

Income Sprinkling Rules Updated

Income sprinkling rules, the second attempt was released on December 13, 2017.

After the business community and the Senate Community on National Finance asked for a delay on the rules, the government released the updated draft rules on income sprinkling. The rules are effective for 2018 and future tax years and some guidance has been released by the Canada Revenue Agency on these rules.

As the draft legislation has just been released we have summarized some of the main points. As this draft legislation has many new components we will provide our clients with updates as we further explore the supplementary documentation.

The main points in the updated version of the income sprinkling rules provide exemptions to the tax on split income "TOSI" which are as follows:

- **Amount paid to the business owner's spouse, provided the owner meaningfully contributed to the business and is age 65 or older.** For example, if Sally is a business owner that is 65 years of age, and has worked in the business on a full-time basis for the past 20 years, due to the significant labour contributions, the business would be an excluded business for the application of TOSI even for any dividend distributions made to Sally's spouse who has not worked in the business.
- **Adults aged 18 or over who have made a substantial labour contribution (generally an average of at least 20 hours per week) to the business during the year, or during any five previous years.** For example, Pierre is a business owner and has his kids, Justin (22 years old) and Sacha (20 years old) working for him in the business. Both Justin and Sacha work on a full-time basis (20 hours or more per week) for 2017 and 2018. Under this scenario dividends paid to Justin and Sacha should not be subject to TOSI because both have made significant labour contributions.
- **Adults aged 25 or over who own 10 per cent or more (must be 10 per cent of votes and value) of a corporation that earns less than 90 per cent of its income from the provision of services and is not a professional corporation.** For example, Frank Morneau has run a benefit consulting firm since 1966 and his son Bill joined the firm in 1987. Bill has worked his way up to president and Chief executive officer (CEO) of the firm in 1998. During this time Bill acquired 25% of the firm's shares which he had to sell in 2015. The proceeds of the share sale had been transferred into a holding corporation that for the last 2 years and has only earned investment income on the money invested which has been paid out to the shareholders as dividends. During 2018 Bill who is now 56 year of age and owns 50% of the shares of the holding company will receive a dividend from the holding company which should not be subject to TOSI. The reason is he is older than 25 and owns 50% of the holding company and the income earned by the holding company neither earns income from the provision of services nor meets the definition of a professional corporation.
- **Individuals who receive capital gains from the sale of qualified small business corporation shares should not be subject to TOSI.** For example, If Pierre sold a business that was a qualified small business corporation and his sons Justin and Sacha each had owned shares which were included in the sale. Even if dividend payments to Justin or Sacha would be subject to TOSI, the capital gains should not be subject to TOSI.

If the exemptions noted above do not apply to family members aged 25 or over, payments of dividends to these family members would still be subject to a reasonableness test to determine how much income, if any, would not be subject to the highest marginal tax rate. In certain cases, adults aged 18 to 24 who have contributed to a family business with their own capital will be able to use the reasonableness test on the related income.

We are reviewing the draft legislation in depth and will provide our clients with additional updates as developments occur.