Income Splitting

December 7, 2021

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Income Splitting

- Move income from high to low rate taxpayer
- Multiply capital gains exemption ($892,218 per individual for 2021)
- Savings in 2020 from income splitting (maximum)

Federal	$22,942
Ontario	$14,581
Exemption	$2,389
	$37,523

- Very large benefit
- Per person per year
- But it becomes their money

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Income splitting involves moving income from a high rate taxpayer to one or more low rate taxpayers, to utilize their personal exemptions and lower tax brackets. It can also involve splitting the capital gains exemption among individuals. The benefit from income splitting has become larger as a result of personal tax increases. The maximum benefit is around $37,500 per individual per year. The benefit of the capital gains exemption is around $238,000 per individual.

Note that if income is split with another taxpayer, it becomes their income. Any attempt to route the money in a circle can undo the tax benefits as CRA may contend that the income remains that of the high rate taxpayer.

Tax Update

2021 Benefits of Income Splitting

For Various Tax Brackets

Taxable Income					
Lower	**Upper**	**Ordinary**	**Capital Gain**	**Eligible Dividend**	**Non-eligible Dividend**
0	**45,142**	33.48%	16.73%	39.34%	38.50%
45,142	49,020	29.38%	14.68%	39.34%	33.79%
49,021	79,505	23.88%	11.93%	32.95%	27.46%
79,506	90,287	22.05%	11.02%	30.42%	25.36%
90,288	93,655	19.64%	9.81%	27.10%	22.58%
93,656	98,040	15.62%	7.81%	21.55%	17.96%
98,041	150,000	10.12%	5.06%	13.96%	11.64%
150,001	151,978	8.56%	4.28%	11.81%	9.84%
151,979	216,511	5.24%	2.62%	7.23%	6.02%
216,512	220,000	1.56%	0.78%	2.15%	1.79%
220,001	∞	0.00%	0.00%	0.00%	0.00%

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This chart shows the marginal tax rate benefit from income splitting. It can be seen that the benefit declines as the tax rate increases, and becomes very small at the high tax brackets. However, the high tax brackets are broad ($150,000 to $220,000) so the benefit is still significant.

Normally though one would target income splitting up to the second tax bracket at $49,020 or the next main bracket at $98,040. Interestingly, the benefit is greatest for dividends, and the least for capital gains.

Dividends push up the tax brackets due to gross-up (ineligible 115%; eligible 138%).

This table uses the marginal tax rate and does not consider personal tax credits. In practice there will be a nil tax rate due to personal tax credits (not shown).

Owner-Manager Remuneration
Income Splitting

- Spouse/common-law partner (attribution)
- NAL person under 18 - Regular income (attribution)
  - Capital Gains (no attribution)
- Trust if reversionary (attribution)
- Trust and corporate attribution (income imputation)
- Low interest/interest-free loan (attribution)
- Related person – TOSI (top tax rate)

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There are six general sets of considerations when it comes to income splitting, because different rules apply to prevent income splitting in various circumstances.

The first is to split income with the spouse or common-law partner, where the income attribution rules are relevant to impute income (and losses) and capital gains (and capital losses) back to the transferee.

Non-arm's length children under the age of 18 will be subject to income attribution for income (but not capital gains) back to the contributor.

If a trust is created which is reversionary, then income and capital gains of the trust will attribute to the person who has contributed the property. This takes priority over paying out the income.

If an estate freeze type structure is put in place with a trust, there can be an imputation of income to the preferred shareholder (discussed in more detail later).

Where a person makes an interest-free loan or a loan at interest of less than fair market value (less than the prescribed rate as a minimum) to a non-arm's length individual, then any income earned by the borrower on the proceeds will, if it is investment income, attribute back to the lender. This does not apply to capital gains or losses, nor does it apply to losses from property or business income.

Lastly TOSI creates an additional set of considerations.

To have a successful income splitting strategy, all of the above rules must be managed successfully.

Who to Split Income With

- Spouse/common-law partner
  - Prescribed rate loan (directly or through a trust) for income and capital gains, FMV transfer, freeze
- Children/grandchildren, niece, nephew (<18)
  - Prescribed rate loan (directly or through a trust) for income
  - Gift or loan (directly or through a trust) for capital gains, or via freeze
- Parents, grandparents, siblings, cousins
  - Gift or prescribed rate loan (directly or through a trust) for all types of income
  - Gift or loan (directly or through a trust) for capital gains
- Especially beneficial – children age 18+ (tuition, car, house, etc.)

Establishing an income splitting strategy is an exercise of working through all of the potential income attribution rules, and avoiding all of them in the given circumstance.

Income splitting with a spouse or common-law partner can be done through a fair market value transfer. If that person subscribes for shares of a corporation at fair market value with their own money, and not with money of the other spouse or common-law partner (the high income person), then there will not be attribution. If the high income spouse or common-law partner transfers property to the other spouse/common-law partner, then it is necessary for that person to pay fair market value. This can be done through issuing back a loan which pays interest at the prescribed rate. Such a structure can be done either directly or through a trust.

Children, grandchildren, and nieces and nephews under the age of 18 create the circumstances for income attribution. However, capital gains do not attribute. Only income from the property will attribute. Again, a prescribed rate loan can work around the income attribution rules. Normally, such a structure is done through a trust.

Income splitting can be carried out with parents and grandparents, and also siblings and cousins without issues under the income attribution rules except for the low interest/interest-free loan rule which needs to be avoided. Income splitting is particularly beneficial with children that have no income or nominal income, and children who are in university who have tuition for which a tax credit is given. Income splitting has become significantly more restricted because of TOSI. Still it can be accomplished with publicly traded securities.

Note that income earned by children from income splitting becomes their money. As long as the money is spent on them, that is fine. If the parents take the money, CRA may not accept this. Also the children will have a claim to the money.

Attribution Rules

Spouses/Common-Law Partners

- Applies to property income and capital gains
- No attribution where the transferor is a non-resident or deceased
- Attribution ceases on spouses/common-law partners becoming separated

Income attribution ceases when the transferor becomes a non-resident or is deceased. It also ceases between spouses and common-law partners upon separation.

Attribution can potentially be helpful especially where capital losses result.

There is a rule to prevent deliberately using the income attribution rules for benefit. If the attribution rules are used to deliberately cause attribution, then attribution does not apply. (reference subsection 74.5(11))

Attribution Rules

Transfers to NAL Minors
(including nieces and nephews)

- ❖ Income attributes to transferor (unless FMV transfer including prescribed rate loan)
- ❖ Capital gains (losses) do not attribute

- No attribution of income earned on income
- Attribution ceases in year transferee turns 18

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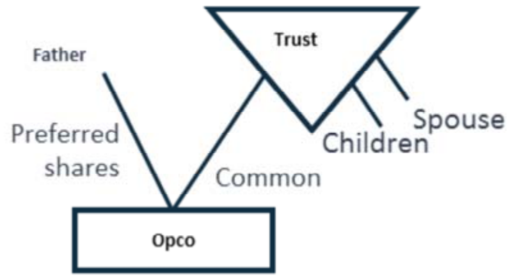
Income attribution from minors does not apply to capital gains or capital losses, and ceases at the beginning of the year in which the person turns 18. The attribution applies to income but does not apply to income earned on income. This used to be a more interesting planning alternative when interest rates were high.

Corporate Attribution Section– 74.4

Example: Typical Freeze Structure



If Opco not a SBC, notional imputation of interest income on value of preferred shares held by Father

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A special income attribution rule, called the corporate attribution rule, applies in an estate freeze type of structure. The rule imputes a return as interest income on the preferred shares, equal to the prescribed rate.

Spouse (common-law partners) and children under 18 (and nieces, nephews) are “designated persons”. This triggers the attribution rule.

Where this rule is triggered, interest income is imputed as if paid from the corporation. In the example above, Father is deemed to receive interest income from Opco. No deduction is given to Opco.

There is a purpose test in 74.4 where “one of the main purposes of the transfer may reasonably be considered to reduce the income of the individual and to benefit … a designated person”.

2019 APFF Q16 - 2019-0812751C6 – CRA indicated that even if TOSI applies to the designated person, it is not a good enough reason on its own to claim that the purpose test is not met. However, CRA then said that a dividend included as TOSI income reduces the deemed interest income to the transferor under 74.4(2)(g)(ii)

Transfer to Spouse or Children Using Corporation – 74.4

- Father is deemed to have received interest on the value of the preferred shares (prescribed rate x FMV)
- Dividends (at the grossed-up amount) received by Father on the shares in the year may be subtracted from the imputed income (Does not include deemed dividends on a share redemption)
- Suppose preferred shares worth $10 million, and prescribed rate is 1%, Father includes interest of $100,000 for the year. Nobody gets a deduction for this interest

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In this example, Father is deemed to receive interest income equal to the prescribed rate times the value of the preferred shares. The prescribed rate is currently 1%. If the preferred shares are worth $10 million, this will be an income imputation of $100,000 a year. The corporation does not receive a deduction. Note that in this case, the prescribed rate can fluctuate, so that the imputation per quarter can go up or down.

Dividends received on the preferred shares (at the grossed-up amount) are subtracted from the imputed income. However, deemed dividends created from share redemptions are not subtracted.

Exception Applies If

- Individual is not a Canadian resident (non-resident or dead)
- Corporation is a small business corporation (but the exception ceases while the corporation is not an SBC)
- Special clause for children under 18 (or spouse/common-law partner) not to receive benefits under a trust which owns the shares until age 18 (ceases to be spouse/common-law partner)
- No designated person as a shareholder (no spouse or minor children)

The rule applies only if a shareholder is a designated person, either through a direct shareholding or by being a beneficiary of a trust. For this purpose, a designated person is a spouse or common-law partner of the individual or a person who is under the age of 18 and who does not deal at arm's length with the individual or who is a niece of nephew of the individual.

The rule only applies while the individual is alive and resident in Canada.

The imputation is suspended during any period where the corporation is a small business corporation. As a result, the rule could apply, then cease to apply, and then apply again depending on whether the corporation meets or fails to meet the small business corporation tests.

However, 74.4 will apply if the trust holds shares of a holding company instead, the holding company is not a small business corporation and owns an operating company which is a small business corporation. The CRA has stated that the status of the operating company as an SBC does not exempt the trust from 74.4 because the trust holds shares of a holding company which is not an SBC.

Where a trust is used, a clause can be inserted in the trust document to prevent the rule from applying. Provided no designated person can benefit under the trust while a designated person, then the rule does not apply. Thus, the trust could be drafted so that no spouse or common-law partner or person under the age of 18 can benefit under the trust during the lifetime of the individual. The problem with this approach is that it prevents those beneficiaries from accessing the capital gains exemption because they cannot currently benefit under the trust.

Revocable Transfers - Subsection 75(2)

Where property is held on the condition that it:

- Can revert to the transferor
- Pass to persons to be determined subsequently by transferor

OR

- Cannot be disposed of without the transferor's consent

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Another income attribution section applies to impute income of a trust to a person who has contributed property to the trust. This rule applies where the property can revert to the contributor, pass to persons to be determined subsequently by the contributor, or cannot be disposed of without the contributor's consent. However, recent case law has narrowed the application of this provision to confine it to the property which was used to settle the trust , or property substituted therefore, or additional property from the settlor that is an additional settlement. The case law holds that a fair market value transfer of property to the trust will not be subject to the reversion rule. However, it is safer for the settlor to not be a beneficiary and for additional funding to come from someone else. Typically the additional funding is done via a prescribed rate loan.

If the reversion rule applies, then all income or losses from the property and all capital gains or losses from a disposition of the property attribute back to the transferor. This is the one circumstance where losses can actually be allocated from a trust.

Note that the other income attribution rules apply only where an individual has income (or capital gains), not where income is retained in a trust. However, this rule (subsection 75(2)) attributes income (loss), capital gains (capital losses) directly from the trust.

Revocable Transfers - Subsection 75(2)

Then:

- All income (loss) and capital gains (losses) from the property attribute back to transferor

Common to find this problem in trust arrangements

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This slide illustrates two examples of where this rule could apply. In the first case, property is settled on the trust by Mr. X who is also a beneficiary. Because the property can revert to him by virtue of him being a beneficiary, the rule may have application. However, the scope of the rule in this connection has not been fully tested, and an argument might be made that if Mr. X is a discretionary beneficiary, the rule still does not apply. It would apply, however, if Mr X could revoke the trust and obtain back the property.

The second circumstance is where Mr. X transfers property to the trust and is the trustee. If he is one of two trustees, then they must act together, and the rule could still apply. However, if he is one of three trustees, who are required to act by majority, then the rule would not apply.

It is best to stay well clear of any situation that might cause subsection 75(2) to apply.

Revocable Transfers - Subsection 75(2)

Solutions

- 3 trustees
- Contributor not a beneficiary
- FMV sale to the trust by other than settlor
- Additional contribution by prescribed rate loan

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Because there is still uncertainty as to the scope of the attribution rule under subsection 75(2), it is prudent to stay well away from this rule. Therefore, it is wise to structure a trust with three trustees, where decision making is by majority, particularly if one of the trustees is also the settlor or contributor to the trust.

It is helpful to not have the settlor be a beneficiary of the trust, because this eliminates the argument that the property can revert.

Lastly, based on case law, a fair market value sale of property to the trust does not trigger this attribution rule (as long as it is not part of the settlement of the trust), and this can be used sometimes to advantage. But how far the exception extends is not completely clear, so exercise caution.

Trust Distribution and 75(2)

- Where subsection 75(2) applied at any time, a trust cannot roll property tax-free to beneficiaries other than contributor or spouse
- Capital distributions from the trust will be at fair market value, which may result in capital gains as per ss. 107(4.1)
- Issue ceases when contributor dies

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When a trust distributes property to a beneficiary, the normal rule is that the transfer occurs at tax cost. This is helpful, and quite fundamental to how trusts are used.

However, if subsection 75(2) has ever applied at any time to any property of the trust, then a tax-free distribution to beneficiaries cannot be done unless it is to the contributor or the contributor's spouse or common-law partner. Otherwise, the transaction will take place at fair market value, resulting in the creation of capital gains. The restriction ceases after the contributor dies.

Prescribed Rate Loan

- Loan at prescribed rate
  (2021 – 4th quarter – 1%)
- Rate can be fixed for life of loan (indefinite)
- To avoid attribution, by FMV transfer, loan at prescribed rate and interest paid within 30 days of calendar year-end

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One way to avoid the income attribution rules is with a fair market value transfer. Where the recipient (a trust for example, or possibly a spouse or common-law partner) obtains property, it can be paid for with a promissory note. However, for this to be a fair market value transfer, the promissory note must pay interest at a minimum of the prescribed rate, and the interest must be paid within 30 days of the end of the calendar year. Once the loan is made, the prescribed rate is locked-in to that which is applicable at the time, unless the loan is later repaid and reloaned, in which case a new prescribed rate may be applicable on a subsequent loan.

Because the prescribed rate at the moment is 1%, this represents an excellent opportunity to carry out income splitting utilizing the prescribed rate loan.

It is very important that interest be paid within 30 days of the end of the calendar year. Paying the interest late, or paying an insufficient amount, will cause attribution to start to apply, and this situation cannot be cured with a later payment of the additional interest.

Low Interest Loans and Indebtedness – 56(4.1)

- Broader than other attribution rules:
  - Where it is reasonable to conclude that one of the main reasons for making the loan was income splitting…
- Any income earned on the proceeds of the loan or the indebtedness will be attributed back to the lender. (Does not apply to capital gains or to losses)
- This applies on loans to non-residents too
- Loans and indebtedness which have fair value interest paid, or prescribed rate interest paid, are excluded

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Another attribution rule applies to loans between non-arm's length persons, including non-residents.

In many ways, this is broader than the other income attribution rules, because there is no limitation based on who the recipient of the loan is, as long as it is a non-arm's length person. Accordingly, a loan to a child who is 18 years of age, or to a parent, brother, sister etc., can trigger the application of this rule.

The investment income derived from the proceeds of the loan is what is subject to income attribution from the borrower to the lender. It does not apply to capital gains or to losses.

The rule does not apply if a fair value interest rate is provided for on the loan. Interest at the prescribed rate is a safe haven, but the interest must be paid within 30 days of the end of the calendar year.

Tax on Split Income (TOSI)

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Interestingly, CRA has prepared slides to illustrate the overview of the rules of TOSI in 2018-0773811C6. It is understood that many of the views in these presentation slides are outdated as the CRA has updated many of its administrative positions since 2018.

In the notes we provide most of the CRA interpretations to date. Some of them conflict which creates confusion and uncertainty. The later views should be taken as more authoritative in case of conflict.

Income Subject to TOSI

Applies To

- Potentially all private company income sources and capital gains unless excluded
- Dividends (but not capital dividend)
- Taxable capital gain (many exceptions)
- Interest income of private corporation, partnership or trust
- Rental income from partnership
- Business income from partnership
- Foreign private companies as well as Canadian companies

What is Subject

Essentially all income from private sources is potentially subject to the TOSI rules. In addition, capital gains from the sale of private assets are subject to the rules. While the most common application of these rules will be to dividends from private companies, the rules apply to a wide range of income.

These sources include:

- Dividends from private companies (both foreign and Canadian) but not to capital dividends
- Taxable capital gains (although there are many exceptions)
- Interest income from private companies, partnerships and trusts
- Rental income from partnership
- Business income from partnership
- Income derived indirectly from these sources through trusts
- There are some limited exceptions

CRA in STEP 2021 Q3 – 2021-0883151C6 indicated that interest on a promissory note issued to a beneficiary (in order to distribute trust income) will be subject to TOSI. Reasonable return may not consider whether arm's length rate of interest is charged.

Income not subject to TOSI

However, CRA 2018 APFF Q12 – 2018-0768831C6 – indicated that a partnership that derives income from publicly traded stock, and distributed that income to partners is not subject to TOSI.

A similar position for trusts in CRA 2018 APFF Q3 – 2018-0765801C6 – a trust that derives income from publicly traded stock, and distributed income to beneficiaries is not subject to TOSI.

A similar position for debt obligation from publicly traded markets. In CRA 2019 APFF Q15 – 2019-0812741C6 – interest earned from debt obligation from publicly traded markets by a trust, and distribute to beneficiary is not subject to TOSI

Income Not Subject to TOSI

Proprietorship

- Interest income of individual derived from other individual's business

Related person loans to another person (Owner) for financing Owner's business

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This avoids TOSI because the interest income is not paid by a corporation, partnership or trust.

Income Subject to TOSI

About Age

Age 18	Attained age 17 before the year
Age 25	Attained age 24 before the year
Age 65	Attained age 64 before the year

The age limits are confusing because e the legislation uses the words “attained age XX before the year”.

Last year the person attained the age of 17, so this year the person is age 18 at some time in the calendar year.

The important ages are 18, 25, and 65.

What and Who is Excluded?

Long List of Arbitrary Exclusions:

a) Amounts from a property received on death of another person who is
   - Parent
   - anyone if full-time post-secondary student or disabled provided under age 25

b) Property obtained by spouse/common law partner on separation / divorce

c) Taxable capital gain on death

<u>What and who is Excluded</u>

The rules contain a large number exclusions, which revolve around three main factors; age, type of income and circumstance.

There is no real way to understand these exclusions other than to note what is listed. In other words, there is no compelling theory for the majority of the exceptions.

For a person under the age of 25, income from property received on death of another person, and capital gains from the disposal of such property, is exempt of the TOSI rules if;

- The property is received from a parent
- The property is received from anyone if the person is a full time post-secondary student or disabled.

The exemption ceases to apply in the year that a person attains age 25. There seems to be no theoretical basis for the age 25 limitation.

Property obtained by a spouse or common law partner on separation or divorce is also exempt of the rules.

A taxable income realized on the death of a person is exempt of the rules in all circumstances for the deceased.

What and Who is Excluded?

d) Taxable capital gain by individual on QSBC shares or qualified farming or fishing property (except if kiddie tax applies (under 18 and NAL))

e) Not from related business or from excluded business if age 18 or older

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The taxable capital gain from QSBC notes shares (and qualified farming/fishing property) is excluded from TOSI. The gain may be allocated from a partnership or trust. The capital gains exemption does not need to be claimed and does not even need to be avaible (perhaps already used or blocked by CNIL).

The exception does not override the kiddie tax rule (discussed later) for NAL disposition by person under age 18.

Related business and excluded business discussed later. These are defined terms.

What and Who is Excluded? (continue)

f) if 18 but under 25, amount is
   - safe harbour capital return or
   - reasonable return considering only arm's length capital

g) if 25 and over
   - income or taxable capital gain from excluded shares or
   - reasonable return

h) If spouse is age 65 and would be excluded from TOSI on that amount, then other spouse is excluded

In addition if the person is between the ages of 18-24, the amount can be excluded if it does not exceed a safe harbor capital return or a reasonable return considering only arm's length capital. Both of these are defined terms, and usually produce very small figures.

If the person is age 25 or older, then the concept of excluded shares becomes relevant. This is a defined term. Income from excluded shares and the taxable capital from disposal of excluded shares are exempt from TOSI. This is a major way out of TOSI.

In addition, an amount which is a reasonable return (discuss later) is also exempt.

Age 65

The exemption from TOSI for age 65 and older is:

- Spouse (or common law partner) A is age 65 or older and exempt of TOSI (e.g., substantially active or excluded shares)
- Spouse (or common law partner) B is any age
- Amount is received by Spouse B
- If amount would be excluded amount (not TOSI) if received by Spouse A, then not TOSI for Spouse B

In other words, exemption of Spouse A from TOSI gives outright exemption to Spouse B.

STEP 2019 Q5 – Spouse A and B do not have to rely on the same reason for an amount to be "excluded amount". For example, if Spouse A relies on "excluded share", Spouse B does not have to rely on "excluded share"

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To explain this rule consider:

- Amount is actually received by Spouse B.
- If amount was received by Spouse A (age 65 or over), exempt of TOSI for Spouse A?
- If so, exempt for Spouse B.

How could it be exempt for Spouse A? Most common ways:

- Active (20 hours / week)
- Previously active for 5 years
- Active to some level so some amount (or some portion) is reasonable
- Excluded Share of Spouse A

STEP 2019 Q5 (2019-0799941C6) – Spouse A and B do not have to rely on the same reason for an amount to be "excluded amount". For example, if Spouse A relies on "excluded share", Spouse B does not have to rely on "excluded share"

Other Exemption

Under age 18

No Parent resident in Canada at any time in year

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This exemption is derived from the definition of "specified individual".

Split income applies only to a specified individual.

This exemption lasts only until the year the person attains age 18.

Applies if parents both non-resident or deceased.

Excluded Amount (Sort by Age)

Under 18	A.1	•	property received on death of parent, or any person if individual is full-time student or disabled (only before age 25)
	A.2	•	capital gain on death or
		•	capital gains which potentially qualify for capital gains exemption and arm's length sale (if under 18), or
	A.3	•	no parent resident in Canada and not 18
Age 18 - 24		•	A.1 plus A.2 plus
	B	•	not from related business or
		•	is from excluded business
	C	•	safe harbour capital return amount or
		•	reasonable return re. arm's length capital

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Analysis by Age

One way to look at the analysis is based on age, as laid out in this slide. Note that the exemptions are, generally speaking cumulative.

Under Age 18

For a person under the age 18, exemptions are:

> **A.1** Property received on death of a parent, or from anyone if the individual is a full time student or disabled (but before age 25)
>
> **A.2** A capital gain realized on death of that person, or a capital gain on a sale to an arm's length person if the amount would qualify for the capital gains exemption because the asset disposed of so qualifies and the sale is arm's length

Age 18-24

> **A.3** Ceases when a person attains the age of 18 in the year, A.1 and A.2 both apply, plus certain other amounts which can be excluded. These amounts are:
>
> **B** - The amount is not from a related business or is from an excluded business actively involved.

Note that the amount in A.3 (no parent resident in Canada) is not applicable once a person reaches age 18.

In addition, the individual is exempt on :

> **C-** The safe harbor capital return amount or a reasonable return based on arm's length capital.

Presumably one can take the greater of the two amounts. Both of these terms are defined, and are discussed later.

Excluded Amount (Sort by Age)

Age 25	**D**	• A.2 plus B and • income from or taxable capital gain re. excluded shares • reasonable return (this will be at least C above)
Spouse age 65	**E**	• A.2 plus B plus D plus • amount excluded for other spouse / common-law partner if spouse age 65 or older and excluded from TOSI

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Age 25 or Over (meaning that the person has attained age 25 in the calendar year):

D - The person attains the exclusions above (except note that A.1 and A.3 drop away) and:

Income from or a taxable capital gain from disposal of excluded shares (a defined term) and

Reasonable return (which is more generous than the amount in C above being the safe harbor capital return or the reasonable return based on arm's length capital).

Age 65 and Over

An additional exemption applies if a person's spouse is age 65 and over. All of the other exemptions apply plus

E. An amount that would be excluded for the spouse or common-law partner

Related Business

Related Business (3 parts) Bad

a) Business carried on by source individual or partnership, corporation, trust where source individual actively engaged on regular basis **[Services provided]**

b) Partnership where source individual is a partner **[Ownership, any percentage]**

c) Corporation where source individual owns 10% or more of value of shares **[Ownership, 10%+]**

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It is fundamental to the rules to determine the related businesses, because TOSI is defined to be income from a related business. There are three parts to the definition, and meeting any of the criteria results in a related business.

The first part of the definition looks at activity of the source individual in the business. The second and third aspects of the definition deal with ownership (Ownership in a partnership or a corporation).

A business will be a related business if it is carried on by the source individual (an unincorporated business or even a rental property).

If carried on by a partnership, corporation or a trust, it is a related business if the source individual is actively engaged on a regular basis. If the source individual is involved in the business, but not actively engaged on a regular basis, then the business is not a related business per this aspect of the test. There is no guidance as to what is meant by the term "actively engaged on a regular basis". One can imagine situations where a source individual is involved in the business but not active on a regular basis.

The second test is for a partnership, and applies where the source individual is a partner in the partnership. Any percentage ownership of the partnership by the source individual will result in the partnership being considered a related business if another partner is a related individual.

Related Business

Related Business (3 parts) Bad - continued

Corporation where source individual owns 10% or more of value of shares

Formula $0.1A \leq B + C$

A = stock FMV in total

B = stock owned

C = property convertible to stock

Means owns 10% or more of value (including convertible instrument or stock options). Voting is not relevant.

The third aspect deals only with corporations. A corporation will be a related business where the source individual owns 10% or more of the value of the shares. For this purpose, property which is convertible into shares is included in determining value for the 10% test. For example, a convertible debenture or stock options are included in determining the fair market value test.

APFF 2018 Q10 – 2018-0768811C6 – CRA stated that whether property that derives FMV from a corporation for clause (c)(i)(B) of “related business” is a question of fact.

Note that for purposes of the partnership rule and the corporation ownership rule, the source individual merely has to be an owner, so that the test of being actively engaged on a regular basis is not relevant.

Related Business

<u>Related Business (3 parts) Bad</u> - continued

Related means (meaning of "source individual")

- parents, grandparents
- spouse, common-law partner
- brothers, sisters
- children
- grandchildren
- great grandchildren
- in-laws

but not nieces, nephews, aunts, uncles, cousins

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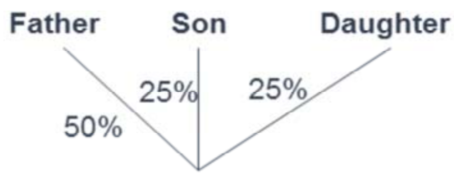
Related individuals include one's seven closest relatives. This is an easy way to remember the rule. They are father and mother, spousal or common-law partner, brother, sister, son, daughter. The rule is extended to grandchildren, great-grandchildren, grandparents and in-laws of these people.

Note though that nieces, nephews, aunts, uncles, cousins, and more distant relatives are not related persons.

2019-0795291E5 – CRA clarified that step-mother is not a source individual.

Related Business (continued)

Real Estate Co-Tenancy



Real Estate Co-tenancy
(Managed by father - Source Person)

All people are Specified Individuals with a Related Business

Assume not a partnership but real estate activity is a business carried on

No TOSI because not in list of items in Split Income Definition

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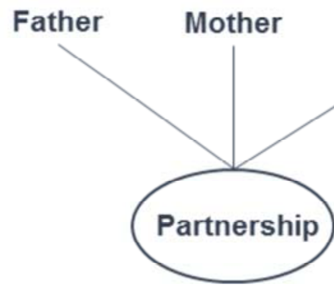
In this example, the real estate co-tenancy is a related business if it is a business in the first case (likely). But the definition of split income does not include this type of income or capital gain from sale.

An unincorporated related business or income generating activity is <u>not</u> split income because list of items defined to be split income fails to list this.

If the co-tenancy interest was held by a trust, it would be split income.

If the con-tenancy were in fact a partnership it would be split income.

Related Business (continued)



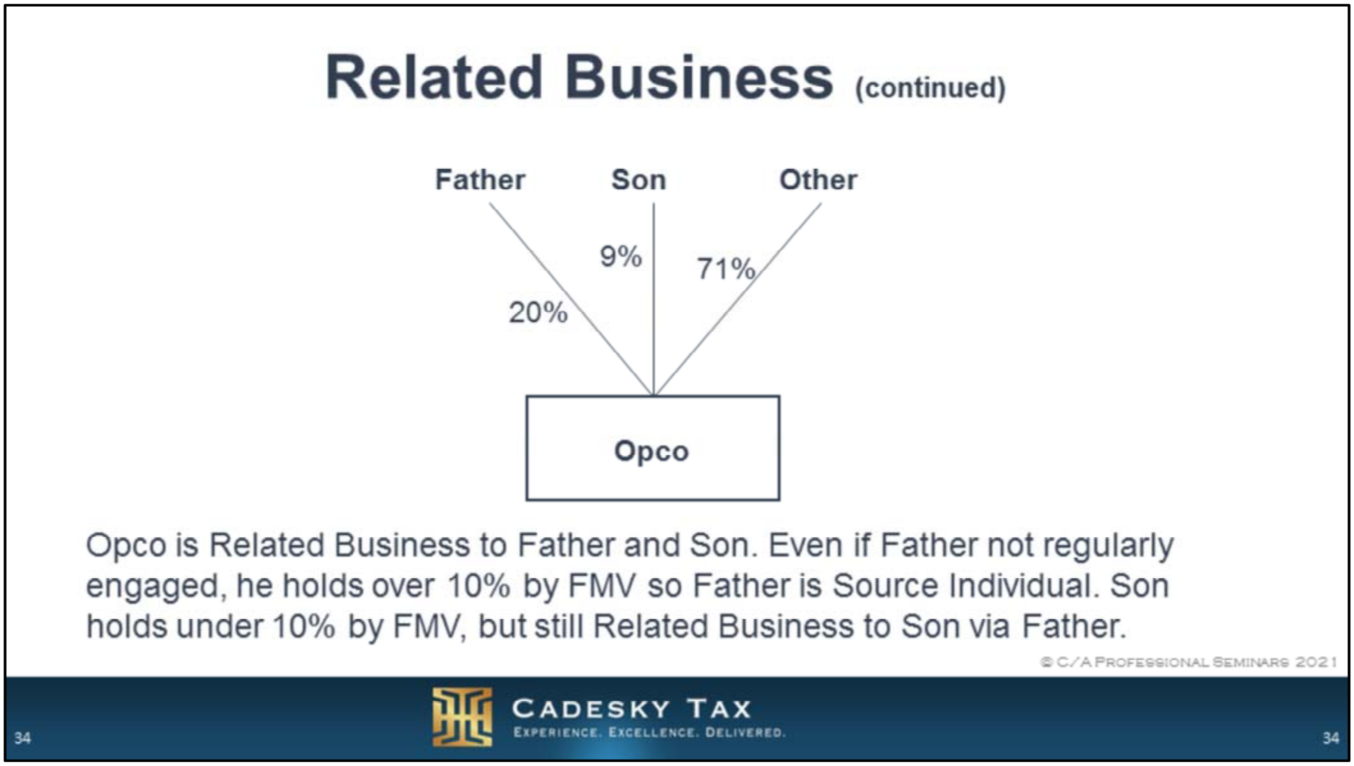
Father/Mother are both Source Individuals

Partnership is Related Business

No minimum % rule

Any partnership which has two partners who are related results in partnership income being TOSI (even a publically traded partnership).

Normally public vehicles are excluded from TOSI but not publically traded partnerships. This is a clear oversite. It means that the partnership income and a taxable capital gain on sale would be split income if two partners are related. In practice we would expect that most people would ignore this issue in the case of publically traded partnership.



The related business test is met because father has 10% or more of value of Opco shares. It does not matter if son holds under 10%. Opco is a related business to father and son.

Excluded Business

Excluded Business (Good) [18 and over]

Business where individual actively engaged on a regular, continuous substantial basis (substantially engaged)

- in taxation year of individual or
- any 5 prior taxation years of individual

This is the substantially engaged (e.g. 20 hours per week) exemption

20 hours per week on average is "safe harbor", deemed substantially engaged or substantially active

STEP 2019 Q3 – 2019-0799901C6 - Even if the business requires fewer than 20 hours of work, it could still meet the test if the individual is actively engaged on a regular, continuous and substantial basis.

CRA 2018-0783741E5 - It does not matter when in the past the individual worked for 20 hours a week for 5 years. If that test is met for any 5 years, the "excluded business" exception can be relied upon. The years need not be consecutive.

CRA 2019-0792001E5 – 20 hours per week does not include paid days of leave, vacation time and sick days

Further, CRA in APFF 2019 Q18 – 2019-0812771C6 – maternity leave, sick leave or injury does not count in the time for excluded business. This is in contrast to an older CRA view of 2018-0770911E5 where CRA commented that maternity leave may still allow the taxpayer qualify for excluded business for that particular year.

CRA 2019-0814181E5 – If the person has carried on the business as a sole proprietor and the business is transferred to a corporation, the 5 year rule will count the time when the person was involved in the business as a sole proprietor. This applies to the full time employee who works for both the sole proprietor business and subsequently for the corporation. In addition, if a corporation is amalgamated with another corporation, the 5 year rule will count the time worked for the predecessor corporation as long as Amalco carries on the same business. If Amalco does not carry the same business as the predecessor corporation in which the person was actively engaged, then Amalco does not qualify for excluded business

CRA 2020 STEP Q9 – 2020-0837631C6 – If there is multiple businesses in a corporation, must trace the hours per business. However, if the business does not need 20 hours/week to achieve "regular, continuous and substantial basis", can still qualify for excluded business. CRA has indicated even 5 hours/week will meet the test.

CRA 2019-0824411C6 – 2019 CTF Q8 & 2020 STEP Q10 – 2020-0837641C6– If an active business ceases and the corp uses the profit to carry a different business. The excluded business extinguishes because it is not the same business. Taxpayer will need to put in the hours again.

Death Exemption

Property acquired on death of person substantially engaged in year of death or for any 5 prior years then recipient is deemed substantially engaged, but only if and when age 18 or older.

STEP 2019 Q6 – 2019-0799941C6 – CRA notes that if an individual inherits a share (golden share) from an active parent, individual attains the active status of deceased parent. Dividend paid on shares (including ones that are not received from inheritance) would be excluded amounts.

CRA also clarified that the active status can pass on to multiple generations.

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Death Exemption

If an individual was actively engaged in the business in the year of death or in any five prior taxation years, then a person receiving the property on death is also exempt of the TOSI rules. The property can be personally held assets such as a proprietorship, real estate, a partnership interest or shares of a corporation (Canadian or foreign).

STEP 2019 Q6 – 2019-0799941C6 - CRA notes that if an individual inherits a share (golden share) from an active parent, the individual attains the active status. Dividend paid on shares (including ones that are not received from inheritance) would be excluded amounts. Based on the wording of 120.4(1.1)(b), at least a nominal amount of income may need to be paid in order for the individual to achieve the active status.

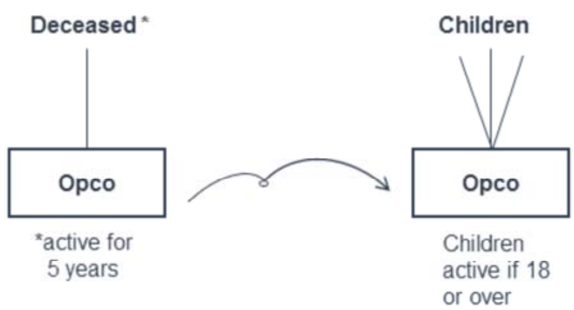
There is a view that a substitution of the golden share for another share may not jeopardize the individual's active status as long the individual achieves the active status from inheritance in the first place (provided at least a nominal amount of income is paid on that golden share first).

If shares are held by a trust after death of the source individual

CTF 2019 Q7 – 2019-0824401C6 – Transfer of property from an inter vivos trust as a result of death of another person is treated as meeting the condition "as a consequence of the death". But if shares continued to be held by the trust, and dividends are paid by the trust to a beneficiary as a consequence of death of a person, it will not qualify for the death exemption because shares have not been acquired by the beneficiary.

However, this should be contrasted with the death exemption with respect to spouses. Under STEP 2019 Q5 – 2019-0799961C6 – the inheritance exemption applies to the surviving spouse even if the shares are held through a trust. However, the CRA is not ready to comment if TOSI applies if the shares of the surviving spouse are held through a holding company.

Death Exemption (continued)



Note also death exemption under age 25 for property from death of parent

The deceased was active, full time, for at least 5 years and so is TOSI exempt. The children each take over the active attribute of the parent from age 18.

The under age 25 death exemption would apply up to age 18 (and to age 25), so there is no age issue.

Excluded Shares

Excluded Shares (Good) [25 and Over]

Shares if

- under 90% of "business income" was from services (at least 10% not from services) for last taxation year
- not professional corporation
- 10% votes and value held immediately before that time
- under 10% of income from another related business (source individual and specified individual)

Then excludes income from the shares (i.e. dividends) and taxable capital gain from disposal of shares

Excluded Shares

For persons age 25 and over, there is an exemption for shares of a corporation which qualify as excluded shares.

Put another way if the specified individual (the person receiving dividends etc.) holds shares of a corporation which are excluded shares, the TOSI rules are not applicable to dividends received from these shares or to a capital gain from disposal of the shares.

This is an important exception to the TOSI rules, but unfortunately has significant limitations and uncertainty.

Four conditions must be met for shares of a private corporation to qualify as excluded shares.

1. Less than 90% of the business income of the corporation was from services. Because this test can only be determined at the end of the corporation's taxation year, the legislation looks at the income for the previous taxation year. For example, for a corporation with a calendar year, the test for 2021 would be based on the corporation's income for 2020. The challenge is to determine whether income is from services or not. In addition, if a corporation sold goods that are incidental to the service provided, can the goods sold be counted as regular business income that is not from services?
2. The corporation is not a professional corporation.
3. The specified individual holds at least 10% of the shares by reference to both votes and value.
4. Under 10% of the income of the corporation is from another related business

Excluded Shares (Mix Component)

- Do you need to have at least some business income?
- More guidelines from CRA on what is considered service income
- Business income from provision of service and non-service income
  - Plumber, mechanic, sub-contractors, cleaning
  - CRA 2018-0743961C6: Depends on if the non-service business component is considered incidental to the service

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CRA in 2019-0813021E5 has considered that a business of the corporation includes a business of a partnership owned by the corporation.

CRA has considered the following as service income:

1) Contract truck driver – CALU 2018 Q6 - 2018-0745871C6
2) Hair salon – 2018-0761601E5
3) Cleaning business – 2018-0761601E5
4) Plumbers – CRA website TOSI Q3
5) Management and IT consulting service – CRA website TOSI Q1

CRA has considered the following not as service income:

1) Pizzeria business – 2018-0761601E5
2) Right to download digital content, CRA treats this as a sale of intangible property – 2019-0833181E5

A hairdresser that sells shampoo and cosmetics could be an excluded business if the sale of products constitutes more than 10% of the gross revenue. CRA website on TOSI Q4 has indicated that if the products are incidental to the service, then the incidental goods amount would not be subtracted from the service part of the gross business income. However, on the same website Q5, if the goods are not incidental to the service, then the goods are not included in the service income calculation test. This is confirmed by CRA 2018-0743961C6 and 2018-0761601E5

Excluded Shares (Nil Business Income)

- 90% of business income – test is gross revenue, not net income
- What happens if there is no business income?
  - Old view – CRA 2018-0744031C6 – no business income disqualify for excluded share
  - New view – CRA 2018-0768801C6 – no business income but property income that constitutes a business qualifies for excluded share (Investco)
    - However, if corporation with property income has no business, can escape TOSI with another avenue (next slide)

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STEP 2018 Q5 - CRA 2018-0743961C6 - For this purpose, CRA interprets the 90% of business income test to be gross revenue, not net income.

There is the threshold question of what constitutes business income. Again in many cases it will be clear that income is or is not business income. However, there will be borderline situations. While the renting of real estate on a small scale will likely constitute a business, it does not follow that the income is business income. There is no "bright line" test to determine whether rental income is business income or property income, although a large real estate operation with employees that manage the real estate will likely result in the income being business income. On the other hand, a small real estate investment activity (say a small rental property in a corporation where there is minimal activity and no employees on a payroll) would likely constitute property income.

CRA in 2019-0813021E5 has considered that a business of the corporation includes a partnership business. This may imply purchasing a publicly traded partnership with business income may work to technically meet the requirement for some business income.

Old view - STEP 2018 Q7 - CRA 2018-0744031C6 stated that to qualify for excluded share exception, there needs to be some business income (zero business income would not qualify for this).

New view – APFF 2018 Q9 – CRA 2018-0768801C6 and APFF 2018 Q2 – CRA 2018-0765791C6 clarified that a business can also derive income from property, such as interest, dividends, rents. CRA assumes that there was some level of activity to constitute that income was derived from a business. The corporation does not need to derive income strictly from business income but can also derive income from property. As such, as long as there is a "business" in the broadest sense, even with zero business income, this can meet the test.

Excluded Shares (Property Income)

- CRA has two broad views on how TOSI does not to apply to property income
  - Business exists, use excluded share

    2018-0768801C6 (APFF 2018 Q9)
    2018-0765791C6 (APFF 2018 Q2)
    2021-0883141C6 (STEP 2021 Q4)

  - Business does not exist, no excluded share, but no related business

    2018-0778661C6
    2018-0780081C6 (CTF 2018 Q10)
    2018-0765811C6 (APFF 2018 Q4)
    2021-0883141C6 (STEP 2021 Q4)

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APFF 2018 Q9 – CRA 2018-0768801C6 and APFF 2018 Q2 – CRA 2018-0765791C6 clarified that a business can also derive income from property, such as interest, dividends, rents. CRA assumes that there was some level of activity to constitute that income was derived from a business. The corporation does not need to derive income strictly from business income but can also derive income from property. As such, as long as there is a "business", even with zero business income, this can meet the test.

CRA 2018-0778661C6 and CTF 2018 Q10 - 2018-0780081C6 – If Holdco derives income from its stock market holdings but does not carry a business, then no TOSI because there is no business.

In addition, under APFF 2018 Q4 – 2018-0765811C6 – in the context of a spousal trust, if rental income earned by the spousal trust does not constitute a business, then any income distributed to a beneficiary is not subject to TOSI. The basis of this is that no related individual is actively engaged on a regular basis in the activities related to rental of the property.

Excluded Shares (Ownership)

- Targets professionals, service businesses (these are not excluded).
- Must hold shares with 10% or more of votes and value.
- Knocks out holdings via trusts.
- Need direct shareholding, generally not via holding company.

Note that the exception does not apply to a professional corporation or to a business that derives 90% or more of its income from services.

The ownership must be individual ownership. So a corporation owned by a trust will not qualify as excluded shares. This is confirmed by CRA 2018-0777361E5 where an estate will not qualify for the excluded share exemption and shares must be rolled out to beneficiaries to qualify.

CRA 2018-0771811E5 stated that owning different classes of shares (one with vote, one with value) would still qualify if same shareholder.

Excluded Shares (Holdco)

- Holding companies are problematic and uncertain.
  - Old view - CALU 2018 Q6b – 2018-0745871C6 - CRA addressed that shares of a holding corporation generally (that holds an operating company) do not qualify as excluded shares.
  - New view - Second generation income in Holdco is okay (even from capital derived from Opco) - 2018-0771861E5, APFF 2018 Q9c – 2018-0768801C6
    - If Holdco has both second generation income and income from Opco, must trace source of funds when dividend is paid – APFF 2018 Q11 - 2018-0768821C6

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Holding companies are also problematic in that the holding company may fail the test by having 10% or more of income from a related business.

In CALU 2018 Q6b – 2018-0745871C6 & 2018 STEP Q6 – 2018-0743971C6- CRA addressed that shares of a holding corporation (that holds an operating company) do not qualify as excluded shares.

However, if Holdco earns second generation income, 2018-0771861E5 and APFF 2018 Q9c – 2018-0768801C6, 2020-0839581E5 - CRA says that it will not be TOSI.

Particularly in CTF 2018 Q9 – 2018-0779981C6, assume Holdco owns Opco, and two years ago Opco was sold. Holdco has the sales proceeds and invests it. No income in previous year via Opco (e.g. dividends), then Holdco could qualify.

If Holdco has both second generation income and income from Opco, must trace source of funds when dividend is paid. CRA said that as long as Holdco is paying out from the second generation income portion, then excluded share still applies – APFF 2018 Q11 - 2018-0768821C6

Excluded Shares (Old Business)

- What if a business is sold and proceeds are re-invested in the stock market?
  - CTF 2018 Q9 2018-0779981C6
  - As long as the old business was sold more than 2 years ago, excluded share is available
  - Income from a related business not derived from the previous year (2 years ago is ok)
  - Reminder again – property income is okay for excluded share
- What if Opco share is sold by Holdco and proceeds are re-invested in the stock market?
  - 2019-0792011E5 – Similar answer, as long as Opco shares were sold more than 2 years ago, excluded share is available

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Reminder again, CRA 2019-0824411C6 – 2019 CTF Q8 & 2020 STEP Q10 – 2020-0837641C6– If an active business ceases and the corp uses the profit to carry a different business, excluded business extinguishes because it is not the same business. Taxpayer will need to put in the hours again.

However, as pointed in this slide above, the taxpayer may be able to use excluded share exception

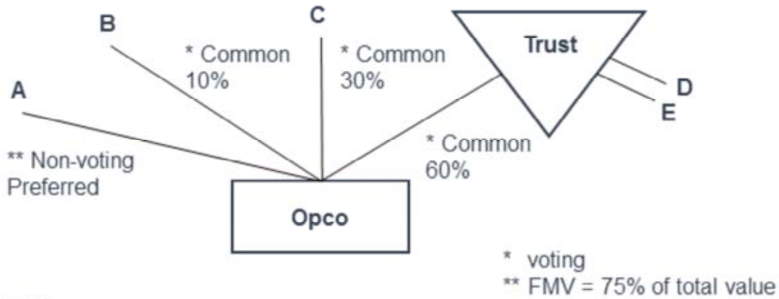
Excluded Shares (Old Business)

- Beware of certain traps on disposition of old businesses and continuance of business elsewhere
- Example: (CRA 2019-0819431E5) – Aggressive view by the CRA
  - Medical practice PC1 derives professional income but wound up in Year 1, not PC after
  - Non-active spouse becomes 100% s/h & receives dividend from PC1 in Year 2 and 3
  - Dr. spouse starts a new medical practice in PC2 in Year 2
  - CRA view is that dividend in PC1 in Year 3 is TOSI (no excluded share)
  - "derived directly or indirectly" from a "related business" carried on by PC2
  - CRA 2020-0839581E5 subsequently clarifies that second generation income in PC1 is still okay, no TOSI

This view (2019-0819431E5) by the CRA is considered a very broad interpretation of the phrase "derived directly or indirectly from a related business". However the subsequent clarification by the CRA in 2020-0839581E5 provides helpful relief that second generation income in PC1 still provides excluded share relief. But if this structure is done deliberately, then CRA may apply GAAR.

A similar view CRA CTF 2019 Q9 – 2019-0824421C6 – a business was sold by a corporation to an unrelated corporation, but due to transitional period, the source individual was working for the unrelated corporation. CRA is of the view that the business is still carried on by the source individual, and so there is a "related business" (despite being carried in an unrelated corporation). Dividends paid will still be subject to TOSI.

Excluded Shares (continue)



Assume all age 25 or over

A holds non-voting shares

B and C may have under 10% FMV

D and E do not hold directly

Nobody qualifies for Excluded Shares

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Illustration of Excluded Shares

In this example, A, B, C, D and E are all related family members. Assume they are all age 25 or over, so that the excluded shares exception is potentially applicable. Assume that Opco would otherwise meet all of the tests for excluded shares (It has business income, sufficient gross revenue from other than service, no income from another related business etc.).

A has non-voting preferred shares. These do not qualify as excluded shares because although the shares may be worth more than 10% of the total fair market value (here 75%), they are non-voting.

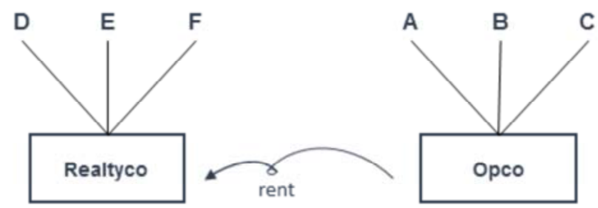
B and C may qualify for excluded shares, except that the common shares are only worth 25% of the total value, so neither B nor C meets the 10% fair market value test.

D and E hold their shares through a trust, and therefore the shares do not qualify because they do not own the shares directly.

The end result is that nobody qualifies for excluded shares in this example.

This could be fixed by the preferred shares becoming voting and the trust distributing 30% to D or to E.

Excluded Shares (continue)



Assume A, B, C, D, E, and F all related, age 25 and over.

A, B, and C hold excluded shares unless Opco earns 90% or more from services or professional corporation.

D, E, and F do not hold excluded shares as Realtyco receives income from related Opco, a related business.

<u>Excluded Shares - Related Business</u>

Assume that all persons (A, B, C, D, E, and F) are related and Age 25 or over.

Opco carries on an operation business and does not derive more than 90% of its revenue from services. It is not a professional corporation.

Opco rents premises from Realtyco and pays rent to Realtyco. All of the persons are source individuals and all of the persons are specified individuals for purposes of testing whether the TOSI rules apply. Opco and Realtyco are related businesses. Realtyco obtains more than 10% of its revenue from Opco, a related business.

In this example, A, B and C hold excluded shares. D, E and F do not hold excluded shares because Realtyco receives over 10% of its income from Opco, a related business.

What is Service?

Not a defined term

Rely on case law

Allarcom Pay Television (1996 DTC 1558)

Dixie X-Ray Associated Limited (1988 DTC 6076)

Industrial Forestry Service Ltd (1992 DTC 1060)

Dr. Brian Hurd Dentistry PC (GST) (2017 TCC 142)

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Allarcom Pay Television (1996 DTC 1558) - Taxpayer purchases movies from major studios and "process" the film by adding ratings, inspecting tapes, re-doing tapes and resale as a package to cable companies. Court concluded it as provision of service (no tangible property transferred).

Dixie X-Ray Associated Limited (1988 DTC 6076) – Taxpayer is an x-ray laboratory and develops the films by qualified technicians. The films are stored for 5 years and sold for silver recovery. Court concluded it as provision of service (no evidence of contract on the x-ray film itself, key feature of business is for radiological diagnosis)

Industrial Forestry Service Ltd (1992 DTC 1060) – Taxpayer produces digital maps. Court concluded as goods for sale, notwithstanding that the data content gives these goods their value, the subject matter of the sales are maps. Taxpayer not hired to work for their customers but are commissioned to supply with a specific product.

Dr. Brian Hurd Dentistry PC (GST) (2017 TCC 142) – Taxpayer claimed both the orthodontic service and the orthodontic appliance as one single exempt supply. Court concluded as a single supply of service. The appliance is "interconnected" with the service in the overall dental treatment. Although invoice separately, they should be seen as one service.

What is Service? (continued)

Feasible to have product sales.

Gross revenue from product sales versus services

- Plumber sells faucets
- Gardener sells flowers
- Hairdresser sells shampoo/cosmetics
- Dry cleaner sells used clothes
- Garage sells car parts
- Computer programmer?
- Taxi Driver?
- Truck Driver?
- Courier?
- Consultant?
- Real Estate Agent?
- Travel Agent sells tours
- Hotel sells food/beverage
- Airline charter service?
- Cinema?
- Bowling alley?
- Health Club?

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CRA has considered the following as service income:

1) Contract truck driver – CALU 2018 Q6 - 2018-0745871C6
2) Hair salon – 2018-0761601E5
3) Cleaning business – 2018-0761601E5
4) Plumbers – CRA website TOSI Q3
5) Management and IT consulting service – CRA website TOSI Q1

CRA has considered the following not as service income:

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2) Right to download digital content, CRA treats this as a sale of intangible property – 2019-0833181E5

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What is Service? (continued)

- How to track product sales?
- Fixed contract price, can you segregate? How to allocate!
- If broken out separately, need to add up invoices. Note - place to start is last complete year.
- CALU 2018 Q6 – 2018-0745871C6 – CRA stated that what is service depends on the facts and circumstances, but stated that the distinction should be clear. In the same TI, CRA confirmed that a business that sources drivers on contract for logistics companies is service.

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Reasonable Return (18-24)

- Reasonable return age 18-24 limited to:
  - Reasonable return on arm's length capital; or
  - Safe harbour return
- Considers only capital, not labour or risks.
- Unlikely to be of much use practically. If person 18-24 provides services (but under 20 hours per week) pay reasonable salary.

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Reasonable Return (Age 18-24)

If no other exception applies, then the last way out of the TOSI rules is reasonable return. Two sets of rules apply. One set of rules applies in the age 18-24 group, and another for people age 25 and over.

In the age 18-24 category, the reasonable return does not take into account labour or risks. It only considers capital invested in the business.

There are two possible ways to determine the amount of a reasonable return. They are the reasonable return on arm's length capital and the safe harbour capital return. These are defined terms.

The amount appears not to be reduced by salary paid.

Pay reasonable salary to person aged 18-24 if person really works in the business. Can pay to younger family members also, subject to reasonableness.

Arm's Length Capital

- Age 18 - 24
- Property of the individual not received from related people or related business
- Not received by loans
- Capital received from related person on death — OK
- Salary after tax — OK
- Investment funds derived independently — OK

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In determining arm's length capital, amounts which the individual attained from related people or related businesses do not count. Also, amounts received by way of loans do not count. However, amount contributed from that persons own resources (such as salary earned even from a related business or investments derived from independent sources) are includable. Also, capital received from a related person on death of that person can be included.

Arm's Length Capital (continued)

- Relevant for reasonable return but only age 18 – 24
- Reasonable return on arm's length capital
- What is reasonable not defined

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In practice, usually family members age 18-24 have no capital in the family business.

Once the arm's length capital is determined, a reasonable rate of return can be calculated based on the arm's length capital. No guidance is given as to what rate of return is reasonable on the arm's length capital. Presumably one would look to what a market rate of return would be. This can be a high percentage especially of the company is not particularly credit worthy. In fact, the less credit worthy the company the higher the return which can be taken on the arm's length capital.

Safe Harbour Capital Return

- Age 18-24
- Prescribed rate (now 1%), but highest of any quarter in calendar year can be taken
- Gives minimum reasonable amount
- Not limited to arm's length capital, applies to all capital contributed
- Prescribed rate is below normal cost of capital for a business
- Unlikely to be of much use practically

The second alternative is the safe harbour capital return. This allows all capital to be considered without the limitation to arm's length capital. However, the rate which can be taken is the prescribed rate of interest. Although the explanatory notes state that the prescribed rate is the highest prescribed rate, this is misleading. It is the lowest of the three "prescribed rates". The current prescribed rate is 1%. This means that even if the person had a million dollars invested in the business, the safe harbour capital return would currently be calculated at $10,000 for the year.

Safe Harbour Capital Return (continued)

Safe Harbour Capital Return - Under Age 25 Worksheet

Client Name:
Smith Family
Individual name:
John%20Smith

CONTRIBUTED PROPERTY

Fair market value of property contributed (includes contribution that was originally received from non-arm's length capital)	$ 0

DAYS

Number of days used to support the related business	0
Number of days in the year	365
Ratio	-

PRESCRIBED RATE

Highest prescribed rate of interest for any quarter in the year	0.00 %

ESTIMATED SAFE HARBOUR CAPITAL RETURN $0.00

The TOSI worksheet is available in the Cadesky TOSI Web App

Reasonable Return (25+)

- Work performed
- Property contributed directly or indirectly
- Risks assumed
- Amounts paid to person (reduction)
- Other relevant factors (not defined)

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Reasonable Return Age 25 and Over

When a person is age 25 and over then the reasonable return is calculated based on an expanded list of factors. These include the work performed, the property contributed directly or indirectly, the risks assumed and other relevant factors reduced by amounts paid to the person.

CRA has said that it will not substitute its own judgement in determining a reasonable return, if a bona fide attempt is made to determine the amount. However, no real comfort can be taken from this statement, and it is likely to be controversial.

CRA 2018-0771851E5 has clarified that undistributed retained earnings is not a factor to determine reasonable return because it does not represent capital contributed. CRA also stated that the risk in providing a startup loan can be taken into account even after it is repaid.

CRA 2019-0814161E5 has clarified that investment from spouses' joint bank account to a corporation will unlikely count for the passive spouse as contribution of property.

CRA in STEP 2021 Q3 – 2021-0883151C6 indicated that interest on a promissory note issued to a beneficiary (in order to distribute trust income) will not count to relieve TOSI.

Reasonable Return (25+) (continued)

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The TOSI worksheet is available in the Cadesky TOSI Web App.

The value of the work performed would be calculated based on what would be reasonable to pay an arm's length person for similar work. This could be an hourly rate or an annual salary.

The property contributed directly/indirectly looks at the capital invested in the business and one would apply a reasonable rate of return on the capital. Although not defined, one would imagine that this capital does not include the fair market value of the shares, but only considers the amount paid into the company for the shares. It is not clear how capital used to purchase shares of the company would be treated, and this may depend on how the acquisition is structured or later re-organized.

No guidance is given as to how one determines risks assumed. One would imagine that this relates to personal guarantees, and amounts for which the individual is exposed to liability. For example, the individual might have guaranteed a bank loan or a lease. If the person is a director then the person could be responsible for unremitted payroll taxes and HST. The less credit worthy the company, the higher the amount that may be taken for risk assumed.

Reasonable Return (25+) (continued)

- Amounts paid to shareholder reduces reasonable return, but how is not known.
- Over what period?
- Salary, dividends or both? Just current year?
- How to evaluate?
- How to determine for a capital gain? Over what period? What if installment sale?
- 2018-0771851E5 – CRA stated that the risk in providing a startup loan can be taken into account even after it is repaid.

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Other relevant factors can be taken into account, although these are not defined. Special know how and goodwill might be relevant factors.

The amounts are reduced by amounts paid to the person. For example, if the person receives a salary, this would be deducted from the reasonable return. Also, if the person receives interest on a shareholder loan this would be deducted from the component for property contributed.

Beyond this, it is not clear as to how the calculation would be done, or whether amounts paid in prior years are relevant or not to the calculation.

It is also not clear as to how one determines reasonableness in respect of a capital gain, or the period which is to be taken into account. For example, suppose that shares of the corporation are sold in an installment sale where payment is to be made over a period of years. How does one make a determination of reasonable return in this situation? It may be that after the company is sold, no work is performed, no capital is at risk other than under the installment sale payment (not from the company and for which interest might be provided), and no risks are ongoing.

2018-0771851E5 – CRA stated that the risk in providing a startup loan can be taken into account even after it is repaid.

Reasonable Return (25+) (continued)

- Heart of the issue still
- Unworkable still
- How to value?
- How do past payments relate?
- What about capital repaid, risks assumed now discharged?
- What if person becomes disabled and can no longer work?
- Relative contributions what does this mean?

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In many cases reasonable return will be the heart of the TOSI determination. It is difficult to know what level of documentation the CRA will request, or how closely this will be examined. Given that this may apply to tens of thousands of people across Canada, one could imagine that there will be a great deal of controversy and litigation.

Also reasonable return is stated to be based on relative contributions, what this means is unknown.

CRA 2018-0771851E5 has discussed reasonable return.

Other Rules

Other Issues

No deduction against TOSI for interest expense on loan to finance corporation. But should resolve because loan counted in determining reasonable return.

If capital gain is TOSI, other capital losses, net capital loss carryover, do not offset.

Expenses allowed in determining net rental income, business income for TOSI

No TOSI on income retained in a trust,

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Other Rules

Split Income Calculation

- Do get DTC, FTC, disability tax credit, but no personal exemptions against split income.
- Applies to foreign dividends, foreign capital gains, not just CCPCs.
- Could lose claim for personal exemption, donation credits, medical if all income is split income.
- 15(2) loan deemed TOSI but subsequently paid
  - CRA CTF 2021 Q2 – 20(1)(j) deduction still allowed but unclear under what system, what rate. Regular tax rate deduction? Or TOSI tax rate deduction?
- No deductions (expenses) allowed.

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If TOSI applies, then only three tax credits are allowed against the tax which are:

- The dividend tax credit
- The foreign tax credit
- The disability tax credit

No personal exemptions are allowed. In addition, no claim for a donation tax credit or medical expenses can be taken.

CRA STEP Q8- 2020-0837621C6 – confirmed that no donation credit is available to reduce TOSI

There is no guarantee that at least one person in the family will be exempt of the TOSI rules. It is possible that everyone in the family could be subject to these rules, which is a startling and punitive result.

In the context of 74.4, 2019 APFF Q16 - 2019-0812751C6 – CRA indicated that even if TOSI applies to the designated person, it is not good enough of a reason to claim that the purpose test is not met. However, CRA then said that TOSI income reduces the deemed interest income to the transferor under 74.4(2)(g)(ii)

<u>Unique situation – 82(3) election to transfer dividend to spouse to utilize dividend tax credit</u>

CRA 2020-0856081I7

First scenario (excluded business) – Electing spouse does not own shares of Opco but works for the business. Recipient spouse does not have excluded business or excluded share exception.

CRA position – TOSI does not apply to electing spouse

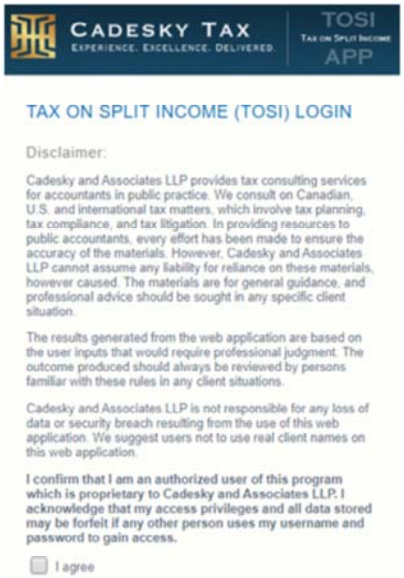
Second scenario (related business) – Electing spouse does not own shares of Opco and neither works for the business. Recipient spouse does not have excluded business or excluded share exception. But Opco is controlled by another related party.

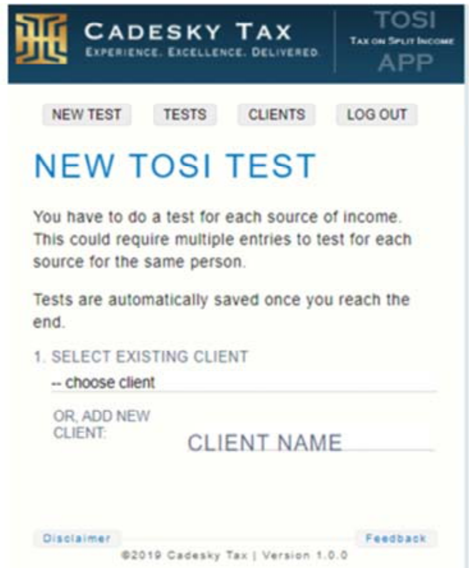
CRA position – TOSI applies due to related business and so applies to Electing spouse

Third scenario (excluded share) – Electing spouse owns 20% of Opco and does not work for the business. Recipient spouse does not have excluded business or excluded share exception. There is a source individual (third person) of Opco.

CRA position – 82(3) deems the Electing spouse to have received the dividend paid on the Opco shares held by Recipient spouse. 82(3) technically does not deem the dividend to be paid on the Ocpo shares actually held by the Electing spouse. Since Recipient spouse has no excluded share, Electing spouse technically is subject to TOSI. However, CRA is ready to take the position that the dividend deemed received b/c of 82(3) by the Electing spouse to be paid on the shares actually held by the Electing spouse. As such, excluded share exception applies.

TOSI Web App





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Cadesky designed web app that allows users to prepare first diagnostics on whether TOSI applies

TOSI Central

TOSI CENTRAL

A. Legislation

- TOSI Legislation

B. Explanatory Notes

- TOSI Explanatory Notes
- Technical Backgrounder on Measures to Address Income Sprinkling
- Guidance on the application of the split income rules for adults
- FAQ
- CRA website - TOSI (Excluded Share & Gross Income Test) (July 22 2019) NEW

C. CRA Publications

- CRA View 2018-0745871C6 - Meaning of Service Income & Holdco Not as Excluded share (CALU Q6) (May 8 2018)
- CRA Views 2018-0761601E5 - Tracing of Hours & Trust Distribution (May 25 2018)
- 2018 STEP CRA Roundtable Question 5, 6, 7 (May 29 2018)
  - CRA Views 2018-0743961C6 - Meaning of Income (Gross Income) (STEP Q5) (May 29 2018)
  - CRA Views 2018-0743971C6 - Holdco Excluded Share (STEP Q6) (May 29 2018)
  - CRA Views 2018-0744031C6 - No business income cannot be excluded share (STEP Q7) (May 29 2018)
- C - CRA Views 2018-0759521E5 - PBE Election (Jul 6 2018)

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TOSI Central (which can be logged in through TOSI Web App) has all the TOSI materials and all CRA publications

TOSI Planning

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These slides outline possible approaches to tax planning in respect of the TOSI rules.

There is a lot of uncertainty concerning the rules, and so the suggestions outlined here should not be acted upon without appropriate professional judgement. The examples give broad illustrations of possible planning approaches, but in practice these very much depend upon the particular facts.

Areas of uncertainty involve the definition of what constitutes services because the term is not defined in the Income Tax Act, nor is there a working definition. It will be clear that in some cases an activity constitutes services (consulting services for example) and in other cases the income does not constitute services (sale of goods). There is an area which is "grey" where it is not clear at all. One would imagine that a barber shop probably derives the bulk of its income from services, although there may also be product sales. One would imagine that such things as transportation services, dry cleaning, alteration of clothing , and janitorial services would constitute services income.

For income derived from computer programming, the issue may turn on the nature of the revenue (is it a fee for service for consulting, or is it a licensing fee for use of the program). Even if the income is a licensing fee for use of the program, it is still unclear as to whether or not this would constitute income from services. Even if this is income from services, is it from the provision of services, the key word here being "provision". CRA 2018-0745871C6 has indicated that the determination of service is based on specific facts and circumstances.

Introduction to TOSI Planning

2 broad approaches

If subject to TOSI and want to avoid it:

1. Try to restructure shareholding/ownership/ mix of income to meet exception
2. Change remuneration strategy to retain income in corporation or pay dividends only to substantially active people. Income split in other ways (e.g. investment income personally). Use of CDA.

The first step in the evaluation process is to determine whether or not TOSI is applicable in the current situation. If it would be applicable, there are two broad alternatives which can be considered. These are:

1. To try to restructure the ownership, shareholdings, mix of income, way in which the business is carried on etc. in order to meet an exception to the TOSI rules.
2. To change the remuneration strategy in some way to bypass the TOSI rules. This may involve creating an internal capital gain and generate CDA

The examples which follow show many instances of how a restructuring might be done to meet an exception to the TOSI rules. The examples also give certain comments concerning changes to remuneration if no other alternative is available and TOSI would otherwise be applicable. For example, the family might look to other ways to carry out income splitting, such as using personal investment funds to derive investment income not subject to the TOSI rules. Another example might be to defer income in the corporation, rather than pay tax at the top tax rate.

Even if income splitting is not an objective, TOSI can still produce a bad result.

Planning to Restructure

General Ideas

- Not a related business, only one shareholder/owner and no other related source individual
- Excluded shares
- Non-resident ownership
- Other approaches

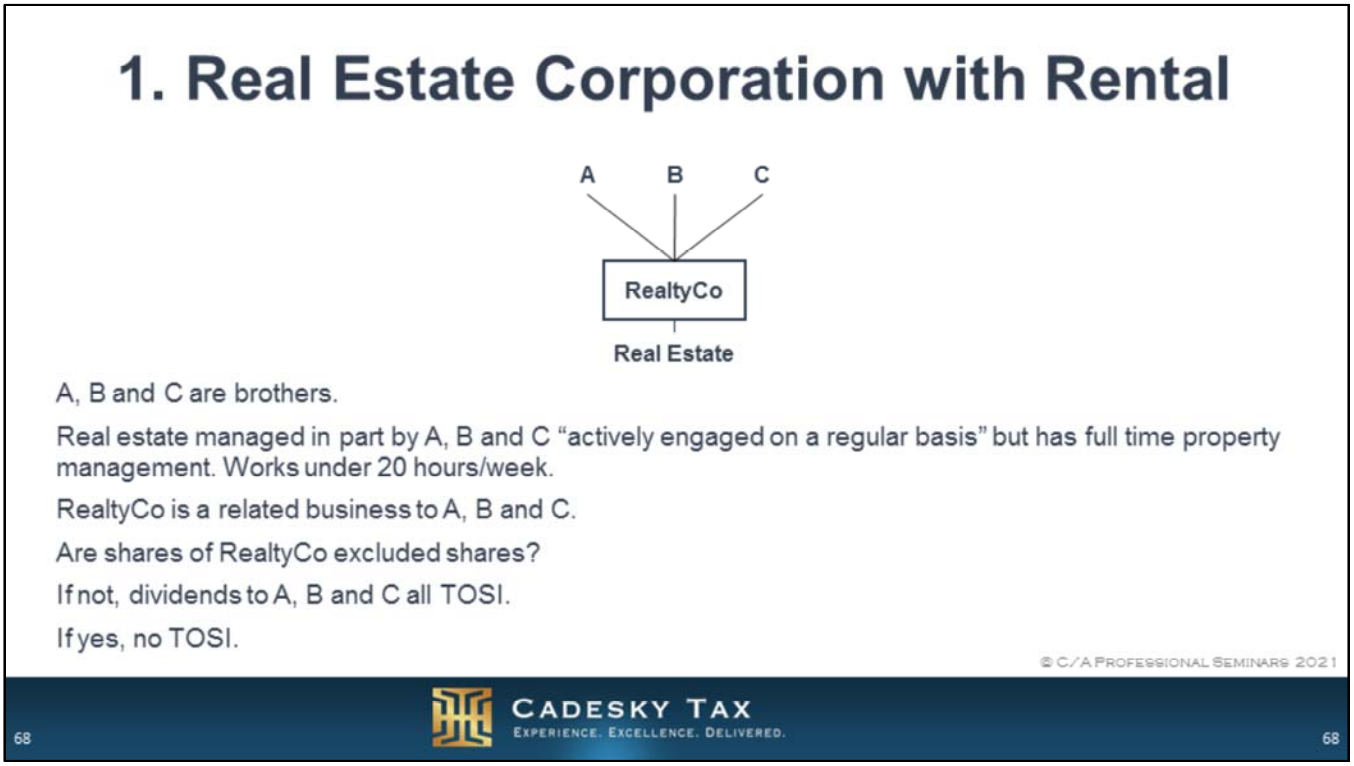
In looking at possible ways to restructure the business in order to meet an exception to the TOSI rules, there are certain broad possibilities.

One possibility is not to have a related business, because there is only one shareholder/owner and no other person who is a source individual who provides services.

Another alternative which will be commonly used is excluded shares, although the examples show the limitations and complications with the excluded shares exception.

Since non- residents are not subject to the TOSI rules, a reorganization could be done and ownership placed in the hands of non-residents if the circumstances were appropriate for this.

There are also other approaches which are considered (such as conversion of a partnership to a co-tenancy), incorporation of a partnership to obtain excluded shares.



In this example, A, B and C are brothers. RealtyCo has rental real estate and there is full time outside property management. The brothers A, B and C are actively engaged on a regular basis in the affairs of the company, but are not sufficiently active to meet the exception from the TOSI rules. One can imagine a situation where the brothers approve leases, review management reports, and make important decisions (such as replacement of a roof). However, they are not involved in the day to day management.

As a result of RealtyCo being owned by related persons, RealtyCo is a related business to A, B and C. If an exception cannot be found to TOSI, then dividends to A, B and C in excess of a reasonable amount based on their effort and capital will be taxed at the top tax rate.

The question then becomes whether the exception for excluded shares applies or not.

If TOSI applies, none of A, B or C get graduate tax rates on dividend income.

This example was specifically addressed by the CRA in the 2021 STEP Q4 – 2021-0883141C6. The CRA's position is written in the next slide.

1. Real Estate Corporation with Rental

Tests for Excluded Shares:

Less than 90% of "business income" from services?

- Rental income is considered business income (CRA position)

Is there a business?

- If yes, excluded share available (2021-0883141C6)
- If not, no related business, can be an excluded amount

What if RealtyCo also receives a management fee from tenants?

- Management fee can be considered "service", but not over 90% so no issue

So no TOSI

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Four conditions must be met in order for shares to be considered excluded shares. The conditions are:

1. Less than 90% of the business income of the corporation for the last taxation year was from the provision of services.
2. The corporation is not a professional corporation.
3. The particular shareholder hold shares with at least 10% of the votes and fair market value of the corporation.
4. Under 10% of income is derived directly or indirectly from one or more related businesses (except the business in question).

When applied to RealtyCo in this example, conditions 2, 3, and 4 will be met. The issue becomes condition 1 being is less than 90% of the business income for the last taxation year is from the provision of services?

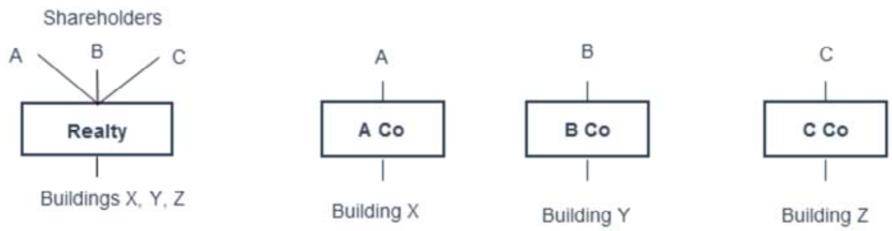
It is normal for a real estate company involved in renting commercial real estate to receive a management fee. This is typically a percentage of the expenses. Such a management fee is not typical in residential real estate. Thus if the business of the corporation is the rental of commercial real estate, part of the income is a management fee, and it is possible that this could be business income from the provision of services. These services are the management of the real estate, payment of expenses etc. on behalf of the tenants.

If RealtyCo earns (very likely) business income and the management fee represents less than 90% of total (gross) business income, the excluded share exception would be met.

2. Real Estate Corporation - Butterfly

Butterfly into separate corporations so no common ownership.

Cannot be source individual in respect of yourself.



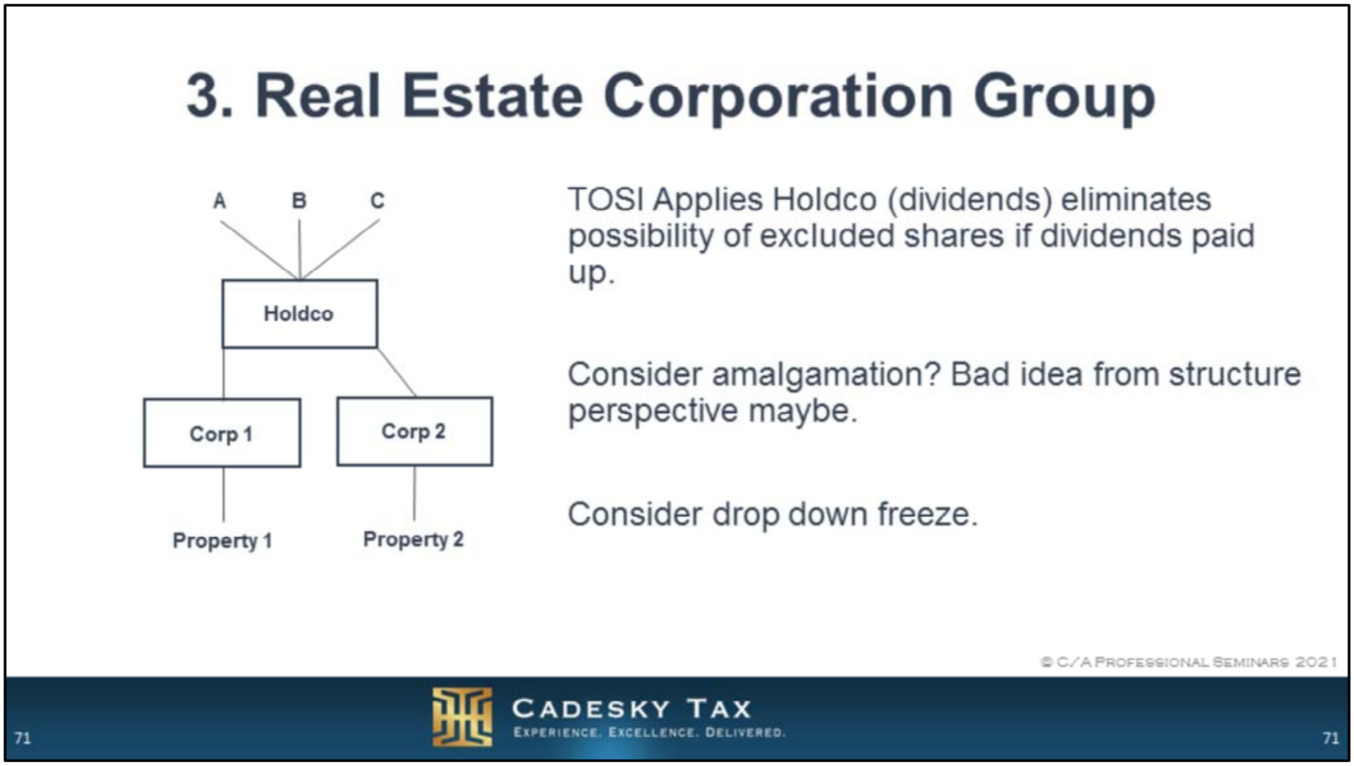
Drastic and costly solution for solving TOSI issue.

May not be feasible or desired. May not be needed.

In this continuation of the example, a butterfly reorganization is considered as an alternative to the TOSI rules. The real estate corporation is split up between the shareholders so that each shareholder has a corporation with a building. Assuming that the shareholders (assumed to be brothers) do not become involved in each other's corporations, then there would not be a source individual and TOSI would not apply.

The CRA stated in 2021 STEP Q4 – 2021-0883141C6 that the analysis on whether TOSI applies on the post-butterfly structure is the same as the pre-butterfly structure.

In other words, there is no need to go through a costly exercise to butterfly buildings out in order to solve the TOSI issues.



In this third example, there is a more extensive group involving a holding company and two operating companies, which each holding a rental property. Even if one can satisfy the conditions required of the nature of the income (discussed above), the shares of Holdco would not qualify as excluded shares on the basis that they derive income from a related business being Corp1 and Corp2, probably through the payment of dividends. The cash flow from Corp1 and Corp2 funds the payment of dividends to Holdco and then to the shareholders. Thus the excluded shares definition would not be met as a result of not meeting condition 4.

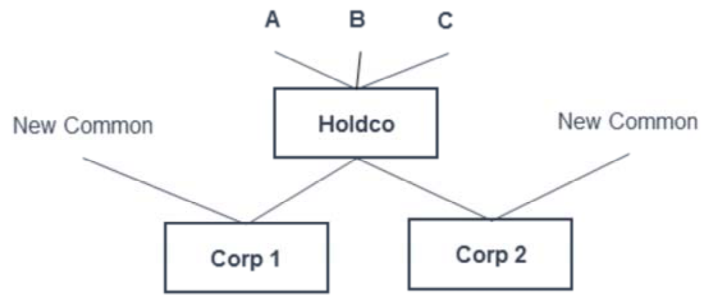
Recall from previous slides that second generation income in Holdco does not give rise to TOSI (even capital derives from Opco) – 2018-0771861E5, APFF 2018 A9c – 2018-0768801C6.

If Holdco has both second generation income and income from Opco, must trace source of funds when dividend is paid. APFF 2018 Q11 – 2018-0768821C6

If Holdco has no second generation income, then excluded share is not met.

Consider alternatives to structure out of TOSI rules.

3. Real Estate Corporation Group



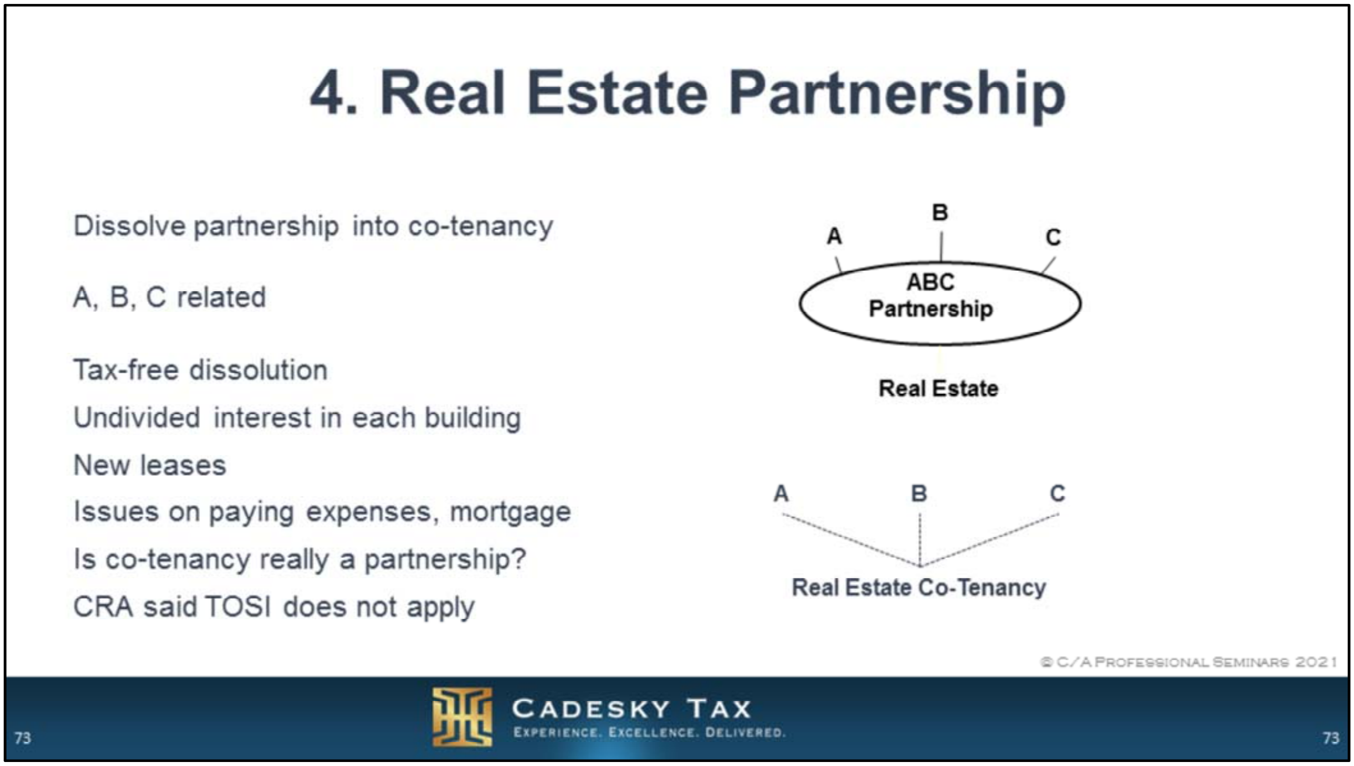
New common must be worth 10% of value per individual and have at least 10% of votes

Need to pay substantial amount for common share issuance to bring value to 10%

In this circumstance, it might be possible to reorganize the shares of Corp1 and Corp 2. The existing shares would be converted into fixed value preferred shares. Before this a dividend might be paid to reduce the value of Corp1 and Corp2 by as much as possible. Then new common share equity would be issued to A,B and C sufficient for each of them to have 10% of the votes and 10% of the value. Depending on the circumstances, this might require a very substantial contribution to common share equity. Aside from the fact that from a credit proofing point of view this is undesirable, it may also require a significant cash outlay.

However, if this is done, and if the nature of the income in Corp1 and Corp2 can meet the requirement for excluded shares in condition 1, the new common shares might qualify as excluded shares, and dividends on the new common shares would then be exempt of TOSI. (Before dividends can be paid on the common shares, there would have to be some retained earnings allocable to the common shares or, as a minimum, some value attributed to the common shares. Thus the structure requires the passage of time in order to be effective and allow dividends to be paid on the common shares).

The preferred solution here is an amalgamation rather than the drop down freeze.



In this example there is a partnership of A, B and C (ABC Partnership). It holds rental real estate. The rental income derived via a partnership is subject to TOSI potentially as it is split income.

A co-tenancy which produces rental income should fall outside of the TOSI rules even though the co-tenants are related persons, because such rental income is excluded from the definition of what constitutes split income. It is therefore not necessary to find an exception to the TOSI rules because the income is not split income to start with.

Existing real estate co-tenancies should be exempt of the TOSI rules, and creation of the new co-tenancy should also give rise to rental income exempt of the TOSI rules.

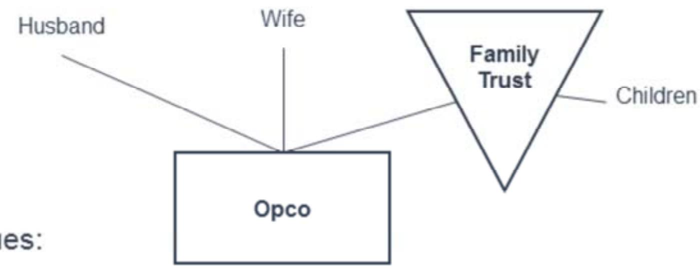
The partnership can be dissolved on a tax free basis such that the partners each have an undivided interest in the real estate. The issue becomes whether or not the co-tenancy is actually a partnership. Simply calling the form of organization a co-tenancy, and changing the form of legal title is not sufficient to defeat an argument that the arrangement is in substance a partnership.

The more passive the co-tenancy activities the more likely it will not be a partnership. However, if the co-tenancy itself pays expenses, and has a mortgage where mortgage payments are made, then it may be more difficult to support that this is not a partnership. Having outside management attend to every aspect of the real estate would assist in finding that it is a real estate co-tenancy.

This is ultimately a legal question and a question of fact, but this type of planning should be approached with caution.

2020 STEP Q7 – 2020-0837611C6 - CRA said that if the business is truly a co-tenancy and not a partnership, then TOSI does not apply.

5. Service Opco



Excluded shares issues:

a) Under 90% from services

   Need gross revenue from non-service at least 10%

   Sell goods (barber shop now selling alcohol)

b) at least 10% of shares by votes and value

Need to distribute Opco shares from trust, poor structure for family?

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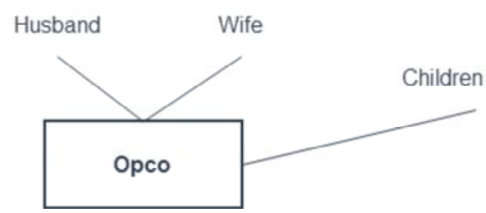
While the shares of Opco may be excluded shares to husband and wife (assuming each meet the 10% test), they will not be excluded shares to the children who are beneficiaries of the family trust.

Distribution of the Opco shares will work provided children are at least 25 (in the year) and hold 10% or more of votes and value each.

5. Service Opco



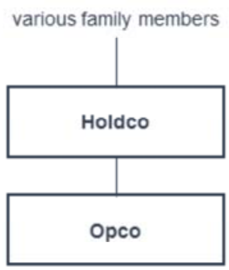
- Sells goods (10% of gross revenue)
- Children age 25 and older
- 10% test of ownership met
- Excluded shares
- Give up control and protection of trust

It is therefore necessary in this example to remove shares from the family trust (at least 10% of votes and value per child) where upon TOSI would not apply for children age 25 and older.

It may well be desirable to keep the majority of the shares in the family trust, and consequently one could consider a program of distributing shares to each beneficiary so that the 10% test is met and then carrying out share redemptions. The family trust would distribute sufficient common shares so that each of the children age 25 and older had at least 10% of votes and value. Then the shares would be redeemed at least in part producing dividends. A redemption could also be carried out for husband and wife, so that the share ownership remained proportionate. Of course this is not necessary if the family trust is to be abandoned completely, and the shares distributed to the children (provided that each holds at least 10%).

The trust could retain shares for children under age 25 since the excluded shares exception does not apply for them.

6. Opco and Holdco



Excluded shares:

a) Holdco needs some non-service business income

b) Holdco must derive under 10% of income from Opco (related business). Dividends are income to Holdco

c) 10% of shares by votes and value

Possible solution – drop down structure

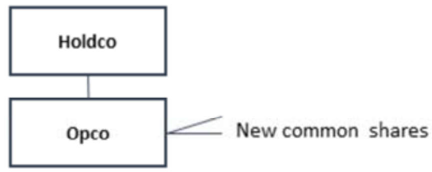
In this example there is an operating company which is assumed to meet all of the conditions for excluded shares, but it is owned by a holding company. Because of the mere existence of the holding company, the fourth condition for excluded shares is not met, since the income is derived by Holdco from Opco. Thus the shares of Holdco cannot be excluded shares. This illustrates the arbitrary nature of these rules.

Recall from previous slides that second generation income in Holdco does not give rise to TOSI (even capital derives from Opco) – 2018-0771861E5, APFF 2018 A9c – 2018-0768801C6.

If Holdco has both second generation income and income from Opco, must trace source of funds when dividend is paid. APFF 2018 Q11 – 2018-0768821C6

The solution is to use the “dropdown” structure previously explained in the real estate example.

6. Opco and Holdco



- Issues new shares from Opco
- Need to value Opco
- Can strip retained earnings by paying dividend to Holdco, reduce the value
- Family members need cash to subscribe to shares
- Each must have 10% of votes and value
- Applies only to age 25 and over

The idea would be to pay up a dividend from Opco to Holdco sufficient to reduce the value of Opco, and then exchange the common shares into preferred shares. In paying the dividend, subsection 55(2) needs to be considered as to whether or not the dividend produces a capital gain. That said, having a capital gain is probably an advantage as opposed to a disadvantage.

Then the affected family members subscribe to new common shares of Opco sufficient that each has 10% of votes and value. Then for persons age 25 and older, the Opco common shares will be excluded shares.

If certain family members are active, and meet the exception , they do not need to become new Opco shareholders. So the target persons are the inactive family members age 25 and older.

It may take time for the Opco common shares to grow in value to meet the 10% of value test.

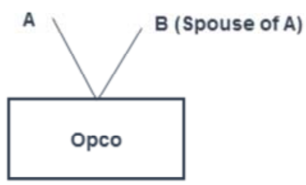
6. Opco and Holdco

- Excluded share test – less than 90% of income not received from a related business. Prior year test.
- Possibly pay dividend by Opco to Holdco every other year

If Holdco receives a dividend from Opco every other year, does this avoid the less than 10% from a related business requirement? Possibly not because the later dividend paid by Holdco is from income derived from Opco. Risky strategy. Amalgamation is better if feasible.

7. Two Share Classes

If family not in top bracket, do not pay dividends to inactive family members. Reorganize shares, two common classes. Beware of attribution.



- A is active, B is not
- Income $100,000
- Better if all incomes goes to A than 50/50 since A not in top bracket
- Change to two classes of common shares, class A common, class B common.
- Pay dividends only on class A common, or switch to salary

In this example, A and B are spouses and Opco earns around $100,000 of income after tax. A and B take all of the income out each year. A is actively engaged in the business and B is not. Dividends paid to B are therefore subject to TOSI. Since if all the income was allocated to A, it would not be sufficient for A to be in the top tax bracket, it makes sense for A to receive all of the income and for none of the income to go to B.

This means that if dividends are to be paid to A and not to B, some methodology has to be adopted for this. One temporary methodology could be redemption of shares by A, but over the longer term this may not be feasible. Another approach is for B to transfer the shares to A, but then the income attribution rules have to be considered. The third approach is to have discretionary common shares, so that dividends can be paid on class A common shares and not on class B common shares. (However, if all of the income is paid on the class A common shares every year, and nothing is paid on the class B common shares, there is a question as to whether B has conferred a benefit on A, such that the income received by A could be directed back to B. No view is given in the possible application of subsection 56(2), except to note that case law has held that this provision should not be applicable (the Neuman case) to dividends and that multiple classes of common shares are recognized in the Release in the examples which are given).

Another simple alternative is to abandon dividends and pay a salary to A.

7. Two Share Classes (continue)

Table illustration of the taxes

Assume $100,000 of income to be paid as non-eligible dividend

	50/50 – no TOSI	50/50 – yes TOSI	100% to A
A – taxes	$ 3,500	$ 3,500	$ 17,200
B – taxes	$ 3,500	$ 23,500	$ nil
Total taxes	$ 7,000	$ 27,000	$ 17,200
Tax rate	7%	27%	17.2%

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There is a large tax increase here ($7,000 to $17,200) but not as bad as B having TOSI ($27,000).
Figures are approximate.

8. Become Active

- Involve family members in the business and document to justify reasonableness.
- Keep track of hours worked (20 per week is magic number)
- Time sheets for family members.
- What if several corporations, several businesses – 20 hours in each?

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One way to be exempt of the TOSI rules is to become actively engaged in the business on a regular, continuous and substantial basis. Working 20 hours a week on average throughout the part of the year while the business is carried on is a safe haven to meet this requirement. However, this means that family members will have to potentially demonstrate their active engagement, which might lead to a request from CRA for evidence as to the time spent. There may well be situations where a client is prepared to become more actively engaged in the business, meeting the 20 hour a week on average threshold, and changing the way in which the business is carried on, in order to be exempt of the TOSI rules. One example would be property management of a real estate company. Taking the property management "in house" and becoming involved with it could be a feasible alternative in certain circumstances.

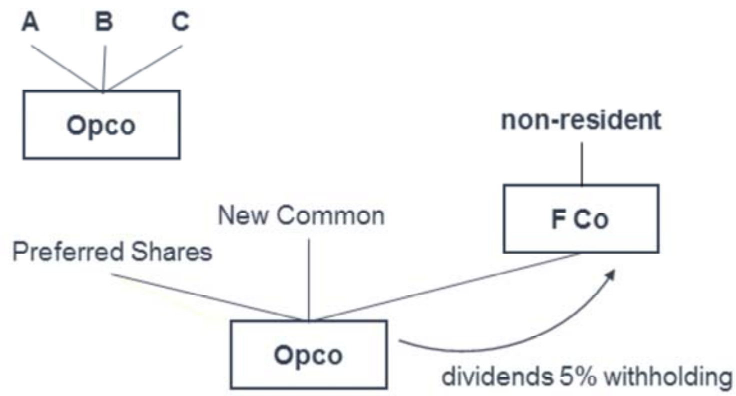
CRA indicated in 2018-0761601E5 that a taxpayer needs to trace and keep separate record of number of hours worked for each business. If a corporation has income directly or indirectly from two or more businesses, tracing of hours is required in order to meet the test. STEP 2019 Q3 – 2019-0799901C6 - CRA indicated that if the business requires fewer than 20 hours, individuals could still meet the "excluded business" test if they are actively engaged on a regular, continuous and substantial basis.

In one case a doctor had a professional corporation. The spouse was the shareholder of the management company. Ordinarily one would imagine that dividends paid by the management company to the spouse would be TOSI. However, the spouse was actively engaged in management of the practice, serving full time as the office receptionist. Even though the reasonable remuneration for the spouse would be commensurate with a person performing the role of receptionist, once the person does meet the test of active involvement, there is no limitation on the amount of dividends which are considered reasonable. For example, assume that the role of receptionist, carried out 20 hours a week is worth $20,000 being what it would cost for an unrelated person to be hired to perform this service. This does not mean that dividends paid to the spouse from the management company above $20,000 are unreasonable, and therefore TOSI.

STEP 2019 Q4 –2019-0799911C6 - If an individual works for 20 hours+ a week on average for the year, despite earning dividend income in excess of a reasonable equivalent salary, the dividend income is not TOSI.

9. Non-Resident

Involve non-residents in ownership. Issue them shares.



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One alternative is to consider having ownership held by non-residents. Such an arrangement has to be reasonable in the circumstances, and cannot simply be a conduit where funds are transferred to a non-resident and then back to the Canadian resident shareholders. In the right circumstances, where it is truly intended that a non-resident benefit from dividends and appreciation in value in a corporation (Canadian or foreign), a freeze type transaction could be carried out with new common shares issued to the non resident. Dividends paid to the non-resident would be subject to withholding tax. The basic rate is 25%. The rate is typically reduced to 15% for dividends paid to an individual resident in a treaty country, and could be as low as 5% if a foreign holding company is used.

It is noted that whether or not this plan is viable will depend on the particular family situation.

9. Non-Resident

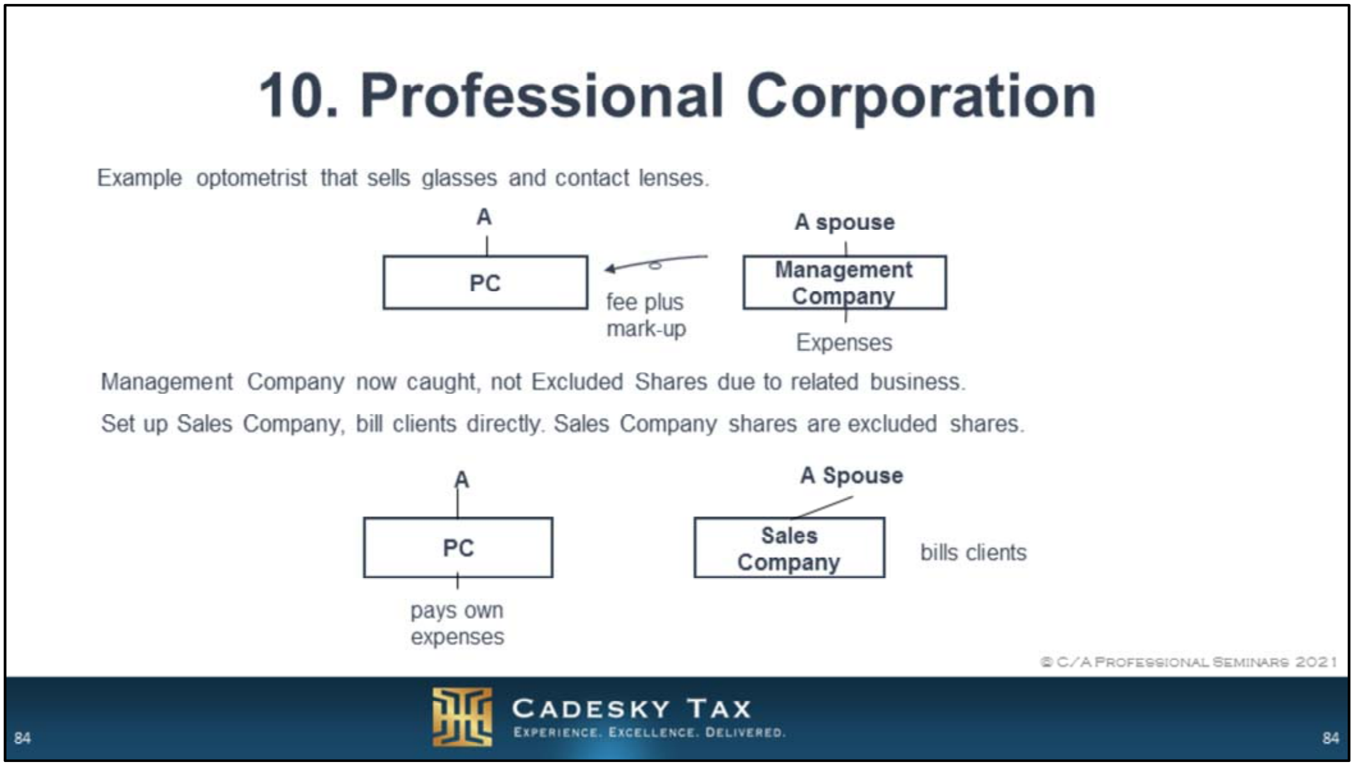
Irene set up family trust many years ago. Beneficiaries are Irene, children, parents, siblings. Assume the trust is not a reversionary trust.

In practice dividends always paid out to Irene and children 18 and over.

Now TOSI applies. Several beneficiaries are non-resident.

Pay out income to non-resident beneficiaries. Likely 15% or 25% withholding tax (subject to tax in foreign country possibly).

Cannot have "round robin" where funds gifted back.



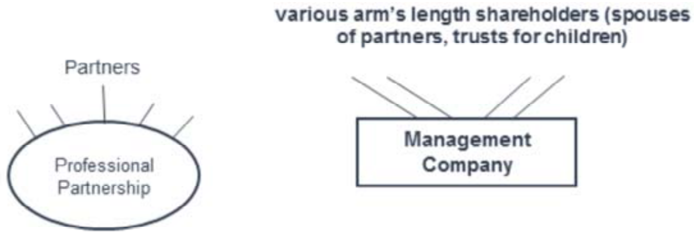
In this example a professional corporation sells products as part of its business. The example given is an optometrist that sells contact lenses and glasses.

The idea is to split the business so that the sales are carried out through a separate corporation. No fees are paid between the professional corporation and the sales company, except perhaps for some commission or referral fee which the sales company might pay to the PC. Importantly the PC does not make payments to the sales company. The idea is that the sales company qualifies as excluded shares.

Whether this type of restructuring is feasible or not will depend very much on the circumstances. It will be important for the sales company to act autonomously, without services being provided by the professional involved in the PC. Otherwise that person may become a source individual in respect of the sales company and the sales company may then be a related business.

This type of planning needs to be carried out with considerable care.

11. Management Company Widely Held



- No shareholder has 10%
- Provided no source individual actively engaged in Management Company on a regular basis, not a Related Business.
- Large professional firm, managed by non-partner employees. Not a related business. No source individual. Under 10% ownership by multiple family members including trusts.
- Can income split from age 18.

This example shows a widely held management company. For example, a large law firm or medical partnership might have a management company which receives a fee. Spouses or trusts own the management company. Each owner is under 10%. E.g. family A has 15% where 7% owned by spouse, 8% by family trust for children.

Assume that none of the professionals are involved with managing the management company, which is done separately by independent management.

This allows dividends to be paid exempt of the TOSI rules for persons age 18 and over.

12. Timing of Planning

- Income tests refer to prior year.
  - If offside in 2021, not excluded share for 2022.
  - Means planning now for 2021 to qualify for 2022 (by meeting the income tests in 2021).

- Makes planning very prospective

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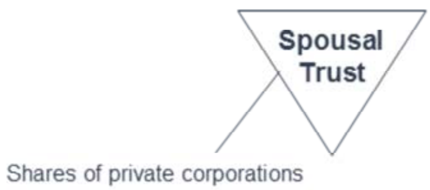
The tests to determine income (under 90% from services, less than 10% from another related business) for the excluded shares definition (tests 1 and 4) are based on the income of the corporation for the taxation year ending before the dividend is paid.

This means if offside last year, don't qualify for this year.

13. Use of Trust

- Howard is a top rate taxpayer, married.
- TOSI is not an issue but he cannot reduce TOSI with donations
- Howard sets up a spousal trust, transfers shares to the trust.



Dividends (from share redemptions) and capital gains taxed in trust at top rate.
Trust makes donations. Donation credit available. No TOSI issues for trust.

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CRA STEP Q8- 2020-0837621C6 – confirmed that no donation credit is available to reduce TOSI

CRA 2019-0802331E5 - CRA clarified that taxable capital gain picked up as TOSI on its own, no offsetting allowable capital loss even if from TOSI source.

14. Sale of Shares to PubCo

- Erica is not active. Has shares of EZCo (not small business corporation) being sold to public company (PubCo) for PubCo shares.
- Gain to Erica is TOSI (assume).

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In this example, Erica is selling the shares of EZCo to a public company. Assume that the gain is TOSI. Erica does not want to have a gain which is subject to TOSI, because for example she may have capital loss carry forwards which can be applied or she might not be a top rate taxpayer.

Thus, she is interested in planning to avoid the TOSI result.

14. Sale of Shares to PubCo (continue)

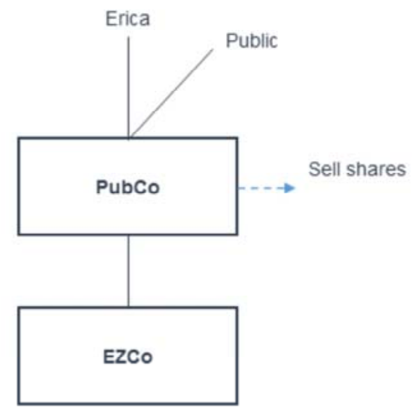
Planning

Erica rolls EZCo shares to PubCo for PubCo shares (no gain).

Erica sells PubCo shares in the market.

Gain not TOSI as public company shares.

Practical challenge: Getting PubCo to agree to a rollover, since PubCo would get low basis in EZCo shares, and thus lose opportunity to bump underlying assets.



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In this example, Erica transfers the shares to Pubco on a rollover basis, in exchange for shares of Pubco. Erica then sells shares in the market and realizes a capital gain from the sale of Pubco shares. Since Pubco is a public company and not a private company, The gain is not TOSI. It losses its character as TOSI, and the capital gain is not subject to the TOSI rules.

Another variation of this type of planning could be done with a private company where Erica transfers the shares of EZCo to a private company in exchange for shares. The private company is not a related business, and Erica can then sell the shares of the unrelated private company to the shareholders.

The interesting point is that the TOSI rules do not contain tracing rules. If shares would be subject to TOSI, and are exchanged for other shares, it is possible for these other shares to not be subject to TOSI if not a related business or excluded shares.

15. Inheritance

Under age 25, income from property received from inheritance may not be TOSI. Conditions are:

a) Under 25 – must receive from a parent or

b) Under 25 but enrolled in full-time university – can receive from anyone or

c) Under 25 and claims disability tax credit – can receive from anyone

But what about taxpayers age 25 and above?

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Inheritance received on death of a parent (a) or anyone (b) or (c) (relevant for individuals below age 25), no TOSI.

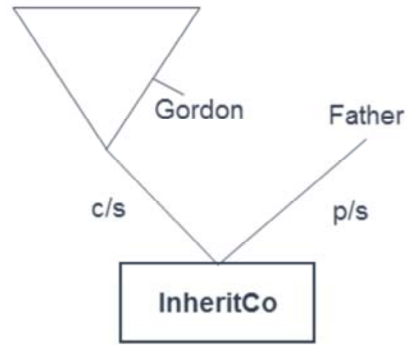
15. Inheritance

Example

Gordon (age 18 or older) is a beneficiary of a family trust that owns common shares of InheritCo

Normally dividend paid on the common shares of InheritCo is TOSI to Gordon

Gordon cannot claim excluded share because he does not own InheritCo shares directly



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Note inheritance rule on active attributes applies at age 18, overlaps with previous rule in age 18-24 range.

15. Inheritance

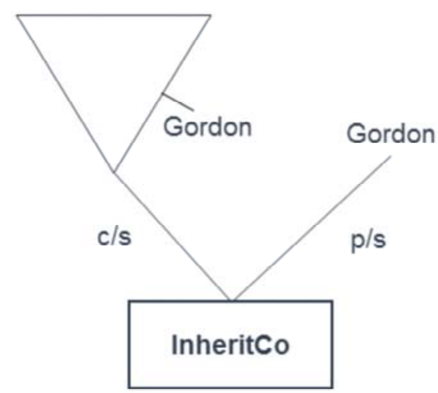
Example

Father passes away and Gordon inherits the preferred shares and also all the "active attributes" from father

Dividends paid from InheritCo to Trust and to Gordon not TOSI anymore

Gordon claims "excluded business" exception for dividends received (common and preferred)

The preferred share is the golden share that gives Gordon the golden status of active attributions



STEP 2019 Q6 – 2019-0799941C6 - CRA notes that if an individual inherits a share (golden share) from an active parent, individual attains the active status of parent. Dividend paid on shares (including ones that are not received from inheritance) would be excluded amounts. Can apply to multiple people as long as they all inherit at least 1 share.

CRA also clarified that the active status can pass on to multiple generations.

15. Inheritance

Cautionary Notes

Based on the strict wording of the Act, a nominal amount may need to be paid on the preferred share in order for Gordon to achieve the golden active status.

The golden active status is only in respect of the business of the deceased.

If there is a new business in InheritCo, Gordon does not have golden active status on that business.

STEP 2019 Q6 – 2019-0799941C6 - CRA notes that if an individual inherits a share (golden share) from an active parent, individual attains the active status of parent. Dividend paid on shares (including ones that are not received from inheritance) would be excluded amounts. Based on the wording of 120.4(1.1)(b), at least a nominal amount of income may need to be paid in order for the individual to achieve the active status.

There is a view that a substitution of the golden share for another share may not jeopardize the individual's active status as long the individual achieves the active status from inheritance in the first place (provided at least a nominal amount of income is paid on that golden share first).

16. Preferred Beneficiary Election

Preferred beneficiary (PB):

- Severe and prolonged impairment (any age)

  or

- Age 18 or older and dependent due to infirmity and income (excluding income from trust) does not exceed basic personal amount (2021 - $13,808)
- Beneficiary is settlor of trust, spouse or common law partner, child, grandchild, great grandchild.

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Preferred beneficiary is a beneficiary of a trust, and settlor or spouse (common law partner), child, grandchild, great grandchild of settlor.

Severe and prolonged impairment or, if age 18 or older, dependent due to infirmity and other income under personal amount.

Once PB status, TOSI exemption possible.

16. Preferred Beneficiary Election

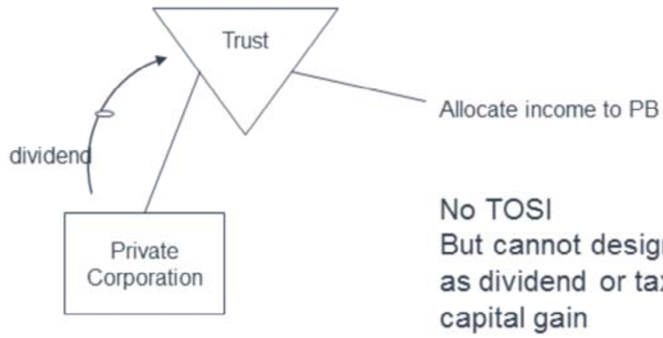
- Trust can allocate income to PB, does not need to be paid or payable (but can be)
- No TOSI if amount not designated as taxable dividend or taxable capital gain by trust (means amount is regular income)
- But if under 18, income attribution can apply so beware of this

Reason: Income allocated to PB as regular income not on list of split income amounts

2018-0759521E5 and CRA STEP 2019 Q13 & 14 – 2019-0798501C6 & 2019-0798511C6 indicate that no TOSI will apply under the PBE election because the PBE election results inclusion to the beneficiary pursuant to 104(14), instead of 104(13) or 105(2).

However, if the trust designates the income as taxable dividend under 104(19), then the income distributed would be considered TOSI. CRA provided guidance to avoid such designation by indicating on the T3 slip to show the amount distributed as "Other Income" under box 26.

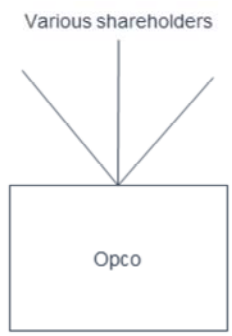
16. Preferred Beneficiary Election



No TOSI
But cannot designate as dividend or taxable capital gain

Strange result. Probably not intended. In other words, it was missed on drafting because no commentary on this in technical notes or initial CRA examples.

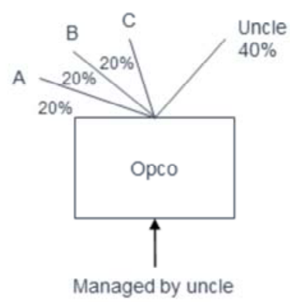
17. Widely Held Private Corporation



If ownership under 10% by FMV and no source individual managing Opco, no TOSI

Easy way around the rules in the right circumstances. Multiple people all under 10%.

17. Widely Held Private Corporation



A, B, C are siblings
Opco is related business due to siblings at 10% or more

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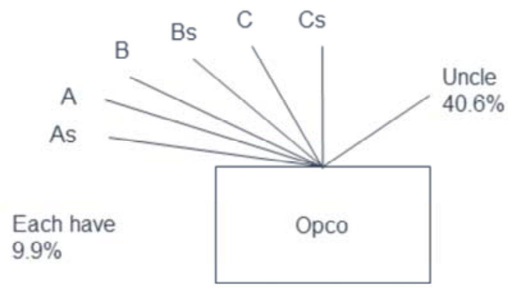
Because business is managed by uncle, not a related business for activity test (good).

17. Widely Held Private Corporation

Plan – A, B, C each sell 9.9% to spouses (make sure attribution rules avoided by FMV sale)

– A, B, C each sell .2% to uncle



Not related business

Each of A, As, B, Bs, C, Cs under 10% of FMV. Opco not a related business.

Change Remuneration Strategy

- Income split with non-TOSI income
- Keep income at corporate level (defer)
- Limit dividend income to reasonable amount for persons a bit but not substantially active
- Create capital gains at corporate level, pay out CDA
- Create personal capital gains on SBC shares, use ACB to extract funds (but strategy has risks)

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One point of view to plan around TOSI is to change the remuneration strategies for owner-managers.

Owner-manager can simply keep income at corporate level and defer the extraction of income to be used personally. Reinvest the income in the corporation for the business.

If dividend needs to be paid to inactive shareholders, limit the amount of dividend income to a reasonable amount such that the reasonableness factor can be used to avoid recharacterization of dividend to TOSI.

Alternatively, owner-manager can create capital gains to extract capital dividends as shareholder remuneration, to inactive person. The shareholder can later use the capital dividends to split income with family members using prescribed rate loans.

See previous notes on capital gains strategies.

Change Remuneration Strategy

Shareholder Loan

- Sell shareholder loan to spouse for note at prescribed rate (1%)
- Pay interest on shareholder loan at reasonable interest rate (say 7%)
- Spouse nets 6% interest rate spread
- Argue reasonable amount based on capital at risk, no TOSI

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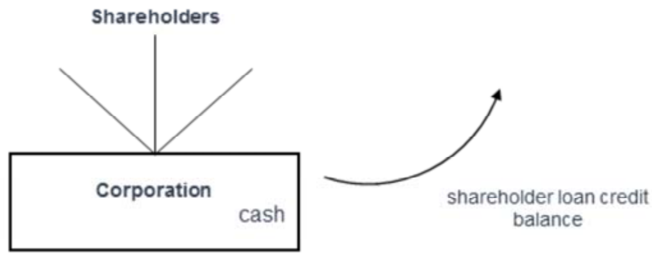
To avoid attribution, interest at prescribed rate needed. Sell shareholder loan to spouse for 1% prescribed rate loan back. Spouse receives interest on shareholder loan from company. Check to make sure interest is deductible on payout, redo loan if in doubt.

Shareholder Loan Credit Balance

Income split in other ways to some level such as family trust and investment income. Fund by withdrawal of corporate assets.



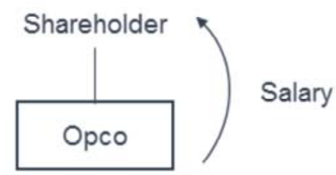
Repay shareholder loan, income split at personal level with investment income.

An alternative to income splitting with income from private companies is to set up a structure to split income at the personal level. This can be done with investment income, and if done properly to avoid the attribution rules (through use of a prescribed loan), there is no minimum age.

In this example, shareholders have a loan owing from the corporation. The loan is repaid, and capital then becomes available at the personal level for investment. This is used in an income splitting structure with public securities possibly with a trust.

Salary

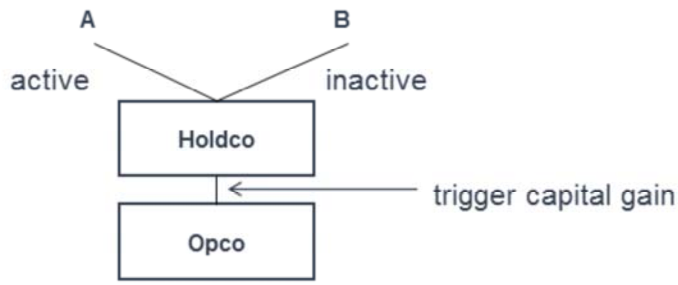
- Switch to salary, defer the rest in corporation. Pay reasonable amounts.
- No split income rules for salary but beware denial of deduction to corporation, if unreasonable.
- Could also result in appropriation of property if unreasonable (subsection 15(1)), then TOSI.
- Especially useful for under age 25 but has risks if unreasonable



Instead of paying dividends, switch the remuneration strategy to salary, and pay it in a reasonable amount. This is particularly helpful for people under the age of 25 who are involved in the business. While dividends would be TOSI (absent very stringent limits), the test for salary is overall reasonableness. This may produce a better result.

Note that an unreasonable salary could possibly cause the corporation to be unable to deduct the salary and be an appropriation taxable under subsection 15(1) and thus TOSI.

Capital Gain – Existing Holdco



Pay taxable dividend to A

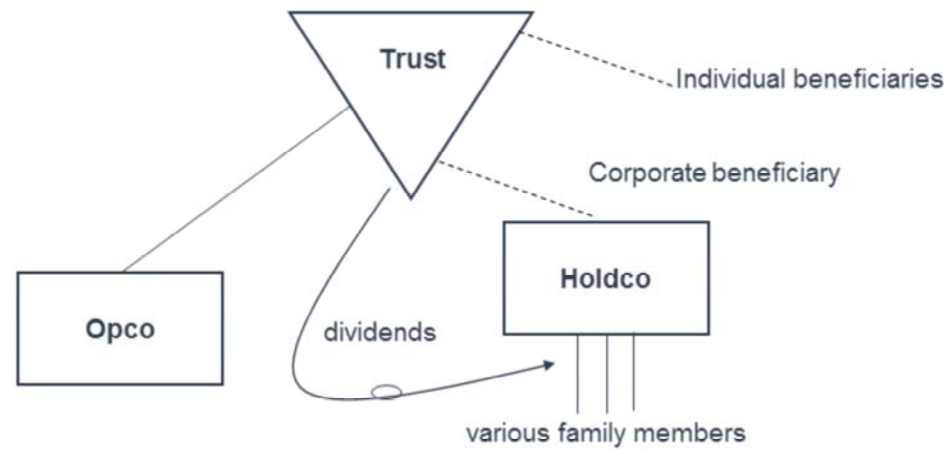
Pay capital dividend to B

Either two classes of common shares or by redemptions

B uses investment funds a personal level to produce income

In this example, the capital gain is triggered in Holdco from a reorganization of Opco shares. The capital gain is paid out from Holdco. A is active in the business and receives the taxable dividend. B is not active in the business and receives a capital dividend. While this does not achieve income splitting, it could generate sufficient funds that an income splitting structure at the personal level could be undertaken. It also provides cash to the shareholders at a significantly lower tax cost than would otherwise be the case.

Retain Income at Corporate Level



As an alternative to paying tax at the top tax rate under TOSI, one can consider deferring income in the corporate group. In order to do this, and keep an operating company pure of having excess investment assets, the trust sandwich type structure could be useful.

Many families will reject the idea of paying tax at the top tax rate (47% approximately on the ineligible dividend). The active family members may take extra income to compensate but still staying below the top bracket.

Summary

Income splitting very rewarding but very difficult

Wealthier families more able to do

Up to age 18, investment assets and prescribed rate loan with trust

Limited scope otherwise except inheritance, no parent in Canada

Age 18-24, no related business plan

Age 25, excluded share

Spouse, age 65 exemption

With spouse, children under 18 need to avoid normal attribution rules also

Complex area, lots to go wrong

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