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Just a spoonful of TOSI may help the medicine go down

Guy Desmarais, H. B. Com., LLB, T.E.P., *is affiliated with the Sudbury office of Collins Barrow*

The Department of Finance released its long-awaited proposed amendments to the tax on split income (TOSI) rules on December 13. The release completes a tumultuous year for small business owners, tax professionals, Department of Finance officials, Members of Parliament and the Minister of Finance. The initial July 18 proposals and the short consultation period precipitated a groundswell of consternation and frustration.

The new TOSI amendment package generally strikes a better balance for fairness and the vital small business sector. Professional corporations (PCs) and certain service businesses (SBs) are sometimes treated differently and may remain subject to TOSI. However, with careful manoeuvring, solutions for many PCs and SBs appear possible.

From a technical perspective, the amendments demonstrate a return to the Canadian custom that tax law arises from the *Income Tax Act* and not from administrative decree.

TOSI applies to everyone, including the founder, if a related person holds 10 per cent or more of the value of the "related business." TOSI results in tax at the top marginal rates.

We will provide an overview of the "excluded amounts" to which TOSI will not apply. As will be seen, we enter a new era of very detailed tax, corporate and estate planning for small-business families.

Exclusions to the application of TOSI

An "excluded business" is a business in which an individual, who has reached age 17 before the year, is actively engaged on a regular, continuous and substantial basis (RCSB) during the taxation year. The RCSB requirement is deemed to be satisfied if a person works an average of 20 hours a week for the year. Once a person has accumulated five years of RCSB, they qualify forever. The exclusion applies to all businesses, including PCs and SBs.

The "excluded shares" exception raises many questions. We note a few of them:

- The exclusion applies to anyone 25 years and older who holds at least 10 per cent of shares representing votes and value "immediately prior" to the dividend payment.
- On its face, this exception does not apply to a PC or to corporations that have 90 per cent or more of their business income arising from services during their last completed taxation year (SB). This may snare many service businesses: e.g., cleaners, roofers, plumbers, financial consultants, IT and financial consultants etc. Of course, the status of a corporation may change over time. Clarity as to what specifically constitutes a SB and measuring the 90 per cent threshold will be challenging.
- TOSI may apply to many holding companies in which various family members hold shares if the assets derive from related operating businesses. This aspect can be complex and requires careful planning.
- The income of the corporation may not "all or substantially all" arise directly or indirectly from "one or more other related businesses," including income that is "derived from an amount that is derived directly or indirectly" from a related business. We hope the Department of Finance will clarify the significance of the word "other" in the near future.
- This "all or substantially all" test is an income test. For example,

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if a holding corporation derived only 65 per cent of its income from related businesses (perhaps even from a PC or SB or former PC or SB) and the rest from other sources, it would qualify as an "excluded share."

For those older than 17 years prior to the year, taxable capital gains from qualified small business corporation (QSBC) shares and qualified farm or fishing property (QFFP) are exempt. This exemption may apply to many small "active" business corporations that meet stringent passive assets limitation tests at that time and over two previous years. Fortunately, the exemption may also apply to some PCs and SBs. However, maintaining this status requires keeping the corporations "purified" of excess assets, and will require very detailed planning and careful execution.

TOSI also does not apply if the income does not derive from a "related business." This rule would exclude, for example, income from investments and perhaps rental income in some cases, provided it is not derived from a related business or (as noted above) from an amount derived therefrom.

If the "source" spouse or common-law partner attained age 64 in a prior year, income or taxable gains to the other spouse are excluded from TOSI (even if younger), provided the amount would be excluded in the source spouse's hands. This news will be a relief to many families (including many PCs and SBs) who must plan their retirements from retained earnings of corporations, and synchronises with the current pension income-splitting regime.

Income on inherited property will often be excluded for those who are 17 before the year. For those younger, income from a property acquired from a parent as a consequence of death is also exempt. Another inheritance provision provides exclusion for full-time, post-secondary students or disability tax credit qualifiers under age 25. Careful multi-generational estate planning will be required, with special attention to lifetime trust provisions.

Income flowing from property passing as a result of marriage breakdown is also excluded.

Conclusion

It is reassuring that the Bill Morneau package now reaffirms Canadian principles of certainty and predictability by eliminating the use of broad basket provisions and all-encompassing anti-avoidance rules. The package brings timely relief to the July 18 proposals in many cases, but with particular complexity and limitations for PCs and SBs.

Comprehensive and ongoing corporate and estate planning will be critical.

We must remember that the package is but a step in the government's tax fairness plan. We now await the expected passive income changes in the 2018 Budget, and the Department of Finance's review of the disparity inherent in a system that has a large spread between taxes on capital gains and dividends. Contact your Collins Barrow advisor for continuing guidance on how these amendments will affect you.

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