New Developments in the TOSI rules

As of January 1, 2018, owners of private corporations in Canada must be careful when paying dividends to related individual shareholders. Under the recently expanded Tax on Split Income ("TOSI") rules, where related individuals (aged 18 and over) receive dividend income from a private corporation, they may be taxed at the highest marginal tax rate on the income unless they meet certain tests based on their business contributions or qualify for one of the exceptions from TOSI.

This article will not be discussing the details of the TOSI rules, criteria for the reasonableness tests, or the exceptions involved. Rather, it will provide an overview of the recent technical interpretations by CRA that provide more clarity on where TOSI **may not** apply.

No business means no TOSI

CRA confirmed that if a private corporation is earning income from investments and not carrying on a business in the year (i.e. the corporation is only earning income from property such as rental properties and investments), then TOSI would not apply to dividends paid to individuals aged 18 and over. Although this is good news for passive investment corporations, it is also important to note that there is no objective test to determine when the private corporation would be considered as earning income from a business as opposed to income from property. CRA typically applies a subjective test that looks at various aspects including the number, volume, nature, and frequency of the transactions to determine if the corporation may be carrying on a business. It may be prudent to err on the side of caution unless a clear distinction can be made. The burden will be on the taxpayer to prove that the corporation was not carrying on a business if challenged by CRA.

No TOSI after sale/dissolution of operating business

In other technical interpretations, CRA confirmed that TOSI would not apply after the sale/dissolution of the operating business where shares meet the excluded share exception. As a refresher, the following criteria must be met to qualify for the excluded share exception:

a) less than 90% of the business income of the corporation for the last taxation year of the corporation that ends at or before that time was from the provision of services **and** the corporation is not a professional corporation;

b) immediately before that time the specified individual owns shares in the capital stock of the corporation that give the holders 10% or more of the votes and the fair market value of all the issued and outstanding shares; and

c) all or substantially all of the income of the corporation for the relevant taxation year is income that is not derived, directly or indirectly, from one or more related business in respect of the specified individual **other than a business of the corporation**.

Under the fact scenario, CRA considered a hypothetical situation where Mr. A and Mrs. A are both married and above 25 years old. They each own 50% of votes and value in ACo. Mrs. A was actively engaged in ACo's business on a regular, substantial and continuous basis for at least five years in the past. Mr. A never made any business contributions to ACo. ACo sold the operating business 2 years ago (lets call it "Year 2") and the sale proceeds and accumulated retained earnings have been invested in a portfolio of public securities since the sale.

Assuming ACo is deemed to be carrying on an investment business due to its activity level, ACo shares will qualify as excluded shares starting this year (lets call it "Year 4") and dividends received by Mr. A would not be subject to TOSI because of the following reasons:

a) ACo did not earn business income from provision of services in Year 3 and it is not a professional corporation

b) Mr. A owns 50% of votes and value of ACo.

c) ACo's income in Year 3 was not derived, directly or indirectly, from a related business other than ACo's business

In this fact scenario, if ACo did not have a sufficient level of activity to be considered as carrying on a business in Year 3 and onwards (i.e. all business activities were ceased in Year 2 with the sale of the operating business) then TOSI would not generally apply to dividends received by Mr. A in Year 3 and onwards as it would be considered an "excluded amount" (see discussion under "No business means no TOSI").

Under the excluded share exception, CRA clarified that the timing of dividend payments from the subject corporation is an important factor in determining whether TOSI applies. If dividends are paid in Year 3 then the corporation would need to qualify for the excluded share exception based on Year 2 income.

Given the complexity of these rules, owners of private corporations should work with their advisors to determine if they would be subject to the TOSI rules before paying dividends to related individual shareholders.

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