



Wealth
Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES



Barnsdale & Hussain Wealth
Management Group
of RBC Dominion Securities
1672 Lakeshore Rd. W.
Mississauga, ON L5J 1J5
ca.rbcwealthmanagement.com/
web/barnsdalehussain.wealth

David Barnsdale, CFP, CIM, FCSI, FEA
Senior Portfolio Manager
& Wealth Advisor
Tel: 905-822-1793
david.barnsdale@rbc.com

Qamar Hussain
Associate Advisor
Tel: 905-822-1262
qamar.hussain@rbc.com

Bilkis Walji
Associate Advisor
bilkis.walji@rbc.com

Income splitting through private corporations

As an incorporated business owner, you may be interested in income splitting strategies that help reduce your family's overall tax liability. These strategies generally involve shifting income that would otherwise be taxed in your hands at a high marginal tax rate to your lower-income family member(s), taking advantage of their lower marginal tax rate. Common income splitting tools used by incorporated business owners include paying a salary to a family member employed by the corporation or a dividend to a family member who's a shareholder of the corporation. When considering splitting income through your corporation, it's important to be aware of certain anti-avoidance rules, such as the Tax on Split Income (TOSI) rules, that may limit your opportunity to split income with family members. This article discusses the TOSI rules and how they impact your income splitting plans.

Any reference to a spouse in this article also includes a common-law partner.

TOSI

The TOSI rules are not attribution rules, but they do affect income splitting through a private corporation. These rules are designed to discourage business owners and incorporated professionals from income splitting with family members who do not meaningfully contribute to the business or practice.

"Kiddie tax"

Prior to 2018, the TOSI rules were narrower in scope and commonly referred to as the "kiddie tax" rules.

The rules only applied to certain types of income (referred to as "split income") received from a private corporation, such as dividends and shareholder benefits, by a minor child (under the age of 18) who had a parent resident in Canada. The TOSI rules also applied to capital gains realized by a minor child on the sale of private company shares to a non-arm's length person. In this case, the capital gain realized on the sale of the shares is reclassified as a non-eligible dividend (the 50% inclusion rate for the capital gain is lost). The TOSI rules do not apply to salaries or bonuses.

Where the TOSI rules apply, the income is subject to tax at the highest personal marginal tax rate. There is no ability to claim personal tax credits on the split income, other than the disability tax credit, dividend tax credit and foreign tax credit. A minor child's parent is also jointly and severally liable with the child for the taxes payable on the split income. If TOSI applies to the income received by the minor, the income attribution rules will not apply on the same income.

Expanded TOSI rules

The TOSI rules were significantly expanded on January 1, 2018. The rules now also apply to certain amounts received, either directly or indirectly, from a related business by adults aged 18 and over who are tax residents of Canada. Generally, a related business is one where a related person is either actively engaged in the business on a regular basis or owns, directly or indirectly, a significant portion of the equity in the corporation that carries on the business (10% or more of the fair market value of all of the issued and outstanding shares).

The amounts subject to TOSI do not include salary paid by the related business, but could include dividends from private corporations; shareholder benefits from private corporations; interest from private corporations, partnerships or trusts; income derived from a partnership or trust from a related business; or, certain capital gains from the disposition of private company shares, unless the amount falls within a specific exclusion.

As in the case of minor children, income subject to TOSI will be taxed at the highest personal marginal tax rate. For individuals aged 18 and over, the person related to the individual who's sufficiently connected to the business will be jointly and severally liable for the taxes owing.

The TOSI rules include bright-line tests which set out conditions that if met, would exclude the amounts from the application of the TOSI rules. A summary of these tests and the conditions that must be satisfied are provided in the following sections.

Adult individuals aged 18 or over

For individuals aged 18 or over, an amount received from an **"excluded business"** is excluded from TOSI. An excluded business is one in which the individual is actively engaged on a regular, continuous and substantial basis ("actively engaged") in the current tax year or in any five previous tax years. The five taxation years do not need to be consecutive or after 2017.

An individual is deemed to be actively engaged if they work in the business at least an average of 20 hours per week during the part of the year the business operates. For example, if a farm or fishing business operates for 4 months of the year,

The TOSI rules were significantly expanded on January 1, 2018. The rules now also apply to certain amounts received, either directly or indirectly, from a related business by adults aged 18 and over who are tax residents of Canada.

the individual would be considered actively engaged in the business for the full year if they were actively engaged during that 4-month period.

If the individual does not meet the 20-hour threshold, then it is a question of fact as to whether they are actively engaged in the business.

Adult individuals aged 25 or over

For individuals aged 25 or over, if an amount is not excluded from TOSI under the excluded business exception, the amount received may not be subject to TOSI if it is income from **"excluded shares"** or taxable capital gains from the disposition of excluded shares. Excluded shares are shares of a corporation personally owned by an individual if the following conditions are met:

- The shares represent at least 10% of the votes and value of the corporation;
- Less than 90% of the corporation's business income for the prior tax year (or its current tax year if no such prior tax year exists) was from providing services;
- The corporation is not a professional corporation (such as a corporation that carries on the professional practice of an accountant, a lawyer, a doctor or a dentist); and
- All or substantially all (generally this means 90% or more) of the income of the corporation for its previous tax year is not derived directly or indirectly from another related business.

If you run a services business and want to continue to income split with family members, consider employing them in your business and paying them a reasonable salary.

Individuals aged 25 or over who do not meet the excluded shares or excluded business exceptions are subject to a reasonableness test to determine how much income, if any, will be subject to TOSI. Amounts received that qualify as a **"reasonable return"** will be excluded from TOSI.

To determine whether an individual received a reasonable return from a related business, a number of factors may be considered, including the individual's labour contributions, direct or indirect capital contributions, risks assumed, previous amounts received from the business, as well as

any other relevant factors. The Canada Revenue Agency has provided guidance on the application of the income splitting rules for adults and, in particular, elaborated on the factors it will consider in determining whether a payment is a reasonable return.

Adult individuals aged 18 to 24

If individuals between the ages of 18 and 24 do not meet the excluded business exception, they are entitled to a return on the capital contributed in support of a related business.

If the individual contributed “arm’s length capital,” the individual will be able to use the reasonableness test and be permitted a reasonable return on the contribution. Arm’s length capital is essentially any capital contributed to the business other than property income from a related business, borrowed funds, or funds received from a related person (other than inherited property).

If the capital contributed is not arm’s length capital, the individual is permitted to receive a return based upon a prescribed formula (known as a safe harbour capital return).

Spouse of a business owner

If a business owner is 65 years or over in the year (or is deceased), and if an amount paid to them would not be subject to TOSI under one of the exceptions, then any amount paid to their spouse would also not be subject to TOSI. This attempts to recognize the challenges associated with planning for retirement and better aligns the TOSI rules with the existing pension income splitting rules.

Any individual (including minors)

In general, taxable capital gains realized from the disposition of qualified small business corporation (QSBC) shares or shares of a family farm corporation (or qualified farm or fishing property) will not be subject to TOSI. This ensures the TOSI rules do not limit access to the lifetime capital gains exemption (LCGE). It also places more importance on satisfying the active business asset test for QSBC shares.

In addition, if a trust holds QSBC shares or shares of a family farm corporation (or qualified farm or fishing property) and disposes of the property to an arm’s length person, the taxable capital gain realized as a result of the disposition can be allocated out to the beneficiaries (including a minor beneficiary) and be excluded from TOSI. The beneficiaries of the trust may be able to use their LCGE to shelter the capital gains from tax.

As previously noted, there is an exception to this rule where a minor child, either directly or indirectly through a trust, disposes of private company shares to a non-arm’s length person. In such a case, the capital gain realized on the

The TOSI rules include continuity rules for inherited property, which help individuals aged 18 and over who have inherited property and who may not meet an exemption from TOSI on their own merits to qualify for an exemption.

disposition of the shares will be deemed to be a non-eligible dividend, subject to tax at the highest personal marginal tax rate. As a result, a minor will not be able to claim the LCGE on the disposition of the QSBC shares or shares of a family farm corporation to a non-arm’s length person.

Inherited property

The TOSI rules include continuity rules for inherited property, which help individuals aged 18 and over who have inherited property and who may not meet an exemption from TOSI on their own merits to qualify for an exemption. These rules effectively allow the beneficiary of the inherited property to step into the shoes of the deceased and benefit from the contributions made by the deceased individual when applying the reasonable return and excluded business exemptions. For example, an amount received on the inherited property will not be subject to TOSI if it would have been a reasonable return for the deceased had the amount been received by the deceased. As well, an amount will be considered to be received by the beneficiary from an excluded business if the deceased was engaged on a regular, continuous and substantial basis in the activities of the related business in any five previous tax years. For the purposes of the excluded shares and reasonable return exemption, the rules deem the beneficiary to have attained the age of 24 before the year, provided the deceased had attained age 24 before the year.

Other income excluded from TOSI

The following types of income are also excluded from TOSI:

- Capital gains arising on an individual’s death;
- Income or capital gains from property acquired by an individual pursuant to a judgement or written separation agreement as a result of breakdown of marriage or common-law relationship;
- Income or capital gains on property inherited by an individual under age 25 as a result of the death of their parent; and,
- Income or capital gains on property inherited from any person by an individual under age 25 who is enrolled as a full-time post-secondary student or entitled to the disability tax credit.

Conclusion

In light of these TOSI rules, if you are involved, either directly or indirectly, in a private corporation, you may need to review your corporation's ownership structure, and any tax and estate planning strategies you've implemented that relate to the private corporation. You may reach out to qualified tax and legal advisors to determine how these rules could impact you, your family and future tax and estate planning strategies.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.



**Wealth
Management**

This document has been prepared for use by the RBC Wealth Management member companies, RBC Dominion Securities Inc. (RBC DS)*, RBC Phillips, Hager & North Investment Counsel Inc. (RBC PH&N IC), RBC Global Asset Management Inc. (RBC GAM), Royal Trust Corporation of Canada and The Royal Trust Company (collectively, the "Companies") and their affiliates, RBC Direct Investing Inc. (RBC DI)*, RBC Wealth Management Financial Services Inc. (RBC WMFS) and Royal Mutual Funds Inc. (RMFI). *Member-Canadian Investor Protection Fund. Each of the Companies, their affiliates and the Royal Bank of Canada are separate corporate entities which are affiliated. "RBC advisor" refers to Private Bankers who are employees of Royal Bank of Canada and mutual fund representatives of RMFI, Investment Counsellors who are employees of RBC PH&N IC, Senior Trust Advisors and Trust Officers who are employees of The Royal Trust Company or Royal Trust Corporation of Canada, or Investment Advisors who are employees of RBC DS. In Quebec, financial planning services are provided by RMFI or RBC WMFS and each is licensed as a financial services firm in that province. In the rest of Canada, financial planning services are available through RMFI, Royal Trust Corporation of Canada, The Royal Trust Company, or RBC DS. Estate and trust services are provided by Royal Trust Corporation of Canada and The Royal Trust Company. If specific products or services are not offered by one of the Companies or RMFI, clients may request a referral to another RBC partner. Insurance products are offered through RBC Wealth Management Financial Services Inc., a subsidiary of RBC Dominion Securities Inc. When providing life insurance products in all provinces except Quebec, Investment Advisors are acting as Insurance Representatives of RBC Wealth Management Financial Services Inc. In Quebec, Investment Advisors are acting as Financial Security Advisors of RBC Wealth Management Financial Services Inc. RBC Wealth Management Financial Services Inc. is licensed as a financial services firm in the province of Quebec. The strategies, advice and technical content in this publication are provided for the general guidance and benefit of our clients, based on information believed to be accurate and complete, but we cannot guarantee its accuracy or completeness. This publication is not intended as nor does it constitute tax or legal advice. Readers should consult a qualified legal, tax or other professional advisor when planning to implement a strategy. This will ensure that their individual circumstances have been considered properly and that action is taken on the latest available information. Interest rates, market conditions, tax rules, and other investment factors are subject to change. This information is not investment advice and should only be used in conjunction with a discussion with your RBC advisor. None of the Companies, RMFI, RBC WMFS, RBC DI, Royal Bank of Canada or any of its affiliates or any other person accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or the information contained herein. ®/™ Registered trademarks of Royal Bank of Canada. Used under licence. © 2023 Royal Bank of Canada. All rights reserved. NAV0223 (06/23)