



Canadian Tax Alert

Updated “income sprinkling” proposals for private corporations

December 18, 2017

Updated proposals related to “income sprinkling” have now been released by the Department of Finance. Income sprinkling generally refers to the transferring of 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. This approach is commonly implemented to reduce the overall tax burden for a family.

Your dedicated team:

Sheri Penner

National Deloitte Private Tax Leader
Tel: 506-663-6637

Quebec

Geneviève Provost

Tel: 514-393-7806

Eastern Region

Sheri Penner

Tel: 506-663-6637

Toronto

Michael Belz

Tel: 416-643-8712

Original framework

Existing rules known as “kiddie tax” or “tax on split income” (TOSI), in place long before the release of the July 18, 2017 proposals, eliminate any benefit of splitting income with minors. These rules do not generally apply to adults, including spouses, and also do not apply to certain “excluded amounts”.

July 18, 2017 proposals

The proposals released on July 18, 2017 contained an extensive series of changes that significantly widened the application of the TOSI rules. By extending the age of the individuals affected and expanding the definition of “split income”, the proposals made the rules applicable in a broader range of circumstances and adversely affected family income planning for private company shareholders.

Also included in the July 18, 2017 proposals was a reasonableness test based on four criteria: labour, capital, risk and amounts previously paid. These tests were anticipated to be applied differently to individuals between the ages of 18 and 24, and those over 24.

Updated proposals released on December 13, 2017

The modifications to the original proposals include a series of so-called “bright-line” tests to exclude certain individuals from the TOSI rules. These include:

- The spouse of a business owner who is aged 65 or over, where the owner has meaningfully contributed to the business;
- Adults aged 18 or over who have made a “substantial” labour contribution to the business during the year, or during any five previous years;
- Adults aged 25 or over who own shares with 10% or more of the votes and value of a corporation that earns less than 90% of its income from the provision of services and that is not a professional corporation; and
- Individuals who realize capital gains on the disposition of qualified small business corporation shares, or qualified farm or fishing property, if they would not be subject to the highest marginal tax rate on the gains under existing TOSI rules.

Excluded business

The revised framework provides that individuals will not be subject to TOSI on amounts received from an “excluded business”. An excluded business is a business where the individual is actively engaged on a regular, continuous and substantial basis in the year or in any combination of five previous years of the individual. The Department of Finance has clarified that an excluded business will include one where the individual works an average of 20 hours per week during the part of the year that the business operates. If the 20 hours per week threshold is not met, it may still be possible for an individual to be actively engaged depending upon the facts.

Western Region

[Mike Bird](#)

Tel: 403-267-1852

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If the excluded business definition is not met, the individual may be subject to TOSI on amounts derived from the business, if the amounts are not excluded amounts.

Excluded shares

The updated proposals also exclude amounts derived from “excluded shares” from the application of TOSI. Excluded shares are those owned by an individual who has attained the age of 25 in or before the year, the individual owns at least 10% of the votes and value of the shares of the corporation, and the corporation meets three conditions:

- 1) It earns less than 90% of its income from the provision of services;
- 2) It is not a professional corporation; and
- 3) All or substantially all of its income is not derived from a related business in respect of the specified individual.

For the 2018 taxation year, individuals will have until the end of 2018 to meet the 10% votes and value threshold.

Retirement and inheritance

The updated provisions provide improved alignment with other specifically-permitted income sprinkling measures, particularly pension income sprinkling. TOSI is not expected to apply to amounts received by an individual from a related business if the individual’s spouse made the contributions to the business and has reached the age of 65 in the year or in a previous year. Further provisions are expected to apply so that a surviving spouse remains exempt from TOSI after the death of their spouse.

Rules are also adjusted for property inherited, such that the individual inheriting the property should be in the same tax position as the deceased would have otherwise been.

Elements abandoned with revised proposals

In addition to the foregoing, the release by the Department of Finance reconfirmed that certain originally-proposed provisions would be abandoned or modified. These include:

- Abandoning provisions aimed to limit access to the Lifetime Capital Gains Exemption (LCGE). TOSI will not apply to taxable capital gains from the disposition of property that can qualify for the LCGE.
- Abandoning the application of TOSI to “second generation income”, income subsequently derived from income that was subject to TOSI or the attribution rules.
- Abandoning an expansion of “related individuals” for TOSI purposes to include aunts, uncles, nieces and nephews.
- Ensuring that TOSI does not apply to property acquired as the result of marriage or common-law partnership breakdown.
- Allowing a reasonable return, in excess of the prescribed rate, for individuals aged 18 to 24 where the capital contributed is from an unrelated business.

Challenges with updated framework

While many of the adjustments provide welcome steps to simplify the income sprinkling provisions, challenges remain for many private companies in Canada. For example, if a non-active adult individual, such as the spouse of the active shareholder, directly owns 10% or more of the votes and value of a private corporation, TOSI is not expected to apply as the shares meet the definition of "excluded shares". Conversely, if those same shares, with the same value and attributes, were owned by a trust that was established solely for the benefit of that same spouse, TOSI seems to apply as a consequence of the shares not being directly held by the spouse. Thus, it appears that corporate structures involving trusts will need to be revisited in light of the changes. Additional challenges may arise as these rules are applied.

Actions before December 31, 2017 and beyond

As the revised proposals are still anticipated to take effect January 1, 2018, an opportunity remains to provide income to individuals who may be subject to TOSI going forward if those payments are made before the end of the 2017 calendar year.

In addition, a review of corporate structures and compensation strategies, particularly for those corporate groups where a family trust holds a notable interest in shares, is encouraged. Your Deloitte tax professionals are ready to help guide you through these changes as they unfold.

Deloitte LLP
Bay Adelaide Centre, East Tower
8 Adelaide Street West, Suite 200
Toronto ON M5H 0A9
Canada

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