The “Income Sprinkling” Trilogy – V3 of the Tax on Split Income Proposals

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March 26, 2018

When we think about trilogies, our brains often think about movies and not tax proposals. Quick: can you think of any good movie trilogies? There aren’t many. As one movie critic aptly states:

Unfortunately, there are few good examples of a solid collective trilogy. Many fall apart on the second or third go-around, often tarnishing the reputation of the original for added insult. And with franchises these days trying to continue as long they keep making money, the overarching stories are getting hard to manage without rigid structure and planning.

For those of Kim Moody’s vintage, one decent movie trilogy was Back to the Future. But, like the above movie critic stated, the second and third go-round of the movie fell apart a bit. But let’s discuss tax trilogies and in particular the “tax on split income” (“TOSI”) trilogy, and whether it follows the above movie model for trilogies. We have previously written about the ongoing saga of the TOSI rules as well as the Government’s ill-fated attempt at a mini-Canadian tax reform as a result of the July 18, 2017 private corporation tax proposals. The newest chapter in this tale arrives to us in the form of a Notice of Ways and Means Motion (“NWMM”) released by Finance on March 22, 2018. Amongst the legislative proposals covered in the NWMM are Version 3 of the TOSI rules and the revised corporate passive income proposals that were announced in the 2018 federal budget. The edits from V2 of the TOSI rules, seemingly minor at first glance, appear to be renewed attempts by Finance to mitigate some of the heavily criticized aspects of these two proposals. While these new revisions are welcomed, there are still many issues raised by the tax community – see for example the submission by the Joint Committee on Taxation regarding V2of the TOSI rules – that Finance ignored.

A. V3 of the TOSI Amendments – Some Observations

We have updated our firm’s TOSI flowchart to take into account in V3. Let’s take a look at a few of these improvements in V3 that will likely have the broadest impact.

1. Historical “related business” taint removed

Let’s illustrate this using a simple scenario: “Husband” and “Wife” are 50/50 owners in a corporation which carried on a consulting business, in which only Wife has been active in the business. The consulting business ceased in 2015, and the corporation’s sole activity since then has been passively investing the historical business retained earnings in GICs to earn interest income, which is distributed to Husband and Wife annually, as dividends. Wife is under the age of 65.

When this common situation is applied against V2 of the TOSI proposals, it appears that TOSI could apply to post-2017 dividends received by the Husband resulting in automatic top marginal rate taxation. Per subparagraph (e)(i) of the definition of “*excluded amount*” contained in V2, TOSI could apply where Husband’s dividend is “derived directly or indirectly from a related business in respect of

[Husband]". "*Related business*" is a year-by-year concept so that there arguably is no "related business" in the current year (as long as the passive investment in GICs is not considered a business), however, there was indeed a related business for 2015 and prior years. The current year's income from which the dividend is being paid is arguably derived "directly or indirectly" from such historical "related business" because the dividend is paid from interest income generated by the retained earnings of that historical "related business." V2 technically required this interpretation because subparagraph 120.4(1.1)(d)(iii) of V2 states that "derived directly or indirectly from a business" includes an amount derived from another amount that is derived directly or indirectly from the business. This was technically an infinite iterative rule that could catch any and all subsequent earnings associated with a historical business.

Furthermore, similar reasoning potentially prevented the shares from being "*excluded shares*" under V2, because paragraph (c) of that definition required that all or substantially all of the income of the corporation for the previous taxation year to be income, not derived directly or indirectly from one or more other related businesses. Some practitioners interpreted that the historical consulting business was potentially an "other" related business because that business no longer exists today. This would have disqualified the shares of the corporation from the "excluded shares" definition.

Effectively, under V2 of the TOSI proposals, a historical "related business" potentially taints a corporation forever for TOSI purposes – even after the business has long ceased. This had real adverse consequences for many retired business owners. Fortunately, the government has now largely stepped back from this approach in V3.

V3 has added the words "*for the year*" in subparagraph 120.4(1)(e)(i) of the definition of "*excluded amount*" when referring to the "related business in respect of the individual." This makes it clear – in our opinion – that for TOSI to apply, the amount must be derived directly or indirectly from a "related business" that exists in the current year. In our example, the consulting business ceased in a previous year so Husband's dividend is not derived directly or indirectly from any "related business … for the year" (of course, this again assumes the GIC investment does not constitute a "business", which is not necessarily a certainty since a "business" is defined to include "undertaking of any kind whatever"). Therefore, post-2017 dividends to Husband from the corporation should not attract TOSI.

Also, in this situation, Husband's shares will qualify as "excluded shares." In V3, paragraph (c) of the "*excluded shares*" definition has replaced the phrase "*other related business*" with "*related business … other than a business of the corporation.*" Since the historical consulting business was carried on by the corporation itself, the interest income earned from the historical retained earnings of the business would not prevent "*excluded shares*" treatment. However, the "*excluded shares*" definition will remain problematic for any ownership structure that is more complicated than a single-tier corporation.

The above improvements in V3 are welcome and should clear up many headaches and uncertainties for those retired business owners holding investment corporations that used to carry on active businesses. Further, it is worthwhile to note that the infinite iterative rule in paragraph 120.4(1.1)(d) of V2 of the TOSI proposals has been narrowed to a second generation income rule that applies only in certain circumstances.

2. Fixing the 10% votes and value threshold issue for "excluded shares"

One of the key criteria for "*excluded shares*" is the 10% votes and value requirement. Under V2 of the TOSI proposals, paragraph (b) of the "*excluded shares*" definition requires that "the shares" on which the dividend or capital gain arises must give the holder 10% votes and value in respect of the

corporation. Two common issues would have arisen from this:

1. It is not unusual for a shareholder to hold two (or more) different classes of shares, where one class has voting rights but little value (a.k.a. skinny shares) and another class has value but no voting rights (e.g. non-voting freeze shares). Even if the multiple classes of shares, in aggregate, give the holder more than 10% votes and value in the corporation, these shares may still fail the "*excluded shares*" test in respect of a particular dividend because the class of shares from which the dividend arises would not have both 10% votes and value. This requirement in V2 that votes and value be embodied in the same class had many practitioners scratching their heads because it was unclear what mischief this particular requirement targeted. Some practitioners had advised clients to reorganize and combine share classes to meet this silly requirement.
2. Even if a shareholder holds shares representing more than 10% votes and value and meet all other criteria of the "*excluded shares*" definition, the shares could still fail to qualify if the shareholder sold a portion of her or his holdings representing less than 10% of the corporation. For example, assume a shareholder holds 60 out of 100 voting common shares of a corporation, and the shareholder sells 9 shares. Under V2 of the TOSI proposals, the shareholder would not be protected by the "*excluded shares*" designation because the shares on which the capital gain arises do not themselves provide the shareholder with more than 10% votes and value of the corporation. This result appeared nonsensical as there was no policy reason for punishing shareholders for selling too little of their stake.

V3 fixes this by shifting the 10% votes and value threshold requirement from the tested shares to the shareholder. Paragraph (b) of the "*excluded shares*" definition now requires that, immediately before the dividend or capital gain, the shareholder owns shares of the corporation that give the shareholder 10% or more of the votes and value of the corporation. Under this new wording, there is no longer a need for votes and value to reside in the same class; as long as the shareholder holds shares that in aggregate provides 10% or more votes and value then the shares could qualify. Moreover, there is no longer a requirement to sell any minimum block of shares as long as the shareholder meets the threshold immediately prior to the sale.

This fix was much needed.

3. New exception for separated spouses or common-law partners

V2 of the TOSI proposals provided a narrow exclusion from its application for income or gains from property acquired pursuant to a decree, order or judgment of a competent tribunal or pursuant to written separation agreement at the time the couple is separated and living apart. This narrow exclusion remains the same in V3, but V3 introduced a new deeming rule in paragraph 120.4(1.1)(e) whereby, for purpose of applying the TOSI rules, spouses and common-law partners living separately and apart at the end of a year because of a relationship breakdown are deemed <u>not</u> to be related to each other at any time in the year.

The implication is that a business that was considered a "*related business*" prior to the relationship breakdown would no longer be a "*related business*" for the year. This means that income or capital gains earned by one spouse or common-law partner directly or indirectly from a business in which the other spouse or partner is involved is no longer subject to TOSI if they live separately and apart from each other at the end of the year because of a relationship breakdown. This is welcome clarification.

B. Minor Amendments to the Passive Investment Proposals as Released in the 2018 Federal Budget

1. ERODTOH and NERDTOH transitional rule fix

The corporate passive income proposals released in the 2018 federal budget requires, for taxation years beginning after 2018, that a private corporation's refundable dividend tax on hand ("RDTOH") pool be differentiated between eligible RDTOH ("ERDTOH") and non-eligible RDTOH ("NERDTOH"). As their names suggest, ERDTOH is recoverable through the payment of eligible dividends while NERDTOH is recoverable through the payment of non-eligible dividends.

To facilitate this, a transitional rule was needed to establish the opening balance of ERDTOH versus NERDTOH. Corporations that are not Canadian controlled private corporations ("CCPC") simply have their RDTOH converted into ERDTOH (since a non-CCPC would not have been entitled to the small business tax rate). Corporations that are CCPCs have to divide their 2018 RDTOH balance into ERDTOH and NERDTOH: the amount converted into ERDTOH is equal to the balance of the CCPC's general rate income pool ("GRIP"). The reasoning is that GRIP represents earnings taxed at the general corporate tax rate as well as eligible dividends received from other corporations. However, in the material released in the 2018 federal budget, the transitional rule did not contemplate corporations that are CCPCs in 2019 but were not CCPCs in the preceding years, or that have elected under subsection 89(11) to not be a CCPC for GRIP and small business tax rate entitlement purposes. These CCPCs would not have a GRIP balance at the beginning of 2019 so under the 2018 federal budget proposals, all of the CCPC's opening RDTOH would have become NERDTOH, even though the amounts involved were not entitled to the small business tax rate in the first place. Under the proposals released in the March 22, 2018 NWMM, these types of CCPCs will no longer have any opening NERDTOH. In addition, the NWMM provides transitional rules for ERDTOH and NERDTOH for corporate mergers.

PS: Someone in the Finance Department clearly has a sense of humour by coming up with "non-eligible refundable dividend tax on hand" or NERDtoh, which is fun to say and helps promote the stereotype of tax accountants and lawyers as being the life of the party…not!

C. The improvements that we hoped would be in V3 of the TOSI rules but were not there

We would be remiss if we did not provide some closing comments on what is missing in V3 of the TOSI rules. Many in the tax community provided cogent comments regarding the TOSI proposals especially the Joint Committee. However, many of the Joint Committee comments have been ignored. This is disappointing. Here are some of the larger concerns that still remain:

1. Automatic top marginal rate application

If the TOSI rules apply, the specified individual will pay the top marginal personal rate applicable to that income with no personal tax credits available. For example, let's assume that Husband and Wife own shares of Opco. Let's further assume that any dividends paid to Husband would attract TOSI and both Husband and Wife are not in the top marginal rates of income, even if such dividends were received by Wife. If Husband receives dividends from Opco, he will pay the top marginal personal tax rate on those dividends as a result of the application of the TOSI rules; even though, had Wife received those dividends on top of her actual dividends, she still would not have paid top marginal rates. This is unfair.

2. The "*Excluded Share"* exception for service companies

One of the key criteria that must be met for "*excluded share*" treatment is that less than 90% of the

business income of the corporation for the last taxation year of the corporation must be from the provision of services. In other words, service companies will not be afforded excluded share treatment. The Joint Committee stated the following in its recent submission:

We recommend that the requirement that less than 90% of the corporation's business income be from the provision of services be deleted. This would eliminate the anomalous disqualification of shares as excluded shares, simply because the corporation earns "too much" income from the provision of services. It would also avoid the inevitable uncertainty and proliferation of disputes regarding what constitutes income from the provision of services. We also recommend that if *there are particular service activities the Finance finds problematic, those activities should be addressed directly.*

Well, V3 of the TOSI proposals has completely ignored the Joint Committee recommendation and thus the uncertainty and proliferation of disputes will start. We find this disappointing.

In addition, the definition of "excluded shares" is hostile to multi-tiered corporate structures and trusts that hold shares of the corporation. V3 of the TOSI proposals maintains this hostility. Again, quite disappointing.

3. Relationship breakdown – paragraph (b) of the definition of "*excluded amount*" is too narrow

V3 of the TOSI proposals introduced new paragraph 120.4(1.1)(e) as discussed above. However, V3 did not respond to the Joint Committee's concern that paragraph (b) of the definition of "excluded amount" is too narrow. In many cases, a breakdown of a marriage or common-law relationship is accompanied by a divisive "butterfly" transaction using the provisions of paragraph 55(3)(a) of the Income Tax Act. The Joint Committee recommended that paragraph (b) be expanded to include situations involving paragraph 55(3)(a) reorganizations. It is disappointing that V3 did not respond to this observation. Accordingly, the TOSI rules will now need to be very carefully considered when planning property settlement agreements that might rely on paragraph 55(3)(a) transfers.

4. No bright line use of the word "business"

The TOSI proposals use the word "*business*" or "*businesses*" in various places throughout the legislation. For example, the definitions "*excluded business*" and "*related business,*" and various other places in the legislation use these phrases. Subsection 248(1) of the Income Tax Act provides an inclusive definition of "*business*" that is not exhaustive. In other words, one must rely on the common-law definition of what a "*business*" is, ultimately depending on the facts of each situation. Given the significant consequences of being wrong – top rate taxation of the "*split income*" – it would have been preferable to use a more bright line definition of business rather than relying on the uncertain common-law definition of "business." Disappointingly, V3 of the TOSI proposals does nothing to add clarity to this uncertainty.

5. Overall complexity

As we pointed out in our December 14, 2017 blog regarding V2 of the proposals, the TOSI proposals are complex. Very complex. The Joint Committee stated the following in its recent submission:

The Proposals target a wide range of payments from private businesses to individuals. They are drafted very broadly and can apply – indeed are intended to apply – to individuals in low tax brackets. Even very small businesses can be affected. These businesses normally do not have access to – and likely cannot

afford – sophisticated legal, tax or accounting advisors. Realistically, these taxpayers will have to rely on their own, or, at best, their generalist advisors' sense of what the rules mean.

…

There is a time and place for complexity. Rules likely to apply primarily to multinational corporations, who can be expected to have access to sophisticated advisors can reasonably be complex and involved where necessary for their purpose. The TOSI rules apply in a context that could not be more different. Every single individual resident in Canada who receives or realizes an amount derived from a private corporation, partnership or trust will need to understand these rules in order to comply with the law.

We respectfully suggest the burden imposed on such taxpayers by these complex Proposals is simply unreasonable. While we acknowledge that Finance has attempted to address complexity issues by narrowing the range of situations in which the "reasonableness" test needs to be considered (for example through the 20-hour rule in the "excluded business" definition), we believe that considerably more simplification of the rules is necessary to make them something that small businesses can understand and deal with. We acknowledge the Government's legitimate interest in reducing opportunities for tax avoidance, but at the same time, a reasonable balance needs to be struck between this objective and the compliance burden placed on small taxpayers. We therefore recommend that further efforts be made to simplify the TOSI rules, and we would be happy to work with Finance in this regard.

We very much agree with the Joint Committee. Unfortunately, V3 of the TOSI proposals does nothing to simplify the material. We will, without doubt, be left in a situation where many general practitioners will struggle with giving the most basic advice to their private clients – how they should pay themselves from their private corporations. Not good.

So, back to the trilogy movie/tax model. While V1 of the TOSI was atrocious, V2 hired a new scriptwriter and was somewhat better, making V3 a slight improvement over V2. So this seems to follow the reverse model for movies where the best is usually reserved for the first. In tax trilogies, the "best" is usually saved for last. Having said that, the "best" in this case is certainly not good at all. In fact, this tax trilogy is not a solid collective masterpiece. Hopefully, when we go "back to the future," the significant rough edges of the TOSI legislation will be smoothed out, or better yet, eliminated.