signing the bank's required paperwork.

The plan is to pay Pat a dividend from ProCorp.

The dividend paid to Pat is not from an 'Excluded Business' because Pat is not and has never been 'Actively Engaged' in the professional corporation.

The dividend paid to Pat is not paid on an 'Excluded Share' because the business is a professional corporation, which is specifically mentioned as not qualifying within the 'Excluded Share' exception.

According to the CRA's analysis of a similar situation, the dividend payment may qualify under the 'Reasonable Return' exclusion because it represents a reasonable return on the risk incurred by Pat associated with signing the guarantee for the business's line of credit and allowing the couple's home to act as security.

EXAMPLE THREE

Assume the following facts:

- Opco carries on an active business of farming and is neither a service business nor a professional corporation. Opco is a seasonal business operating about six months per year.
- Spouses, George and Irene, own all of the fixed-value preferred shares that were the result of an estate freeze completed last year.
- A discretionary family trust owns all of the common shares of Opco. Beneficiaries of the trust include George and Irene's children and grandchildren.

Grandchild A is 27-years-old and has recently completed an MBA. He has not worked on the farm in past years; however, he was in need of cash flow so spent four months in the current year, working 40 hours per week.

Grandchild B is 24-years-old and has worked weekends on the farm for the last six years, clocking about 6 hours per weekend for a total of about 150 to 200 hours per season.

Grandchild C is 30-years-old and works in his own professional practice in a city very far away. When C finished high school at age 17, he worked with George on the farm, full-time for five years before returning to school.

The plan is to pay dividends from Opco to the trust and allocate the dividend amounts as one-third to each of Grandchildren A, B and C.

For Grandchild A, the dividend amount meets the 'Excluded Business' exception because he worked at least an average of 20 hours per week during the farm's current operating season.

For Grandchild B, the dividend amount does not meet the 'Excluded Business' exception because, while he has worked every year for six years, the work time is less than an average of 20 hours per week during the farm's operating season. As such, the dividend paid to Grandchild B will be taxed at the top marginal rate.

For Grandchild C, the dividend amount meets the 'Excluded Business' exception because he worked at least an average of 20 hours per week during the farm's operating season in at least five prior years.

In summary, Grandchildren A and C will be taxed at their regular marginal rate of tax on the dividends they each receive, while Grandchild B will pay tax at the highest marginal rate on the dividend amount he receives.

In conclusion, the TOSI rules are all encompassing, complex and still evolving as new information continues to be released and interpretations develop. This article is general in nature as it is intended to simply create awareness based on information available at the time of writing. Individuals should reach out to their professional advisors to understand how the TOSI rules will align with their particular set of circumstances.

FIGURE ONE – FACTOR REVIEW

Below is a list of factors that the CRA has indicated may be considered in their analysis of 'Reasonable Return.' The facts and circumstances specific to each case will be important to the CRA's analysis. It is noted that the list is not exhaustive.

Labour Contribution

- The nature of the tasks performed;
- Hours required to complete the tasks;
- A competitive salary/wage for the tasks in relation to businesses of similar size and industry;
- Education, training and experience;
- Degree and nature of activities in relation to those of a business of a comparable nature and size;
- Time spent on the activity in comparison to time spent in other activities or undertakings;
- Particular knowledge, skills or know-how that the individual possessed;
- Business acumen; and,
- Past performance of functions.

Property Contribution

- The amount of capital contributed to the business;
- The amount of loans to the business;
- The fair market value of property (both tangible and intangible property) transferred to the business, including technical knowledge, experience, skill, or know-how;
- Whether the individual has provided property as collateral for loans or other undertakings;
- Whether other sources of capital or loans are readily available;
- Whether comparable property is readily available;
- Whether property is unique or personal to the individual;
- Opportunity costs; and,
- Past property contributions.

Risk Incurred

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

Total Amounts Paid

When evaluating this factor, the CRA's documents note that amounts previously paid to the individual should be included in the analysis. Examples offered include payments of any kind including salary or any kind of remuneration, dividends, interest, proceeds or fees, benefits and deemed payments (as may be reasonably required in the circumstances).

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Publication Agreement # 40069004