March 2019

Tax on Split Income (TOSI)

HTKAcademy Comprehensive Guide

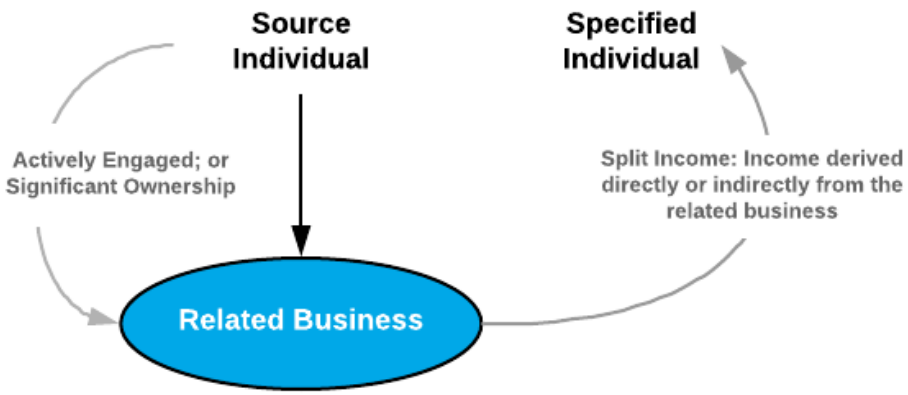
Updated with most recent CRA Interpretations and Examples

High Level Overview

High Level Overview

Who does TOSI apply to?

- The Tax on Split Income ("TOSI") will potentially apply in respect of **split income** received by **specified individuals**, either directly or indirectly, from a **related business**.
- **Specified individuals** = Canadian residents or minor children of Canadian residents.
- Generally, a business will be a **related business** if an individual who is related to the specified adult individual (i.e., the **source individual**) either:
  - is actively engaged in the business, or
  - owns a significant portion of the equity in the corporation that carries on the business.



High Level Overview

What is Split Income?

1. Private company dividends,
2. Private company shareholder loans/benefits
3. Partnership income derived from related business or rental property.
4. Trust income derived from the above 3 items
5. Interest income from private corporations, partnerships, and trust.
6. Taxable capital gains

High Level Overview

Is Salary Split Income?

- Salary is not Split Income.
- Salary is not subject to TOSI rules
- Nevertheless, only a reasonable salary should be paid so as to claim a deduction in the corporation.

High Level Overview

Common Exemptions from the TOSI Rules

Exemption	Age Requirement	Description
Excluded Business	≥ 18 Years	• Specified adult individuals who contribute labour to a related business on a **regular, continuous and substantial basis.** • To provide greater certainty, an individual who works an **average of 20 hours per week** during the part of the year that a business operates will be **deemed to be actively engaged on a regular, continuous and substantial basis for the year.**
Excluded Shares	>24 Years	• Specified adult individuals who have a significant equity investment in a corporation, other than a corporation that carries on a services business or that is a professional corporation.

High Level Overview

Common Exemptions from the TOSI Rules (Cont'd)

Exemption	Age Requirement	Description
Seniors	Spouse ≥65 Years or Spouse not alive	• Aligned with the existing pension income splitting rules • TOSI rules will not apply to income received by an individual from a related business if the individual's spouse made the contributions to the business and has attained the age of 65 years in or before the year the amounts are received. In other words, if the income would have been an excluded amount if received my the spouse, then the individual does not have TOSI. • Similar rule if the taxpayer's spouse is no longer alive and the income would have been exempt from TOSI in the year of death if the deceased spouse received that income, then the taxpayer's (i.e., living spouse's) income is exempt from TOSI in future years (after the spouse's death).

High Level Overview

Common Exemptions from the TOSI Rules (Cont'd)

Exemption	Age Requirement	Description
Lifetime capital gains exemption	Any Age	• TOSI will not apply on capital gains from the disposition of property that can qualify for the Lifetime Capital Gains Exemption (i.e., qualified small business corporation shares and qualified farm or fishing property). • Exemption will apply regardless of whether or not the LCGE is claimed.

High Level Overview

Common Exemptions from the TOSI Rules (Cont'd)

Exemption	Age Requirement	Description
Other Exemptions	Varies	• See detailed slides and the summary flow chart below.

High Level Overview

Does TOSI apply to 2nd Generation Income?

- Generally, no
- TOSI does not apply to compound income (i.e., income earned from the investment of an initial amount of income that is subject to the TOSI rules).
- See **Examples 14A and 14B**.

High Level Overview

Related Persons for TOSI Rules

- Aunts, uncles, nieces and nephews are not related individuals for the purposes of the TOSI rules.

High Level Overview

Safe Harbour Test for Individuals Between 18 to 24 Years

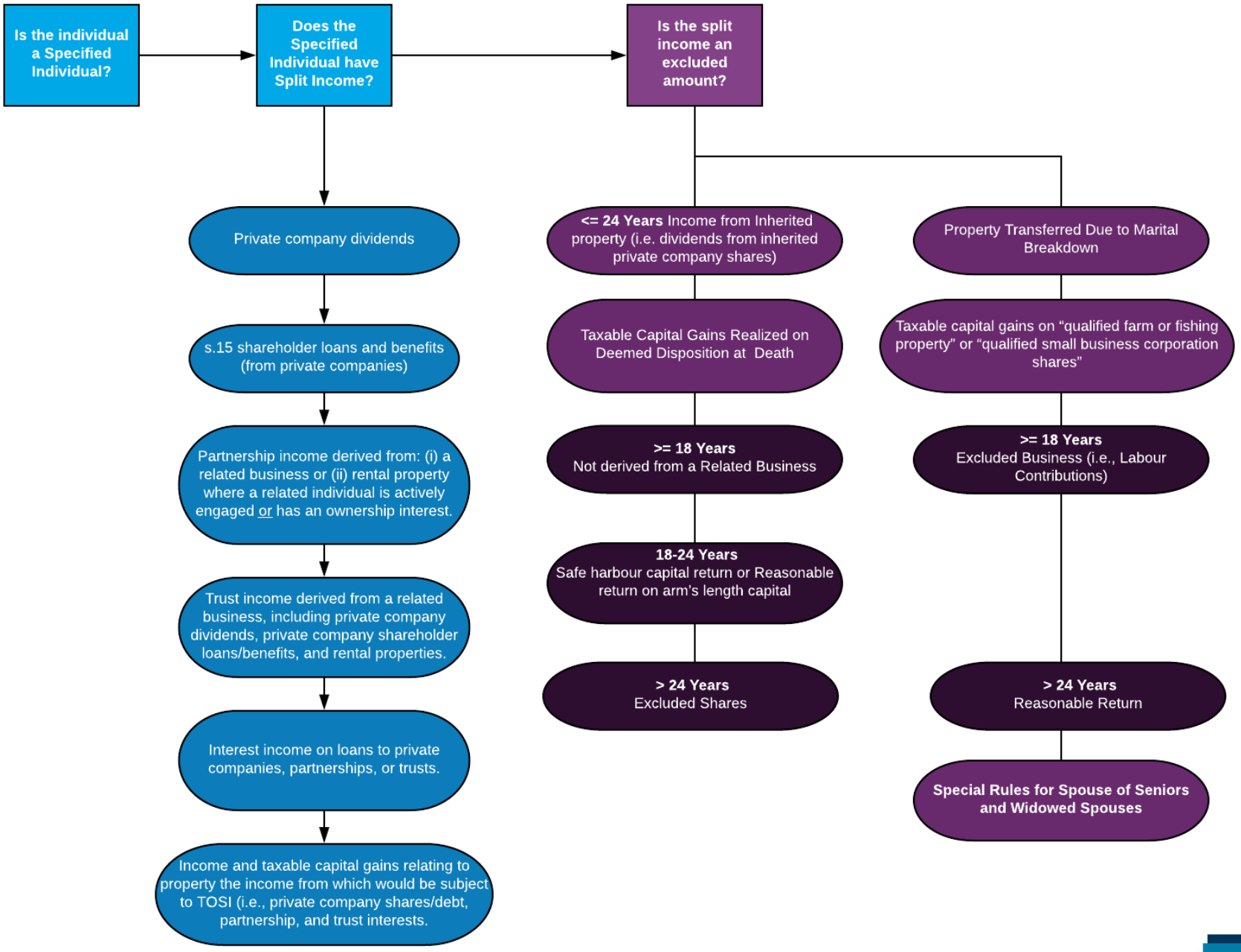
- Permitted a prescribed rate of return on capital contributed to a related business.

High Level Overview

Can you claim tax credits against the TOSI?

- Only the following tax credits may be claimed against TOSI:
  - Dividend tax credits
  - Foreign tax credits
  - The disability tax credit

Summary Flow Chart: Analysis Starts with Three Questions…



Detailed Commentary

Tax on Split Income

- A **specified individual** has to pay taxes on his or her **split income** for the year using the highest individual tax rate for the year.
- We need to ask two questions:

1
- **Is the individual a Specified Individual?**

2
- **Does he or she have split income for the year?**

- If the answer to both question is YES, then the individual's split income is taxed at the top marginal tax rate.

1. Who is a Specified Individual?

- Almost Anyone!
- An individual (other than a trust) is a **specified individual** for a taxation year if one of two conditions are met:

1. The individual is a resident of Canada at the end of the taxation year or, if the individual died during the taxation year, the individual was a resident of Canada immediately before their death; and

2. If the individual has not attained the age of 17 years before the year, the individual has a parent who is resident in Canada at any time in the year.

- **Note** how a **trust is not a specified individual**; however, a trust's individual beneficiaries may be a specified individual (i.e., if they are a resident of Canada).

2. What is Split Income?

Split Income = the total of all the following amounts (other than **excluded amounts**):

Split Income	Description
ITA 120.4(1)(a) **Private company dividends, shareholder loans/benefits**	• **Taxable dividends** received by the individual (other than from shares listed on a designated stock exchange), and • Amounts included under **section 15** (i.e., **shareholder benefit** or **shareholder loan**) – other than from shares listed on a designated stock exchange. • In other words private company dividends and shareholder benefits are caught.
ITA 120.4(1)(b) **Partnership income derived from related business or rental property.**	• **Partnership income** derived directly or indirectly from: (A) one or more **related businesses** in respect of the individual for the year, <u>or</u> (B) the **rental of property** by a particular partnership or trust, if a person who is related to the individual at any time in the year: (I) is actively engaged on a regular basis in the activities of the partnership or trust related to the rental of property, **<u>or</u>** (II) has an interest in the partnership directly or indirectly through one or more other partnerships.

2. What is Split Income?

Split Income = the total of all the following amounts (other than **excluded amounts**):

Split Income	Description
ITA 120.4(1)(c) **Trust income**	Income received by a trust beneficiary that can reasonably be considered: **(A)** to be in respect of **taxable dividends** received (other than from shares listed on a designated stock exchange), **(B)** to arise because of **section 15** (other than from shares listed on a designated stock exchange), **(C)** to be income derived <u>directly or indirectly</u> from one or more **related businesses** in respect of the individual for the year, **<u>or</u>** **(D)** to be income derived from the **rental of property** by a particular partnership or trust, if a person who is related to the individual at any time in the year is actively engaged on a regular basis in the activities of the particular partnership or trust related to the rental of property.

2. What is Split Income?

Split Income = the total of all the following amounts (other than **excluded amounts**):

Split Income	Description
ITA 120.4(1)(d) **Interest income from private corporations, partnerships, and trust.**	• Income from debt (e.g., interest) received from a private corporation (i.e., shares not listed on a designated stock exchange), partnership or trust. • There are THREE exclusions for interest on: 1. certain debts of, or debts guaranteed by, governments, 2. publicly-listed or traded debt; and 3. a deposit standing to the individual's credit at a bank or credit union.

2. What is Split Income?

Split Income = the total of all the following amounts (other than **excluded amounts**):

Split Income	Description
ITA 120.4(1)(e) **Taxable capital gains**	This paragraph applies when two conditions are met. **1. Taxable capital gains** <u>and</u> **income** from the disposition of property.(including those allocated to a trust beneficiary); and 2. The property referred to in the first condition must generally be property the income from which would be split income if received by the specified individual (i.e., private company shares, private company debt, interest in a partnership or trust). ○ For property other than shares of a corporation, the property must also be a property such that 1. an amount was included in the individual's split income for the year <u>or</u> a previous year, or 2. all or part of its fair market value immediately before the disposition was attributable to a share of a private corporation.

3. Excluded Amounts

- **Split Income** excludes "excluded amounts"
- If an amount is an excluded amount, TOSI rules do not apply.
- **Excluded amount =** individual's income or taxable capital gain from a property to the extent that it is one of the following amounts:

Excluded Amount	Age Requirement	Description
ITA 120.4(1)(a) **Income from Inherited property (i.e. dividends from inherited private company shares)**	**≤ 24 Years**	Excludes split income from a property that was acquired by, or for the benefit of (i.e., held by a trust), the individual **as a consequence of the death** of: (i) a parent of the individual, or (ii) any person, if: (a) the individual (receiving the income) is enrolled as a full-time student during the year at a post-secondary educational institution, or (b) the individual (receiving the income) may deduct a disability tax credit under section 118.3 (i.e., one or more severe and prolonged impairments in physical or mental functions).

3. Excluded Amounts

- **Excluded amount =** individual's income or taxable capital gain from a property to the extent that it is one of the following amounts:

Excluded Amount	Age Requirement	Description
ITA 120.4(1)(b) **Property Transferred Due to Marital Breakdown**	**No Age Requirement**	• Excludes split income from property acquired by the individual under a transfer described in subsection 160(4). • Where a taxpayer transfers property to the taxpayer's spouse or common-law partner pursuant to a decree, order or judgment of a competent tribunal or a written separation agreement and, at that time, the taxpayer and spouse or common law partner were separated and living apart as a result of the breakdown of their marriage or common-law partnership, the income derived by the spouse or common-law partner from the property will be an excluded amount.

3. Excluded Amounts

- **Excluded amount =** individual's income or taxable capital gain from a property to the extent that it is one of the following amounts:

Excluded Amount	Age Requirement	Description
ITA 120.4(1)(c) **Taxable Capital Gains Realized on Deemed Disposition at Death**	**No Age Requirement**	• Excludes from split income a taxable capital gain that arises because of subsection 70(5): a deemed disposition of capital property owned by a taxpayer immediately before their death.

3. Excluded Amounts

- **Excluded amount =** individual's income or taxable capital gain from a property to the extent that it is one of the following amounts:

Excluded Amount	Age Requirement	Description

ITA 120.4(1)(d)
 	
Taxable capital gains on "qualified farm or fishing property" or "qualified small business corporation shares"
	No Age Requirement	• Excludes from split income taxable capital gains on:
		  • qualified farm or fishing property or
		  • qualified small business corporation shares.
		• This exclusion would also apply to taxable capital gains realized by a trust that are allocated to beneficiaries.
		• This exclusion **does not apply** to a taxable capital gain deemed to be dividend under subsection 120.4(4) or (5).
		  • (This occurs when minors realize a capital gain on private company shares on a sale to non-arm's length persons. The capital gain is deemed to be a dividend.)

3. Excluded Amounts

- **Excluded amount =** individual's income or taxable capital gain from a property to the extent that it is one of the following amounts:

Excluded Amount	Age Requirement	Description
ITA 120.4(1)(e)(i) **Related Business**	**≥ 18 Years**	• Excludes from split income amount that is not derived directly or indirectly from a "**related business**" in respect of the individual for the year. • The words "directly or indirectly", denotes that the phrase was meant to have a broad interpretation (see *CRA document no. 2018-0779981C6, 27 November 2018 CTF Roundtable Q. 9*).

3. Excluded Amounts

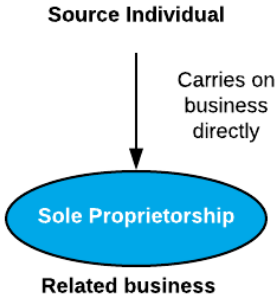
What is a Related Business?

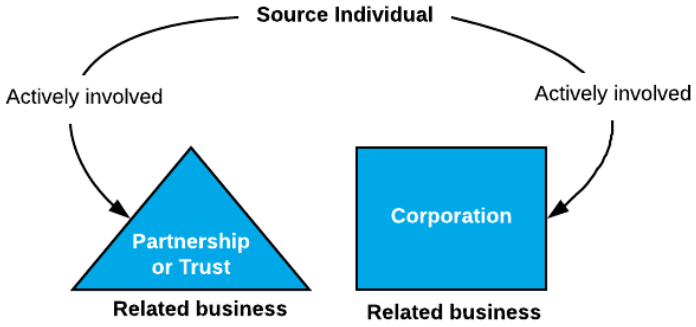
- A **"related business"** is defined in respect of a **specified individual** for a taxation year and refers throughout to a **"source individual"**.
- A source individual in respect of the specified individual must be sufficiently connected to the business.
- A **"source individual"** in respect of a specified individual means an individual (other than a trust) who, at any time in a year, is both **resident in Canada** and **related** to the specified individual.
- **Note:** Trusts are not source individuals.

3. Excluded Amounts

What is a Related Business?

- A ***related business***, in respect of a specified individual for a taxation year, could occur in one of three situations:
  - **Situation #1:**
    - A business carried on directly by a "source individual".
    - It also includes a business carried on by a partnership, corporation or trust if a "source individual" is actively engaged in the business.

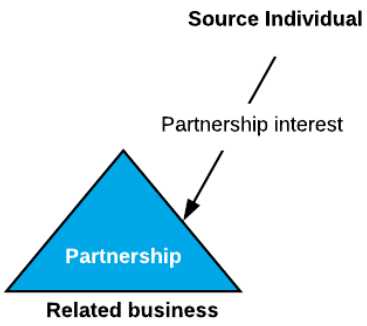


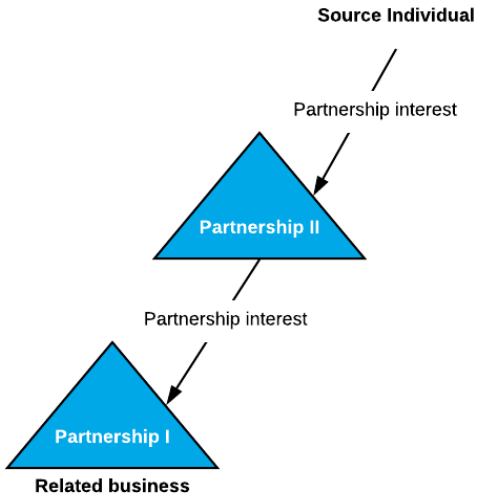


3. Excluded Amounts

What is a Related Business?

- A ***related business***, in respect of a specified individual for a taxation year, could occur in one of three situations:
  - **Situation #2:**
    - A business of a **partnership**, if a "source individual" has an interest (including directly or indirectly through one or more partnerships) in the partnership.





3. Excluded Amounts

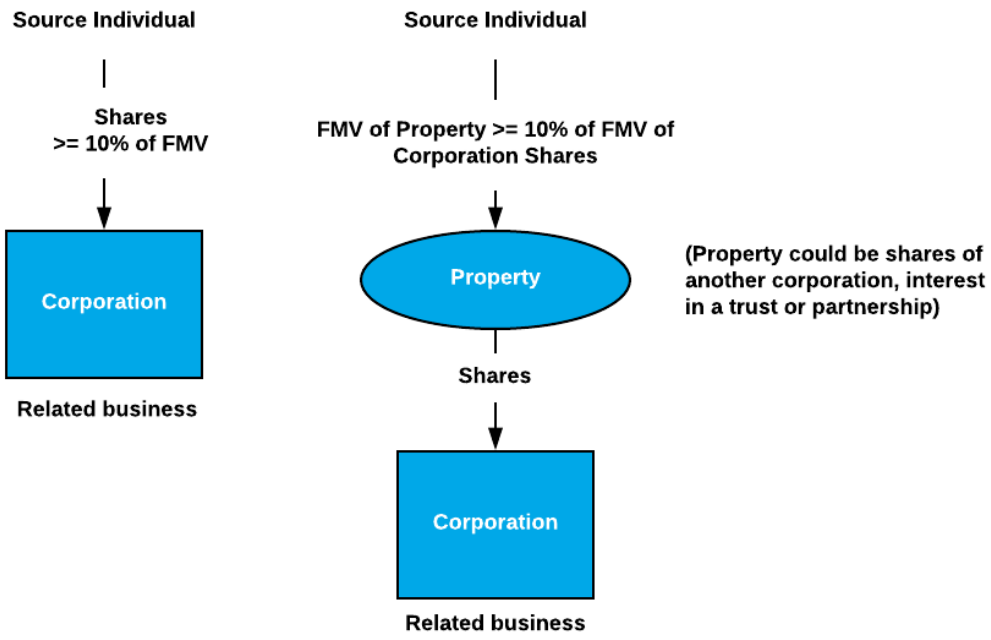
What is a Related Business?

- A ***related business***, in respect of a specified individual for a taxation year, could occur in one of three situations:
  - **Situation #3:**
    - A **business carried on by a corporation** in which the following conditions are met:
      1. a source individual owns (i) shares of the corporation or (ii) property that derives, directly or indirectly, all or part of its fair market value from shares of that capital stock, and
      2. the total fair market value of the shares and property described above that is owned by the source individual is ≥ 10% of the total fair market value of the shares of the corporation.

3. Excluded Amounts

What is a Related Business?

- A ***related business***, in respect of a specified individual for a taxation year, could occur in one of three situations:
  - **Situation #3:**



3. Excluded Amounts

Amount Derived, Directly or Indirectly, from a Business

- The TOSI rules refer to **income derived, directly or indirectly, from a business.**
- 120.4(1.1)(d) clarifies that an amount derived directly or indirectly from a business includes the following the following THREE amounts:

    1. an amount derived from the **provision of property** <u>or</u> **services** to, or in support of, the business.
    2. an amount relating **the ownership or disposition** of an interest in the person or partnership carrying on the business.
        - equity returns on an interest in a partnership, corporation or trust carrying on a business will also be considered to be an amount derived from that business
    3. amounts derived from an amount described above (catches situations where income is streamed up a multi-tiered corporate structure).
        - income derived from income derived from a business is income derived, directly or indirectly, from the business.

3. Excluded Amounts

What is a Related Business?

- The CRA states that it is a question of fact as to whether the income is from a business or property which can only be resolved after the review of all the facts and circumstances
- If a corporation earns income from passive sources, including interest, dividends, rents and royalties, the company may cross a sufficient level of activity to support the view that their income may be considered to be from a business rather than property. It this is the case, then income may be from a Related Business.
- See *CRA document no. 2018-0780081C6*.

3. Excluded Amounts

Related Business <u>For the Year</u>:

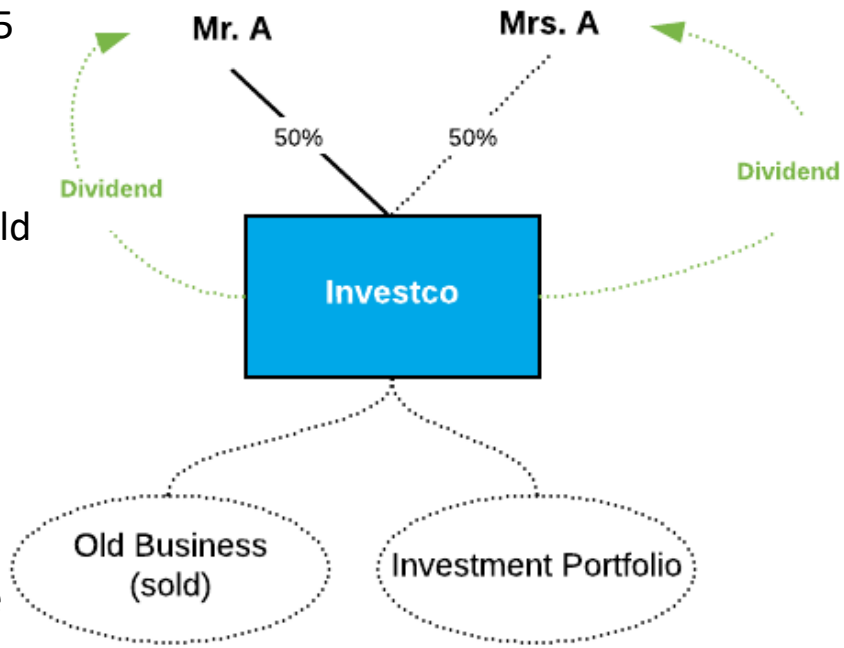
- The CRA ruled that the Related Business test has a two-part test:
    1. Whether the split income is derived <u>directly or indirectly</u> from a related business; and
    2. Is so, whether that income is in respect of the individual <u>for the year</u>
- See *CRA document no. 2018-0779981C6, 27 November 2018 CTF Roundtable Q. 9*).
- CRA confirmed that even if the dividend is considered to be derived directly or indirectly from the historical retained earnings of an old business or from the proceeds of disposition of an old business, it is not deriving it from a related business "<u>for the year</u>".
- The next two examples illustrate this related business "for the year" concept.

3. Excluded Amounts

Example 1 - Related Business <u>For the Year</u>

Facts

- Mr. A and his spouse, Mrs. A, are both over 25 years old and are resident in Canada.
- Each own 50% of the shares of ACo,
- In the past A Co carried on a business (the "Old Business") in which <u>Mrs. A had been actively engaged for at least five prior taxation years.</u>
- Mr. A was never involved in or contributed to the Old Business.
- ACo sold the Old Business two years ago.
- ACo's sole activity since the sale has been the investment of the sale proceeds and the historical retained earnings from the Old Business.
- In the current year, ACo declared a taxable dividend to Mr. A and Mrs. A.



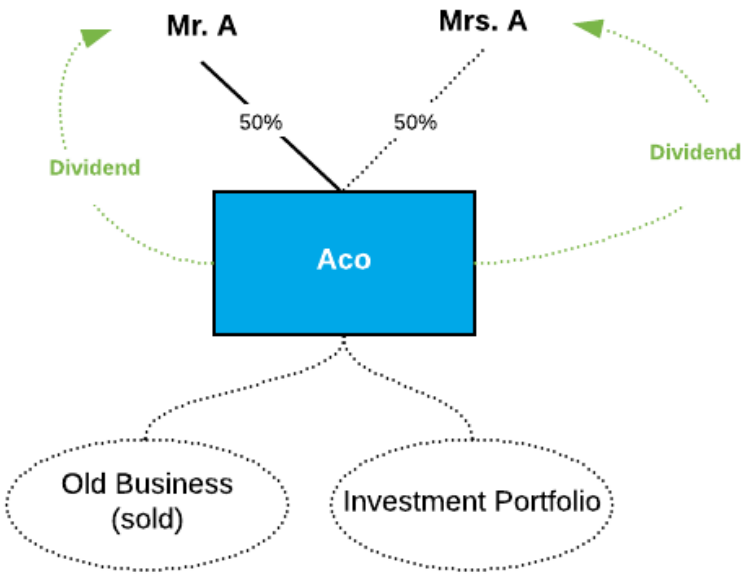
**Example from CRA Document no. 2018-0779981C6*

3. Excluded Amounts

Example 1 - Related Business For the Year

Analysis

- CRA was asked to confirm that the dividend will not be considered split income given that the dividend is not derived directly or indirectly from a related business in respect of the individuals for the year? More specifically, the CRA was asked to confirm that even if the dividend is considered to be derived directly or indirectly from the historical retained earnings of the Old Business or from the proceeds of disposition of the Old Business, it is not deriving it from a related business "for the year"?
- Subparagraph (e)(i) of the "excluded amount" definition in subsection 120.4(1) provides that an amount that is not derived directly or indirectly from a "related business" in respect of the individual for the year is an excluded amount.



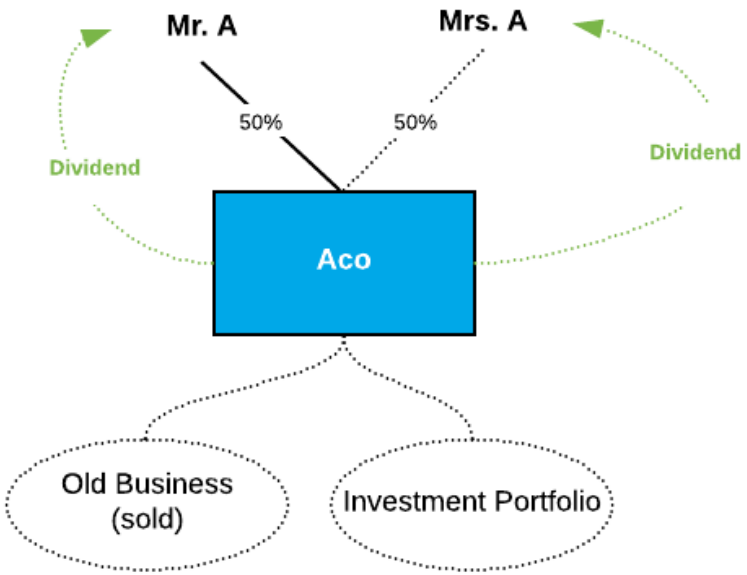
**Example from CRA document no. 2018-0779981C6, 27 November 2018 CTF Roundtable Q. 9*).

3. Excluded Amounts

Example 1 - Related Business For the Year

Analysis

- The CRA agreed that the Related Business test has a two-part test:
  1. Whether the split income is derived directly or indirectly from a related business; and
  2. Is so, whether that income is in respect of the individual for the year
- If the answer to both questions is yes, then a specified individual cannot rely on the Related Business test.
- So, if the investment activity does not constitute a business for the year (say 2019), then even if the dividend is considered to be derived from the Old Business or from the proceeds of disposition of the Old Business, it is not derived from a related business "for the year". In other words, the old business no longer exists, it cannot be a business for the year 2019.
- It is CRA's view that there will not be a related business in respect of the individual for that year where a related business was wound up in a preceding taxation year.
- But, In circumstances where the related business continues to operate in the year, it is CRA's view that there will be a related business in respect of the individual for that year. (See next example.)



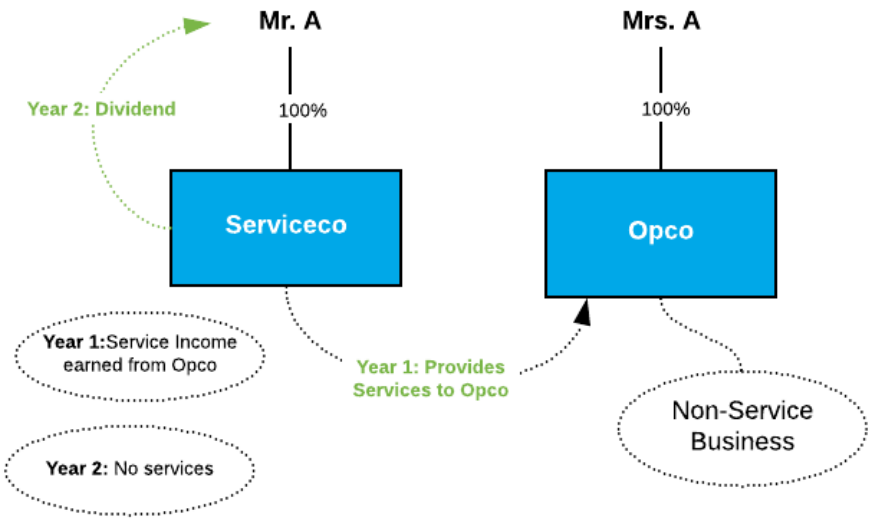
**Example from CRA document no. 2018-0779981C6, 27 November 2018 CTF Roundtable Q. 9*).

3. Excluded Amounts

Example 2 - Related Business <u>For the Year</u>

Facts

- Mr. A and his spouse, Mrs. A, are both over 25 years old.
- Mrs. A is the sole shareholder of Opco.
- Opco is not a professional corporation and carries on an operating business that is not a services business.
- Mr. A is the sole shareholder of Serviceco but is not actively engaged on a regular, continuous and substantial basis in the activities of Serviceco.
- In **Year 1**, Serviceco's income was derived from the providing services to Opco.
- Serviceco does not pay any dividends to Mr. A in Year 1.
- In **Year 2**, Serviceco does not render any services and its activities for the year do not rise to a level that is sufficient for Serviceco to be considered to have a business for the year.
- In **Year 2**, Serviceco pays a dividend to Mr. A.



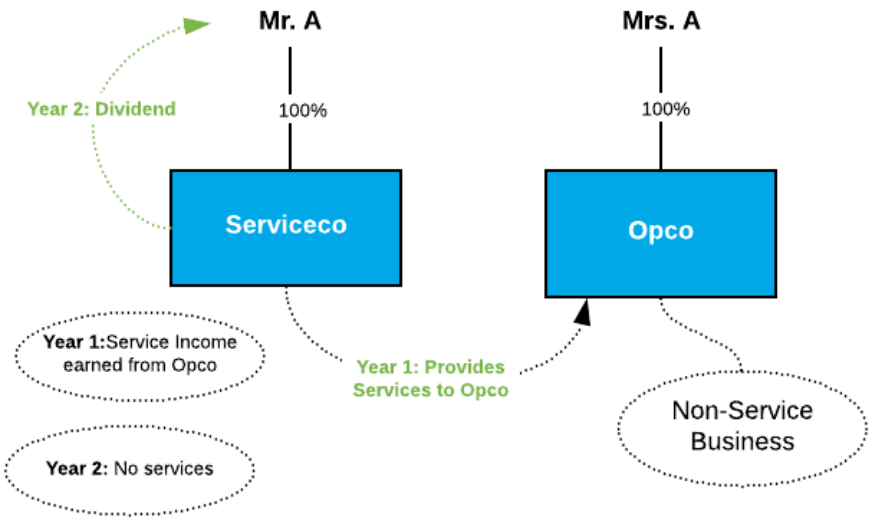
**Example from CRA document no. 2018-0779981C6, 27 November 2018 CTF Roundtable Q. 9*).

3. Excluded Amounts

Example 2 - Related Business <u>For the Year</u>

Analysis

- In this case, Mr. A would need to meet the Related Business test to be exempt from TOSI.
- The dividend needs to be:
  - (i) derived directly or indirectly from a related business (ii) and
  - from a related business for the year
- **Test 1:** Since "derived directly or indirectly" has a broad meaning, the dividend – which is derived from Opco's business – is derived a Related Business. See 120.4(1.1)(d)(ii).
- **Test 2:** Since Opco continues to exist (i.e., a related business continues to exist) in Year 2, the there will be a related business in respect of Mr. A in Year 2.
- Therefore, Mr. A does not meet the Related Business exemption. His dividends in Year 2 are subject to TOSI.
- He gets to claim the dividend tax credit against the tax payable on dividends.



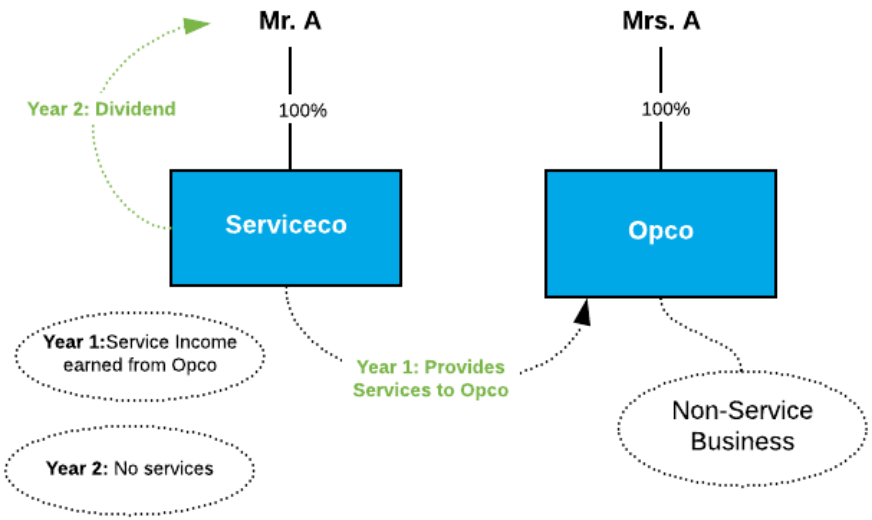
**Example from CRA document no. 2018-0779981C6, 27 November 2018 CTF Roundtable Q. 9*).

3. Excluded Amounts

Example 2 - Related Business <u>For the Year</u>

Analysis

- Contrast this with Example 1.
- In Example 1 there was no related business operating in the year, it was wound up a few years back.
- In Example 2, even through the dividend was derived from the related business activities in Year 1, the related business nevertheless continued to exist in Year 2, when the dividend was received by Mr. A.



**Example from CRA document no. 2018-0779981C6, 27 November 2018 CTF Roundtable Q. 9*).

3. Excluded Amounts

- **Excluded amount =** individual's income or taxable capital gain from a property to the extent that it is one of the following amounts:

Excluded Amount	Age Requirement	Description
ITA 120.4(1)(e)(ii) **Excluded Business (i.e., Labour Contributions)**	**≥ 18 Years**	• Excludes from split income amounts derived directly or indirectly from business in which the individual is **actively engaged** on a **regular, continuous and substantial basis in the year or** in **any five previous years**. • The five preceding years does not need to be continuous. • The five-year test is intended to ensure that individuals who have made significant labour contribution to a business over a number of years will continue to be exempt from the TOSI after **retirement** from, or a **reduction in their involvement in**, the business.

3. Excluded Amounts

- **Excluded amount =** individual's income or taxable capital gain from a property to the extent that it is one of the following amounts:

Excluded Amount	Age Requirement	Description
ITA 120.4(1)(e)(ii) **Excluded Business (i.e., Labour Contributions)**	**≥ 18 Years**	**Regular, Continuous and Substantial Basis:** • Whether an individual is actively engaged a "regular, continuous and substantial basis" will depend on the circumstances, including the **nature of the individual's involvement** in the business and the **nature of the business** itself. • Based on the **time**, **work** and **energy** that the individual devotes to the business. • The more an individual is involved in the **management and/or current activities** of the business, the more likely it is that the individual will be considered to participate in the business on a regular, continuous and substantial basis. • The more an individual's contributions are **integral to the success of the business**, the more substantial they would be.

3. Excluded Amounts

- **Excluded amount =** individual's income or taxable capital gain from a property to the extent that it is one of the following amounts:

Excluded Amount	Age Requirement	Description
ITA 120.4(1)(e)(ii) **Excluded Business (i.e., Labour Contributions)**	**≥ 18 Years**	**Reorganizations:** • Lawmakers intended that reorganizations and other changes to the person or partnership carrying on the business should not affect the Excluded Business exemption. • For example, if a business operated as a sole proprietorship is transferred to a corporation, an individual's involvement in the business before the transfer is to be taken into consideration in determining whether the business carried on by the corporation is an Excluded Business of the individual.

3. Excluded Amounts

- **Excluded amount =** individual's income or taxable capital gain from a property to the extent that it is one of the following amounts:

Excluded Amount	Age Requirement	Description
ITA 120.4(1)(e)(ii) **Excluded Business (i.e., Labour Contributions)**	**≥ 18 Years**	**Deeming Rule - 20 hours per week** • 120.4(1.1)(a) contains a deeming rule that provides additional certainty. • A specified individual who works an average **of 20 hours per week** of work throughout the portion of the year when the business operates is deemed to be engaged a "regular, continuous and substantial basis." • Suppose the business only operates from December to March (i.e., a Winter sports business) and an individual works an average of 20 hours during those months. The individual should qualify for the exemption because he or she contributed those hours throughout the portion of the year when the business operated. • **Note:** a person who works less that 20 hours could still qualify for the Excluded Business exemption; the above is just a deeming rule. It does not limit the generality of the "regular, continuous and substantial" test described earlier.

3. Excluded Amounts

- **Excluded amount =** individual's income or taxable capital gain from a property to the extent that it is one of the following amounts:

Excluded Amount	Age Requirement	Description
ITA 120.4(1)(e)(ii) **Excluded Business (i.e., Labour Contributions)**	**≥ 18 Years**	**Deeming Rule - 20 hours per week** • For example, the test would be satisfied where an individual works 30 hours per week for 20 weeks in a year in respect of a business that operates for 25 weeks out of the year (30 x 20 / 25 > 20). • **Note:** a person who works less that 20 hours could still qualify for the Excluded Business exemption; the above is just a deeming rule. It does not limit the generality of the "regular, continuous and substantial" test described earlier.

3. Excluded Amounts

- **Excluded amount =** individual's income or taxable capital gain from a property to the extent that it is one of the following amounts:

Excluded Amount	Age Requirement	Description
ITA 120.4(1)(f)(i) **Safe harbour capital return**	**18 to 24 Years**	• Excludes from split income a return on contributed capital up to a prescribed rate. • The prescribed rate was 2% at the time of the writing of this commentary (February 2019).

3. Excluded Amounts

- **Excluded amount =** individual's income or taxable capital gain from a property to the extent that it is one of the following amounts:

Excluded Amount	Age Requirement	Description

ITA 120.4(1)(f)(ii)
 	
Reasonable return on arm's length capital by the individual
	18 to 24 Years	• Excludes from split income a **reasonable return** in respect of the individual, having regard only to the contributions of **arm's length capital** by the individual.
		
		What is a Reasonable Return?
		
		• A **reasonable return** is based on having one or more of the following:
		  • the **work performed** in support of the related business;
		  • the **property contributed** in support of the related business;
		  • the **risks assumed** in respect of the related business;
		  • such **other factors** as may be relevant.

3. Excluded Amounts

- **Excluded amount =** individual's income or taxable capital gain from a property to the extent that it is one of the following amounts:

Excluded Amount	Age Requirement	Description
ITA 120.4(1)(f)(ii) **Reasonable return on arm's length capital by the individual**	**18 to 24 Years**	• Excludes from split income a **reasonable return** in respect of the individual, having regard only to the contributions of **arm's length capital** by the individual. **What is a Arm's Length Capital?** • **Arm's length capital** is property that was: 1. Not acquired as income (e.g., as a dividend) from another property or as a gain from the disposition of another property where the income or gain was derived directly or indirectly from a related business ; 2. Not borrowed by the specified individual; or 3. Not transferred to the specified individual from a related person (other than by reason of death).

3. Excluded Amounts

- **Excluded amount =** individual's income or taxable capital gain from a property to the extent that it is one of the following amounts:

Excluded Amount	Age Requirement	Description
ITA 120.4(1)(f)(ii) **Reasonable return on arm's length capital by the individual**	**18 to 24 Years**	• Excludes from split income a **reasonable return** in respect of the individual, having regard only to the contributions of **arm's length capital** by the individual. **What is a Arm's Length Capital?** • Generally, "arm's length capital" is property earned, inherited or acquired but not from a relative or from a related business (other than as salary). • Salary = arm's length capital.

3. Excluded Amounts

- **Excluded amount =** individual's income or taxable capital gain from a property to the extent that it is one of the following amounts:

Excluded Amount	Age Requirement	Description
ITA 120.4(1)(g)(i) **Excluded Shares**	**> 24 Years**	• Excludes from split income amounts that are income from, or a taxable capital gain from the disposition of, "**excluded shares**". **What are Excluded Shares?** • **Excluded shares** are shares of the capital stock of a corporation that are owned by the individual if **all** of the following FOUR conditions are met: 1. less than 90% of the business income of the corporation -- for the last taxation year of the corporation that ends at or before the end of the specified individual's taxation year – is from the provision of services; 2. the corporation is not a professional corporation; 3. the individual owns ≥ 10% of shares of votes and fair market value of the corporation; and 4. all or substantially all (i.e., ≥ 90% per CRA) of the income of the corporation is not derived directly or indirectly from another related business.

3. Excluded Amounts

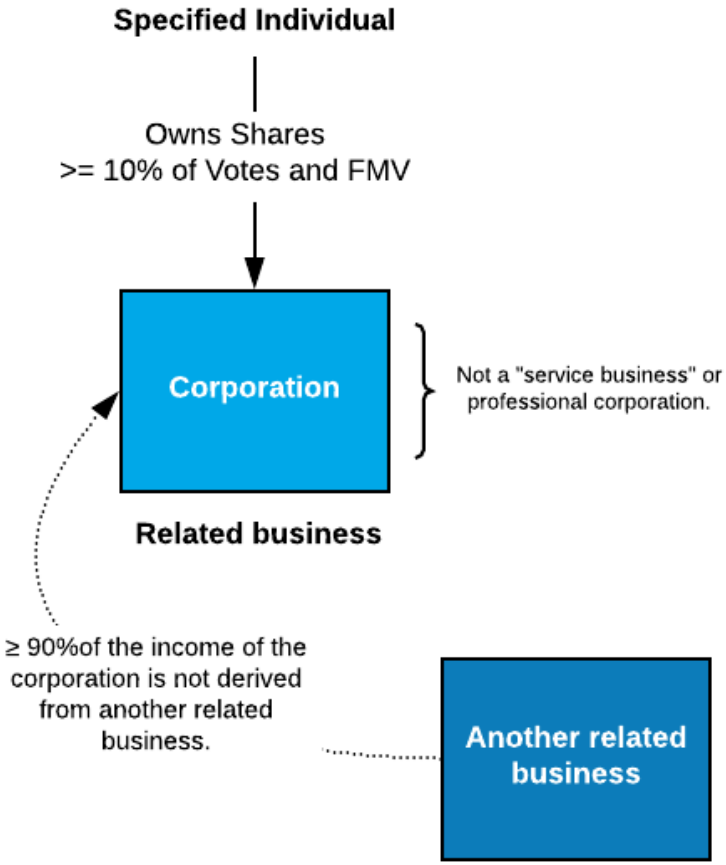
- **Excluded amount =** individual's income or taxable capital gain from a property to the extent that it is one of the following amounts:

Excluded Amount	Age Requirement	Description

ITA 120.4(1)(g)(i)
 	
Excluded Shares
	> 24 Years	• Excludes from split income amounts that are income from, or a taxable capital gain from the disposition of, "**excluded shares**".
		
		What are Excluded Shares?
		
		• **NOTE:** At the STEP CRA Roundtable 2018 (CRA Document no. *2018-0744031C6*), CRA stated that where a business has no business income (say it derives income from property), its shares would not qualify as Excluded Shares. CRA's commentary:
		
		  • CRA stated that in order to meet the condition in subparagraph (a)(i) that less than 90% of the business income of the corporation is from the provision of services, the corporation must have business income to test.
		
		  • Expressed mathematically, the following must be true for the condition to be met: (Services Income) < 0.9(Business Income). If both Services Income and Business Income equal zero, that statement is not true.

3. Excluded Amounts

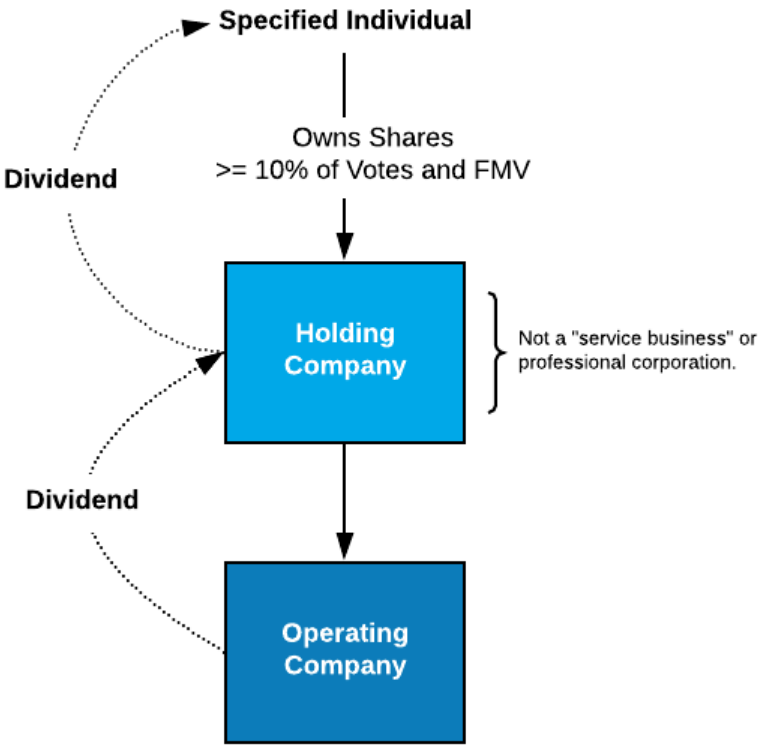
Excluded Shares Exemption



3. Excluded Amounts

Excluded Shares Exemption and Holding Companies

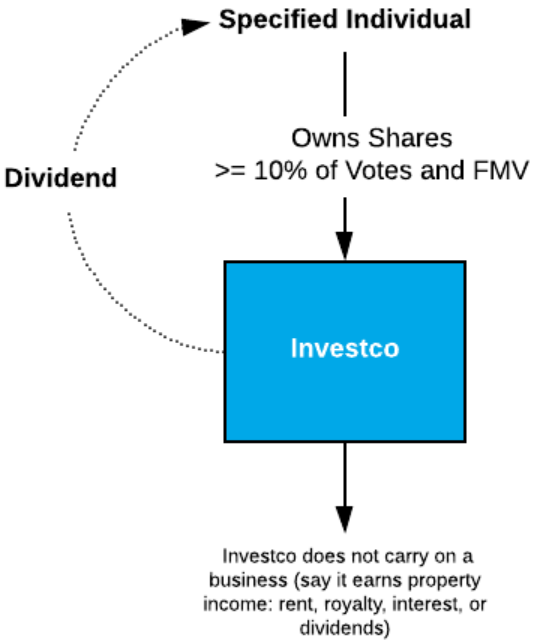
- CRA was asked if is it possible for shares of a holding company to qualify as "Excluded Shares"?
- CRA responded in the negative by stating that the definition **"Excluded Shares" should generally not include shares of a holding corporation.** This is because, in the case of a holding corporation, all or substantially all of the income would be derived from a related business in respect of the individual (other than a business carried on by the holding corporation). As a result, the shares of a holding corporation held by a specified individual will not be Excluded Shares of the individual and any income from, or a taxable capital gain from the disposition of, such shares, will not be an excluded amount and will be split income of the individual and subject to the TOSI unless another exclusion applies.
- See *CRA document no. 2018-0743971C6*.



3. Excluded Amounts

Excluded Shares Exemption and Non-Business Companies

- CRA stated that shares of a corporation that has no business income because it derives income from property (possibly rental income from real property where the activities are not sufficient to constitute business income) cannot qualify as Excluded Shares.
- But, income from the company may be an excluded amount because it is not from a Related Business.
- In this example dividends from Investco should be excluded from TOSI because the dividend is not from a related business (Investco does not carry on a business).



3. Excluded Amounts

- **Excluded amount =** individual's income or taxable capital gain from a property to the extent that it is one of the following amounts:

Excluded Amount	Age Requirement	Description

ITA 120.4(1)(g)(i)
 	
Reasonable return
	> 24 Years	• Excludes from split income amounts that are a reasonable return.
		
		What is a Reasonable Return?
		
		• A **reasonable return** is determined by comparing the relative contributions of the specified individual, and each source individual based on:
		  • the **work performed** in support of the related business;
		  • the **property contributed** in support of the related business;
		  • the **risks assumed** in respect of the related business;
		  • such **other factors** as may be relevant.
		
		• the CRA stated that it will not substitute its judgment for what is a reasonable amount where the taxpayers have made a good faith attempt to determine a Reasonable Return based on the criteria above.

3. Excluded Amounts

- **Excluded amount =** individual's income or taxable capital gain from a property to the extent that it is one of the following amounts:

Excluded Amount	Age Requirement	Description
ITA 120.4(1.1)(b) Inherited Property: Continuity Rules	**No Age Requirement for specified individual; as long as deceased individual met age requirement before death**	• See slide '*Inherited Property: Continuity Rules*'

3. Excluded Amounts

- **Excluded amount =** individual's income or taxable capital gain from a property to the extent that it is one of the following amounts:

Excluded Amount	Age Requirement	Description
ITA 120.4(1.1)(c) Special Rules for Spouse of Seniors and Widowed Spouses	**Specified Individual's Spouse ≥ 65 or deceased; no age requirement for specified individual.**	• See slide '*Special Rules for Spouses of Seniors and Widowed Spouses*'

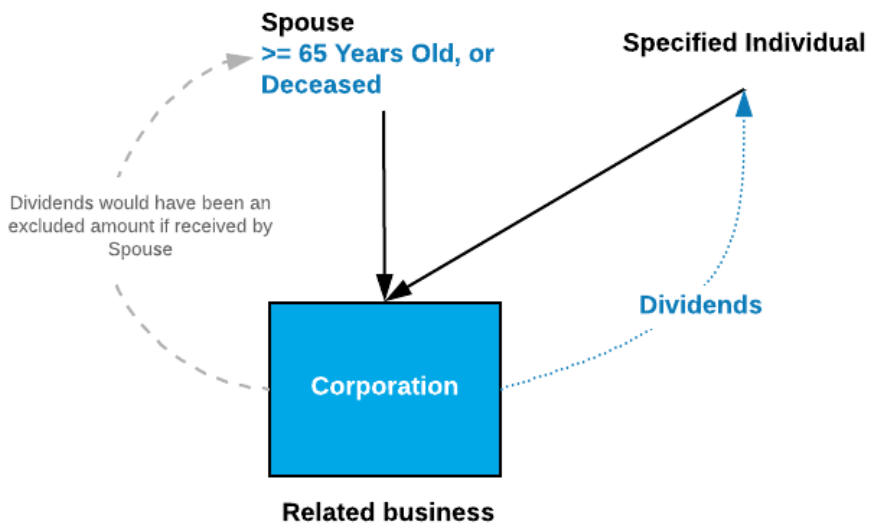
Inherited Property: Continuity Rules

- 120.4(1.1)(b) provides a continuity rule for inherited property.
- There are THREE continuity rules to exempt individuals form the TOSI rules on properties inherited from a deceased person:

    1. If the income from the inherited property, had it been received by the deceased person, would have been a "**reasonable return**" for the deceased person;
    2. If the income from the inherited property, had it been received by the deceased person, would have been from an "**Excluded Business**" because the deceased person was actively engaged on a regular, continuous and substantial basis in the activities of the related business in any 5 previous taxation years;
    3. For the purposes of the "**Excluded Shares**" and "**reasonable return**" tests (which generally apply only to specified individuals 25 years or older), if the deceased had attained the age of 25 years in the year in which they died, the specified individual will also be deemed to have attained the age of 25 years.

Special Rules for Spouses of Seniors and Widowed Spouses

- 120.4(1.1)(c) provides a special rule for split income received by the spouse of a source individual who is (i) **65 years or older** <u>**or**</u> (ii) **who died before the end of the year (regardless of age).**
- An amount will be an excluded amount in the hands of a specified individual if:
  1. the amount would have been an excluded amount in the hands of the specified individual's spouse, if it had been received by the spouse as income in the year, or
  2. the amount would have been an excluded amount in respect of an individual who was, immediately before their death, the specified individual's spouse, if the amount were included in computing the deceased spouse's income for their last taxation year.

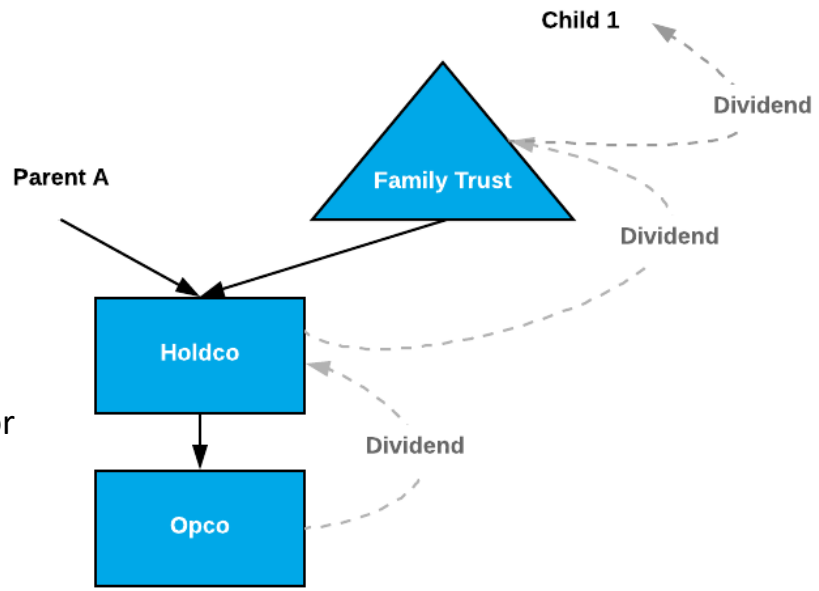


CRA Examples

Example 1: Dividends to adult child not involved in the business*

Facts

- Opco carries on an active business.
- The sole shareholder of Opco is Holdco.
- The shareholders of Holdco are Parent A and Family Trust, a discretionary trust for the benefit of Parent B, Child 1 and Child 2.
- Parent A and Family Trust each owns a separate class of shares of Holdco. Parent A is the founder of Opco's business and is the controlling shareholder of Holdco.
- Child 1 is age 23 and is a full-time graduate student at a university and has never performed any functions for Holdco or Opco and has not made any other contribution to Holdco or Opco and its business.
- Child 2 is age 16 and is a high school student.
- Opco pays a dividend to Holdco. Holdco pays a dividend on the class of shares held by Family Trust. Family Trust distributes the full amount of the dividend to Child 1 and that amount is included in computing the income of Child 1.



**Examples 1-12 are from CRA, Guidance on the application of the split income rules for adults.*

Example 1: Dividends to adult child away at school

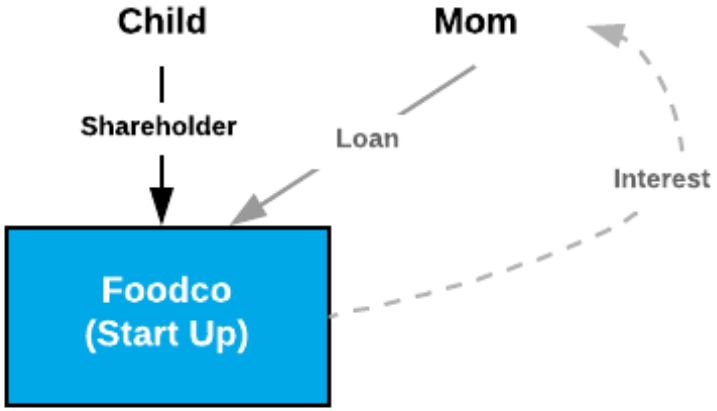
Analysis

- The amount received by Child 1 will be subject to TOSI.
- The distribution received by Child 1 will be split income unless it is an Excluded Amount.
- Since Child 1 is 23 years old, he needs to qualify for one the following exemptions: (i) non-related business, (ii) the Excluded Business, and safe harbour capital return or reasonable return on arm's length capital.
- **Excluded Business** exemption is not met because Child 1 is not actively engaged in the business.
- **Safe Harbour Capital Return or a Reasonable Return on contributions of Arm's Length Capital** exemptions are not met because Child 1 has never contributed property in support of Opco's business.
- Since Opco carries on a business, the **Related Business** exemption is not met.
    - Dividend is derived from a related business (i.e., the business of opco) because Parent A (a source individual to Child 1) is actively involved in Opco's business.

Example 2: Funding start-up business

Facts

- Child is age 25, has opened his own restaurant which is owned and operated by Foodco. Child is the sole shareholder of Foodco.
- Because of the high failure rate of new restaurants, Child was unable to obtain any financing from the bank.
- Mom provided part of the start-up capital of the business through an interest bearing loan to Foodco.
- Other start-up capital was contributed by interest bearing loans from friends.
- The rate of interest on Mom's loan is similar to the interest payable by Foodco to Child's friends, both of which are higher than the prevailing rate of interest generally charged by a financial institution on a typical small business loan.
- Mom has no other investment in or involvement with the business.



Example 2: Funding start-up business

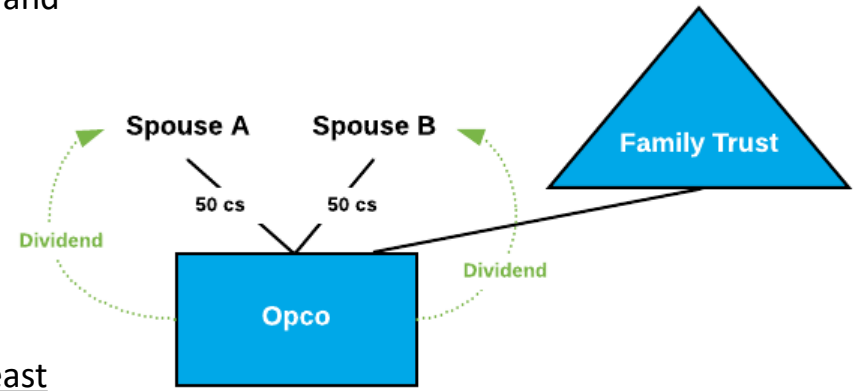
Analysis

- Mom is a specified individual.
- Mom receives interest from Foodco – a private corporation (i.e., split income) and a related business. It is a related business because Child, who is related to Mom, is actively engaged in Foodco's business.
- Mom does not qualify for Excluded Business exemption: she is not actively involved.
- Mom does not qualify for the Excluded Shares exemption: she does not own any shares of Foodco.
- Mom needs to meet the reasonable return test to be exempt from TOSI.
- CRA concludes that Mom's interest income is a reasonable return based on the property contributed and the risk assumed by Mom by lending money to Foodco. The interest is an excluded amount.

Example 3: Dividends to spouse

Facts

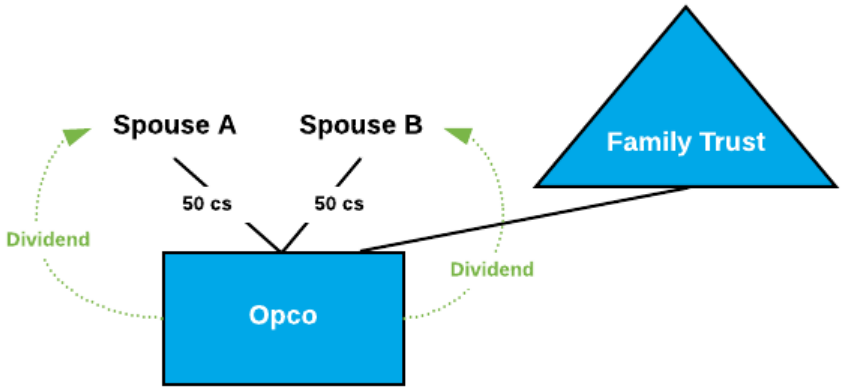
- Spouse A and Spouse B each owns 50 common shares of a different class of Opco. These classes of shares are identical in all respects. The only other shareholder of Opco is a discretionary trust for the benefit of their children, all of whom are under age 17. Spouse A and Spouse B have held common shares of Opco since incorporation.
- Spouse A and Spouse B are over age 25.
- Opco carries on an active business supplying components for processing units of personal computers.
- Opco's business was founded by Spouse A, an engineer, who works full-time managing Opco's operations. Spouse A worked in the business at least an average of 20 hours per week during the taxation year. Initial capital was provided by a relative.
- Spouse B has no direct involvement in any aspect of Opco's business. In general, Spouse B has never performed any functions for Opco; contributed any property directly or indirectly to Opco; or assumed any risks in respect of Opco's business.
- Opco pays the same amount of dividends to Spouse A and Spouse B.



Example 3: Dividends to spouse

Analysis

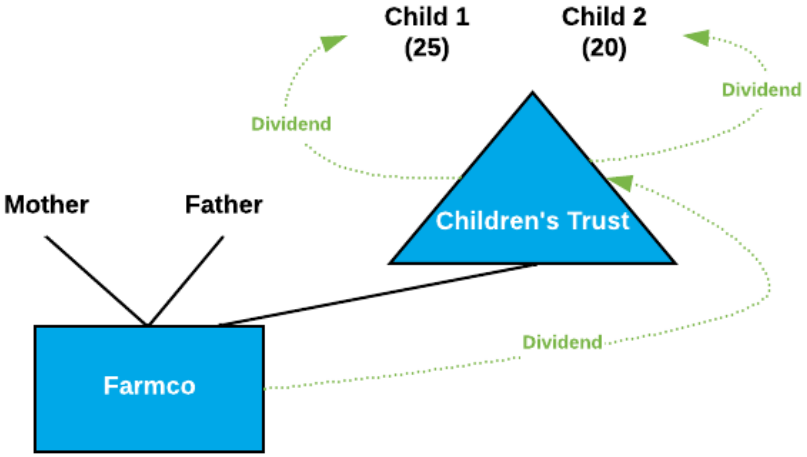
- Dividends received by Spouse A and B is split income (unless it qualifies as an excluded amount).
- Dividends are derived from a related business (i.e., Opco's business)
- **Spouse A** is not subject to TOSI because:
    - he would qualify for the **Excluded Business** exemption: Spouse A has worked in the business at least an average 20 hours per week during the taxation year, and
    - he would also qualify for the **Excluded Shares** exemption (i.e., Opco's business is not a service business and Spouse A owns ≥ 10% of shares of votes and fair market value of Opco).
- **Spouse B** is not subject to TOSI because she would also meet the **Excluded Shares exemption**.
- Even if all of the dividends were paid to Spouse A or Spouse B, they would both still remain exempt from TOSI. The automatic bright-line tests – the Excluded Business and Excluded Shares tests – would exempt them.



Example 4: Dividends paid to adult children active in the family business

Facts

- Farmco carries on an active farming business. All of the issued and outstanding shares of Farmco are held by Father, Mother and Children's Trust, a discretionary trust for the benefit of Child 1 and Child 2. Father, Mother and Children's Trust each owns separate class of Farmco shares.
- All the family members currently work full-time in the business and are involved in almost all aspects of the farming operations, as required.
- Child 1 is age 25 and has a university degree. Child 1's work includes assisting Mother with the administration and marketing of the business in order to gain work experience to help with his future career. Child 1 works in the business at least an average of 20 hours per week during the taxation year.
- Child 2 is age 20 and has indicated an interest in succeeding Father and Mother in running the farming business. As a result, Father and Mother are involving Child 2 more in the discussion of management decisions to learn how to run the business, but actual decisions continue to be made by Father and Mother. Child 2 works in the business at least an average of 20 hours per week during the taxation year.
- Farmco pays dividends to Children's Trust which are then distributed equally to each of Child 1 and Child 2. The children include the distribution in computing their income.
- The total amount received by each Child is similar but is not the same as the salary that Farmco would pay to an arm's length employee.



Example 4: Dividends paid to adult children active in the family business

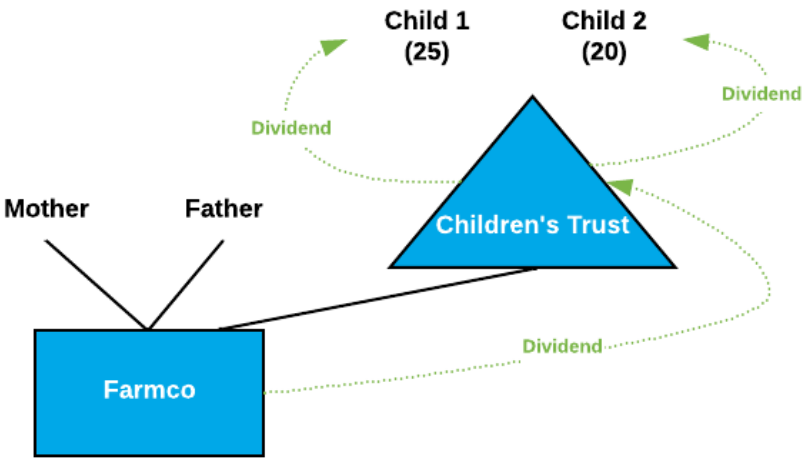
Analysis

- Dividends allocated to Child 1 and Child 2 is split income (unless it qualifies as an excluded amount) since the distribution of dividends pertains to taxable dividends received from a private corporation.
- The dividends are derived from a related business since Mother and Father, who are related to Child 1 and Child 2, are actively engaged in Farmco's business.
- The dividends received by Child 1 and Child 2 are excluded amounts because it is received from an **Excluded Business**. They will each be deemed to be actively engaged in the business because each works in the business at least an average of 20 hours per week during the taxation year.

Example 4A: Dividends paid to adult children active in the seasonal family business

Facts

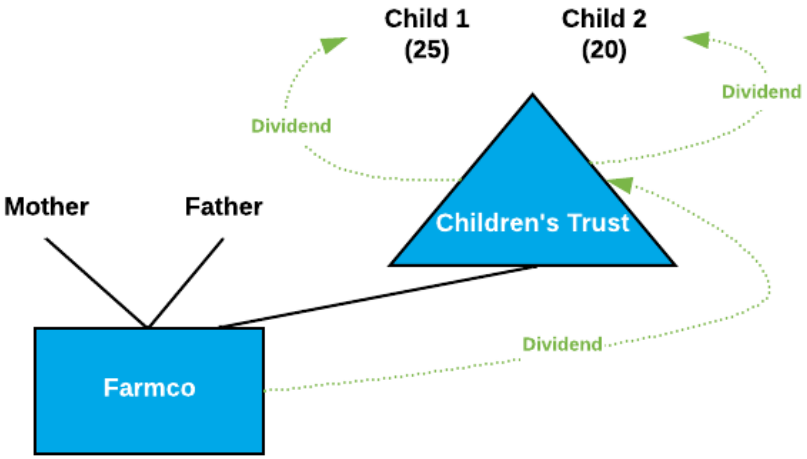
- The same facts as Example 4 except that Opco carries on a seasonal farming business and only operates for 40 weeks in the taxation year.
- Child 1 worked in the business 40 hours per week but only during 20 weeks.
- Child 2 worked in the business at least an average of 20 hours per week during the 40-week period that the farming business operates.



Example 4A: Dividends paid to adult children active in the seasonal family business

Analysis

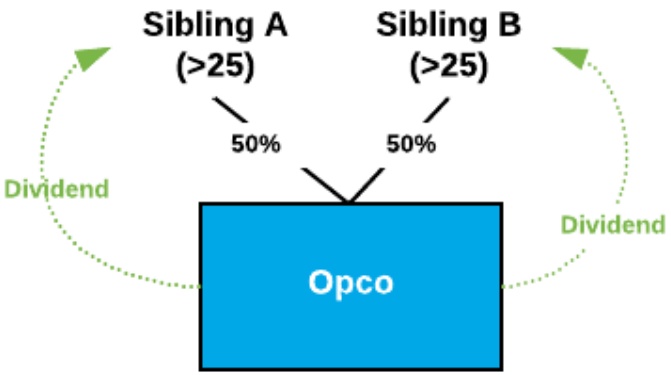
- The distribution of the dividend paid by Farmco will be an excluded amount because it is received from an **Excluded Business** in respect of each of Child 1 and Child 2.
- They will each be deemed to be actively engaged in the business because each works in the business at least an average of 20 hours per week during the portion of the taxation year that the farming business operates.
    - **Child 1:** 40 hours x 20 weeks/40 weeks = 20 hours per week
    - **Child 2:** 20 hours per week



Example 4B: Dividends paid to an adult

Facts

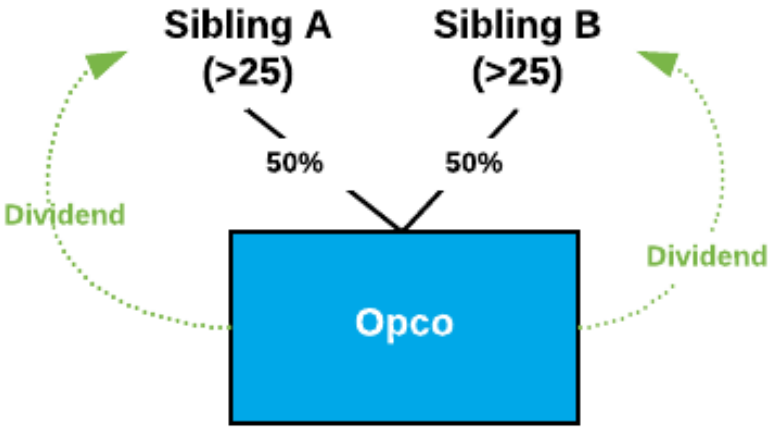
- Opco carries on an active business operating a franchised food court stall in a mall. The shareholders of Opco are Sibling A and Sibling B who are equal shareholders and hold the same class of shares. They are both over age 25.
- Opco retains part-time help during lunch and dinner hours and during the summer season.
- Sibling A works in the business at least an average of 20 hours per week during the taxation year.
- Sibling B worked full-time during the first two years of the business but has since returned to school to complete an accounting degree. Sibling B plans on returning to work in the business but now only works during the summer and when the mall has more shoppers.
- Opco pays dividends of all of its excess cash equally to Sibling A and Sibling B.
- The dividend received by Sibling B is significantly more than what is paid to the other part-time help.



Example 4B: Dividends paid to an adult

Analysis

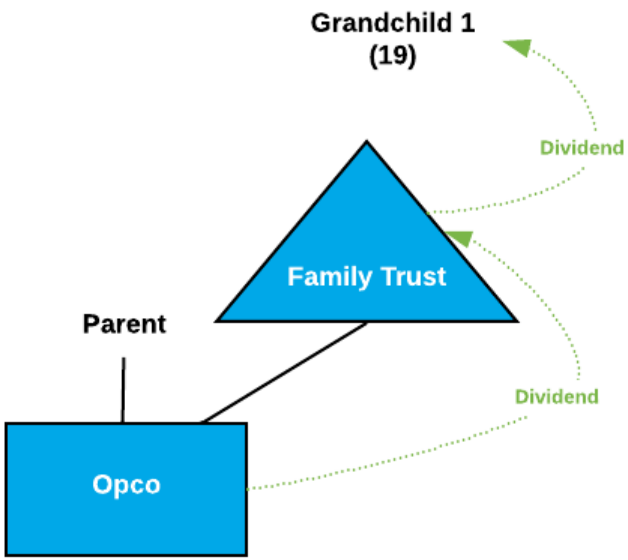
- Sibling A and B are both specified individuals
- Dividends received from Opco – a private corporation – is split income (unless it qualifies as an excluded amount).
- **Sibling A** can rely on the **Excluded Business** exemption since she works in the business at least an average of 20 hours per week during the taxation year.
- Sibling A can also rely on the Excluded Shares exemption since: (i) Opco's business – operating a franchised food court stall in a mall – is not a service business; and (ii) Sibling A owns ≥ 10% of the votes and values of Opco.
- **Sibling B** can also rely on the **Excluded Shares** exemption for the same reason as Sibling A.
- Sibling B cannot rely on the Excluded Business exemption because she is not actively engaged on a regular, continuous and substantial basis in the year or any five prior years. She is also not deemed to be actively engaged because she works in the business less than an average of 20 hours per week.



Example 5: Dividends paid to an adult under age 25

Facts

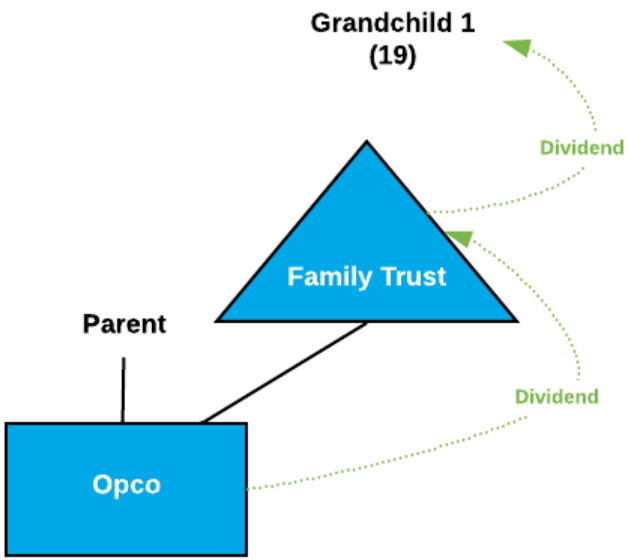
- Grandchild 1 is age 19 and is attending the local university.
- Grandchild 1 does part-time (one day per week) clerical work in the family's business operated by Opco, which operates during the entire taxation year. Grandchild 1 works approximately 350 hours during the taxation year.
- The shareholders of Opco are Parent and Family Trust, a discretionary trust for the benefit of Child 1, Child 2 and Child 3 and their families.
- Opco pays a dividend to the Family Trust, part of which is distributed to Grandchild 1. The amount of the distribution received by Grandchild 1 is the same as the amount paid by Opco to its full-time clerical staff prorated for the time worked by Grandchild 1.



Example 5: Dividends paid to an adult under age 25

Analysis

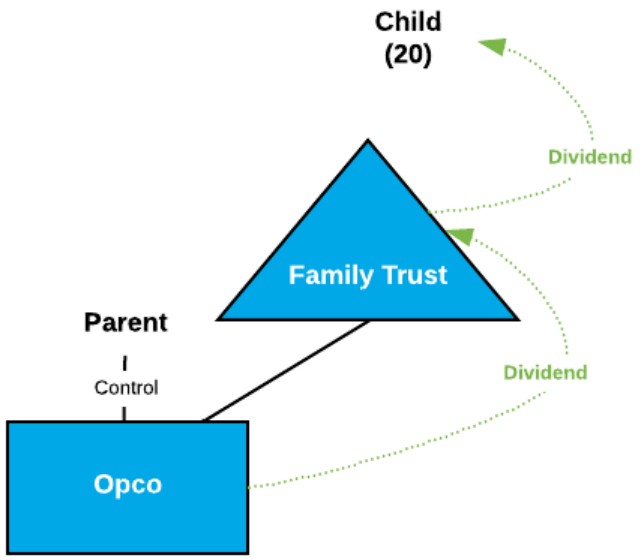
- Grandchild 1 is a specified individual.
- Dividends distributed from the family trust is split income (unless it qualifies as an excluded amount) since it pertains to dividends from a private corporation.
- The dividend is also from a related business because Parent – a significant shareholder of Opco – is related to grandchild 1.
- Grandchild 1 cannot rely on the Excluded Business exemption because he is not actively engaged in Opco's business. He cannot rely on the deeming rule because he does not work an average of 20 hours per week.
- Grandchild 1 cannot rely on the safe harbour capital return, or a reasonable return on contributions of Arm's Length Capital exemptions because he has never contributed property in support of Opco's business.
- Grandchild 1 cannot rely on the Reasonable Return exemption because he is not over 24 years of age.
- In the circumstances, the distribution will not be considered an excluded amount. Therefore, **the dividend is subject to TOSI.**



Example 5A: Dividends paid to an adult under age 25

Facts

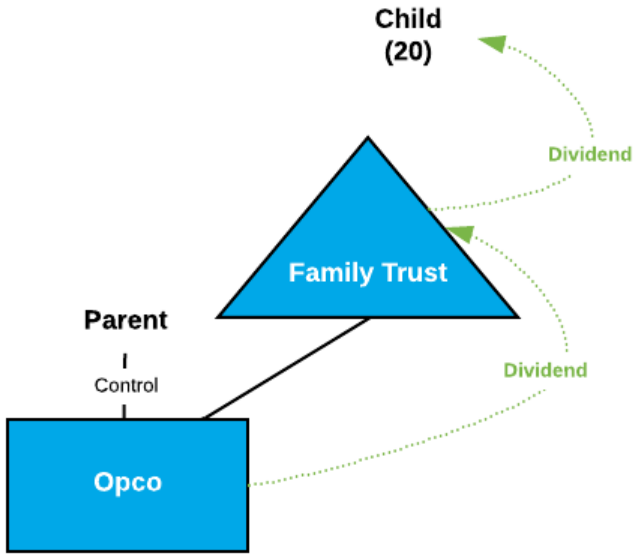
- Child is age 20 and is a full-time student.
- Child works in the family business' warehouse operated by Opco as a summer job (on a full-time basis in May, June, July and August) while attending university. Child works 600 hours during the taxation year.
- The shareholders of Opco are Parent and Family Trust, a discretionary trust for the benefit of Child and his family. Parent controls Opco. Family Trust owns a separate class of Opco shares.
- Opco pays a dividend to Family Trust which is then distributed to Child. Child includes the amount of the distribution in computing his income.
- The amount of the distribution received by Child is similar to the salary paid to another Opco employee doing comparable work prorated for the time worked by Child.



Example 5A: Dividends paid to an adult under age 25

Analysis

- Child is a specified individual.
- Dividends distributed from the family trust is split income (unless it qualifies as an excluded amount) since it pertains to dividends from a private corporation.
- The dividend is also from a related business because Parent – a significant shareholder of Opco – is related to Child.
- Child cannot rely on the Excluded Business exemption because he is not actively engaged in Opco's business on a regular, continuous and substantial basis; he only works part-time. He cannot rely on the deeming rule because he does not work an average of 20 hours per week.
- Child cannot rely on the safe harbour capital return, or a reasonable return on contributions of arm's length capital exemptions because he has never contributed property in support of Opco's business.
- Child cannot rely on the Reasonable Return exemption because he is not over 24 years of age.
- In the circumstances, the distribution will not be considered an excluded amount. Therefore, the dividend is subject to TOSI.



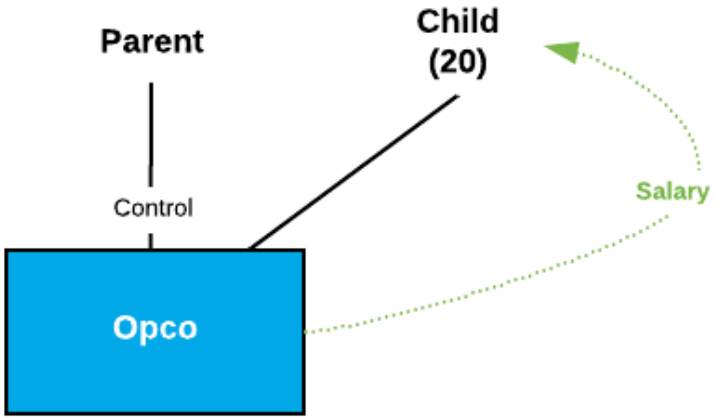
Example 5B: Salary paid to an adult under age 25

Facts

- Same as Example 5 and Example 5A except the same amount is paid as salary instead of dividends.

Analysis

- The TOSI rules **do not apply to salary**.
- In the circumstances, section 67 (deductibility of unreasonable expenses) should also not apply to limit the deduction of the salary expense by Opco; this is because the salary paid to the child is identical to the salary paid to other arm's length employees.



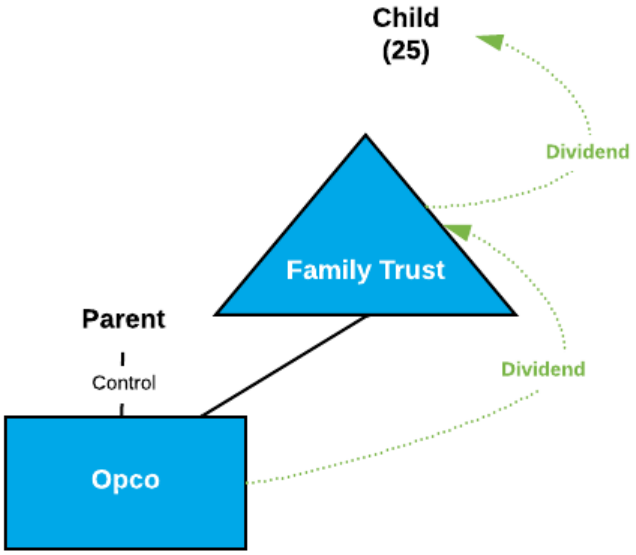
Example 5C: Dividends paid to an adult age 25 or over

Facts

- Same as in Example 5 and Example 5A above except that Grandchild 1 (in Example 5) and Child (in Example 5A) are both age 25 or over.

Analysis

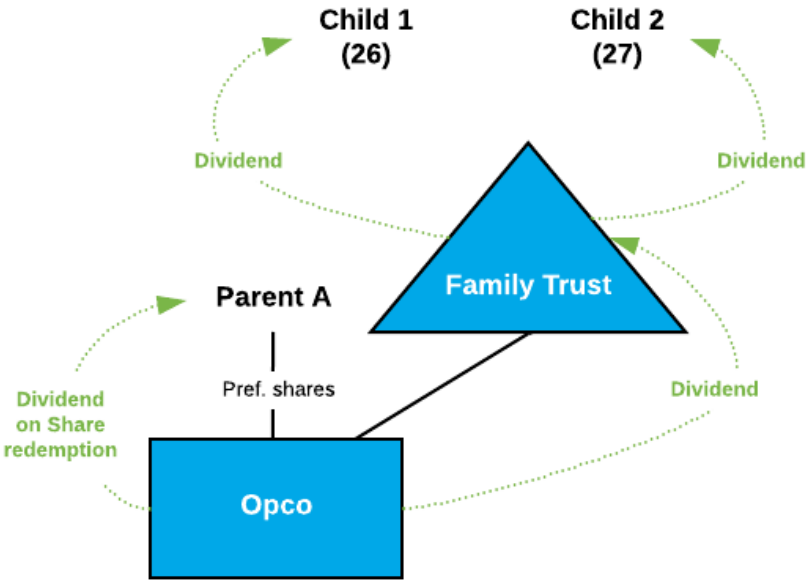
- They can now rely on the reasonable return exemption. The amount received by Grandchild 1 and Child will be an excluded amount as a reasonable return based on the work performed by grandchild 1 and child in support of the business.



Example 6: Estate Freeze

Facts

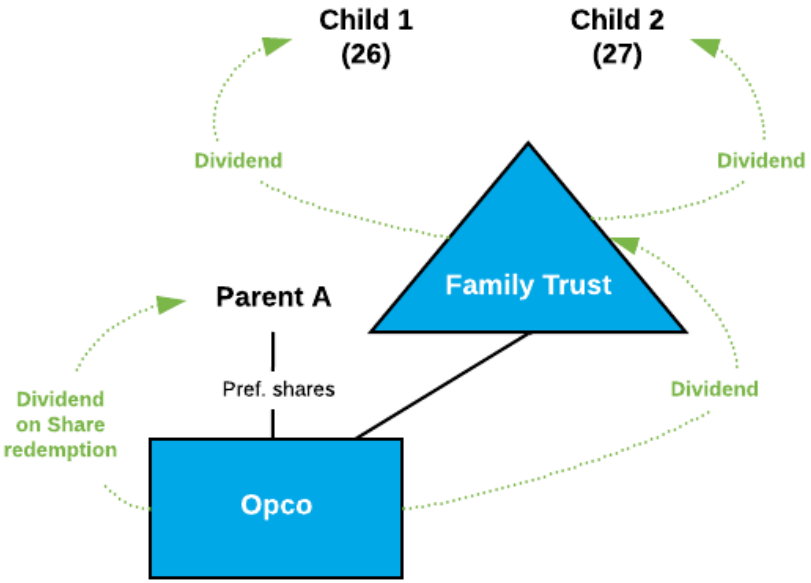
- Opco carries on an active business. The shareholders of Opco are Parent A and Family Trust, a discretionary trust for the benefit of Parent B, Child 1 and Child 2 and their respective children. Parent A holds preferred freeze shares and a class of voting shares which allow Parent A to control Opco. Family Trust owns all of the Opco common shares.
- Child 1 and Child 2 are over the age of 25. Parent A's grandchildren are under age 17.
- Parent A was the founder and owner-manager of the business but has begun to step away from the day-to-day management and has been succeeded by Child 1.
- Parent A worked in the business less than an average of 20 hours per week during the taxation year but has worked in the business at least an average of 20 hours per week during each previous taxation year since Opco was incorporated more than 20 years ago.
- Child 1 <u>worked in the business at least an average of 20 hours per week during the taxation year</u>.
- Child 2 has a successful career with a large public company and is already taxed at the top marginal rate. <u>Child 2 is not involved in Opco's business.</u>
- The family has discussed how Opco shareholdings should be dealt with once Parent A retires from the business so that Child 1 and Child 2 are treated fairly.
- As part of those discussions, Parent A has decided that for the immediate future, Opco will redeem Parent A's freeze shares over a 10 year period; Child 1 will receive salary; and dividends will be paid to Family Trust which will be distributed equally between Child 1 and Child 2.



Example 6: Estate Freeze

Analysis

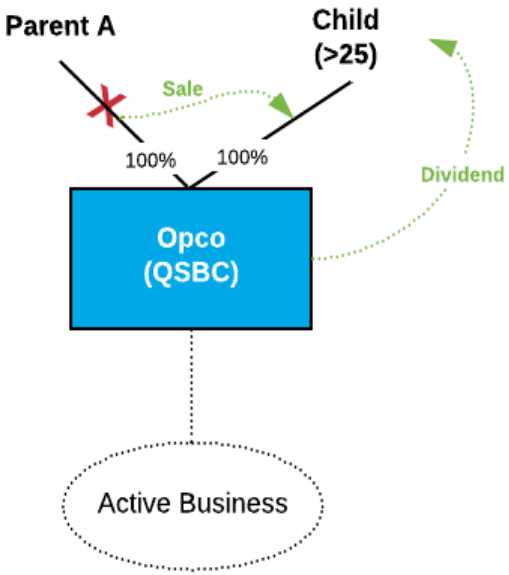
- The amounts received by parent a, child 1 and child 2 will be split income unless it is an excluded amount.
- Parent A can rely on the Excluded Business exemption: Parent A worked in the business at least an average of 20 hours per week in any the five prior taxation years of Parent A.
- Child 1 can rely on the Excluded Business exemption: Parent A worked in the business at least an average of 20 hours per week during the taxation year.
- The distribution paid to child 2 will not be an excluded amount.
- Child 2 does not own shares of opco, the Excluded Shares exception is not available.
- Child 2 was not actively engaged in the activities of the business during the taxation year; the Excluded Business exemption is not available.
- Child 2 cannot rely on the reasonable return exemption: Child 2 has no involvement and has made no contribution in support of the business.
- **Child 2's dividends income is subject to TOSI**; since he is already taxed at the highest marginal tax rate, he would not pay additional taxes than he otherwise would have paid.



Example 7: Sale of QSBC shares to child

Facts

- Opco carries on a successful active business. Parent is the founder of Opco's business, is the sole shareholder and has managed the business since inception.
- Child is over the age of 25 and has been working full-time as an executive at another corporation in a different industry.
- Parent is retiring and would like Child to carry on the business. Prior to retirement, Parent worked in the business at least an average of 20 hours per week in each taxation year since the incorporation of Opco.
- Parent sells all of his shares of Opco to Child for a fair market value purchase price.
- The shares are qualified small business corporation("QSBC") shares.
- Opco continues to carry on the business, now managed by Child.
- Because the acquisition occurs in the middle of the taxation year, Child works in the business less than an average of 20 hours per week during the entire taxation year. (But he worked an average of 20 years since the acquisition.)
- At the end of the taxation year in which the acquisition occurred, Opco pays a large taxable dividend to Child.

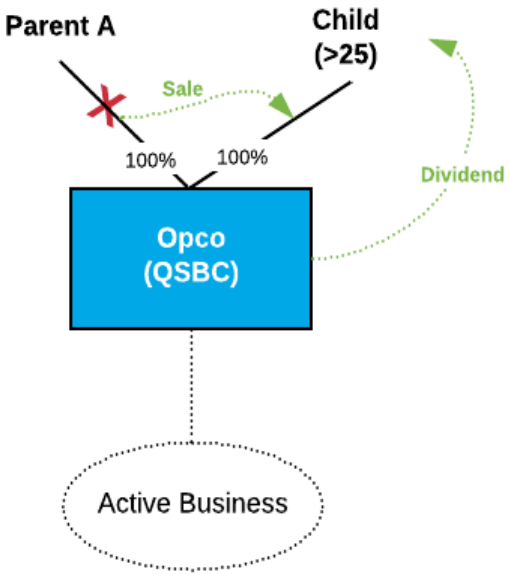


Example 7: Sale of QSBC shares to child

Analysis

Parent

- Parent is a specified individual.
- The capital gain he realizes on the sale of Opco shares is *split income* since it is realized on the sale of a private corporation.
- Parent is exempt from TOSI because the capital gain is an excluded amount:
    - **QSBC Exemption:** The capital gain is from the disposition of QSBC shares.
    - **Excluded Business:** Parent would also meet the Excluded Business test because in any 5 prior tax years he was actively engaged in Opco's business.
    - **Excluded Shares:** If Opco is not a service business, then Parent should also qualify for the Excluded Shares test.

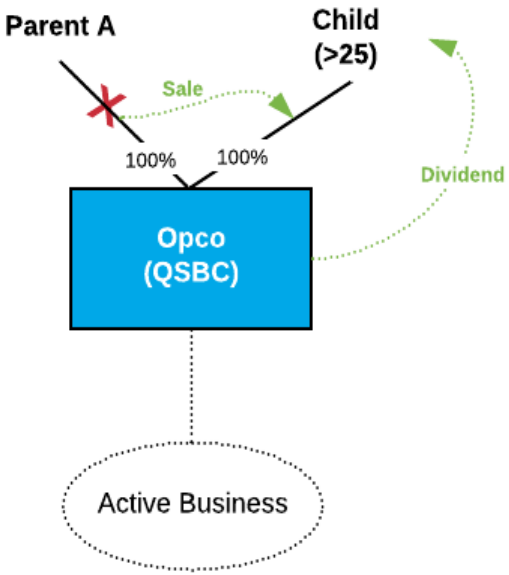


Example 7: Sale of QSBC shares to child

Analysis

Child

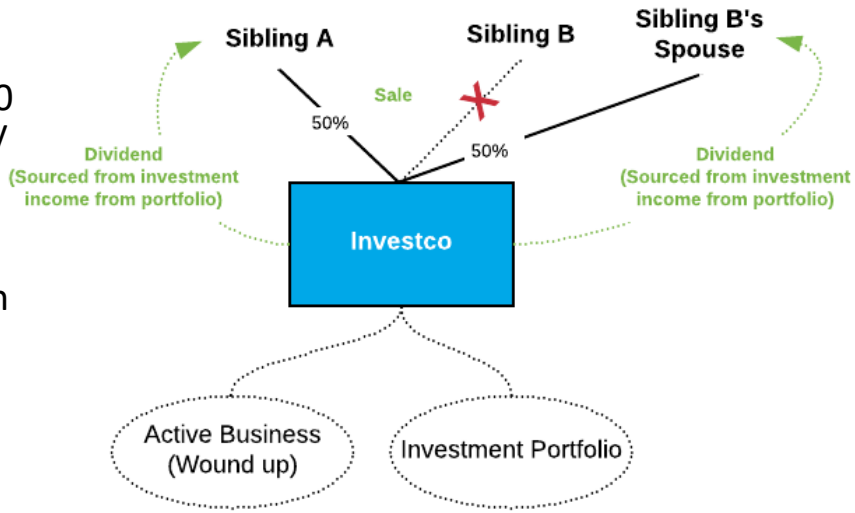
- Child is a *specified individual*.
- The taxable dividend received on the Opco shares is *split income* since it is from a private corporation.
- Child does not fit under deeming rule for the Excluded Business test (i.e., 20 hour per week test).
    - Because the acquisition occurs in the middle of the taxation year, Child works in the business less than an average of 20 hours per week during the entire taxation year.
- Nevertheless, Child is exempt from TOSI because the dividend is an excluded amount:
    - **Excluded Business:** According to CRA, the Child is Actively Engaged in the activities of the business based on the facts and circumstances and the work performed by Child.
    - **Excluded Shares:** If Opco is not a service business, then Child should also qualify for the Excluded Shares test.



Example 8: Retired Owner-Manager

Facts

- Sibling A and Sibling B were the original shareholders of Investco from incorporation.
- They each owned 50% of the common shares of Investco.
- Investco carried on an active business for over 20 years. Investco wound down that business many years ago and now owns a portfolio of passive investment assets that requires sporadic management decisions and investment activity.
- During the period when Investco was carrying on its active business, Sibling A and Sibling B were involved full time in different aspects of the management and operation of the business.
- Sibling A is now retired but still owns shares in Investco. Sibling B passed away a few years ago and his Investco shares were left to Sibling B's spouse, Spouse B.
- Investco pays substantially all of its net investment income each year as taxable dividends to Sibling A and Spouse B to augment their other retirement income.



*The CRA has made the assumption that Investco maintained a sufficient level of activity to support the view that their income may be considered to be from such a business. (see CRA document no. 2018-0780081C6).

Example 8: Retired Owner-Manager

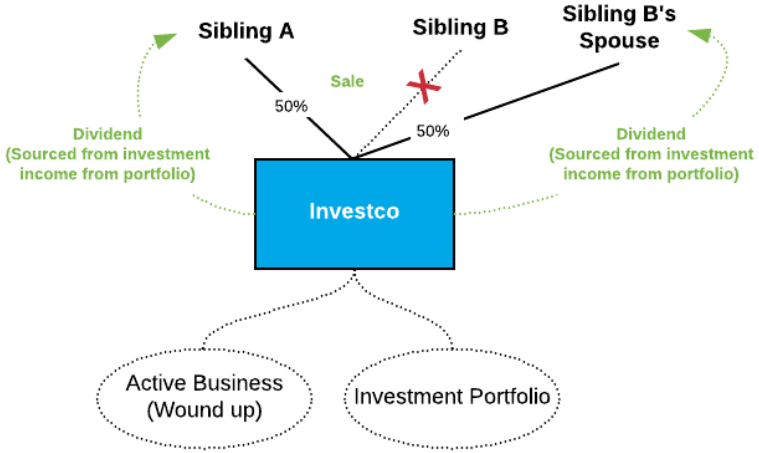
Analysis

Sibling A and Sibling B

- Sibling A and B are specified individuals.
- The taxable dividend received from Investco, a private corporation, is split income.
- Both are exempt from TOSI because the dividend is an excluded amount:
    - **Excluded Shares:** The CRA says that the shares qualify as Excluded Shares. The business (assuming that the investment activity constitutes a business) is not a service business and Sibling A and B own ≥ 10% of the votes & value.

Commentary:

- CRA did not comment whether the dividend is derived directly or indirectly from a related business in respect of the individual for the year (it seems CRA assumed that the investment activity passed the threshold of carrying on a business).
- CRA also did not comment on the Excluded Business exemption. Since the investment business and the active business are separate businesses, and individuals were not actively engaged in the investment business, they likely would not have met the Excluded Business exemption in respect of the investment business (from which the dividends, the split income, was derived from).

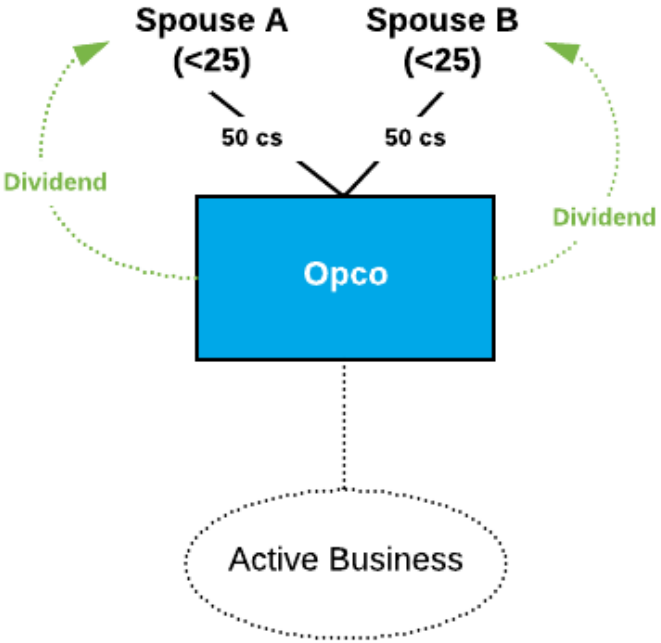


*The CRA has made the assumption that Investco maintained a sufficient level of activity to support the view that their income may be considered to be from such a business. (see CRA document no. 2018-0780081C6).

Example 9: Dividends paid to adults (under 25) active in the business

Facts

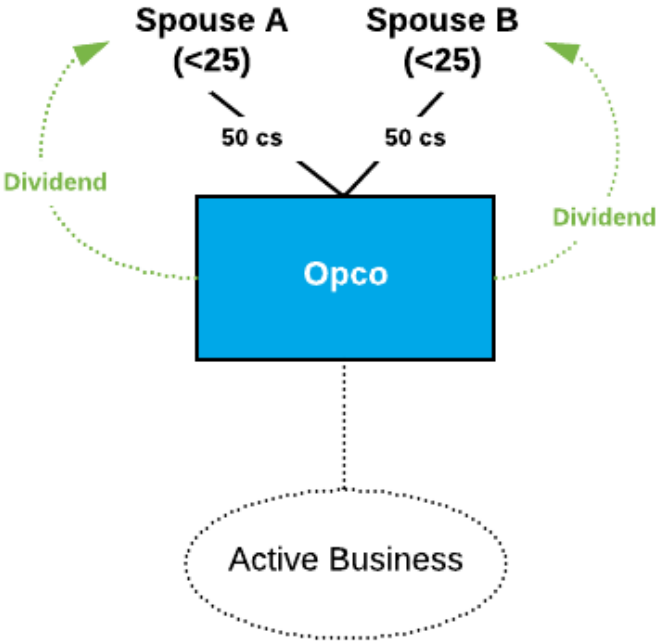
- Spouse A is working part-time in a communications company while completing a master's degree in marketing. Spouse B is working full-time as a software developer for a video game publisher. Both Spouse A and Spouse B are age 23.
- Spouse A and Spouse B are the only shareholders of Opco, a corporation carrying on an active business of developing mobile applications.
- Spouse A and Spouse B each acquired 50 shares of Opco on incorporation for nominal consideration.
- Both Spouse A and Spouse B are involved in Opco's business.
- Spouse A is responsible for the administration and marketing aspects of the business while Spouse B creates the mobile applications.
- Each of Spouse A and Spouse B are working in Opco's business on evenings and weekends.
- <u>Although each of Spouse A and Spouse B are working in the business less than an average of 20 hours per week during the taxation year, Opco does not need other employees or more involvement from Spouse A and Spouse B to carry on its business</u>.
- One of Opco's applications has been particularly successful and has been downloaded by millions of users.
- Opco pays significant taxable dividends to Spouse A and Spouse B.



Example 9: Dividends paid to adults (<25) active in the business

Analysis

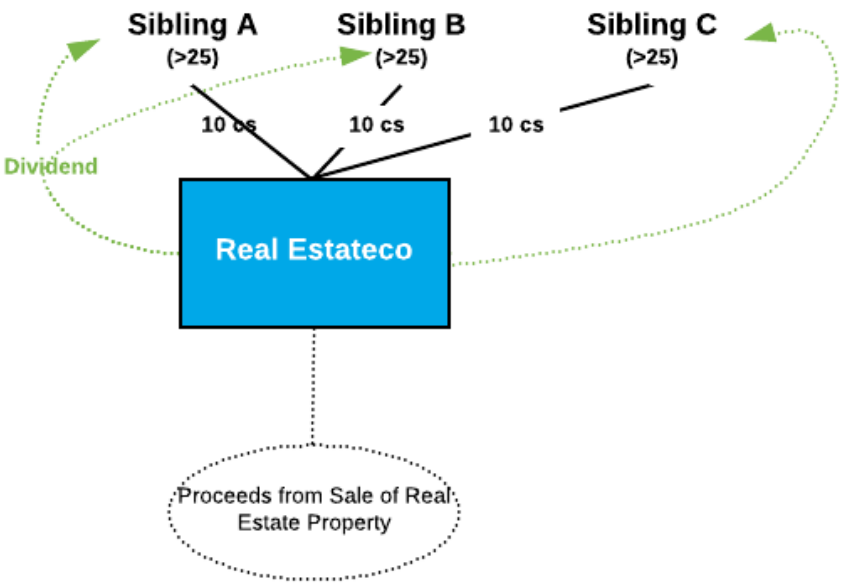
- Spouse A and Spouse B are specified individuals.
- The taxable dividends from Opco, a private corporation, is a split income.
- The dividends are derived from Related Business.
- The individuals made nominal capital contribution to the business; therefore, the dividends exceed a *safe harbour capital return* and a *reasonable return on arm's length capital*.
- Nevertheless, the individuals should be exempt from TOSI because the amount is an excluded amount:
    - **Excluded Business:** they are both Actively Engaged in the activities of Opco's business based on the **facts and circumstances** and the work performed by Spouse A and Spouse B.



Example 10: Reasonable Return as directors of the business

Facts

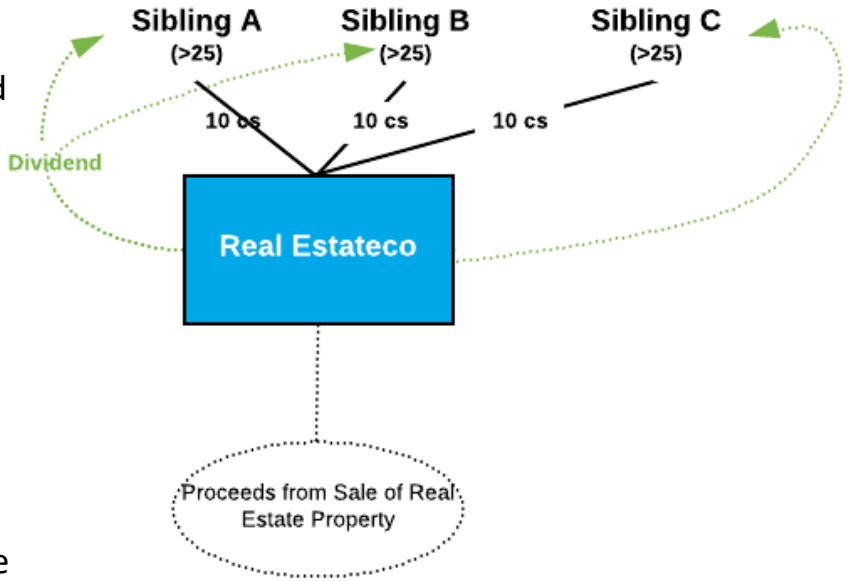
- Sibling A, Sibling B and Sibling C are over age 25 and they each acquired 10 shares of Real Estateco on incorporation for nominal consideration. All siblings are **directors** of Real Estateco.
- Over the years, Real Estateco has acquired several rental properties financed by arm's length financial institutions with limited personal guarantees from each sibling.
- Third Party was engaged to manage all the aspects of Real Estateco's rental activities.
- Real Estateco has sold one of its properties at a significant gain.
- Real Estateco uses the proceeds from such gain to pay taxable dividends to its shareholders.



Example 10: Reasonable Return as directors of the business

Analysis

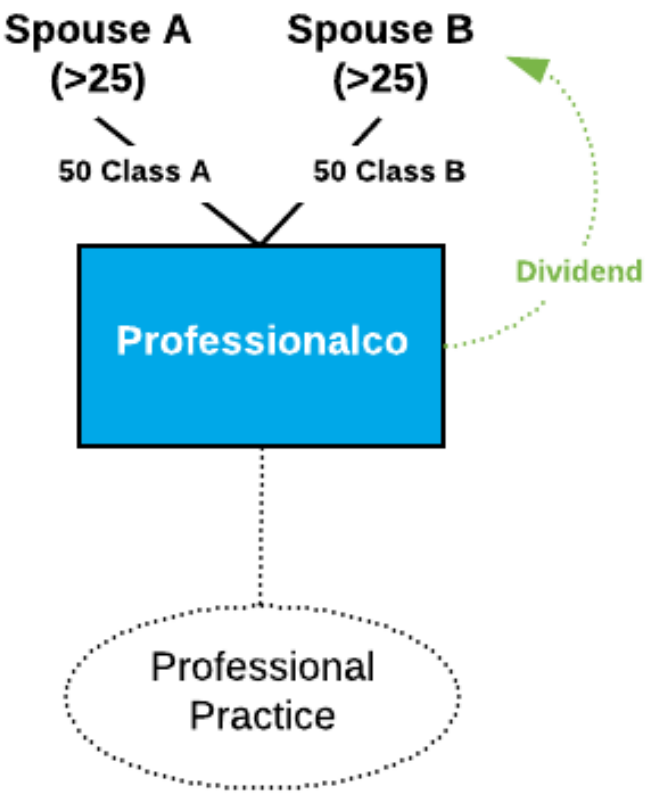
- The individuals are specified individuals.
- The dividend from Real Estateco, a private corporation, is split income.
- The dividend is from a Related Business (i.e., a related person owns ≥ 10% of the company carrying on the business (Real Estateco)).
- The individuals likely do not meet the Excluded Business test since they are not actively engaged (i.e., labour – time, work and energy – contribution).
- Nevertheless, the dividends should be exempt from TOSI because the amount is an excluded amount:
    - **Excluded Shares**: The individuals own shares with ≥ 10 of the votes and values.
    - **Reasonable Amount:** Despite minimal active labour contributions, third parties managing the day-to-day business, limited capital contributed, and risks assumed, the CRA held that the Reasonable Amount exemption should be met. This is because the <u>risk they assumed as the directors, their supervision of Third Party and their involvement in Real Estateco's strategic decisions should render the dividends to be a reasonable amount</u>.



Example 11: Reasonable Return in a Professional Corp

Facts

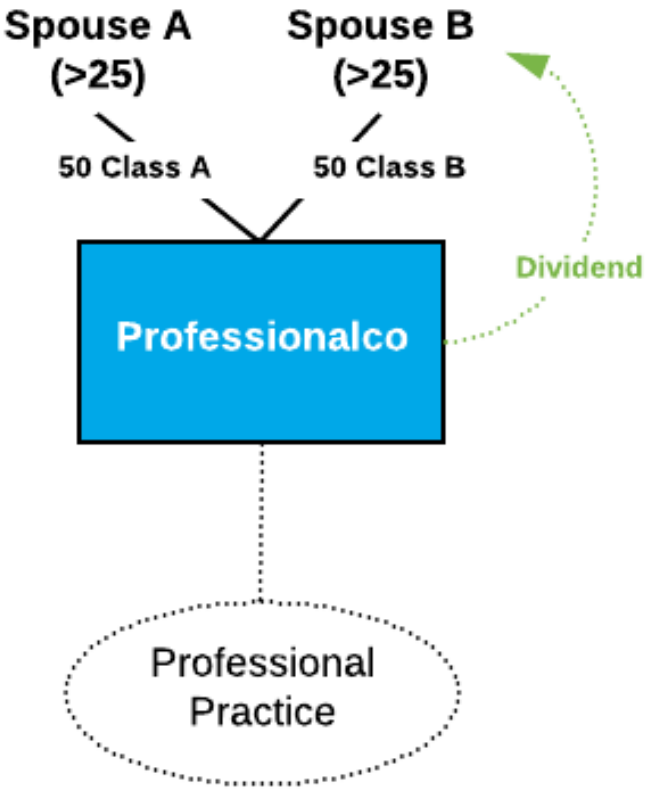
- Professionalco carries on a professional practice business. The sole shareholders of Professionalco are Spouse A and Spouse B. Each holds a different class of shares.
- Spouse A and Spouse B are both over age 25.
- Spouse A is a licenced professional and works full-time in the business.
- Spouse B <u>works less than an average of 20 hours per week and assists with bookkeeping</u>. Before their marriage, Professionalco hired an arm's length person to keep the books.
- Professionalco pays a dividend to Spouse B. The amount of the dividend approximates but is <u>higher than the amount that was paid to the arm's length bookkeeper.</u>
- Spouse B does not receive any other payment for his/her services.



Example 11: Reasonable Return in a Professional Corp

Analysis

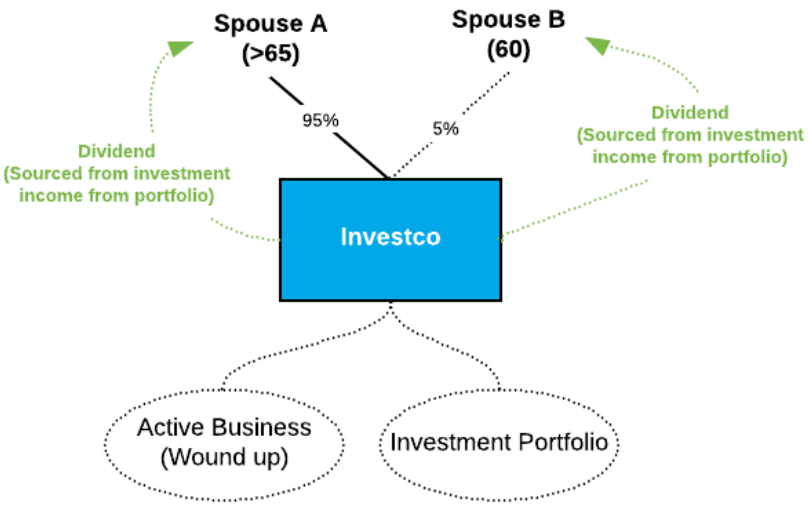
- Spouse B is a specified individual.
- The dividend from ProfessionalCo, a private corporation, is split income.
- The dividend is derived from a Related Business since Spouse A is actively engaged in the business.
- The dividend is not derived from an Excluded Business. Spouse B is not actively engaged and works less than an average of 20 hours per week.
- The dividend is not on Excluded Shares; the corporation is a professional corporation.
- CRA ruled that the dividend is exempt from TOSI because the amount is an excluded amount :
    - **Reasonable Return:** it is a Reasonable Return based on the reasonableness Criteria. Spouse B works at Professionalco's business. While high, the amount of the dividend is comparable to the amount that was paid to an arm's length person. In general, the CRA will not substitute its judgment for what is a reasonable amount <u>where the taxpayers have made a good faith attempt to determine a Reasonable Return based on the Reasonableness Criteria.</u>



Example 12: Retired Shareholders

Facts

- Spouse A and Spouse B own respectively 95 % and 5% of all the issued and outstanding shares of Investco.
- Spouse A is over age of 65 and Spouse B is age 60.
- Investco carried on an active business for over 25 years. Investco wound down that business many years ago and now owns a portfolio of passive investment assets that require sporadic management decisions and investment activity.
- During the period when Investco was carrying on its active business, Spouse A was involved full-time in different aspects of the management and operation of the business.
- Spouse B was never involved in Investco's business.
- Spouse A is now retired.
- Investco pays substantially all of its net investment income each year as dividends to Spouse A and Spouse B to augment their retirement income.

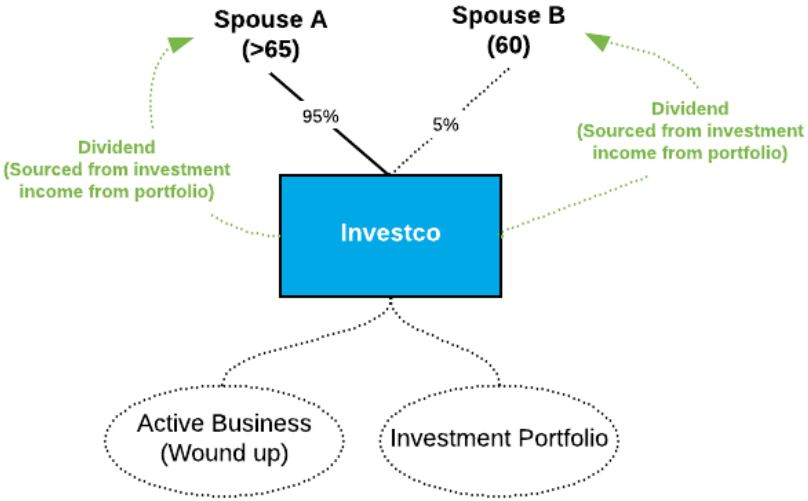


*The CRA has made the assumption that Investco maintained a sufficient level of activity to support the view that their income may be considered to be from such a business. (see CRA document no. 2018-0780081C6).

Example 12: Retired Shareholders

Analysis

- Spouse B is a specified individual.
- The dividend received from Investco, a private corporation, is split income.
- Dividend received by Spouse B is also exempt from TOSI because it would be an excluded amount in respect of the Spouse B's spouse (Spouse A) and Spouse A is 65 <u>or</u> older. The dividend would have been from Excluded Shares of Spouse A because Spouse A owns shares of Investco with ≥ 10% votes and value.
- Dividend received by Spouse A is also exempt from TOSI because the dividend is from Excluded Shares of Spouse A; Spouse A owns shares of Investco with ≥ 10% votes and value.

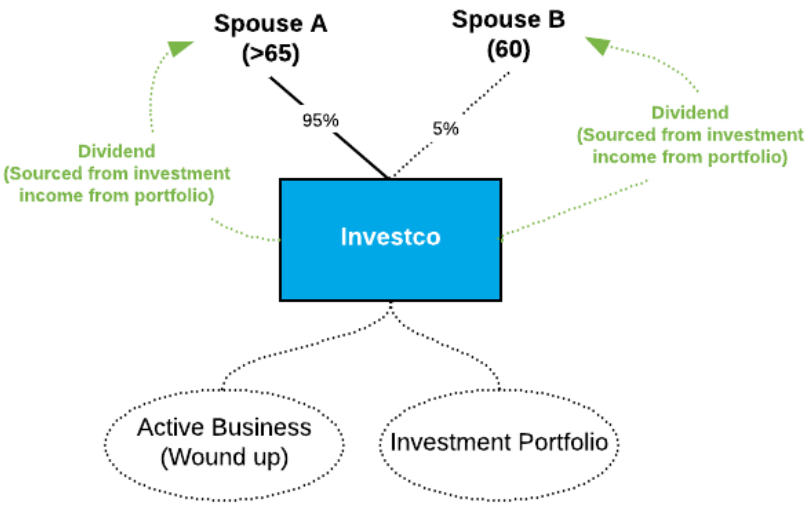


*The CRA has made the assumption that Investco maintained a sufficient level of activity to support the view that their income may be considered to be from such a business. (see CRA document no. 2018-0780081C6).

Example 12: Retired Shareholders

Analysis

- It is interesting to note that the CRA did not comment whether the dividend received by Spouse A is excluded by virtue of the Related Business test. Since Spouse B never participated in the business, it is questionable whether the business is a Related Business of Spouse A. Therefore, Spouse A would fall under the Related Business exemption.

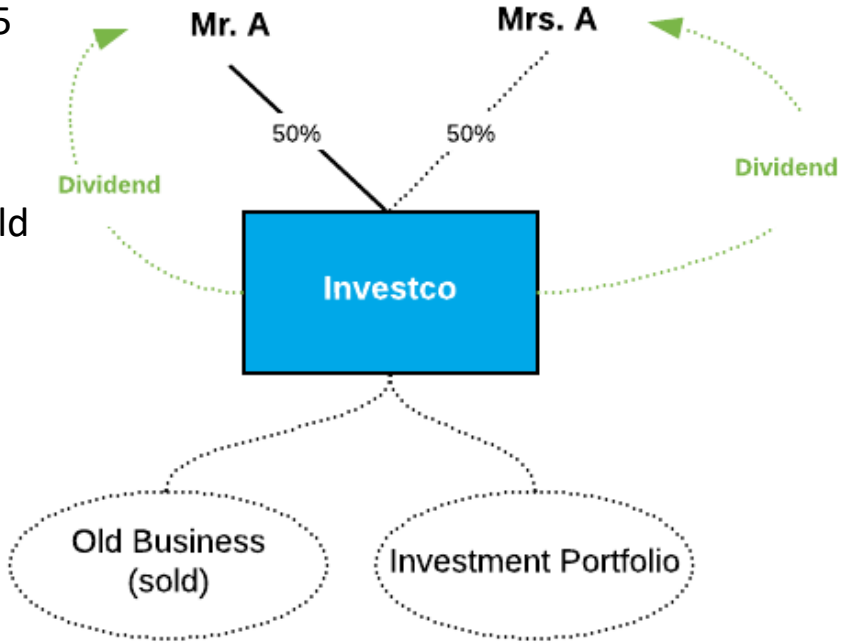


*The CRA has made the assumption that Investco maintained a sufficient level of activity to support the view that their income may be considered to be from such a business. (see CRA document no. 2018-0780081C6).

Example 13A: Related Business and Sale of Old Business*

Facts

- Mr. A and his spouse, Mrs. A, are both over 25 years old and are resident in Canada.
- Each own 50% of the shares of ACo,
- In the past A Co carried on a business (the "Old Business") in which Mrs. A had been actively engaged for at least five prior taxation years.
- Mr. A was never involved in or contributed to the Old Business.
- ACo sold the Old Business two years ago.
- ACo's sole activity since the sale has been the investment of the sale proceeds and the historical retained earnings from the Old Business.
- In the current year, ACo declared a taxable dividend to Mr. A and Mrs. A.

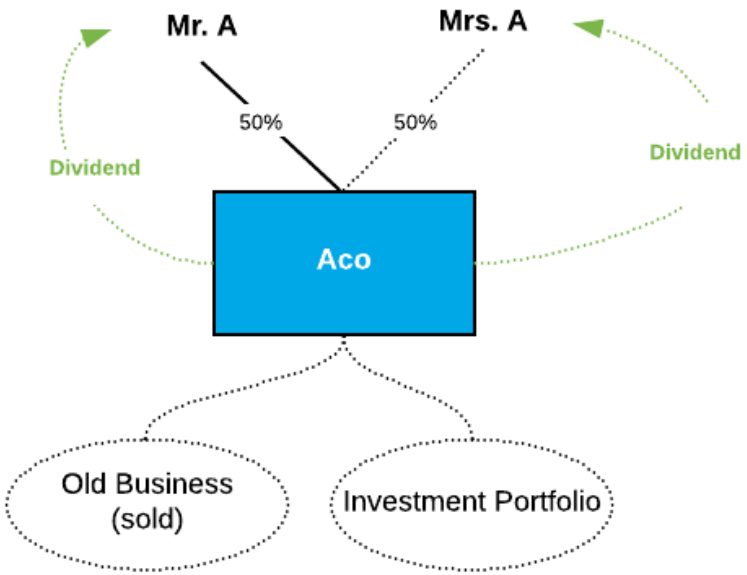


**Example from CRA Document no. 2018-0779981C6*

Example 13A: Related Business and Sale of Old Business*

Analysis

- CRA was asked to confirm that the dividend will not be considered split income given that the dividend is not derived directly or indirectly from a related business in respect of the individuals for the year? More specifically, the CRA was asked to confirm that even if the dividend is considered to be derived directly or indirectly from the historical retained earnings of the Old Business or from the proceeds of disposition of the Old Business, it is not deriving it from a related business "for the year"?
- Subparagraph (e)(i) of the "excluded amount" definition in subsection 120.4(1) provides that an amount that is not derived directly or indirectly from a "related business" in respect of the individual for the year is an excluded amount.



**Example from CRA document no. 2018-0779981C6, 27 November 2018 CTF Roundtable Q. 9*).

Example 13A: Related Business and Sale of Old Business*

Analysis

- The CRA agreed that the Related Business test has a two-part test:

    1. Whether the split income is derived directly or indirectly from a related business; and

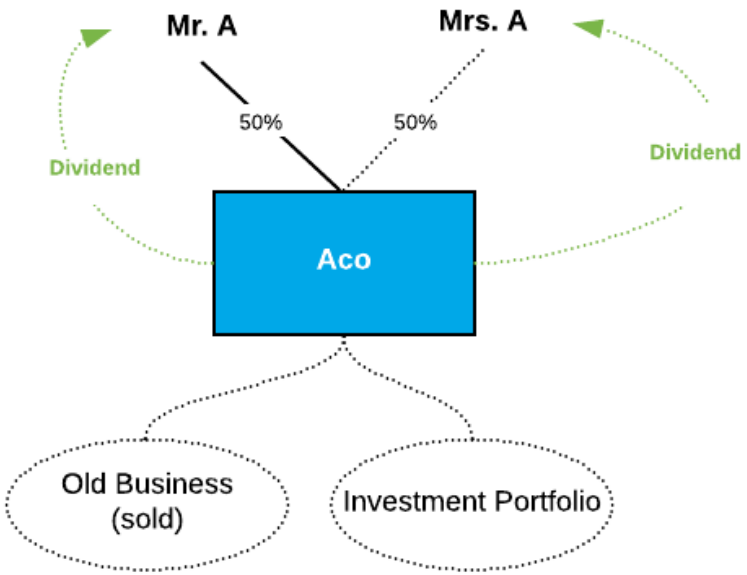
    2. Is so, whether that income is in respect of the individual for the year

- If the answer to both questions is yes, then a specified individual cannot rely on the Related Business test.

- So, if the investment activity does not constitute a business for the year (say 2019), then even if the dividend is considered to be derived from the Old Business or from the proceeds of disposition of the Old Business, it is not derived from a related business "for the year". In other words, the old business no longer exists, it cannot be a business for the year 2019.

- It is CRA's view that there will not be a related business in respect of the individual for that year where a related business was wound up in a preceding taxation year.

- But, In circumstances where the related business continues to operate in the year, it is CRA's view that there will be a related business in respect of the individual for that year. (See next example.)

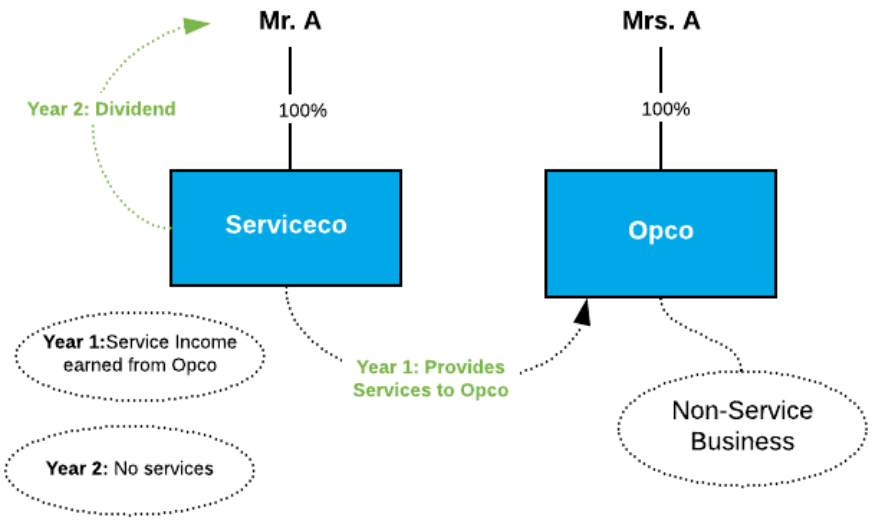


**Example from CRA document no. 2018-0779981C6, 27 November 2018 CTF Roundtable Q. 9*).

Example 13B: Related Business for the Year*

Facts

- Mr. A and his spouse, Mrs. A, are both over 25 years old.
- Mrs. A is the sole shareholder of Opco.
- Opco is not a professional corporation and carries on an operating business that is not a services business.
- Mr. A is the sole shareholder of Serviceco but is not actively engaged on a regular, continuous and substantial basis in the activities of Serviceco.
- In **Year 1**, Serviceco's income was derived from the providing services to Opco.
- Serviceco does not pay any dividends to Mr. A in Year 1.
- In **Year 2**, Serviceco does not render any services and its activities for the year do not rise to a level that is sufficient for Serviceco to be considered to have a business for the year.
- In **Year 2**, Serviceco pays a dividend to Mr. A.

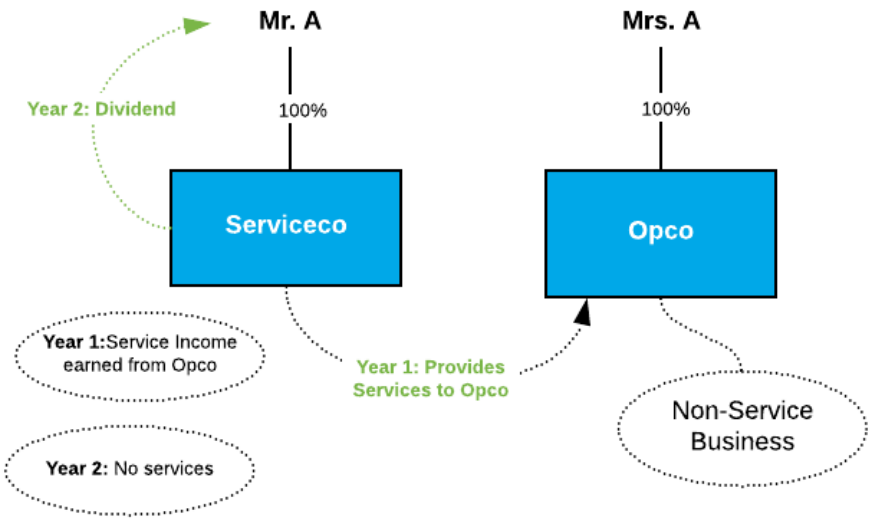


**Example from CRA document no. 2018-0779981C6, 27 November 2018 CTF Roundtable Q. 9*).

Example 13B: Related Business for the Year*

Analysis

- In this case, Mr. A would need to meet the Related Business test to be exempt from TOSI.
- The dividend needs to be:
  - (i) derived directly or indirectly from a related business (ii) and
  - from a related business for the year
- **Test 1:** Since "derived directly or indirectly" has a broad meaning, the dividend – which is derived from Opco's business – is derived a Related Business. See 120.4(1.1)(d)(ii).
- **Test 2:** Since Opco continues to exist (i.e., a related business continues to exist) in Year 2, the there will be a related business in respect of Mr. A in Year 2.
- Therefore, Mr. A does not meet the Related Business exemption. His dividends in Year 2 are subject to TOSI.
- He gets to claim the dividend tax credit against the tax payable on dividends.

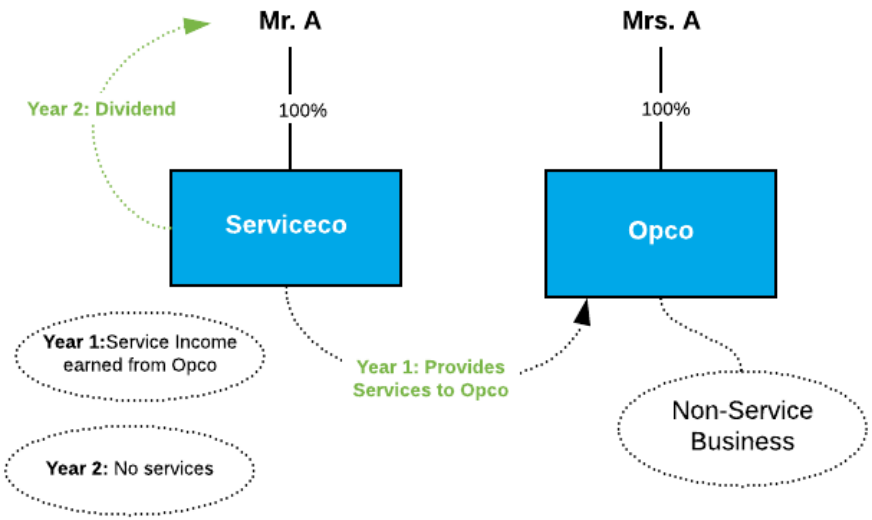


**Example from CRA document no. 2018-0779981C6, 27 November 2018 CTF Roundtable Q. 9*).

Example 13B: Related Business for the Year*

Analysis

- Contrast this with Example 13A.
- In Example 13A there was no related business operating in the year, it was wound up a few years back.
- In Example 13B, even through the dividend was derived from the related business activities in Year 1, the related business nevertheless continued to exist in Year 2, when the dividend was received by Mr. A.

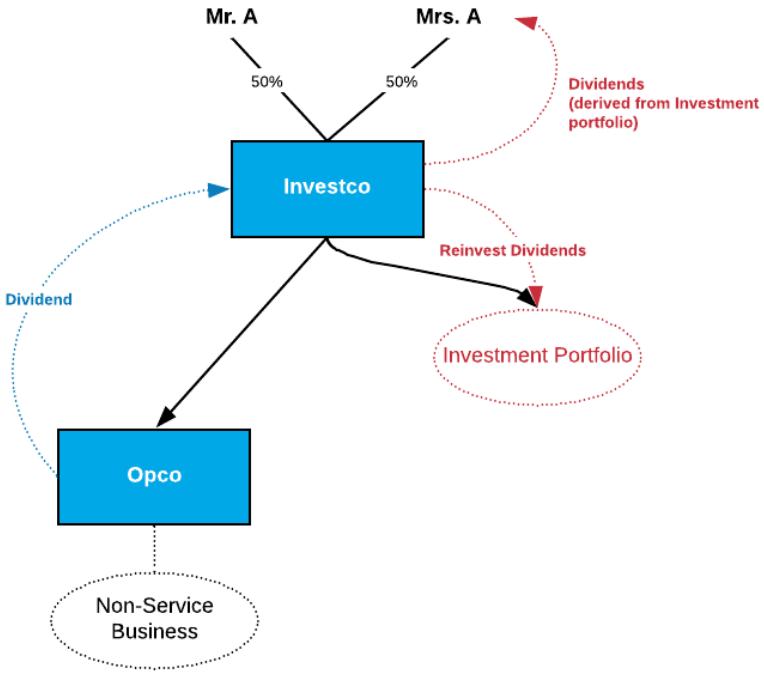


**Example from CRA document no. 2018-0779981C6, 27 November 2018 CTF Roundtable Q. 9*).

Example 14A – Second Generation Income

Example

- Mr. A and Mrs. A are over the age of 30
- Each own 50% of the voting common shares of Investco.
- Mr. A owns 100 Class A common shares and Mrs. A owns 100 Class B common shares of Investco.
- Investco owned all of the shares of Opco, which carries on a non-services business.
- Mr. A is actively engaged in Opco's business; however, Mrs. A is not actively engaged in Opco's business.
- Historically, Opco paid taxable dividends to Investco from its after-tax earnings, all of which Investco has invested into shares of publicly-traded corporations, which pay dividends annually.
- If Investco pays all of the dividend income that it receives from these publicly-traded corporations to Mrs. A, would the dividend income received by Mrs. A be subject to TOSI?

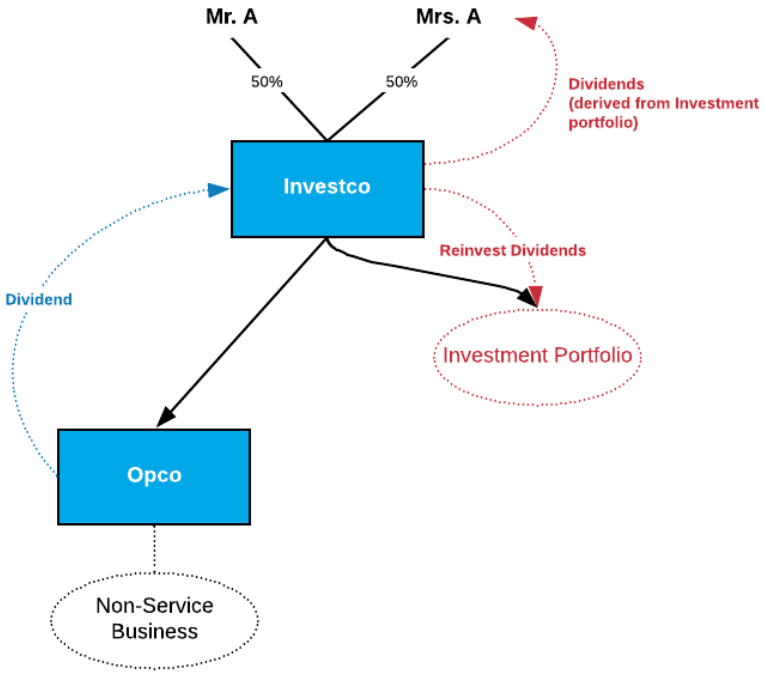


**Example from CRA document no. 2018-0771861E5.*

Example 14A – Second Generation Income

Analysis

- Mrs. A is a specified individual.
- The dividend from Investco, a private corporation, is otherwise split income.
- Mrs. A cannot rely on excluded shares definition because all or substantially all of the income of Investco is derived from Opco. Also, we will assume Investco does not earn any business income.
- Mrs. A will not meet the excluded business test.
- Opco is a related business to Mrs. A because Mr. A is actively engaged.
- CRA says that <u>assuming Invesco does not carry on a business</u>, dividends paid from returns generated by the investment portfolio (i.e., second generation income) is not derived from a "related business" to Mrs. X.
- Mrs. X can rely on the related business exemption.
- TOSI does not apply to the dividends.

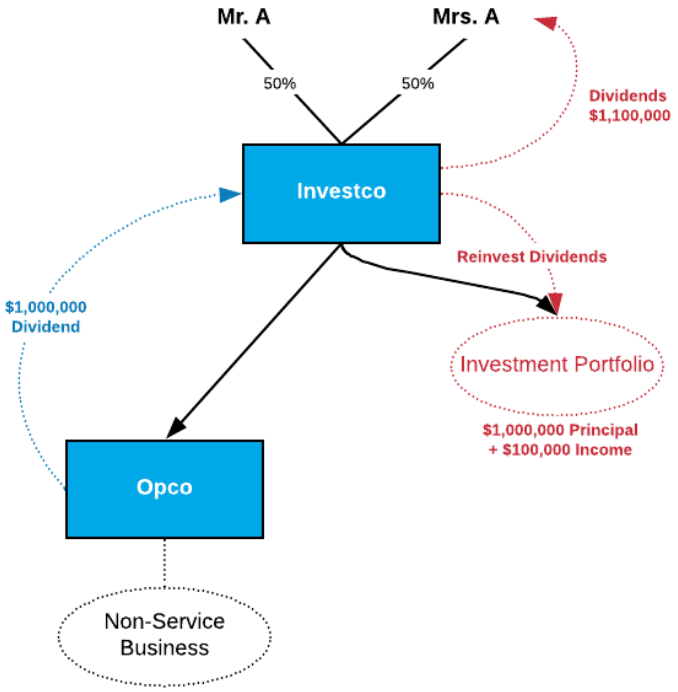


**Example from CRA document no. 2018-0771861E5.*

Example 14B – Second Generation Income

Example

- Mr. A and Mrs. A are over the age of 30
- Each own 50% of the voting common shares of Investco.
- Mr. A owns 100 Class A common shares and Mrs. A owns 100 Class B common shares of Investco.
- Investco owned all of the shares of Opco, which carries on a non-services business.
- Mr. A is actively engaged in Opco's business; however, Mrs. A is not actively engaged in Opco's business.
- Opco pays a $1,000,000 dividend to Investco.
- Investco uses the $1,000,000 dividend to buy Investment Portfolio
- The Investment Portfolio generates $100,000 of investment income.
- Investco pays a $1,100,000 dividend to Mrs. X consisting of the $1,000,000 Investment Portfolio and the $100,000 second generation income.

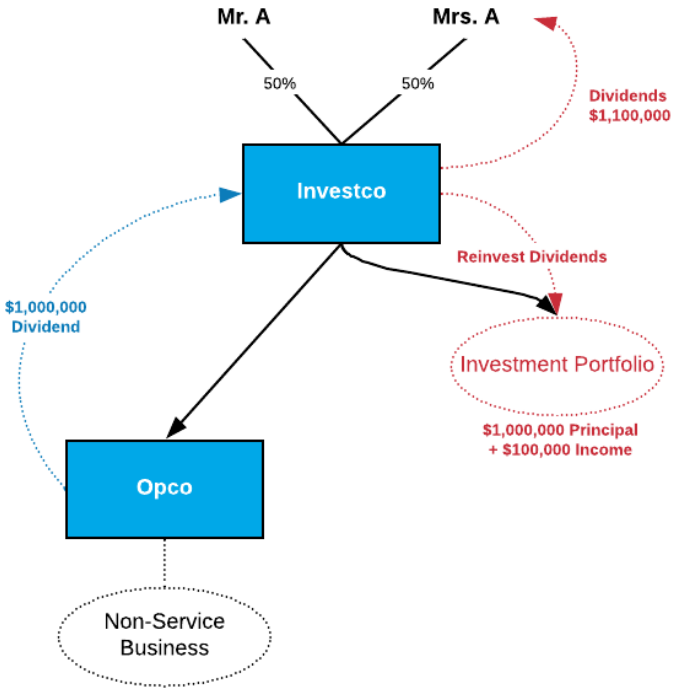


**Example from CRA document no. 2018-0771861E5.*

Example 14B – Second Generation Income

Analysis

- Assuming Investco does not carry on a business, CRA states that only $1,000,000 of the $1,100,000 dividend received by Mrs. A in would be considered to be derived, directly or indirectly, from the related business of Opco in respect of Mrs. A. Therefore, only $1,000,000 should be subject to TOSI. The $100,000 second-generation income should not.
- If Investco has a related business in respect of Mrs. A, the entire $1,100,000 dividend received by would be considered to be derived from the related businesses and subject to TOSI.



**Example from CRA document no. 2018-0771861E5.*