Income Sprinkling:
Where Are We Now?

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On December 13, 2017, the Department of Finance released a number of updates relating to the income sprinkling proposals (originally announced on July 18, 2017). Below is a summary of the proposals as they are currently drafted.

Individuals that receive certain types of income derived from a "related business" will be subject to Tax on Split Income (TOSI) unless an exclusion applies. TOSI is subject to the highest personal tax rate with no benefit of personal credits.

Commencing on January 1, 2018 TOSI will potentially apply in respect of amounts that are received by adults, not just those under 18 years. The application of TOSI to individuals under age 18 (commonly known as the "kiddie tax") would not generally change.

Income Streams at Risk

Private corporation dividends, partnership allocations, trust allocations, capital gains, and income from debt may all be subject to TOSI.

Related Business

A related business includes any business, where another individual related to the recipient of income does any of the following:

- personally carries on the business (this means income from a sole proprietorship to a related person can be subject to TOSI);
- is actively engaged in the business carried on by a partnership, corporation or trust;
- owns shares of the corporation carrying on the business;
- owns property the value of which is derived from shares of the corporation having a fair market value not less than 10% of the fair market value of all of the shares of the corporation; or
- is a member of a partnership which carries on the business.

The definition is broadly drafted to capture income derived directly or indirectly from the business.

Exceptions and Exclusions

Several exclusions from the TOSI rules for adult individuals have been introduced.

Some exclusions depend on the age of the taxpayer at the start of the taxation year. Different rules apply to taxpayers at least 17 years of age at the start of the year (i.e. these exceptions are first available in the year the taxpayer turns 18) and to those at least 24 years of age at the start of the year (i.e. these exceptions are first available in the year the taxpayer turns 25). For the purposes of this analysis, the first age group will be referred to as those "over age 17" while the second group will be referred to as those "over age 24".

The exclusions are as follows:

1. **Excluded Business:** A taxpayer over age 17 will not be subject to TOSI on amounts received from an excluded business. An excluded business is one where the taxpayer is actively engaged on a regular, continuous and substantial basis in either the year in which the income is received, or in any five previous years. The five taxation years need not be consecutive.

   An individual will be deemed to be actively engaged in any year where the individual works in the business at least an average of 20 hours/week during the portion of the taxation year that the business operates. A person not meeting this bright line test may also be "actively engaged" depending on the facts, but this will carry greater risk of challenge by CRA.

2. **Excluded Shares:** A taxpayer over age 24 will be exempt from TOSI in respect of income received from excluded shares, including capital gains realized on such shares.

   Many restrictions apply to qualify for this exclusion, which makes it quite complex and uncertain. The taxpayer must directly own shares accounting for at least 10% of the votes and value of the corporation's total share capital. For 2018, this test can be met by December 31. In later years, it must be met when the income is received. Also, the corporation can not be a professional corporation (i.e. a corporation carrying on the business of an accountant, chiropractor, lawyer, dentist, medical doctor or veterinarian). Further, it must earn less than 90% of its business income from provision of services. Finally, substantially all of its income (generally interpreted as 90% or more) must be derived from sources other than related businesses, which will be problematic for holding companies.

3. **Reasonable Return:** TOSI will not apply to amounts which reflect a reasonable return.
   - For taxpayers over age 24, an amount which is reasonable is based on work performed, property contributed, risks assumed, amounts paid or payable from the business, and any other factors in respect of the business which may be applicable.
   - For taxpayers over age 17, but not over age 24, the rules are more restrictive. Only a reasonable return in respect of contributions of capital will be considered.

4. **Certain Capital Gains:** Although TOSI will be expanded to apply to capital gains of interests in entities through which a related business is carried on, some gains will be excluded. For example, capital gains arising due to a deemed disposition on death. Also, capital gains on qualified farm or fishing property, or qualified small business corporation shares will generally be excluded from TOSI.

5. **Retirement Income Splitting:** The TOSI rules will not apply to income received by an individual from a related business if the recipient's spouse was age 65 in or before the year in which the amounts are received and the amount would have been excluded from TOSI had it been received by the recipient's spouse.

6. **Additional exclusions** apply for some income from inherited property and property acquired as a result of a relationship breakdown.

This new draft legislation is a substantial change from the current rules. The provisions are lengthy, complex and nuanced, and it is likely that additional concerns and challenges will be identified. It is uncertain whether there will be further changes, given the concerns which have already been identified, as well as the recommendations of the Senate Finance Committee released on the same date as these proposals.

If you would like to discuss any of these items further or require assistance, please do not hesitate to contact us at (905) 549-8463.