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Canadian Tax Alert

Income splitting and lifetime capital gains exemption under Department of Finance proposals on "Tax Planning Using Private Corporations"

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On July 18, 2017, the Department of Finance issued broad sweeping proposals impacting private corporations and their owners. Our July 26, 2017 Canadian Tax Alert provided an overview of all the changes, and outlined typical scenarios that could be affected by the proposals.

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This Canadian Tax Alert looks specifically at the proposed changes to income splitting and the lifetime capital gains exemption (LCGE) and is aimed at providing a more thorough analysis of those proposals, with examples of how the proposals could affect various transactions and structures.

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Income splitting framework

Income splitting is a popular tax strategy designed to transfer income that would otherwise be taxed in the hands of one taxpayer at a relatively high tax rate to another taxpayer at a lower tax rate in an effort to reduce the overall tax burden. This strategy is commonly implemented in a family setting to reduce the overall tax burden of the family.

Existing rules in place, known as the "kiddie tax" or "tax on split income" (TOSI), eliminate any benefit of splitting income with minors. The kiddie tax causes certain income received by a child under the age of 18, who has a parent that is resident in Canada any time during the year, to be taxed at the highest personal tax rate. The kiddie tax or TOSI does not apply on "excluded amounts" which include amounts that are income from property acquired by the individual on the death of a parent or on the death of any other person if the individual is a post-secondary student or disabled. There are no personal tax credits available on TOSI.

Under the existing rules, the application of TOSI is relatively narrow as it only applies to minor children. As a result, it has been possible to split income with a spouse and other adult family members resulting in a reduction in the overall tax burden of the family.

The Minister of Finance proposes to significantly expand the application of TOSI to many income splitting strategies involving adults. In particular, the proposed changes include the following:

1) Expanding the definition of "specified individual" to include minors and certain adults that receive split income;
2) Introducing the concept of a "connected individual" to establish a link between the specified individual who receives an amount, the private corporation and an individual (the connected individual) who is related to the specified individual and has a degree of control over the private corporation;
3) Expanding the definition of "split income" to add four additional sources of income;
4) Amending the definition of "excluded amount" to rely on new definition of "split portion"; and
5) Introducing the "split portion" definition, including a reasonableness test for the purpose of determining if TOSI rules apply to an adult specified individual.

Proposed changes to section 120.4 of the Income Tax Act[1]

<u>Expanded definition of "specified individual" in subsection 120.4(1)</u>

Specified individuals may be subject to TOSI. The table below shows how the definition of specified individual has been expanded and now includes minors and adults that receive income from a business of a related individual.

Age	**Current TOSI**	**Proposed TOSI**
Under age 18	Canadian resident throughout the year Parent resident in Canada at any time during the year	Canadian resident at the end of the year or immediately before their death Parent resident in Canada at any time during the year; or A related individual resides in Canada at any time during the year, and the minor receives income that is derived from a business of that related individual.
Age 18 or older	Not applicable	Canadian resident at the end of the year A related individual resides in Canada at any time during the year, and the adult receives income that is derived from a business of that related individual.

Paragraph (a) of proposed new subsection 120.4(1.1), indicates that for purposes of the specified individual definition, an individual is related to his or her aunt, uncle, niece, and nephew. In addition, where a trust and a person are deemed not to deal at arm's length, they will be deemed to be related.

<u>Introduction of the "connected individual" definition</u>

A new definition – connected individual – has been introduced to determine whether an adult specified individual's income from a corporation would be treated as split income. Essentially, this new definition provides a link between the adult specified individual and the business from which the income is received. In general, a Canadian resident individual with a certain measure of influence over a corporation would be treated as connected with the corporation. Influence can take one of four forms:

Strategic influence - The corporation is controlled, directly or indirectly, in any manner whatever by the individual or a related group that includes the individual;

Equity influence - The individual owns property that directly or indirectly represents 10% or more of the equity value of the corporation;

Earnings influence - The individual (or a related party) owns directly or indirectly shares of the corporation and the corporation carries on a service business where either the services or business revenue are primarily attributable to the individual or the services are regulated and performed all or in part by the individual; or

[1] All statutory references in the Alert are to the Income Tax Act.

Investment influence - The individual (or a related party) owns directly or indirectly shares of the corporation and 10% or more of the FMV of the corporation's property is attributable to property acquired from the individual in exchange for

i. less than FMV consideration, or
ii. debt or shares which remain outstanding.

<u>Expanded definition of "split income"</u>

The definition of split income has been expanded to add four additional sources of income:

Current definition	**Proposed definition**
Taxable dividends/shareholder benefit inclusions from a private corporation	Taxable dividends/shareholder benefit inclusions from a private corporation
Partnership income from business/rental property if operated by a related person	Partnership income from business/rental property if operated by a related person
Trust income from a business/rental property if operated by a related person	Trust income from a business/rental property if operated by a related person
	Income from indebtedness of a private corporation, partnership or trust
	Income or gains from dispositions of property where earnings derived from the property would have been considered split income
	Income from conferred benefit per section 246
	Income earned on split income and attributed income (second generation split/attributed income), and certain capital dividends received, by an individual who has not attained the age of 24 years before the year

<u>Amended definition of "excluded amount"</u>

The definition of excluded amount in subsection 120.4(1) describes income that is excluded from split income of a specified individual and therefore not subject to TOSI.

Previously an excluded amount included two types of income: income from a property acquired by or for the benefit of the individual as a consequence of the death of:

i. A parent of the individual; or
ii. Any person, if the individual is a full-time post-secondary student, or disabled.

These two types of income continue to be included in the excluded amount but the definition is updated to include such income received by individuals who have not attained the age of 24 before the year.

The definition is also amended to include all amounts included in the income of individuals who have attained the age of 17 years before the year, other than a "split portion" of an amount.

Introduction of the "split portion" definition and the reasonability tests

The definition of split portion generally represents the portion considered unreasonable of split income; therefore, it is the split portion of an adult's split income that is subject to TOSI.

TOSI applies on split income. Split income is the total of all amounts noted in paragraphs (a) to (g) of the definition, unless the income is an excluded amount. Ignoring the inheritance provision above, to determine the excluded amount, one needs to determine the split portion. The definition of excluded amount has been amended to include an amount received by an adult that is not a split portion of an amount.

There are three components of the split portion definition as follows:

a) Amounts that qualify as split income under paragraph (g) (i.e., second generation income);
b) Amounts that qualify as split income under paragraphs (a) to (d) and (f) that do not meet the new reasonability tests; and
c) Amounts that qualify as split income under paragraph (e) (i.e., income or gains from dispositions of property) that do not meet the new reasonability tests.

For an amount to be included in the split portion of an amount under the reasonableness tests noted for paragraphs b and c above, the amount must be in excess of what would be paid to an arm's length person.

The following factors must be considered when determining if the amount is reasonable:

Where individuals have attained the age of 24 years:

- Labour – the extent of the individual's labour contributions to the "source" business prior to the amount being paid or becoming payable.
- Capital – the assets contributed by the individual, directly or indirectly, in support of the source business.
- Risk – the risk assumed by the individual in respect of the source business.
- Amounts paid – the total of all amounts that were previously paid, directly or indirectly, from the business.

Where individuals are between the ages of 18 years and 24 years:

- Modification to labour - the proposals deem no action to be performed except to the extent the individual is actively involved on a regular, continuous, and substantial basis. Therefore, there is a higher threshold to demonstrate that amounts received by individuals between 18 years and 24 years are reasonable.
- Modification to capital – the proposals limit the return to a prescribed rate of interest.

The proposed legislation contains a very broadly worded anti-avoidance provision that appears to catch even the most mundane income splitting strategies. Specifically, the provision states that the split portion exclusion does not apply if it can reasonably be considered that one of the reasons that any person/partnership acquires or holds a property is to avoid TOSI of a specified individual. In this situation:

- If the property is a security of a mutual fund corporation (MFC), the corporation is deemed not to be a MFC;
- If the property is a security of a mutual fund trust (MFT), the corporation is deemed not to be a MFT; or
- If the property is publicly listed/traded, it is deemed not to be publicly listed/traded.

The proposals also include anti-avoidance rules to exclude labour and capital contributions from the reasonability tests and a rule to ensure the reasonableness test is met with respect to inherited property.

A. Labour – An individual is deemed not to have performed functions where the principal purpose of the business is to derive income from property or 50% or more of its income consists of income from property or taxable capital gains.
B. Contribution of assets - An individual is deemed not to have contributed assets to the extent the assets were derived from split income or acquired with financial assistance from a related person.
C. Inherited property – Where an individual has acquired property as a consequence of the death of a person, the individual will be deemed to have made the same contributions as the deceased with respect to labour, assets contributed, risks assumed and previous payments.

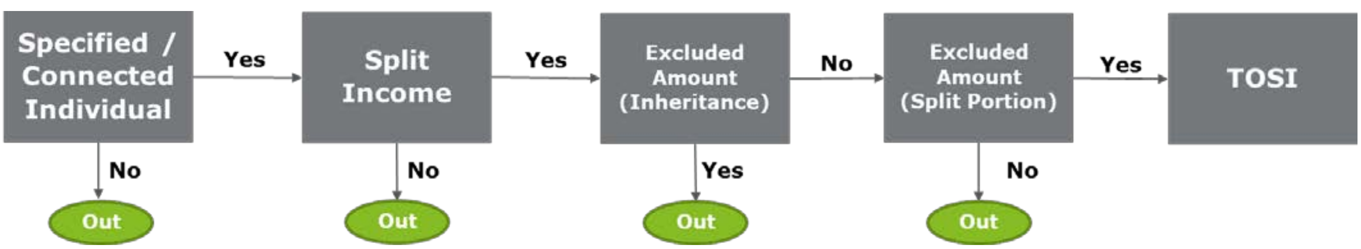
<u>TOSI with respect to taxable capital gains</u>

Subsections 120.4(4) and 120.5(5) have been replaced so that generally, where a specified individual realizes a capital gain on a non-arm's length disposition of shares of a private company, twice the taxable capital gain is included in split income as a non-eligible dividend except to the extent that:

- The taxable capital gain is an excluded amount; and
- If the individual has attained the age of 17 before the year,
    i. The disposition is before 2018, or
    ii. The taxable capital gain is an excluded amount.

<u>TOSI framework and examples:</u>

The diagram below shows the step-by-step analysis for the proposed application of section 120.4.



The first step is to determine whether the individual is a specified individual which, in the case of an adult, requires the determination of whether there is a connected individual. If the answer is yes, the next step is to determine whether an individual has received split income. If the answer is yes, the next determination is whether the split income is an excluded amount, which is a two-part test.

1. If the individual has not attained the age of 24 before the year, is the income earned on property inherited from a parent? If the answer is yes, the income is an excluded amount and not subject to TOSI. If the answer is no, is income earned on property inherited from any person other than a parent and the individual is either a full-time post-secondary student or disabled? If the answer is yes, the income is an excluded amount and not subject to TOSI. If the answer is no, proceed to part two.
2. Is the amount a split portion? If the answer is yes, the amount is subject to TOSI.

TOSI is eliminated if the individual's taxable income is in the highest bracket.

The following are examples of common scenarios that exist where TOSI does not currently apply but will apply under the proposed legislation:

Scenario	Impact under proposed legislation
Mrs. A operates the business of Opco. Mr. A is a stay-at-home spouse, doesn't participate in the business of Opco, and has not invested his own money in Opco. The shares are held 50/50. Mr. & Mrs. A each receive $200k in taxable dividends.	The new definition of "split portion" will likely capture the dividend paid to Mr. A.
Mr. A is the president of Opco. Mrs. A manages the back office of Opco. Child 1 is 27 and is VP of sales. Child 2 is 21, a student and does not work. Mr. A owns voting preferred shares. The trust owns common shares. No family member receives a salary, each person receives a $200k dividend through the trust.	All dividends paid are subject to the reasonability test. It is likely that Mr. A, and possibly Child 1, will meet this test. The others will likely fail the test and some portion (or all) of the dividend will be subject to TOSI
Mrs. A operates the business of Opco. Mr. A is a stay-at-home spouse, and doesn't participate in the business of Opco. Mrs. A sells half of her shares to Mr. A at fair value, and takes back a note receivable bearing the prescribed rate of interest. Mr. & Mrs. A each receive $200k in taxable dividends.	Based on the new definition of 'split portion', Mr. A is deemed not to have contributed assets in support of the business, as Mrs. A has provided financial assistance, clause 120.4(1.1)(e)(ii)(B), and therefore the dividends are subject to TOSI. Mr A should consider a third party lender, if possible.
Mr. A owns voting preferred shares. Trust owns common shares. Child 1 is 26, and has loaned $500k to Opco at 10% interest. Child 2 is 22, and has loaned $500k to Opco at 8% interest.	Child 1's interest rate is subject to reasonability (arm's length comparison), the excess considered split income. Child 2's interest rate is restricted to the prescribed rate, the excess considered split income.

LCGE framework

Canadian residents are entitled to a LCGE on the disposition of shares of a qualified small business corporation (QSBC) or qualified farm or fishing property (QFFP). The LCGE is $835,716 for 2017 for QSBC shares and $1,000,000 for 2017 for QFFP.

The Department of Finance is concerned about the use of family trusts that effectively multiply the use of the LCGE to reduce capital gains tax where family members may not have invested in, or contributed to, the gains.

The Department of Finance has proposed the following measures to address the LCGE multiplication issue:

1. Apply an age limit – individuals no longer qualify for the LCGE before they attain 18 years of age.
2. Apply a reasonableness test – no LCGE for the disposition of property that is included in split income.
3. Eliminate LCGE for gains accrued while property was held in trust.

The proposed rules will apply for dispositions in 2018 and subsequent tax years. However, the proposals include special 2018 grandfathering provisions that will allow taxpayers to make an election in 2018 to trigger a deemed disposition and effectively crystallize the LCGE.

<u>Amendments to subsection 104(21.2)</u>

Currently, subsection 104(21) permits trusts to designate net taxable capital gains to beneficiaries and subsection 104(21.2) permits the beneficiary to claim the LCGE under section 110.6 provided certain conditions are met.

Under proposed subsection 104(21.2), the subsection is narrowed such that only those trusts which meet the definition of "eligible LCGE trusts" can make the above designation of net taxable capital gains.

An eligible LCGE trust, defined in the proposed amendments for subsection 110.6(1), includes a personal trust (graduated rate estate, spousal/common law trust or alter ego trust), as well as some employee share ownership (ESOP) trusts. For personal trusts, the definition also requires the following:

1. No tax-free distribution can be made to any person who is not a qualifying beneficiary; and
2. No amount of net taxable capital gains is designated in respect of any person who is not a qualifying beneficiary.

For ESOP trusts, the additional requirements include:

1. No tax-free distribution to any person other than shares of the issuer corporation to an eligible employee beneficiary; and
2. No amount of net taxable capital gains is designated in respect of any person who is not an eligible employee beneficiary.

The definition and ability to be an eligible LCGE trust is significantly limited.

<u>Introduction of new subsections 110.6(12) and 110.6(12.1)</u>

Proposed subsections 110.6(12) and 110.6(12.1) mandate that certain capital gains will no longer be eligible for the LCGE for dispositions that occur after 2017. A capital gain, or a portion thereof, will not be eligible for the LCGE if:

a. The taxpayer has not attained the age of 17 before the year;
b. The capital gain is allocated from a non-qualifying employees profit sharing plan;
c. A portion of the capital gain accrued before the beginning of the year the taxpayer turned 18;
d. The taxpayer is 18 or older and the property was subject to TOSI;

e. A portion of the capital gain accrued while owned by a trust that is not an "eligible LCGE trust"; or
f. Any gain arising from property distributed on a tax-deferred basis. For example, where a subsection 107(2) distribution is made to a corporate beneficiary that increases the value of the corporation's shares, and the shares are sold in the same series.

<u>2018 special grandfathering provisions</u>

New subsections 110.6(18) and (18.1) allow individuals and certain trusts (referred to as "eligible taxpayers") to recognize capital gains accrued on certain property (referred to as "eligible property") to a particular day in 2018 by filing a prescribed election. The taxpayer can chose any day in 2018 as the disposition day.

To qualify for the election, the property must be eligible property which is defined in new subsection 110.6(17.1). Eligible property means property that is:

i. owned continuously by the taxpayer from the end of 2017 to the disposition day;
ii. capital property at the time of the disposition; and
iii. QSBC shares or QFFP where any reference to 24 months in respect of the holding period test and active business asset test is shortened to 12 months.

The effects of the election are as follows:

- The taxpayer is deemed to dispose of the property at a "designated amount" (must be greater than ACB).
- The taxpayer is deemed to reacquire the property at the lesser of:
  i. Designated amount; or
  ii. FMV – [designated amount – 110% of FMV][2]

An additional grind applies where the excess amount (designated amount – FMV) is greater than the FMV of the property itself.

The election applies to shares received by virtue of a stock option plan, mining property, or an interest in a partnership (including QFFP). It provides the benefit of pre-proposal LCGE and TOSI rules, despite the disposition taking place in 2018. Alternative minimum tax will still apply, as in the past.

The prescribed form for the election is due on the balance-due day for the taxpayer's year. Penalties are significant for late filing and amendments. The penalty is equal 1/3 of 1% of the taxable capital gain multiplied by the number of months late.

<u>2018 QSBC disposition by minors</u>

The election under subsection 110.6(18.1) is not available for shares owned by minors. However, under subsection 110.6(30.1), where there is an actual disposition of QSBC shares by a minor or a personal trust under which the minor is a beneficiary, if the shares were owned continuously from the end of 2017 to the disposition, the new LCGE and TOSI rules do not apply and the 24 month tests in the QSBC definition become 12 months.

[2] This grinds ACB if the taxpayer overvalues the property by more than 10% and eliminates part of their capital gains exemption. The purpose of this cost base reduction is to discourage taxpayers from designating amounts in excess of fair market value in order to realize gains in excess of the gains accrued to the disposition time.

Actions to consider

Based on these proposals, we suggest a review of assets held by the private corporation to consider purification and planning for LCGE crystallization in 2017 or an election filing to crystallize any qualified gain through the use of the 2018 election.

These are still proposals, not law…

The changes described herein are proposals only. They have not been enacted and do not yet represent law. Further, the consultation period associated with the proposals remains open and, as such, there may be varying degrees of change to the proposals as originally presented. Deloitte will be providing a submission to the Minister of Finance as part of the consultation process, which closes on October 2, 2017.

Since the proposals are highly contentious and subject to change, we caution our readers against taking premature actions that may ultimately be unnecessary or counter-productive. We believe a thoughtful and patient approach, assessing both the risk and reward of alternative structures or transactions, remains prudent. Your Deloitte tax team remains available to support you through these uncertain times.

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