TAX FLASH

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Amendments to the Income Tax Act and status of proposed measures

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On December 13, 2017, Amendments to the Income Tax Act and Regulations and Explanatory Notes to simplify measures to restrict income sprinkling were released by Finance Canada. Today's Tax Flash will focus on the changes to the July 18 proposals, exclusions, reasonableness test and a brief update on the status of the proposed measures related to passive investments.

The expansion of tax on split income ("TOSI") to adult Canadian residents (18 years and older) still potentially applies to amounts received by "specified individuals" either directly or indirectly, from a "***related business***". A business is generally considered a "related business" if the specified individual is related to an individual that is sufficiently connected to that business, which requires that individual to either be actively engaged in the business or have a sufficient interest in that business. These changes are proposed to be effective for the 2018 and subsequent taxation years. The mechanics of these proposals differ substantially from the July 18, 2017 tax proposals.

The changes include clear "bright-line" tests to automatically ***exclude*** individual members of a business owner's family who fall into the following categories:

- Business owner's spouse if the owner meaningfully contributed to the business and is aged 65+
- Adults aged 18+ who have made labour contributions during the year or during any 5 previous years on a "*regular, continuous and substantial basis*" (an "excluded business")
- Adults aged 25+ who own at least 10 per cent of a corporation (votes and value) that earns less than 90 per cent of its income from services, is not a professional corporation, and 90 per cent or more of the businesses' income is not from other related businesses ("excluded shares")
- Individuals who receive capital gains from the disposition of qualified small business corporation shares (QSBC) and qualified farm or fishing property, if the disposition is not a non-arm's length sale deemed to be a dividend under subsections 120.4(4) or (5).

Additional changes to the July 2017 proposals include:

- Not proceeding with the proposed measures to apply TOSI to compound income
- Subsections 120.4(4) and (5) will not be extended to specified individuals 18+. These provisions effectively deem twice the amount of a taxable capital gain to be a dividend
- Not extending the definition "related" to aunts, uncles, nieces, and nephews
- Income derived from property acquired as a result of the breakdown of marriage will be exempted from TOSI.

Individuals who do not meet any of the exclusions will be subject to a reasonableness test and will be subject to the TOSI to the extent the amounts exceed a "reasonable return". For individuals aged 18-24, a prescribed rate of return on capital contributed to a related business will be considered a reasonable return (*Safe Harbour capital return*). In certain cases, where these individuals use capital contributed from an unrelated business, they will be permitted a non-prescribed reasonable return on the contribution. In all other cases, a non-prescribed reasonable return will be allowed.

The revised legislative proposals define a "reasonable return" as an amount that is reasonable having regard to the contributions of the

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adult specified individual to the related business relative to other family members who have contributed to the business:

- Includes analysis of labour contributions, capital contributions, risks assumed, and any other relevant factors
- Also determined with regard to previous amounts received from the business.

It is intended that an amount will not qualify as a reasonable return only in cases where it is evident that an amount received is disproportionate relative to the contributions to and amounts received from the business by them and other family members.

Finance Canada also indicated that the Government will be moving forward with measures to limit tax deferral opportunities related to passive investments and said that details of that plan will be included in Budget 2018. When introduced, the passive investment measures will apply only on a go-forward basis. The information released also mentioned that these measures will provide "*business owners with more flexibility to build a cushion of savings for business purposes – for example, to deal with a possible downturn or finance a future expansion – as well as to deal with personal circumstances, such as parental leave, sick days or retirement.*" This is perhaps the most impactful of the changes proposed on July 18, 2017 and we await this complex legislation with skepticism that it can be made workable without significant unintended consequences to shareholders of private corporations.

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