Canada's revised income splitting tax rules (and why your minor child's capital gain may be converted into a taxable dividend)

Tax Update

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On July 18, 2017, the Canadian federal government released for consultation draft legislative proposals targeting income splitting strategies. In response to significant negative feedback received during the consultation period, the government released revised draft legislative proposals with respect to such strategies on December 13, 2017 (the "Proposals").

The Proposals are to apply as of January 1, 2018. If enacted, they will have a major impact on business structures that Canadian entrepreneurs have had in place for decades.

In this legal update, we will provide an overview of the Proposals. Please see our previous article, authored by Kevin Fritz and Sandra Mah of the DLA Piper (Canada) LLP Tax Group for an overview of the original proposals.

Given their complexity, it would be impossible to summarize the Proposals and their possible impact in all instances. Accordingly, we caution you that this summary is being provided as general information only and is not meant as legal opinion or advice. Since every situation is different, your particular situation must be reviewed on its own and deserves appropriate attention and care. Please do not hesitate to contact any member of our Tax

Group if we can be of further assistance in this regard.

Income splitting

It is common for entrepreneurs who control private Canadian corporations to make use of ownership structures involving multiple family members. This can be achieved by either having family members hold corporation shares directly or through a family trust. Under these structures, family members (or the family trust) often hold different classes of shares which allow for dividends to be paid to the different family members at the discretion of the corporation's directors or the family trust's trustees. This share structure permits dividends to be paid to family members who are in a lower tax bracket than the family member who controls the business. This is referred to as "income splitting" in order to reduce the overall tax burden of the family.

Current tax on split income ("TOSI")

In order to prevent income splitting with children under the age of 18, the TOSI (commonly referred to as the "kiddie tax") was introduced in 1999. The TOSI currently applies to dividends (amongst other things) received by a minor child from a private corporation. Where the TOSI applies, the income is taxed at the top marginal rate.

Proposals

The Proposals will extend the TOSI to apply to certain income received by an adult from a "related business", unless the adult qualifies for an exclusion.

The income that will be subject to the TOSI is referred to as "split income" and will generally include dividends and interest (but not salary) paid by a private corporation to the adult (directly or indirectly, such as through a family trust), as well as certain capital gains.

A business will generally be a related business if an individual who is resident in Canada at any time in the year and related to the adult is actively engaged in the business or owns 10% or more of the equity in the corporation carrying on the business.

Exclusions from application of new TOSI rules

Adult family members of the business owner who fall into any of the following categories will automatically qualify for exclusion from the TOSI:

- the business owner's spouse, if the owner is aged 65 or over and is or has been actively engaged in the business or owns 10% or more of the equity in the corporation carrying on the business;
- adults aged 18 or over who have made a substantial labour contribution to the business (generally at least 20 hours on average per week) during the year or any five previous years (the "Active Engagement Exclusion");
- adults aged 25 or over who own shares of a corporation that give the holder 10% or more of the votes and 10% or more of the equity in the corporation, if the corporation earns less than 90% of its business income from services and is not a professional corporation (the "10% Safe Harbour Corporate Exclusion") (individuals will have until the end of 2018 to qualify for this exclusion for 2018); and
- individuals (other than minor children under certain circumstances) who realize capital gains, or are allocated capital gains realized by a trust, from the disposition of qualified small business corporation shares or qualified farm or fishing property.

This last exclusion is important because it preserves the ability of a family trust to hold and sell qualified small business corporation shares or qualified farm or fishing property and allocate the resulting capital gain to multiple beneficiaries who can each then claim their lifetime capital gains exemption, without the resulting capital gain being subject to the TOSI.

Adults aged 25 or over who do not qualify for any of these exclusions will be subject to the TOSI on amounts received from a related business, but only to the extent that the amount exceeds a "reasonable return".

Reasonable return exclusion

A reasonable return will be an amount that is reasonable having regard to the following factors relating to the contributions of the adult, relative to the contributions of his or her family members, to the business:

- labour contributed;
- capital contributed;
- risks assumed;
- previous amounts received by the adult from the business; and
- such other factors as may be relevant.

Adults aged 18 to 24 will generally be entitled to receive a prescribed rate of return on capital contributed to the business, unless the individual has earned (or inherited) the capital contributed to the business, in which case the individual will be entitled to receive a reasonable rate of return on the capital.

10% Safe Harbour Corporate Exclusion

It is interesting to note that in order to meet the conditions for the 10% Safe Harbour Corporate Exclusion, the shares on which the dividends are paid must be voting shares. It is not clear that the 10% votes and value tests can be met by holding different classes of shares, i.e. a shareholder holding non-voting common shares having 10% or more of the equity and voting preferred shares holding 10% or more of the votes does not appear to qualify for the exemption. This remains to be clarified.

Similarly it is impossible to value common shares of different classes when discretionary dividends can be paid on one of those classes without having to be paid on the other classes. While this is allowed (and efficient) for income splitting purposes, the holders of these shares will have a hard time proving to the tax authorities that these shares meet the 10% equity test. Under these circumstances, it is always possible that the equity of the company could be paid out as a dividend on the “other” classes of shares entitled to discretionary dividends!

In a classic estate freeze, a discretionary trust may be used to hold the common shares of a corporation. While this structure may allow for multiple capital gain exemptions, dividend income from shares held by a trust while so held will not qualify for the 10% Safe Harbour Corporate Exclusion and may be subject to the TOSI. The 10% Safe Harbour Corporate Exclusion requires direct ownership and not ownership through a trust.

In order to qualify for the 10% Safe Harbour Corporate Exclusion, the corporation must earn less than 90% of its business income from services. For this purpose, will business income include investment income such as dividends? Intercorporate management fees are income from services. What if the top holding company of a business group which holds shares with significant value only has revenue from management fees? The shares of the holding company will not qualify for the 10% Safe Harbour Corporate Exclusion.

There is also no similar safe harbour exclusion for an interest in a partnership or a trust.

Taxable capital gain or taxable dividend?

If the shares (i) do not qualify for the 10% Safe Harbour Corporate Exclusion or the Active Engagement Exclusion, (ii) do not qualify for the lifetime capital gains exemption, and (iii) have generated “split income” at any time, then a disposition of these shares will result in a taxable capital gain taxed at the top marginal rate.

On a similar disposition (either directly or indirectly by a trust) by a child under the age of 18 to a non-arm’s length person, what would otherwise result in a taxable capital gain will be converted into a taxable dividend taxed at the top marginal rate. A minor child will not qualify for the 10% Safe Harbour Corporate Exclusion or the Active Engagement Exclusion. Watch out for a gift of shares by a minor child to a relative or the attempted “crystallization” of the lifetime capital gains exemption by a minor child – what would otherwise result in a capital gain eligible for the lifetime capital gains exemption will be converted into a taxable dividend taxed at the top marginal rate.

Uncertainty ahead

We have only examined the 10% Safe Harbour Corporate Exclusion to give you an idea of the uncertainty that lies ahead. The Proposals are an improvement on the July 18th consultation draft. However, they leave many questions unanswered.

There are many potential traps and pitfalls that may arise under the Proposals and it will be of utmost importance to have corporate, partnership and trust structures reviewed as soon as possible to avoid the payment of unnecessary taxes.

The Proposals, if enacted, will be effective starting in 2018.

For the Canada Revenue Agency's intended approach to applying the Proposals, please click here.

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