TAXTALK

UPDATE TO INCOME SPRINKLING RULES

ANNOUNCED ON DECEMBER 13, 2017

On December 13, 2017 Finance Minister Bill Morneau released what he referred to as clarified rules around income sprinkling. As previously expected, these new income sprinkling rules are set to take effect on January 1, 2018.

Finance also indicated that it will be moving forward with measures to limit the deferral opportunities related to passive investments, while indicating that these rules will apply prospectively from the 2018 Federal Budget date, which has not yet be released. Further updates on these measures will eventually be included in our budget commentary next spring.

Updated Income Sprinkling Rules Still Muddy

Finance stated that the changes to the proposals, first introduced this past summer, included "clear bright-line tests to automatically exclude specific individuals from falling into the new enhanced rules on the Tax On Split Income (TOSI)."

These so called "bright-line" tests included some subjective terms such as "meaningful contribution to the business," and "substantial labour contribution." For those who do not fall under the four specific exclusions, there is still a reasonableness test on income allocated to those individuals.

Here are the exclusions the government is proposing in order to ease the impact of these changes:

1. **You work in the business -** Adults over the age of 18 who have made substantial labour contributions to the business during the year, or during any preceding five years. A substantial contribution is considered to have been made if the individual worked an average of 20 hours per week during the business year, or during any five previous years. For seasonal operations, such as farms and fisheries, the labour contribution requirement is only applied to the period in which the business operates.

2. **You are 25 or over and own shares -** Adults aged 25 or older who own 10 per cent or more of a corporation that earns less than 90 per cent of its income from the provision of services and is not a professional corporation.

3. **You are the spouse of a contributor –** Regardless of your age, if you're the spouse of someone age 65 or over who has made significant contributions to the business.

4. **You realize capital gains on the shares –** Adults who dispose of property that qualifies for the lifetime capital gains exemption.

According to Finance, Individuals who do not meet these exclusions would be subject to a Canada Revenue Agency "reasonableness test" to determine how much income, if any, would be subject to the highest marginal tax rate.

These exclusions target professionals and there are many concerned that the income-sprinkling proposal will be complicated to apply, require significant paperwork, and rely on the subjective determination of tax auditors, inevitably leading to inconsistency and litigation.

The revised draft legislative proposals also make the following changes to the July 18, 2017 proposals:

- The Government will not proceed with proposed measures to apply TOSI to compound income.

- The July 2017 proposals had included amendments to extend the application of subsections 120.4(4) and (5) of the Income Tax Act (which currently apply to minors and effectively deem twice the amount of a taxable capital gain to be a dividend in certain circumstances) to specified adult individuals. These amendments will not move forward. Furthermore, it is proposed that the existing provision be modified so that it will not apply to a minor in circumstances in which a capital gain arises as a consequence of that person's death.

- Income derived from property acquired as a result of the breakdown of marriage or common-law partnership will be exempted from the application of the TOSI rules.

- Generally, individuals aged 18 to 24 will be permitted a prescribed rate of return on capital contributed to a related business. In certain cases, however, such as where the individual earned the capital contributed from an unrelated business, the individual will be permitted a reasonable return on the contribution.

Service Businesses Are Being Targeted

Based on these revised proposals, it would appear that the biggest impact will be to service businesses, as well as professional corporations. For all other types of businesses, it seems that income sprinkling will be allowed for individuals over the age of 24 that own more than 10 per cent of the shares of the corporation, which represent 10 per cent of the votes and value of the corporation. In all other cases, where an individual is providing substantial labour contributions to the business, (i.e. an average of 20 hours per week), those individuals should also be able to continue to receive income.

For spouses who are shareholders of a service business, but are not actively involved in that business, it would appear that they may only be able to receive income once the owner of that business attains the age of 65, and, have provided a meaningful contribution to that business.

Moving forward, for service businesses with passive shareholders, it looks like 2017 will be the last year that dividends can be paid to those shareholders without consequence. As such, it may make sense to maximize the payment of those dividends prior to the end of 2017.

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