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Department of Finance Releases Revised Income Splitting Rules

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Earlier this year, the Department of Finance released a set of far-reaching proposals affecting the taxation of private businesses and their shareholders. Only Rip Van Winkle missed the firestorm reaction to these proposals from a broad range of affected parties. Ultimately, the Government relented, announcing that the proposals would be scaled back and reconsidered. On December 13, the Department of Finance released draft legislation representing a revised version of some of the proposals.

The original proposals, which were released on July 18, involved rules on income splitting, rules preventing the conversion of dividends to capital gains and rules attacking the earning of investment income with a private company's retained active business earnings. Read our comments on these proposals in our bulletin Canadian Government Proposes Major Changes to the Taxation of Private Corporations. The revised draft legislation addresses only the income splitting rules.

The *Income Tax Act* contains a wide range of rules limiting income splitting between spouses and between parents and minor children, including the tax on split income (TOSI) rules, commonly known as the "kiddie tax." Broadly, the July 18 proposals sought to extend the TOSI rules to related persons generally, without regard to age, applying the top marginal tax rate to distributions on equity and debt issued by an affected corporation, partnership or trust where the amounts could be considered not reasonable having regard to the recipient's contributions to the underlying business. The scope of the proposed changes and the obvious uncertainty and administrative burden of a "reasonableness" test in this context understandably drew strong negative reaction.

Today's draft legislation scales back these changes to the TOSI rules as follows:

- A business owner who is 65 years of age or older will be allowed to split income with a spouse without any TOSI restriction.
- The splitting of capital gains realized on the disposition of qualified small business corporation shares or qualified farm or fishing property (property that would be eligible for the lifetime capital gains exemption) will not be subject to TOSI. For properties that do not qualify for these purposes, splitting will be subject to TOSI, placing additional importance on satisfying the active business asset test for qualified small business corporation shares.
- The reasonableness test will be simplified through a number of safe harbours:
  - TOSI will not apply to returns paid to a person aged 18 or older who works more than twenty hours a week in the business in the year in question or in any five prior years.
  - Generally, TOSI will not apply to returns paid to a person aged 24 or older who owns at least 10% of the votes and value of shares of the corporation carrying on the business, except for professional corporations (legal, accounting and various medical practices) or certain other service businesses.
  - Where property is received by inheritance, the recipient is put in the same place as the deceased owner for purposes of these safe harbours, as if he or she were a continuation of the former owner.
- Unfortunately, but not surprisingly, the reasonableness test, although modified, has been retained. It remains to be seen how the Canada Revenue Agency will apply this test; however, as a general rule, taxpayers are less convinced that tests of this nature are

applied appropriately than the Department of Finance must be in proposing them. The CRA has issued its own interpretive guidance in connection with these proposals, which may go some distance in reducing this risk.

Notwithstanding numerous recommendations to defer the implementation date of the proposals for further study and analysis – including those of the Standing Senate Committee on National Finance released earlier today – the proposals are to be effective from January 1, 2018. However, they call for a transition year in 2018, under which the safe harbours described above that relate to 10% or greater share ownership will apply as at December 31, 2018, allowing time for adjustments in the interim.

The Department of Finance has indicated that the provisions proposed on July 18 to prevent the conversion of dividends to capital gains will not be proceeding. The proposals to tax private company investment income at punitive rates were originally put forward in a less-developed form and are being reworked. They are expected to make their next appearance in the 2018 Budget, sometime in the spring. Only then will we be able to assess the extent, if any, to which the Department of Finance has given credence to the many comments and criticisms that were provided in response to their inclusion in the July 18 proposals, including the more than 21,000 submissions received by the Department during the course of the consultation period.

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