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Tax on Split Income Rules ("TOSI")

December 2017 Update

On December 13, 2017, the government and Department of Finance released version two of the "income sprinkling" Tax on Split Income ("TOSI") rules. Version two is significantly scaled back from version one, but will still require small business to review their corporate structures and compensation plans beyond 2017 to ensure they are not caught by these new rules. These rules are still some of the most complex rules in the income tax act although Finance believe that the rules are now simpler and apply to relatively fewer small businesses. Most small business will need to consider these rules in their corporate structure.

The rules come into force on January 1st, 2018 (i.e. 2017 will be the last year you can rely on the current rules) with some ability to ensure changes are made to corporate structures prior to end of December 2018 to avoid the highest rate tax on dividends paid to specified individuals where applicable. As a reference, the below table shows the benefits of income splitting.

Benefits of Income Splitting
2017/2018

The tax savings resulting from transferring ordinary income from an individual in the highest two marginal tax brackets to a person in the:

	Income below $220K		Aggregate Benefit
Income to 46,000	16,954.81	48.04%	48.04%
Income to 75,000	6,591.12	18.68%	66.72%
Income to 91,500	3,170.38	8.98%	75.70%
Income to 142,500	5,098.54	14.45%	90.15%
Income to $203,000	3,210.25	9.10%	99.25%
Income to $220,000	265.27	0.75%	100.00%
	35,290.37		

In our opinion, the most important change was the amendment to ensure capital gains caught by these rules would not be converted to dividends for specified individuals who are 18 and older in the year of receipt on non-arm's length sale of shares. This amendment eliminates many of the issues regarding the 93% effective tax rate article we co-authored in August 2017 as well as the concerns pertaining to business succession planning.

In comparison to the rules prior to the July 18th proposals, version two generally extends the TOSI rules to capital gains realized and dividends paid from related businesses, but does not include aunts, uncles, nieces or nephews as version one did. The new rules also eliminate the imposition of TOSI on income generated from TOSI income. Lastly, version two provides for increased bright line tests to be excluded from the imposition of the rules, although there is still some subjectivity in reasonableness of returns exclusion. The various exemptions to the rules are as follows:

1. Excluded amount:
    a. The property is inherited due to death of an parent;
    b. The property is received due to a divorce or matrimonial separation;
    c. Capital gains eligible for the capital gains exemption on small business corporation shares or farm properties;
        i. Allows for the continued use of multiplying the lifetime capital gains exemption; and
        ii. There is no requirement to claim a life time capital gain for this exclusion.

2. Amounts received by individuals age 25 and older from excluded business:
    a. Excluded business:
        i. Amounts derived from a related business where individuals were active in the business on a regular and continuous basis in the year or any previous five years;
        ii. Regular and continuous basis has been defined to include at least an average of 20 hours per week;

3. For individuals over 25 the receipt must be in relation to excluded shares or be a reasonable return:
    a. Excluded shares:
        i. Less than 90% of the business income of the corporation in the prior taxation year was derived from the provision of services; or
        ii. the corporation is not a **professional corporation**.
            1. If professional corporation shares can never be excluded shares and all income paid other than excluded amounts would be caught.

        2. It is no surprise the government is targeting this group and appears to specifically target Medical Professional Corporations.
    iii. Immediately before the receipt of funds, the shares had 10% votes and fair market value of all issued and outstanding shares of the capital stock of the corporation.
        1. Must be direct ownership, income allocated from trusts will not qualify for the 10% votes and value.
    iv. Substantially, all the income is not derived from a related business (i.e. rental property income earned from OPCO with dividends paid to family members would be caught by these rules).
  b. Reasonable return:
    i. The work performed in support of the business;
    ii. The property contributed directly or indirectly;
    iii. The risks assumed;
    iv. Amounts previously received related to the business; and
    v. Such other factors that may be relevant.

4. For individuals 18 – 24 related to safe harbour capital or reasonable arm's length capital return:
   a. Safe harbour refers to the highest prescribed rate of interest posted for the quarter (for last number of years this has been 1%); and
   b. Arm's length capital return reasonable return analysis.

5. Pension splitting ability once active shareholders are aged 65, spouses will no longer be subject to the rules and qualifications above.

Unfortunately, there is no cookie-cutter solution for everyone and each taxpayer's facts, intention and corporate structure will need to be reviewed to determine if any changes are required by the end of 2018.

The legislation has also left us with a number unknowns and questions to be answered. Without getting into the nitty gritty, we will need further clarification on the definitions of "Business Income" and "Service Business" (i.e. would this include a restaurant, hairdresser or plumber).

It is our opinion that some of the above exclusions, specifically retirement income, may provide limited savings depending on what the passive income rules are moving forward. If you plan to rely on the "actively engaged" test, we recommend creating support for hours worked and time for either the previous five years or the current year activity, should CRA ask for the details. This will require increased documentation and would be akin to a vehicle log book for use of automobiles related to business.

We suspect CRA will perform some target or analytical audits of dividends paid from professional corporations and other services corporations, but otherwise, the cost benefit to these audits will likely not be an overly profitable venture for the government, and as such, could result in a net cost to administer.

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