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A Primer on the New "Income Sprinkling" Rules

Last summer, the government announced a consultation on new tax rules that were intended to prevent tax planning using private corporations. One of the central pillars of those rules is expanding the "tax on split income" ("TOSI"). The TOSI was originally intended to prevent splitting income with a child who is under 18 by applying a 33% tax on split income earned by the child. In effect, the TOSI eliminates any benefits a family might otherwise realize from splitting business income among children in a lower tax bracket. The government expanded the TOSI beginning in 2018 so it applies to adult family members too.

Split income is a complex concept, but it essentially includes most characterizations of income, earned from most types of structures (corporations, trusts, and partnerships), in respect of a "related business." This article provides a detailed discussion of the new rules that apply to 2018 and later years, including the concept of split income, the many exclusions from it, and to whom the tax on split income applies.

What is Split Income?

Subject to the numerous "excluded amounts", the split income of an individual for the year includes the following amounts:

(a) taxable dividends from shares of a corporation (other than publicly listed shares and shares of a mutual fund corporation), whether received directly or through a trust or partnership (other than a mutual fund trust);

(b) shareholder benefits (other than from ownership of publicly listed shares) whether conferred directly or through a trust or partnership (other than a mutual fund trust);

(c) other income received from a partnership or trust (other than a mutual fund trust) where the income is derived by the partnership or trust from a related business;

(d) for 2014 and later years, income directly or indirectly paid to a specified individual from a trust or partnership if derived from a business, rental property, partnership, or trust — the person related to the individual must be actively engaged on a regular basis in the activities of the particular trust or partnership earning business or rental income or have an interest in the partnership whether through one or more partnerships;

(e) effective for 2018 and later years, interest from a debt obligation of a corporation, trust, or partnership, unless the debt is publicly listed, guaranteed by the Canadian government, or a deposit at a bank or credit union; and

(f) effective for 2018 and later years, taxable capital gains or profit from the disposition of property or such amounts included in the individual's income as a beneficiary of a trust where the property is:

(i) an interest in a partnership, an interest in a trust, or a debt obligation; and

(ii) income from the property was previously subject to TOSI, or any value of the property is derived from a share in a corporation.

Clearly, the definition of split income is very broad, and includes many different types of income. However, this is just one piece of a larger mechanism, and just because something is listed above does not mean it will be subject to the TOSI. There are numerous exclusions which are discussed in great detail below.

What Amounts Are Excluded from TOSI?

TOSI does not apply to amounts that are considered an "excluded amount". This term is actually a big list of exclusions, several of which have their own detailed definitions and conditions. All amounts excluded from TOSI are described below, but separate sections are provided where the exclusion is particularly complex. Certain exclusions are available to all taxpayers. Others are available only to taxpayers age 25 and older, and there are several (generally more restrictive) exclusions for taxpayers aged 18 to 24. All of the exclusions that are unique for adult taxpayers apply for 2018 and subsequent years.

Excluded amounts consist of the following:

i. if the individual has not attained the age of 24 years before the year, the amount is from property acquired as a consequence of death of the individual's parent, or as the consequence of death of any person if the individual is a full-time student or eligible for the disability tax credit;

ii. amounts received from property that was transferred from a spouse or common-law partner due to separation;

iii. deemed dispositions occurring as a result of the individual's death;

iv. taxable capital gains from the disposition of qualified farm or fishing property or qualified small business corporation shares;

v. amounts not derived from a related business in respect of the individual if the individual attained the age of 17 before the current tax year;

vi. amounts derived from an excluded business if the individual attained the age of 17 before the current tax year;

vii. an amount that is safe harbour capital return if the individual attained the age of 17 but not 24 before the current tax year;

viii. an amount that is income or a capital gain from an excluded share if the individual attained the age of 24 before the current tax year;

ix. a reasonable return, provided the individual attained the age of 17 before the current tax year; and

x. an amount relating a spouse or common-law partner who is at least 64 years old or deceased.

Amount (v) is a particularly important exclusion because it excludes all amounts that are not from a related business. As such, amounts that are from a related business are subject to TOSI unless one of the other exclusions is met. The definition of a related business is generally the starting point for determining whether the TOSI applies to split income amounts received by a taxpayer. If the amounts are from a related business, generally the next step is to determine whether any of the other exclusions above apply.

Related Business

In simple terms, split income from a related business can be thought of as income earned by the individual from a business of a source individual. A source individual is an individual who is related to the specified individual and is resident in Canada. That is, the specified individual is the person who receives split income, and the source individual is the person running the business from which the split income is derived. If the split income is from a related business, it is subject to the TOSI unless it meets another exclusion. Note that for the purposes of these rules, spouses or common-law partners who are living separate due to a marriage breakdown are not related.

A related business in respect of an individual includes a business carried on by a source individual or a partnership, corporation, or trust if a source individual is actively engaged on a regular basis in the activities of the partnership, corporation, or trust related to earning income from the business.

A related business also includes a business of a partnership in which the source individual has an interest.

A related business also includes a business of a corporation if the following conditions are met at any time in the year:

(a) the source individual owns shares of the corporation or some property that derives its value from shares of the corporation; and

(b) the source individual's total value of property referred to in (a) above represents is greater or equal to 10% of the fair market value of all the corporation's issued shares.

If the individual receives split income from a related business, the TOSI will apply unless any of the other exclusions listed above are met. Note that the related business exclusion applies only where the individual attained the age of 17 before the year. Thus, where a minor (under 18 in the year) receives any income amounts that are "split income", the amounts can be subject to TOSI (notwithstanding other potential exclusions) even if they are not from a related business.

Excluded Business

The definition of an excluded business is simple and can apply to individuals who attained the age of 17 before the current year. This exclusion essentially applies where, in the government's view, the individual has contributed a sufficient amount of labour to the business to justify the income as compensation. An excluded business is a business where the individual is actively engaged on a regular, continuous, and substantial basis in the activities of the business in the current year, or in any five prior years. An individual is deemed to be actively engaged if the individual works in the business at least an average of 20 hours per week during the portion of the taxation year of the individual that the business operates, or met that requirement for any five prior years. The five taxation years need not be consecutive — just a total of five. In any other case, whether an individual is actively engaged depends on the facts and circumstances. Should the individual's split income be received from an excluded business, all of that income is exempt from TOSI.

Safe Harbour Capital Return

Where the individual attained the age of 17 but not 24 before the current tax year, there is an exclusion for safe harbor capital return. Subject to other exclusions, safe harbor capital return places a limit on how much income can be split with young adult family members before TOSI applies.

Safe harbour capital return is exempt from TOSI, and cannot exceed an imputed rate of return on the fair market value of capital contributed to the business by the individual. The product of the value of contributed capital and the highest quarterly prescribed rate published by the CRA in the year (currently 2% at the time of writing) is the safe harbour capital return that an individual can receive TOSI-free every year.

Excluded Share

The excluded share exclusion only applies if the individual attained the age of 24 before the current year. This definition is cumbersome, and there are several conditions that must be met for the exclusion to apply. But if the individual's split income is found to be from an excluded share, all of that income is not subject to TOSI. The individual's shares are excluded shares if:

(a) less than 90% of the business income of the corporation for the most recent taxation year of the corporation that ended was from the provision of services;

(b) the corporation is not a professional corporation (professional practice of an accountant, dentist, lawyer, medical doctor, veterinarian, or chiropractor);

(c) the individual owns the shares of the corporation that give the individual at least 10% of the votes and at least 10% of the fair market value of the corporation; and

(d) 90% or more of the gross income of the corporation for its most recent tax year is not derived from any related businesses of the individual other than the corporation's own business.

Reasonable Return

Perhaps the most subjective exclusion from the TOSI is where the amounts received by the individual are a reasonable return. This exclusion applies only where the individual attained the age of 17 before the year. In determining whether an amount is reasonable, the government examines the relative contributions to the business by the individual and the related family member(s). Specifically, reasonableness is based on:

(i) the work they performed in support of the business;

(ii) the property they contributed, directly or indirectly, in support of the business;

(iii) the risks they assumed in respect of the business;

(iv) any amounts that were paid to them (directly or indirectly) in respect of the business; and

(v) such other factors as may be relevant.

However, for young adult individuals who have not attained the age of 24 before the current year, the reasonable test is restricted so that the determination of whether an amount is reasonable only regards contributions of "arm's length capital" by the individual. Arm's length capital is essentially capital contributed to the business by the individual that was not acquired as income or a gain derived from a related business, borrowed money, or transferred from a person related to the individual.

Simply put, only contributions of arm's length capital are factored into whether amounts paid to an individual under 24 years old are reasonable. When determining whether the amount is reasonable on the basis of labour contributed to the business by an individual younger than 24, the "excluded business" exclusion must be relied on instead.

Amounts Relating to a Spouse Who Is At Least 64 or Deceased

Where an individual receives split income in the year, but the amount would be excluded by virtue of any of the other above exclusions had it been received by the individual's spouse or common-law partner, and the spouse or common-law partner had attained the age of 64 before the current year or is deceased, the amount is excluded from TOSI for the individual. Simply put, the age 64 exclusion allows a business owner to split income with their spouse in their retirement years. When the business owner dies and structured their business so that it continues paying income to their living spouse, they need not worry about the TOSI applying to those amounts.

It's Complicated

These proposals were very controversial, so much so that the government overhauled them in December 2017. The rules discussed here were significantly different when they were first presented in July of the same year. Even after the government simplified them, these new rules are troublesome to navigate. They can affect a wide variety of business owners who pay income to their family members, and it is not an exact science to determine where income splitting ends and the TOSI begins. Therefore, going forward, it is important to consider these new rules when paying income from your business to any family members.