IG PRIVATE WEALTH MANAGEMENT

Income splitting: Understanding the changes and exclusions

Effective January 1, 2018, the Department of Finance amended measures with respect to the expansion of the tax on split income rules. The following is a summary of those measures and how they might apply in certain situations.

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WHO IS SUBJECT TO THE TAX ON SPLIT INCOME RULES?

Previously, the tax on split income (TOSI) rules applied only to persons under the age of 18, hence it was not so affectionately known as the Kiddie Tax. The rules were meant to prevent parents from income splitting with their minor children, who had access to their own unused personal income marginal tax brackets and non-refundable tax credits. However, Finance considered this legislation to be insufficient as it did nothing to prevent strategies to income split with lower-income adults.

The amended legislation seeks to expand the application of the TOSI to limit "income splitting" with persons 18 years or older. How this is accomplished is far from straight forward. Now non-salary income (most often in the form of dividends and other shareholder benefits from a private corporation) that is paid to adults 18 years of age or older who are related to a "source individual" will be taxed at top personal rates unless the amount received is considered to be an excluded amount. Excluded amounts are just that, amounts which are excluded from the application of the TOSI rules.

In order for the TOSI to apply, the amount must first be received from a related business. A related business is defined generally as a business carried on by a source individual (in simple terms, the high-income earning person wishing to split income with a low-income earning person) who is related to the specified individual (in simple terms, the low-income earning person, resident in Canada, we are concerned may be subject to the TOSI rules). A source individual is someone, resident in Canada, who either carries on a business and/or has an interest of 10% or more of the votes and value of the corporation.

Secondly, for the TOSI rules to apply, the amount received must be an amount that is not excluded from these rules. Excluded amounts generally are going to include amounts from an excluded business, amounts from excluded shares, or amounts which are considered to be a reasonable return.

EXCLUDED BUSINESS (TOSI EXCLUSION AVAILABLE TO INDIVIDUALS 18 YEARS OF AGE OR OLDER)

For an amount to be considered received from an excluded business, and as such, not subject to the TOSI, the following must apply:

- The specified individual is 18 years of age or older
- They have received an amount from a related business and that specified individual was actively engaged in that related business on a regular, continuous and substantial basis in the current year or in any five prior taxation years.

Thankfully, Finance has clarified that an individual will be considered "actively engaged" if they work in the business at least an average of 20 hours per week. For seasonal businesses, the average will apply only to the months which the business operates.

The following is an example of how this exception applies:

Rebecca works part-time for a corporation controlled by her father while she pursues post-secondary education. Due to the demands of the business, she works on average 25 hours a week year-round, as she is required to work weekends as well as during the weekdays. The common shares of the corporation are held by a family trust, of which Rebecca is an income beneficiary. When dividends are paid on those common shares, Rebecca is allocated a portion of those dividends and therefore must report the dividends as personal income. As a result of the work she provides to the company, the dividend she receives from the corporation (through the distribution from the family trust) will not be subject to the TOSI, regardless of the amount she has received.

As we shall see, for many professional and service related businesses, income splitting will only be possible in most situations if the low-income shareholder meets the excluded business test by being actively engaged in the business for an average of 20 hours per week.

EXCLUDED SHARES (TOSI EXCLUSION AVAILABLE TO INDIVIDUALS 25 YEARS OF AGE OR OLDER)

If the individual is 25 years or older, the excluded share exception may be applicable for amounts received on or from excluded shares. Shares will be Excluded shares if:

- The individual owns 10% or more of the votes and value of the corporation
- The corporation was not a professional corporation
- The corporation's business income was less than 90% from the provision of services, and
- 90% or more of the income of the business is not from another related business in respect of the individual.

The last criteria is meant to prevent a company (e.g. a professional corporation) from paying rent to a non-professional corporation in order to shift income to a company that is not excluded under these rules.

The following is an example of when the excluded share exception **will not** apply:

Blaine and Brian are brothers and are 50% shareholders of ABC Ltd. The sole asset of ABC Ltd. is a building which is rented only to Happy Drilling, a dental practice carried on by Dr. P. Lee Professional Corporation. Dr. Lee is the father of Blaine and Brian. Despite having more than 10% of the votes and value of ABC Ltd., Blaine and Brian cannot utilize the excluded share exception for dividends they receive on their shares of ABC Ltd. since the income earned by ABC Ltd. is from a related company that is a professional corporation.

The following is an example of when the excluded share exception **will** apply:

Elaina is the wife of Estevan who carries on a manufacturing business, XYZ Ltd. Estevan holds 85% of the Class A voting common shares of the company, while Elaina owns the remaining 15% of the Class A voting common shares. Elaina has nothing to do with the business and never has. Despite her non-involvement, since she owns more than 10% of the votes and value of XYZ Ltd., dividends paid to her will not be subject to the TOSI rules, regardless of the amount she receives.

While a manufacturing business is clearly not earning income from the provision of a service, in other forms of business it may not be clear as to whether income is derived from the provision of services or some other activity.

REASONABLE RETURN (TOSI EXCLUSION DIFFERS BASED ON AGE)

If the amount received is not protected under the excluded business or shares exceptions, it may be excluded from the TOSI if it is deemed to be a reasonable amount.

For individuals aged 25 years or older, a reasonable return will be based on a comparison of contributions made by other source individuals (high-income individuals wishing to split income) to the related business. The comparison will be made by looking at the following factors:

- Work performed in support of the business
- Property contributed in support of the business
- Risks assumed in respect of the business
- Other relevant factors

For persons aged 18-24, a reasonable return is going to be determined by whether the capital they contributed to the business is from an arm's length source, meaning not from a related business, not from a related person, and not obtained through financing.

When the capital contributed is from an arm's length source, these individuals can use the reasonable return criteria we noted above for persons aged 25 and older. If the source of the capital contributed is not from an arm's length source, a reasonable return will be limited to a return not exceeding a prescribed rate of return.

For example, if a 19 year old has a part time job at a local restaurant and earns wages, they could use those wages to purchase shares in a company controlled by their parent. Therefore, when dividends are received on those shares, the reasonable return criteria can be looked to in order to determine whether the TOSI applies.

A key aspect of the legislation is that when the amount is not from an excluded business, nor from excluded shares, only the amounts received which exceed a reasonable return will be subject to the TOSI.

For example, if a 26 year old individual received a dividend in the amount of $100,000 and, based on the reasonable return criteria, a reasonable return would be $60,000, only $40,000 of the dividend will be subject to the TOSI and as such be taxed at the top personal marginal rate of tax.

This should provide some comfort to owner-managers who wish to still engage in some form of income splitting with family members.

Additional exceptions available

RETIREMENT PROPERTY

In order to provide similar benefits as the existing pension income splitting provisions, the TOSI rules will not apply when income is received by an individual from a related business, and that individual's spouse (the source individual) is 65 years or older.

If the source individual had received the payment and it would have been excluded in a way described earlier, the exclusion in effect transfers to the specified individual, and thus the TOSI would not apply to amounts they receive.

For example, a wife carries on a dental practice in which she is actively engaged in on a regular basis - she is what Finance refers to as a source individual (e.g., a high-income earning individual). If she had received the dividend, the payment would have been excluded from the TOSI under the excluded business exception. She is now 65 years old.

Her spouse, who is 62, has never participated in the business in any capacity but he has had non-voting common shares in the company since inception. Now that the wife is 65 years of age, the corporation can pay dividends to the husband and the husband will no longer be subject to the TOSI. Prior to her being 65 years old, he would have been subject to the TOSI rules as none of the exceptions would have applied to him.

INHERITED PROPERTY

When the property has been inherited by an individual, 18 years or older, the income from that property will not be subject to the TOSI if the income would not have been subject to the TOSI had it been received while the property was held by the deceased. If the deceased would have met the excluded business, excluded share, or the reasonable return exceptions, those exceptions would now apply to the individual who has inherited the property generating the income.

For example, a 22 year old niece inherits shares from her uncle who owned a 20% interest (votes and value) in a corporation which operated a local restaurant. Even though he didn't participate in the business, any payments to him would have been excluded under the excluded shares exception noted above, since he was aged 25 or older while he held the shares. As such, even though she is not yet 25, the shares the niece has inherited would be excluded shares to her since they were excluded shares for her uncle.

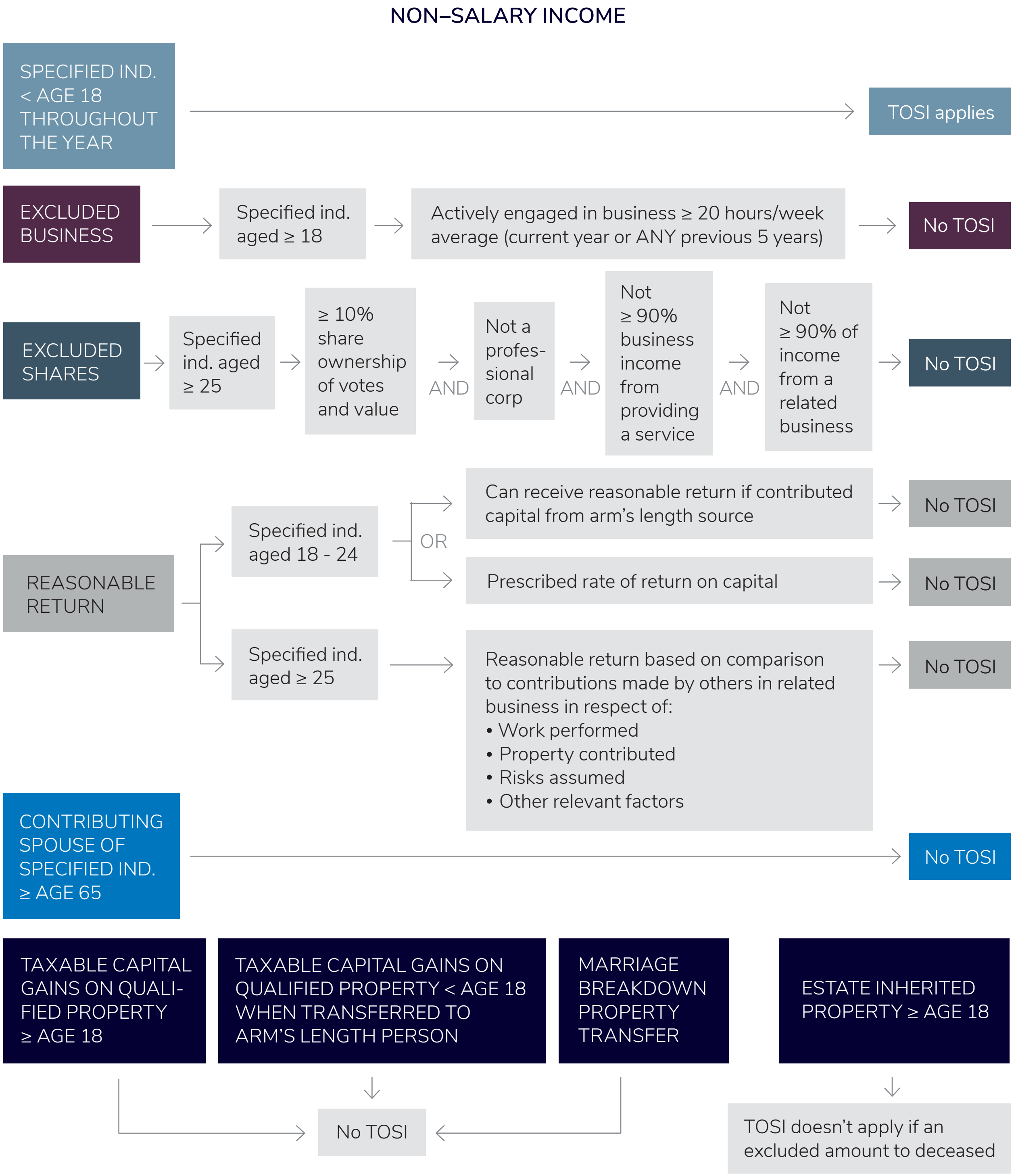
QUALIFIED PROPERTY ELIGIBLE FOR THE LIFETIME CAPITAL GAINS EXEMPTION

The TOSI will not apply to taxable capital gains resulting from the disposition of property which qualifies for the lifetime capital gain exemption (LCGE). The exemption applies regardless of whether the individual actually claims the LCGE in respect of the resulting taxable capital gain. Qualified Small Business Corporation Shares and Qualified Farm or Fishing Property are the only types of property eligible for the LCGE.

> *These rules are complex, so speak with your IG Consultant and your tax advisor, who can help you navigate these new tax provisions and determine how they may impact you and your family.*

Tax on split income (TOSI)

Simplified guidelines – speak to your accountant regarding your specific situation



This flowchart has been prepared for informational purposes only. We encourage you to obtain professional tax advice regarding your particular circumstances. IG Wealth Management is not responsible for the accuracy or completeness of this report and is not liable for any errors or omissions therein. Source: advantage financial planning IG Wealth Management.

Explanatory Note 1: Specified individual: Minor or Adult, resident in Canada, related to a person who is either actively engaged in carrying on a business in Canada or owns a significant portion of the equity of that related business.

Explanatory Note 1A: Specified individual < Age 18 throughout the year. Under the previous TOSI rules, an individual (other than a spouse) would not have been a specified individual if they had attained the age of 17 in the prior year. This allowed for persons who were 17 at the time of payment to not be subject to the old TOSI rules if they were 18 by the end of the calendar year.

Explanatory Note 2: Split income includes the following types of income: Taxable dividends and shareholder benefits from private corporations; trust income allocations derived from private corporation dividends or benefits, or a rental where a related person is involved; income earned from debt owing from a private corporation, partnership or trust; partnership income generated from a related business (generally defined as a business sufficiently connected to a related individual), or a rental where a related person is involved. Income or gains resulting from the disposition of property noted above. Excluded amounts will not be considered to be split income and as such not subject to the TOSI.

Explanatory note 3: An individual will be deemed to be actively engaged in the business on a regular, continuous, and substantial basis, if they work at least an average of 20 hours per week in the related business. For seasonal businesses, this test will apply only to the months during which the business operates.

Explanatory note 4: The "safe habour capital return" is a formula based on multiplying the fair market value (FMV) of property contributed in support of a related business by the prescribed rate of interest. Income subject to TOSI is reduced by the safe harbour capital return.

Explanatory note 5: A reasonable return is based on the criteria available for individuals 25 years and older. In order for these rules to be in effect, the capital must come from an arm's length source and must not be borrowed nor received directly or indirectly from a related person. For example, if the 18 year old has income from a non-related source and uses that income to contribute capital to the related business, then a reasonable return can be received without being subject to TOSI rather than being limited to a prescribed rate of return on the capital contributed.

Explanatory note 6: When determining if an amount is reasonable, the individual's contributions must be compared to the contributions made by others in the related business. Contributions may include work performed in the business, property contributed to the business and risks assumed in respect of the business. The contributions should be compared to those of the "source individual(s)" of the related business (i.e. the person(s) carrying on the related business), not to the contributions of other specified individuals.

Explanatory note 7: The specified individual must, before the payment is received, hold shares which gives them 10% or more of the votes that can be cast and must represent a FMV of 10% or more of the FMV of all of the issued and outstanding shares of the related corporation.
For 2018 only, an individual has until the end of 2018 in order to obtain the required ownership percentage in order to have access to this exception.

Explanatory note 8: The excluded share exception does not apply to professional corporations nor to corporations who have 90% or more of their business income derived from providing services. Additionally, 90% or more of the income of the corporation is not derived from a related business other than the business of the corporation. A related corporation cannot be used to move income from a service business to a non-service business in order to try to have this exception apply.

Explanatory note 9: TOSI will not apply to income received by an individual from a related business when their spouse has made contributions (current or previous) to that business and is 65 years of age or older. For this exclusion to apply, the amount would have had to be an excluded amount to the contributing spouse had the contributing spouse received it directly because of one of the three exceptions (excluded business, excluded shares, or reasonable return). When those conditions are met, such receipts will be deemed to be an excluded amount to the specified individual. There is no requirement for the spouse receiving the income to be 65 years of age or older.

Explanatory note 10: The amount will be an excluded amount for a specified person (aged 18 or older) who has inherited the property if the income from the inherited property, had it been earned by the deceased, would have been an excluded amount to the deceased due to one of the three exceptions (excluded business, excluded shares, or reasonable return). For the purposes of this provision, individuals aged 18-24 will be deemed to be 25 or older if the deceased was 25 or older so they can have access to the same exceptions as the deceased would have had access to.

Explanatory Note 11: Property received by an individual as a result of a separation agreement or judgement due to breakdown of marriage or a common-law partnership will not be subject to the TOSI.

Explanatory Note 12: Taxable Capital Gains resulting from the disposition of qualified farm or fishing property and/or qualified small business corporation shares are excluded from the TOSI.

Explanatory Note 13: Taxable Capital Gains resulting from the disposition of qualified farm or fishing property and/or qualified small business corporation shares are excluded from the TOSI when transferred to arm's length persons. Non-arm's length dispositions by persons under the age of 18 remain subject to the TOSI.

Final Thoughts

The amended tax on split income rules have resulted in a significant shift with respect to planning for business owners. What once might have been considered standard planning, may no longer be appropriate. However, what this document should demonstrate is that there are still opportunities for income splitting with certain family members. It is also important to think about future income splitting opportunities, not just ones that may or may not be available today. As such, it is critical owner managers review their business structure considering these rules. Working with a knowledgeable accountant who is familiar with these rules is key to ensure appropriate advice and planning is received and undertaken.

For more information, please speak with your IG Consultant.

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