



The Joint Committee on Taxation of  
The Canadian Bar Association  
and  
Chartered Professional Accountants of Canada

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March 8, 2018

Department of Finance Canada  
90 Elgin Street  
Ottawa, ON K1A 0G5

Attention: Brian Ernewein, General Director, Tax Policy Branch, Department of Finance (“**Finance**”)

Dear Mr. Ernewein,

**Re: Legislative Proposals to Address Income Sprinkling Released December 13, 2017**

This submission sets out comments of the Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada (“**Joint Committee**”) on the proposed changes to the “tax on split income” (“**TOSI**”) provisions of the *Income Tax Act (Canada)* (the “**Act**”) contained in the legislative proposals released on December 13, 2017 (the “**Proposals**”).

Our committee acknowledges Finance’s consideration of our October 2, 2017 submission on the July 18, 2017 version of the TOSI proposals, and commends the many improvements made to the draft legislation. At the same time, we respectfully submit that a number of serious technical and practical issues remain. The purpose of this submission is to share our perspective on these issues.

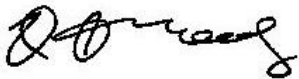
The Joint Committee also notes that, together with the release of the Proposed TOSI Amendments, the Canada Revenue Agency (“**CRA**”) released guidance on the approach to be taken by CRA to administration of these new legislative provisions. We believe it is constructive and helpful for CRA to work closely with Finance with a view to enacting provisions that can be administered in a reasonably consistent and predictable way. We would suggest that further guidance, dealing with more challenging fact patterns than those contained in the CRA guidance released on December 13, 2017, would be helpful. It is hoped that our submission will illuminate areas where further guidance may be of assistance.

A number of members of the Joint Committee and others in the tax community participated in the discussions concerning this submission and contributed to its preparation, including:

Bruce Ball – CPA Canada  
Gabriel Baron – Ernst & Young LLP  
Marlene Cepparo – KPMG LLP  
Ian Crosbie – Davies Ward Phillips & Vineberg LLP  
Rose Cross – BDO LLP  
Ken Griffin – PwC LLP  
Kenneth Keung – Moodys Gartner Tax Law LLP  
K. A. Siobhan Monaghan – KPMG Law LLP  
Kim G C Moody – Moodys Gartner Tax Law LLP  
Hugh Neilson – Kingston Ross Pasnak LLP  
John Oakey – Collins Barrow  
Michael Saxe – MNP LLP  
Anthony V. Strawson – Felesky Flynn LLP  
Jeffrey Trossman – Blake, Cassels & Graydon LLP

We trust that you will find our comments helpful, and would be pleased to discuss them further at your convenience.

Yours very truly,



Kim G. C. Moody  
Chair, Taxation Committee  
Chartered Professional Accountants of Canada



Jeffrey Trossman  
Chair, Taxation Section  
Canadian Bar Association

Cc: Ted Cook, Director General, Tax Legislation Division, Finance Canada

## Legislative Proposals to Address Income Sprinkling Released December 13, 2017

We have divided our comments into two parts.

First, we provide a series of comments on the Proposals, including some recommendations of the Joint Committee.

Second, we have attached an appendix in which we describe an assortment of technical issues that have been identified by members of the Joint Committee and other tax professionals when attempting to apply the Proposals to real life situations.

### Submissions

#### *Overall Structure*

A reader of the Proposals will realize that the structure of the new provisions is to presumptively apply the TOSI rules to an individual who earns an item of income that is a dividend, interest (or other income from debt obligations), partnership or trust allocation or capital gain and to subject such income to top-rate taxation under the TOSI rules. The reader must then search for an exception. If an exception is not found, the TOSI rules apply.

This drafting style may perhaps be appropriate in fact patterns more likely to involve an element of tax avoidance, such as payments to minor children. However, in our respectful view it is inappropriate in the context of a rule that can apply to every individual resident in Canada. While we acknowledge that efforts have been made to articulate a series of exceptions, we are concerned that the adopted drafting style will inevitably lead to assertions by the CRA that the rules apply in a broad range of situations, leaving the taxpayer with the task of proving why a particular exception applies to him or her.

**We believe a more measured approach would be for the drafting style to affirmatively describe the situations in which the TOSI rules are meant to apply, at least in circumstances involving items of income derived by adults. Adopting the starting point that every item is caught, and then requiring a search for an exception in our view is not warranted in the context of these rules.**

#### *Complexity*

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.

In this context, we believe the Proposals are disproportionately complex. The presumptive scope of the rules is very broad. A “specified individual” is defined to mean essentially each and every individual resident in Canada. This is radically different from existing law, which defines a “specified individual” to exclude all adults. To determine whether the Proposals apply, an individual must read through a series of complicated, inter-connected definitions and rules of application. Some of the definitions and operative provisions refer to open-ended concepts, such as a “reasonable return” (subsection 120.4(1)) or an amount “derived from an amount that is derived directly or indirectly from the business”

(paragraph 120.4(1.1)(d)). Individuals and small businesses who do not have access to sophisticated tax advice cannot reasonably be expected to understand these provisions, much less to appreciate the nuances lurking below the surface.

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.**

### ***Inappropriate consequences***

The Proposals are crafted as an “add-on” to the so-called “kiddie tax” rules contained in current section 120.4. These rules apply only to minors. Adult recipients of dividends and similar amounts can safely ignore these rules under current law.

The implied premise of the “kiddie tax” rules is that the dividends or similar amounts in issue would not be received by a minor from a private corporation, partnership or trust in circumstances not involving some element of tax avoidance. In order to deter such tax avoidance, subsection 120.4(2) applies income tax at the top marginal rate to any such amounts. This goes well beyond other attribution rules in the Act, which attribute income to the relevant “other” individual, who may or may not in fact be taxable at the top marginal rate. Because the “kiddie tax” is focused on a fact pattern likely to involve an element of tax avoidance, the potentially harsh imposition of top-rate tax on relevant amounts earned by minors can be defended.

In our view, with the extension of the TOSI rules to (at least potentially) every individual resident in Canada, the imposition of top-rate tax to “split income” amounts can no longer be defended. The sheer breadth of the Proposals inevitably means that the rules can potentially apply in situations where the “other” individual – now defined as the “source individual” – is in fact taxed at a rate that is lower than the top marginal rate. In our view, it is inappropriate for the affected “specified individual” to pay more tax than would have been payable had the income simply been attributed to the “source individual”.

We would be happy to work with Finance to design alternatives, notwithstanding that such alternatives might carry complications.

### **Exception for “excluded shares”**

The Proposals would impose top-rate personal income tax on “split income”. Split income is defined to exclude any “excluded amount”. An “excluded amount” of an individual is defined to include, among other things, an amount that is the individual’s income, to the extent that the amount is, among other things, income from (or a taxable capital gain from the disposition of) “excluded shares of the individual”.<sup>1</sup>

In this convoluted way, the Proposals appear to not apply to, for example, a dividend paid on a share that is regarded as an “excluded share”.

There are several conditions that must be met for a share to be an “excluded share” issued by a corporation:

- (a) the corporation must not be a “professional corporation”;<sup>2</sup>
- (b) less than 90% of the business income of the corporation must be from “the provision of services”;<sup>3</sup>
- (c) the shares in the corporation owned by the holder must give the holder 10% or more of the votes that could be cast at an annual meeting of the shareholders of the corporation;<sup>4</sup>
- (d) the shares in the corporation owned by the holder must have a fair market value (“**FMV**”) of 10% or more of the FMV of all issued and outstanding shares of the corporation;<sup>5</sup> and
- (e) “all or substantially all” of the income of the corporation must be income that is not derived, directly or indirectly, from “one or more other related businesses” in respect of the individual.<sup>6</sup>

The text of the last of these requirements is difficult to understand. It refers to an “other related business”, and yet the preceding text makes no reference to any particular related business. The explanatory notes suggest this provision is meant to disqualify shares of a corporation that derive value from a business other than the main business carried on by the corporation that issued the shares, but it is, to say the least, somewhat difficult to discern any clear meaning from this cryptic provision. We would respectfully suggest that much clearer statutory language is needed to clarify exactly what this paragraph is meant to disqualify (for example, perhaps the wording should say something like “one or more related businesses in respect of the specified individual that are carried on by persons or partnerships other than the corporation”, if that is what is intended). We have a number of examples where this requirement may be an issue, and we would be happy to discuss these with Finance.

More generally, in order to apply the provision, the affected individual needs to somehow determine how much of the issuing corporation’s income is “business income”, and whether or not less than 90%

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<sup>1</sup> This rule applies only where the individual has attained the age of 24 years before the relevant year.

<sup>2</sup> Paragraph (a)(ii) of the definition “excluded shares”.

<sup>3</sup> Paragraph (a)(i) of the definition “excluded shares”.

<sup>4</sup> Paragraph (b)(i) of the definition “excluded shares”.

<sup>5</sup> Paragraph (b)(ii) of the definition “excluded shares”.

<sup>6</sup> Paragraph (c) of the definition “excluded shares”.

of that income was income from “the provision of services”. While some cases will be clear, there are likely to be many cases in practice where there is a lack of clarity as to whether a corporation’s income is income from a business as opposed to income from property, or whether gross or net income is relevant. There is considerable case law on the distinction between business income and property income, focusing on such things as the extent of activity involved in the generation of the income. In addition, the distinction for most CCPCs is largely irrelevant under current law as both income from a specified investment business and investment income are subject to refundable tax. It seems inevitable that disputes will emerge from the use of this distinction.

Furthermore, the distinction between income from “the provision of services” and other income will frequently be less than clear. Many examples come to mind, including many “new economy” activities such as computer software and technology. The distinction between service income, on the one hand, and income from the exploitation of intellectual property, on the other hand, is often unclear. Furthermore, the distinction between service income and non-service income may give rise to arbitrary outcomes that we find difficult to rationalize. For example, if a hairdressing company earns at least 10.1% of its business income from selling shampoos and other products, it seems its shares could qualify as “excluded”, but if only 9.9% came from such sales, the shares would not qualify. We are struggling to understand how this outcome makes sense.

To illustrate further, a corporation that carries on a business of developing and selling land will be able to pay unlimited dividends to any family-member shareholders who own 10% or more of the shares of the corporation without application of TOSI. However, the shares of the excavation company that it hired to develop the land will be limited to paying a reasonable amount of dividends to each family-member shareholder. Both the land development business and the excavation business are capital intensive businesses and in fact, the excavation business may hire more employees than the land development business.

The apparent bias in the rules against service businesses will disadvantage a large portion of Canada’s businesses. According to Statistics Canada “Key Small Business Statistics - June 2016”, there were at that time 1,167,978 ‘employer businesses’ in Canada, of which only 251,451 were in the goods producing sector and 916,527 in the service producing sector (a majority of them being small businesses). It is well known that Canada has moved into a services-based economy, and this is where economic and employment growth is expected to come in the future.

Although the Act does not define “services” or the “provision of services”, there is some jurisprudence that arose in the context of the question whether certain activities are “manufacturing or processing of goods for sale” or provision of services – the former being eligible for the manufacturing and processing credit under section 125.1 and inclusion of related property in Class 29 pursuant to the Regulations and Schedule II of the Act.<sup>7</sup> The case law provides some level of guidance, but there is considerable room for disagreement and therefore disputes.

There are many situations where the line between the provision of goods and the provision of services is blurred, particularly given the proliferation and complexity of today’s service economy, and

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<sup>7</sup> Dixie X-Ray Associates v. The Queen, [1988] 1 C.T.C. 69 (F.C.T.D) 88 D.T.C. 6076, Reg Rad Tech Ltd. v. Canada, [1991] 2 C.T.C. 201 (F.C.A.) 91 D.T.C. 5518, Industrial Forestry Service Ltd. v. M.N.R., [1992] 1 C.T.C. 2182 (T.C.C.) 92 D.T.C. 1060, R. v. Veritas Seismic (1987) Ltd., [1994] 1 C.T.C. 241 (F.C.A.) 94 D.T.C. 6123, Allarcom Pay Television Ltd. v. R., [1996] 3 C.T.C. 2608 (T.C.C.)

technological sophistication, for instance in the area of “fintech”. Many seemingly service-oriented businesses could indeed have a substantial goods-providing side of the business, and vice versa.

**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.**

### **Further comments on “excluded shares”**

#### *Comparison of 4 families*

Compare the following four families and the tax treatment of income or taxable capital gains earned in respect of their shares in their respective corporations – assume none of the shares qualifies as qualified small business corporation (“QSBC”) shares):

1. Mr. A, Ms. B and their son, AB, are equal shareholders of AB Co which carries on an integrated fish fillet business that catches fish and processes them into fillet for sale. Mr. A and Ms. B are common-law partners and both are actively engaged in the business. AB is age 25 and has never been active in the business.

Shares of AB Co are likely “excluded shares”. AB may receive an unlimited amount of dividends or taxable capital gains with respect to AB Co without TOSI applying.

2. Mr. C is the sole shareholder of C Co which carries on a business of processing fish into fillet for sale. Mrs. D and their daughter, CD, are equal shareholders of D Co which carries on a business of catching fish to sell to C Co. Mr. C and Mrs. D are spouses and both are actively engaged in their respective businesses. CD is aged 25 and has never been active in either business.

Shares of D Co cannot be “excluded shares” because all or substantially all of D Co’s income each year is from one or more other “related business”, i.e. the business being carried on by C Co.

Any dividend income or taxable capital gain earned by CD in respect of her D Co shares will be subject to TOSI, because she meets none of the exclusions within the “excluded amount” definition.

3. Mr. E, Mrs. E and their son, EE, are equal shareholders of E Holdco, which in turn owns 100% of E Opco that carries on an integrated fish fillet business. During the last taxation year, E Opco distributed its earnings to E Holdco as an intercorporate dividend. Mr. E and Mrs. E are spouses and are both actively engaged in the business of E Opco. EE is aged 25 and had never been active in the business.

Shares of E Holdco cannot be “excluded shares” in the current year because all or substantially all of E Holdco’s income in the last taxation year is derived, directly or indirectly, from one or more other “related businesses”. Income of a corporation includes dividend income, because the deduction

under subsection 112(1) only applies in the computation of taxable income. During the last taxation year, E Holdco's sole source of income was dividends received from E Opco, which paid the dividends out of the income from its fishing business, which was a "related business".

Any dividend income or taxable capital gain earned by EE in the current year in respect of his E Holdco shares will be subject to TOSI, because he likely meets none of the exclusions within the "excluded amount" definition.

4. Mr. F, Mrs. F and their daughter, FF, are equal shareholders of F Holdco, which in turn owns 100% of F Opco which carries on an integrated fish fillet business. F Opco did not pay any intercorporate dividend to F Holdco during the last taxation year. Mr. F and Mrs. F are spouses and both are actively engaged in the business of F Opco. FF is aged 25 and has never been active in the business.

Shares of F Holdco are "excluded shares" in the current year. Since F Holdco had no income in the last taxation year, it probably means that it has not derived all or substantially all of its income last year from one or more other "related business".

FF may earn an unlimited amount of dividends or taxable capital gain in the current year with respect to F Holdco without TOSI applying.

There are no substantive or economic differences among the four families. Yet, two of the families are able to utilize the marginal tax rates and personal tax credits of their inactive child, while the other two families cannot. The Joint Committee appreciates that paragraph (c) is intended to prevent taxpayers from circumventing the other requirements of the "excluded shares" definition; for example, any specified individual can meet the 10% ownership test by transferring her or his shares to a holding corporation. However, the current drafting of paragraph (c) will result in inconsistent treatment of taxpayers in substantively the same circumstances.

The Joint Committee recommends that Finance consider revising paragraph (c) of the "excluded shares" definition so that it describes a corporation where all or substantially all of its income for its last taxation year was not derived, directly or indirectly, from

- one or more other related businesses that carry on activities that Finance finds problematic, or
- another corporation in which the specified individual does not, directly or indirectly, hold 10% or more of the votes and value.

The above recommendation is consistent with our earlier recommendation that the requirement that business income not be derived from the provision of services be eliminated.

### ***Exception for "reasonable return"***

Where the shares held by the applicable individual are not "excluded shares" – for instance where the holder fails to meet the 10% votes/value test, or where too much of the corporation's income is from the provision of services – dividends on the shares will not be "split income" if they constitute a "reasonable return". The proposed statutory definition of "reasonable return" requires a consideration



of the overall contribution of the individual through labour (“work”), capital (contributed property), assumption of risks, and other amounts paid or payable to the individual.

While of course there are many other provisions in the Act that require a determination of whether an amount is “reasonable”, there can be little doubt that this new test will give rise to a significant number of tax disputes, as the test is inherently subjective. Furthermore, the test anomalously requires a consideration of whether an investor’s return in the form of dividends on shares is reasonable having regard to the individual’s labour contribution and assumption of risk. It is at the very least peculiar for an individual’s return on a share investment to be more or less reasonable based on the work done by that person for the issuer of the share. As a legal matter, a return on shares has nothing whatever to do with the amount of work done by the individual for the company. The analysis is even more strained when it comes to an evaluation of the reasonableness of a capital gain. We realize the text requires an evaluation of the individual’s “relative” contribution, but still the very idea of a capital gain being reasonable or not based on labour contribution seems at odds with basic concepts of corporate law. We are concerned that courts will have some difficulty in applying these unusual concepts, potentially leading to less certainty, predictability and fairness in the application of the law.

As mentioned earlier, we would be happy to work with Finance to help design more objective rules that would eliminate the uncertainty as referred to above while still meeting the understood policy objectives.

#### ***Exception for “excluded business”***

The proposed interpretive rule in subsection 120.4(1.1) would deem an individual to meet the actively engaged test in a year if he/she works in the business at least an average of 20 hours per week during the portion of the year in which the business operates. While this rule is welcome and addresses many of the issues raised in the earlier consultation, questions remain about its application (for example, how does this rule interact with statutory holidays and other absences). Further guidance in the explanatory notes, or in future CRA guidance would be helpful.

#### *Multiple businesses*

In some cases, a family enterprise may have multiple businesses so that it will be difficult for an owner of the enterprise to meet either the factual “actively engaged on a regular, continuous and substantial basis” test or the 20-hour test for each of the businesses, particularly where some or all of these businesses are managed by third-party managers. **We recommend that these situations be addressed by adding to the deeming rule in paragraph 120.4(1.1)(a) an aggregate-hours test.**

As an example of the problems that can arise with multiple businesses, assume “Opco” carries on two separate “related businesses” that are service businesses (Business A and Business B), and Opco is owned equally by two brothers (A and B). Brother A is actively engaged on a regular, continuous and substantial basis in respect of only Business A, whereas Brother B is completely inactive. Parents of the siblings operate Business B. Brother A and B have both signed a personal guarantee in respect of Opco so that Opco can secure an operating line of credit to support both Business A and Business B. During the year, Opco paid equal amounts of dividends to Brother A and B. In this situation, the following uncertainties arise:

- Is the portion of Brother A's dividend that is equal to the profit of Business A protected by the "excluded business" exclusion, or is the protected portion only 50% of the profit of Business A? Both views are justifiable: the former by virtue of Brother A performing all of the work to support Business A, while the latter is more aligned with the concept of dividends being *pro-rata* on the same class of shares.
- To what extent did the personal guarantee support either Business A or Business B? This may depend on the relative working capital requirements of the two businesses as well as their relative credit-risk. To the extent the Brother A guarantee supports Business B rather than Business A, the portion of his dividend protected by the "reasonable return" exclusion would increase (since Brother A's income derived from Business A is already protected by the "excluded business" exclusion, anything he does in support of Business B will increase the amount he can receive under the "reasonable return" exclusion).
- Brother B would be inclined to assert that his personal guarantee is in support of the more profitable of the two businesses which means he may arrive at a different determination than Brother A in terms of how their personal guarantees support either Business A or B.
- To compound the tracing issues, suppose Opco has not historically been tracking the results of Business A and B separately. This will be common for smaller enterprises in particular.

Even in this simplistic illustration, the determinations are subjective and different conclusions can be reached. The tracing issues are exacerbated in multi-tiered structures, particularly where multiple family businesses with different related owners transact with each other. A perfectly reasonable tracing methodology used by one taxpayer could diverge significantly from an alternate but equally reasonable tracing methodology applied by another family member owner, or by the CRA. This will result in significant uncertainty for taxpayers involved in these complex family businesses, making it challenging for the CRA to administer these TOSI rules, and increasing the likelihood of disputes.

#### *Evidentiary issues*

##### *Difficulty of substantiating work performed with respect to "excluded business", "reasonable return", and "related business" tests*

The "reasonable return" exclusion examines the relative contribution of the specified individuals and each source individuals' contribution to a specific "related business". While it is generally possible (but not easy) to produce and retain documentation to substantiate property contribution, risk assumption, and historical amounts paid in respect of the specified individual and each source individual, it is unrealistic to expect that family businesses will have documentation to substantiate the amount of work performed by each member of the family. It will also be costly to create and maintain such documentation.

Similarly, in many cases, documentation to substantiate that an individual has been actively engaged on a regular, continuous and substantial basis, or that the individual has worked at least an average of 20 hours per week, for the current or five prior years, to qualify for the "excluded business" will not be readily available. Similar challenges will exist in substantiating that a "source individual" has not been actively engaged on a regular basis in order to assert that a particular business is not a "related business". This will make it difficult for individuals to be able to accurately reference their historical

contributions to the business. We believe that in administering the new rules, there should be a reasonable transition period that allows accommodation to document the historical contributions to the business.

In conclusion, we want to re-emphasize one of our initial observations. We believe that the complexities discussed above will be beyond the capability of business owners and generalist advisors to comprehend and apply. This is the basis for our main recommendation that the TOSI rules need further simplification beyond the steps you have already taken.

## APPENDIX

### *Other Technical Issues*

#### 1. Inappropriateness of the dividend recharacterization in subsections 120.4(4) and (5)

The recharacterization of capital gains into non-eligible taxable dividends under subsections 120.4(4) and (5) was necessary under the current TOSI regime because the current definition of “split income” does not include taxable capital gains. Following the Proposals, there is no longer a principled policy reason for this recharacterization.

Finance should consider deleting subsections 120.4(4) and (5) and instead replacing them with a specific carve-out against minors in paragraph (d) of the definition of “excluded amount” for taxable capital gains realized in non-arm’s length dispositions, and an amendment to section 110.6 to prevent minors from claiming the lifetime capital gain exemption on non-arm’s length dispositions.

#### 2. The relationship breakdown exclusion is too narrow

Paragraph (b) of the definition of “excluded amount” excludes a specified individual’s income, taxable capital gain or profit arising from property acquired by the individual under a transfer described in subsection 160(4), which covers property transferred 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. While this exclusion is welcomed, its scope is very limited and it will not apply to many typical arrangements made in the family business context as a result of relationship breakdown.

In many cases where a couple involved in a family business separates, one of the spouses or common-law partners will receive assets in his or her holding corporation through a paragraph 55(3)(a) spin-off transaction. In such arrangements, because the transfer of assets occurs between the operating corporation and the holding corporation, the spouse or common-law partner will not have received property personally in a manner described in subsection 160(4). As a result, that spouse or common-law partner will be unable to take advantage of paragraph (b) of the definition of “excluded amount” even though the economic substance of the arrangement is similar to a property transfer to the spouse or common-law partner personally.

In other cases, both spouses or common-law partners may own interests in the family business both prior to and following, a separation. If an inactive former spouse or common-law partner earns income in respect of that interest after the separation, the paragraph (b) exclusion would not apply to protect the former spouse or common-law partner because he or she owned an interest prior to separation. It was not transferred to the former spouse or common-law partner in a manner described in subsection 160(4). Sometimes, as part of the equalization arrangement, a spouse would receive a significant dividend on a share that the spouse already owns. Such dividend also would not be protected by paragraph (b).

Property transfers pursuant to a relationship breakdown arrangement also sometimes occurs while the couple is not living apart, even though their relationship has broken down and a legal separation or divorce is inevitable. This could be due to financial constraints or child-rearing situations.

Paragraph (b) in the definition of “excluded amount” should be expanded to encompass situations described above.

3. Inherited property exclusion in subparagraph (a)(i) of the definition of “excluded amount” being limited to parent-child

Subparagraph (a)(i) of the definition of “excluded amount” is limited to circumstances which the specified individual under the age of 25 acquires property from the individual’s “parent”. There are situations where there are non-tax reasons for the transfer of property directly from grandparent to child, and extending the exclusion to cover such situations would be aligned with the intention behind subparagraph (a)(i) and consistent with certain other provisions of the Act, e.g. subsections 70(10), 75.1(2), and 110.6(1). This exemption should apply to property acquired from the individual’s grandparent and great-grandparent.

It is also not clear whether subparagraph (a)(i) is applicable if a child inherits property from his or her adoptive parent (either legally or in fact). The fact that subsection 251(6) distinguishes a child-parent relationship from a child-adoptive parent relationship suggests that subparagraph would not apply to an inheritance from an adoptive parent. Extending the exclusion to cover factual and legal adoption is consistent with the intention behind subparagraph (a)(i).

4. Arm’s length borrowings with no personal guarantee should be arm’s length capital

The definition of “arm’s length capital” for adults who have not attained the age of 24 before the year excludes any borrowing by the specified individual under a loan or other indebtedness including from arm’s length sources. This appears to go beyond the intent of the provision. If an individual borrows from an arm’s length party (e.g. a financial institution) without any security or guarantee provided by a source individual, that borrowing should conceptually be arm’s length. Finance should consider limiting paragraph (b) of the definition so that it carves out only those borrowings in connection with which financial assistance is provided by any source individuals who have attained the age of 24 before the year.

5. Paragraph 120.4(1.1)(d) clarification of “derived directly or indirectly from a business”

Paragraph 120.4(1.1)(d) provides a “for greater certainty” clarification of the concept of “derived directly or indirectly from a business” which is used throughout the proposed TOSI rules.

Under subparagraph 120.4(1.1)(d)(iii), an amount derived directly or indirectly from a business includes an amount that is derived from an amount that is derived directly or indirectly from the business. The explanatory notes indicate that this is an iterative rule so that income derived from income derived from a business is income derived, directly or indirectly from a business. It is not clear whether the following amounts could be considered derived directly or indirectly from a “related business” of a specified individual:

- a) Opco carries on a “related business” of a specified individual, and Opco pays a dividend to Parentco. Parentco invests the proceeds from the dividend and earns investment income, from

which Parentco pays a dividend to a specified individual. Is the specified individual considered to have received income that is derived directly or indirectly from a “related business”?

- b) A specified individual receives a dividend from Opco, which carries on a “related business” in respect of the individual. The individual then invests the after-tax portion of that dividend in shares of Opco 2, which does not carry on any “related business” with respect to the individual. If the individual earns income or taxable capital gains in respect of her or his shares in Opco 2, is that income or taxable capital gain considered to be derived directly or indirectly from a “related business” in respect of the individual?
- c) Opco carried on a “related business” in respect of a specified individual, and that business ceased ten years ago. Opco invested the historical retained earnings in passive investments. Opco now pays out dividends from the passive investment income to the specified individual. Are those dividends considered derived directly or indirectly from a “related business”?
- d) Opco carried on a “related business” in respect of a specified individual, and it loaned funds to Investco. Investco invests the funds in passive investments and pays out dividends to the specified individual from the investment income. Are those dividends considered derived directly or indirectly from a “related business”? Is some sort of tracing required as to whether and what portion the loaned funds are derived from the earnings of Opco versus the capital of Opco?
- e) Opco carried on a “related business” in respect of a specified individual, and it loaned funds to Newco. Newco invests the funds in a business, conducted by the specified individual, and pays out dividends to the specified individual from the income generated by this business. Are those dividends considered derived directly or indirectly from a “related business”? Is some sort of tracing required as to whether and what portion of Newco’s income is attributable to the capital from Opco, labour and other contributions of the specified individual, and/or other factors enabling Newco’s business to thrive?

As illustrated by these examples, we are concerned that the subparagraph could be interpreted very broadly. While we appreciate that this is perhaps intentional, the potential effort and record-keeping required to properly track “derived amounts” effectively forever seems impractical. Furthermore, it seems particularly inappropriate for the rule to apply in situations such as example b) above, where amounts could be deemed to be derived from a related business “through” amounts that have already been received by, and taxed in the hands of an individual (including amounts that have already been subject to the TOSI). At a minimum, therefore, the subparagraph should be modified to prevent the “iterative derivation” from continuing once an amount has been received by an individual. In addition, it would be helpful if the explanatory notes (or CRA in future guidance) could clarify the intended application of the statutory test, including through examples addressing situations such as those noted above.

6. The application of “excluded shares” and paragraph (c) of the “related business” definition to trust beneficiaries

The preamble of the “excluded shares” definition requires that the shares be “owned by the specified individual”. Since subsection 104(2) deems a trust to be a separate individual in respect of trust property, a specified individual who is a beneficiary of a trust can never access the “excluded shares” exception with respect to shares held by the trust.

Also, paragraph (c) of the definition of “related business” looks at whether a specified individual owns shares or “property that derives, directly or indirectly, all or part of its fair market value from shares...”, and whether it is the case that such holding represents ten percent or more of the fair market value of all issued and outstanding shares of the corporation.

The application of paragraph (c) is unclear in situations where the shareholder of the corporation is a trust. The capital beneficiaries of the trust own a beneficial interest in the trust property, and such beneficial interest should be considered “property”. The common-law guidance on the valuation of a beneficiary’s capital interest in a trust is not definitive (particularly in the area of discretionary trusts - the most commonly used type of trusts in a family business context). Even if the value of a beneficiary’s capital interest can be determined, it will be a difficult to determine what portion of the fair market value of that interest is derived from the shares of the corporation.

7. Does “five prior taxation years” refer to taxation years of the specified individual or the business?

Under the definition of “excluded business”, a business is an “excluded business” of a specified individual if the individual is actively engaged on a regular, continuous and substantial basis in the activities of the business in either the taxation year or “any five prior taxation years”. It is unclear whether this phrase is referring to the number of taxation years of the individual or of the entity carrying on the business. Given that the definition of “excluded business” (as well as the 20-hour deeming rule in paragraph 120.4(1.1)(a)) is relevant to a taxation year of the specified individual, it appears that “any five prior taxation years” refers to taxation years of the specified individual. To avoid uncertainty, the Finance should clarify this.

8. Inclusion of listed shares in the definition of “related business”

The definition of “related business” includes reference to businesses carried on by corporations or trusts, without excluding mutual fund corporations, corporations whose shares are listed on a “designated stock exchange” or mutual fund trusts.

To illustrate, assume a specified individual is a beneficiary of a trust that holds listed shares of an arm’s length corporation. A Canadian-resident sibling of the specified individual is a full-time employee of that corporation. Because of this, the public corporation is carrying on a “related business” in respect of the specified individual since a source individual (sibling) at any time in the year is actively engaged on a regular basis in the activities of the corporation related to earning income from the business. As such, any income or taxable capital gain of the specified individual included pursuant to subsection 104(13) or 105(2) in respect of the trust would seem to be subject to TOSI since the income can reasonably be considered to be “derived directly or indirectly from one or more related business”. In this case, none of the exclusions in the definition of “excluded amount” is likely to apply.

This result is anomalous and it should be clarified that situations of this nature involving public companies were not meant to be caught.

9. Uncertainty regarding the scope of paragraph 120.4(1.1)(b)

Paragraph 120.4(1.1)(b) is a relieving provision that allows a specified individual to inherit the attributes of a deceased in respect of property “acquired by, or for the benefit of, the specified individual as a consequence of the death of another person”. There are a number of areas of interpretive uncertainty regarding the application of this paragraph.

- (a) The use of the words “for the benefit of” appears to suggest that beneficiary of a trust will be entitled to the benefit of this provision, but it is unclear how this may apply to different situations. It would be helpful if Finance could clarify in the explanatory notes how “for the benefit of” is to be applied. For example:
  - a) Does the provision apply to property acquired from a testamentary trust?
  - b) Does the provision apply to a beneficiary of a testamentary trust who is allocated income or taxable capital gains from the trust?
  - c) Do the answers to the above questions change if the trust is an inter-vivos trust that made the distribution as a consequence of the death of another person? Also, is it dependent on the trust indenture and resolution specifying that a distribution is a distribution as a consequence of death of a certain individual?
  - d) Do the answers to the above questions change if the beneficiary acquired his or her beneficial interest in the trust (either inter-vivos or testamentary) as a consequence of the death of another person?
  - e) Do the provisions apply to property acquired from a registered account as a consequence of the death of the annuitant?
  - f) If there are multiple beneficiaries each inheriting a portion of a business (either directly or indirectly), does each beneficiary inherit 100% of the attributes of the deceased for purpose of assessing “reasonable return”?
  
- (b) It is not entirely clear whether paragraph 120.4(1.1)(b) applies for third-generation transfers. In other words, if an individual (“Person 2”) inherits the property from a deceased person (“Person 1”) and because of paragraph 120.4(1.1)(b) inherits the attributes of Person 1, would another individual (“Person 3”) who subsequently acquires the property as a consequence of Person 2’s death also inherit the attributes of Person 1 (in addition to the attributes of Person 2)? It would be helpful if this could be clarified.
  
- (c) Because paragraph 120.4(1.1)(b) specifically limits the inheritance of attributes to that of the deceased, there may be situations where the rules will not apply. To illustrate, assume Mother and Father each own 50% of Opco, and Opco carries on an “excluded business” in respect of Mother only (because Father has never been active in the activities of Opco). Upon the death of Mother and Father, Son inherits Opco shares from Mother and Daughter inherits Opco shares from Father. Based on paragraph 120.4(1.1)(b), Son inherits the attributes of Mother so that Opco’s business is considered an “excluded business” of Son for the remainder of his lifetime. Whereas, Daughter inherits the attributes of Father and will not be able to access the “excluded business” or “reasonable return” exclusions unless she



becomes actively engaged in the business. The property acquirer should arguably inherit the attributes of the deceased and any current and former spouse or common-law partner of the deceased.

- (d) Paragraph 120.4(1.1)(b) deems a specified individual to have inherited the attributes of a deceased to the extent “a property” would have generated split income to an individual (if the section is read without reference to the paragraph) and that property was acquired by, or for the benefit or, the specified individual as a consequence of death of another. It appears that the application of this paragraph can be triggered by the inheritance of a single property, and the benefit of its application is applied to all properties of the inheriting individual with respect to the business in question.<sup>8</sup> It would be helpful if Finance could clarify this in the explanatory notes.

## 10. Attributed income

There are a number of ‘mismatches’ that arise when the income attribution rules interact with the TOSI rules. For example:

- (a) When the attribution provisions under subsections 75(2) and 56(4.1) deems an amount of taxable capital gain to be “of the person”, it does not deem the person to have disposed of property (contrast to the wording in subsection 74.1(2) where the spouse is deemed to have a taxable capital gain from the disposition of property). This could mean that individuals receiving attributed taxable capital gains under these two attribution provisions can never access the “excluded amount” provision because the preamble of that definition requires the taxable capital gain to be from the disposition of a property.
- (b) Attributed dividend income can never qualify for the “excluded shares” exclusion because attribution does not deem the specific share from which the dividend arises to be owned by the individual to whom income or capital gain is attributed. This is the case even if that individual owns shares of the corporation that qualify as “excluded shares”.
- (c) Attributed income will not be entitled to foreign tax credits under subsection 120.4(3) because foreign tax is not deemed to be paid by the individual to whom income or capital gain is attributed. This is a broader issue than TOSI as this mismatch arises also with Part I income tax whenever income is attributed.
- (d) The deemed interest income inclusion under the subsection 74.4(2) corporate attribution rule is not deemed to be an income from property or from a specific debt obligation. It is unclear whether such deemed interest income could be caught under paragraph (d) of the “split income” definition and if so, whether it can access the “excluded amount” provision.

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<sup>8</sup> To illustrate, Opco’s common shares are owned by Son, but it has one preferred share issued to Mother. Opco carries on a service business so its shares cannot be “excluded shares”. Mother has been active in the activities of Opco for at least five previous taxation years so that Opco’s business was an “excluded business” of Mother; Son has never been active with respect to Opco. During Mother’s lifetime, all dividend income from Opco received by Son is subject to TOSI. When Mother dies and Son inherits the one preferred share, it appears that paragraph 120.4(1.1)(b) will apply such that Opco’s business will be an “excluded business” of Son. If that is the case, all of Son’s dividend income and taxable capital gain from the common shares and preferred shares of Opco will no longer be subject to TOSI.

11. Potential technical issue with paragraph 104(21.2)(b) and paragraph (d) of the definition of “excluded amount”

Paragraph (d) of the definition of “excluded amount” excludes a taxable capital gain arising on a disposition of property that is qualified farm or fishing property (“QFP”) or QSBC shares of the specified individual. Where the QFP or QSBC share is held by a trust, the trust may allocate the taxable capital gain to a beneficiary pursuant to subsections 104(21) and (21.2). These two paragraphs deem the taxable capital gain to be taxable capital gains of the beneficiary from a disposition of a capital property that is a QFP or QSBC share, but they do not deem the QFP or QSBC share to be owned by the beneficiary. This potentially results in a technical issue where a specified individual being allocated such taxable capital gain cannot assess the exclusion provided by paragraph (d) of the definition of “excluded amount”, because the QFP or QSBC share is not “of the individual”. It seems clear that Finance intended taxable capital gains arising from disposition of QFP and QSBC share be excluded from TOSI even where the gains are allocated to trust beneficiaries. It is suggested that paragraph (d) could be modified to include a specific reference to a taxable capital gain allocated to an individual by a trust under subsection 104(21) to the extent the taxable capital gain arises from the disposition of QFP or QSBC shares by the trust.

12. Does a deceased source individual still taint a business?

Where a business used to be operated by a source individual who is now deceased, it is uncertain whether the business will remain a “related business”, or whether the income from such business going forward will still be considered “derived directly or indirectly from a related business”. Clarification around this important issue would be helpful.

13. 10% votes and value requirement for the “excluded shares” definition

Pursuant to subparagraph (g)(i) of the definition of “excluded amount”, a taxable capital gain arising from the disposition of “excluded shares” should be excluded from the application of TOSI. However, it appears that this exclusion fails to apply if the specified individual undertakes a partial disposition and the shares being disposed of are below the 10% votes and value threshold. Assume Mr. A holds shares in Opco that represents 20% of the votes and value in Opco and that meet all the other criteria of the definition of “excluded shares”. If Mr. A sells a partial stake in Opco and disposes of shares representing 5% of the votes and value in Opco, it would appear that Mr. A would not be disposing of “excluded shares” since the shares in question do not give Mr. A the required 10% votes and value. We do not believe this is an intended result of the Proposals.

Also, paragraph (b) of the definition of “excluded shares” requires that the shares give the holders 10% or more of the votes of the corporation and have a fair market value of 10% or more of all of the issued shares of the corporation. In many typical family business holding structures, votes and value reside in different classes notwithstanding that the issued shares could be reorganized and exchanged for a single class of shares to satisfy paragraph (b) in some cases.

To address these concerns, we recommend that Finance consider revising paragraph (b) of the “excluded shares” definition to say “immediately before that time, the shares, together with all other shares owned by the specified individual, ...”.