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TOSI
A PRACTICAL APPROACH

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Tax on Split Income (TOSI) – A Practical Approach

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I. INTRODUCTION

Effective January 1, 2018, the Tax on Split Income (TOSI) rules expanded the old income splitting rules (colloquially known as "kiddie tax") in subsection 120.4(1) of the Act.[1] The expanded rules were originally released on July 18, 2017 as part of a proposed tax legislative package that fundamentally overhauled the taxation of private companies and their shareholders. Subsequently, the original proposed TOSI rules were revised to address concerns raised during the consultation period. Nonetheless, the enacted rules have proved to be both complex and vague, leading to uncertainty regarding how the Canada Revenue Agency (CRA) will exercise its considerable discretion in their application.

The paper assumes that the reader has an understanding of the TOSI framework and is familiar with the defined terms used in the TOSI rules. Recognizing that legislative changes and the definitions in subsection 120.4(1) have been covered in detail in other papers[2], this paper provides a high-level overview of the TOSI regime with certain relevant definitions included in Appendix I for the readers' reference. The paper then briefly describes the characterization of income for TOSI purposes followed by a review of certain technical interpretations and other guidance materials[3] ("**CRA Guidance**") published by the CRA in the last twelve months on TOSI rules. In this regard, for the readers' convenience, we have appended a table of CRA technical interpretations, sorted by the TOSI exceptions relied upon. We also offer observations and tax planning opportunities that may be available within the TOSI framework. Lastly, the authors make suggestions on best practices for keeping documentary evidence when relying on selected excluded amount exceptions in Appendix II.

II. TOSI OVERVIEW

The TOSI rules were originally introduced in 2000 as an anti-avoidance measure against certain income splitting structures within a family business. The structures generally involved the use of a private corporation, trust or a partnership to divert income from a high-income family member to their low-income spouse and minor children. A common example of a structure would involve a high income individual who owned and operated a business through a private corporation and was able to split income by having his low income spouse and minor children subscribe for shares of the corporation so that taxable dividends can be paid to them. The taxable dividends would then be taxed in the hands of the low-income spouse and children at a tax rate lower than the high-income individual. In particular, an individual who pays tax on either an ineligible or eligible dividend income at the top marginal can save approximately $11,900[4] and $28,200[5], respectively, in combined Federal and Ontario tax if a family member with no other income received a portion of the dividend. Income subject to TOSI is taxed at the top marginal rate of 53.53% in Ontario on certain income (referred to as split income) earned by specified individuals. Prior to 2018, a specified individual for a taxation year was defined as an individual who was 17 years of age or under, was a Canadian resident throughout the year, and had a parent who resident of Canada at any time in the year. Effective January 1, 2018, the definition of specified individual has been expanded to include individuals aged 18 years and over, who are resident of Canada and receive split income from a "related business" directly or indirectly either from a private corporation, trust or a partnership. The definition of split income has been expanded to include interest income earned on a debt obligation of a private corporation, trust or a partnership, and certain income/gains from the disposition of property.

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[1] All statutory references are to the Income Tax Act, RSC 1985, c.1 (5th Supp.) (the Act), unless otherwise stated.
[2] For example, Stuart F. Bollefer and David Malach, "Tax on Split Income – A detailed Analysis (Or How Not To Get Trapped in the TOSI Rabbit Hole), "*2018 Ontario Tax Conference,* (Toronto: Canadian Tax Foundation, 2018), 3:1-84.
[3] https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/federal-government-budgets/income-sprinkling/guidance-split-income-rules-adults.html
https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/federal-government-budgets/income-sprinkling/guidance-split-income-rules-adults/excluded-shares.html
[4] Tax-free ineligible dividends paid to family members with no other income and the tax saved by the high income earner is $11,929 ($30,325 * 47.4% Ontario).
[5] Tax-free eligible dividends paid to family members with no other income and the tax saved by the high income earner is $28,268 ($71,855 * 39.34% Ontario).

A related business is one for which a related person is actively engaged or owns more than 10% of the fair market value (FMV) of the outstanding shares. The "source individual" is an individual who, at any time in the year, is a Canadian resident and is related for income tax purposes to the specified individual.

An amount received by the specified individual will not be subject to TOSI, if that amount is considered an "excluded amount". There are ten exceptions to split income that are found in the definition of excluded amount and related deeming rules. Some exceptions are available to specified individuals within specific age ranges while others are available to individuals of all ages. Within the excluded amount exceptions there are terms that are further defined which expand the conditions that need to be met before the exclude amount exception can apply. There are also deeming provisions in subsection 120.4(1.1) that provide further interpretive rules to aid in applying the excluded amount exceptions.

The summary of the ten excluded amount exceptions[6] are as follows:

1. Income or taxable capital gains on property inherited from a parent or any person who is enrolled as a full time student during the year at a post-secondary institution or an individual who claims a disability deduction per section 118.3. This exception applies to individuals who are under the age of 25 years.

2. Income or taxable capital gains on property received as a result of marriage breakdown. This exception is a limited exception and applies if the following conditions are satisfied pursuant to subsection 160(4)
    a. there is a transfer of property between spouses;
    b. the transfer of property is as a result of a written separation agreement or pursuant to a decree or court order; and
    c. the spouses were separated and living apart due to marriage breakdown.

    There is no age requirement to this exception.

3. Taxable capital gains that arise on a deemed disposition at death pursuant to subsection 70(5). There is no age requirement for this exception to apply.

4. Taxable capital gains arising from the disposition by the individual of property that qualifies for the capital gains exemption from qualified farm or fishing property or in respect of qualified small business corporation shares. However, this exception would not apply if the amount is otherwise deemed to be a dividend under subsections 120.4(4) or (5).

5. Income or taxable capital gains not derived, directly or indirectly, from a "related business" in respect of the individual for the year; or income or taxable capital gains not derived, directly or indirectly, from an "excluded business" in respect of the individual for the year. These exceptions apply to individuals who are 18 years old or older. Excluded business is a business where the specified individual is actively engaged in regular, continuous and substantial basis in the activities of the business in either the taxation year or any five previous taxation years.

6. Income or taxable capital gains in respect of the property that qualifies as a "safe harbour return" of the individual. Safe habour capital return is defined as an amount that does not exceed the highest prescribed rate (currently 2%) in effect for the particular quarter in which the loan is made; or if the specified individual receives a "reasonable return" on "arm's length capital" contributed. Arm's length capital is, effectively, capital financed from either inherited property or income or gains associated from non-related sources. It excludes a property or substituted property that is:
    a. acquired as income (such as dividends) from, or a taxable capital gain or profit from the disposition of, another property that was derived directly or indirectly from a related business;

[6] Defined in section 120.4 and included in detail in Appendix I.

b. borrowed by the specified individual under a loan or other indebtedness (including from third party/bank); or
c. transferred directly or indirectly by any means whatever, to the specified individual from a related person (other than as a consequence of death).

This exception applies to individuals who are between the ages of 18 and 24 years old.

7. Income or taxable capital gains from the disposition of "excluded shares" of the individual; or a "reasonable return" is paid to the individual. This exception applies to individuals who are 25 years older or older.

   Excluded shares means the shares of capital stock of a corporation owned by specified individual if:
   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.

   A reasonable return is defined as an amount derived, directly or indirectly, from a related business that is reasonable in light of the following factors relating to the relative contributions of the specified individual and each source individual, to the related business:
      a. the work performed;
      b. the property contributed;
      c. the risks assumed;
      d. the total of all amounts paid/payable to specified individual and/or source individual; and
      e. other relevant factors.

8. Where property has been acquired by, or for the benefit of, a specified individual on the death of <u>any</u> individual, these rules allow the specified individual to step into the shoes of the deceased individual for purposes of applying the reasonable return, excluded business and excluded shares exceptions. This exception applies to a specified individual who is 18 years of age or older and ensures that the income from, or taxable capital gains on the disposition of, a property the individual inherited where
   a. the amount would have been a reasonable return had it been received by the deceased person;
   b. the amount would have been from an excluded business had it been received by the deceased person; or
   c. if the deceased individual had attained the age of 24 before the year of death, the amount would have been received on excluded shares, had it been received by the deceased person.

9. The pension exception applies where the specified individual's spouse is of the age 65 or over if the amount were received by the spouse or common-law partner would be an excluded amount. If the amount is an excluded amount then the amount would also be excluded amount for the specified individual.

10. The inheritance exception is extended to spouses where one of the spouses has died and the income received by the surviving spouse would be split income unless the amount would have been

excluded amount if that split income was earned by the deceased spouse in his/her last taxation year. If the amount was excluded amount for the deceased spouse then the income received by the surviving spouse would also be an excluded amount.

The taxpayers should review their current structures and possibly restructure to avail themselves of the excluded amount exceptions so that the income or taxable capital gains paid to a specified individual is not subject to the TOSI rules. This paper will provide potential planning suggestions on restructuring to meet the excluded amount exceptions.

III. CHARACTERIZATION OF INCOME

The application of the TOSI rules require taxpayers to distinguish between income from business and income from property. Whether a corporation, trust or partnership is earning income from business or property is particularly important as TOSI rules may only apply if that income is derived, directly or indirectly, from a related business[7] (unless any exceptions apply). In Technical Interpretation 2018-0768801C6[8], the CRA provided the following comments on the related business definition in the context of a corporation:

1) If it is determined that the income of the investment company is not business income then the dividends paid to a specified individual 18 years of age or older will not be split income because [the income is not derived from a business] (also considering the amount is not derived, directly or indirectly, from a "related business"[9] in the year). If it is established that the investment holding company is carrying on a "business" then dividends paid to a specified individual 25 years of age or older may be subject to TOSI, unless an exception applies.

2) If it is determined that a corporation does not carry on a business, and that the corporation pays a dividend to a specified individual, the amount of that dividend, could be an excluded amount in respect of the individual if it is not derived, directly or indirectly, from a related business in respect of the specified individual. As a result, the amount of the dividend would not be included in the calculation of the split income of the specified individual and the latter would not be subject to the tax on split income in respect of the amount of that dividend.

Accordingly, where it is determined that a corporation does not carry on a business, then the activities of the corporation cannot be a "related business" and TOSI would not apply.[10] Therefore, TOSI should not apply to income that is derived from property provided the earning of such income does not rise to the level of carrying on a business.

How does one determine if a business exists in the first place and secondly, how does one distinguish income from a business versus from property? This question has riddled taxpayers, advisors, CRA and the courts for many decades (as similar analysis is required, for example, for the purposes of claiming the small business deduction).[11] There is no bright-line test that distinguishes between the two sources of income, as the difference is the degree of activity involved in earning the income. If the income is basically a yield on assets (such as interest), without requiring substantial activity, the income is likely going to be considered as income from property.[12] Whereas, if the taxpayer exerts time and effort to earn the income, the income is likely from a business.[13] In the absence of a bright-line test, the analysis is driven by facts and circumstances of each case and through the examination of factors such as the number of transactions, their volume, their frequency, the turnover of the investments and the nature of investments.[14] It is unfortunate that the TOSI rules were designed in such a manner that their application (specifically for

[7] However, rental income for partnerships and trust may still be considered split income and be subject to TOSI. See split income definition under subsection 120.4(1) for details.
[8] Canada Revenue Agency, Technical Interpretation 2018-0768801C6 "Tax on Split Income" (October 5, 2018).
[9] Subparagraph 120.4(1)(e)(i) of the excluded amount definition.
[10] Question 11 at the CRA Federal Round Table of 2018 Annual Tax Conference held by the Association de planification fiscale et financiere (APFF) in October 2018.
[11] Various definitions in subsection 125(7) for the purposes of claiming the small business deduction
[12] *Gascoigne v. The Queen,* 1996 TCJ No. 24 (TCC)
[13] *Stewart v. The Queen*, 2002 SCC 46 at paragraphs 50-51.
[14] *Cragg v. MNR,* 52 DTC 1004 (Ex. Ct.)

taxpayers earning investment income) is hinged on distinguishing income from property and business income. A comprehensive discussion on distinguishing income from a business or property is outside the scope for this paper as it has been covered in detail in other conference papers.[15] We offer relevant commentary on this subject in the context of TOSI while discussing various CRA technical interpretations throughout this paper.

IV. CRA INTERPRETATIONS AND PLANNING CONSIDERATIONS

The complexity of the enacted TOSI rules has led to uncertainty in their application and an increased tax compliance burden on owner-managers carrying on business through the use of a private corporation. The CRA has attempted to address some of these uncertainties through the issuance of technical interpretations and announcements in the last twelve months.

We have highlighted the significant technical interpretations issued in the last twelve months and have organized our discussion by the excluded amount exceptions to the TOSI rules.

A. No Related Business

The exception for a business which is not a "related business" applies to a specified individual over the age of 18 where the income or taxable capital gains arising from a disposition of property is not, directly or indirectly, derived from a related business.[16] Further, the CRA has commented on how this exception would apply in particular circumstances where an investment company earns second generation income from its investment portfolio. Second generation income is income earned on the original capital, that is invested in investment portfolios. The original capital could be funded by dividends the investment company receives from the operating company or from sale proceeds from disposition of the operating company shares or from the dissolution of the business carried on by the operating company.

1) Holdco-Opco Structure

In a typical holding company structure, dividends received by the holding company from the business of the operating company will be considered to be derived, directly or indirectly, from a related business and consequently, any dividends paid by the holding company would be considered to be split income under the definition of split income in subsection 120.4(1).

In the Technical Interpretation 2018-0771861E5[17], the CRA discussed how the second generation income would be treated where the initial capital for the investment assets in a holding company was derived from its operating subsidiary.

The facts are as follows:

1. Mr. A owns 100 Class A common shares and Mrs. A owns 100 Class B common shares of Investco.
2. Investco owns all the shares of Opco. Mr. A is actively engaged in the Opco business on a regular, substantial and continuous basis but Mrs. A is not.
3. Historically, Opco has paid taxable dividends to Investco from its after-tax retained earnings, all of which Investco has used to purchase shares of publicly-traded corporations which pay annual dividends.

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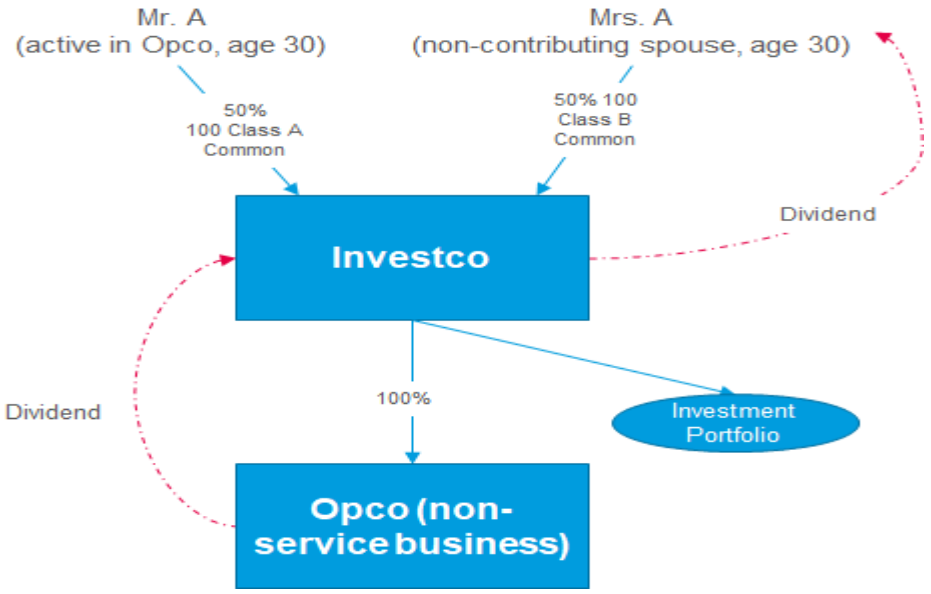
[15] John Durnford, "The Distinction Between Income from Business and Income from Property, and the Concept of Carrying on Business" (1991) 39:5 *Canadian Tax Journal* 1131-1205. Megan Ni and Jessica Fabbro, "An Overview of Tax on Split Income (TOSI)," in *2019 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2019), 8:1-73.

[16] Subparagraph 120.4(1)(e)(i) excluded amount definition

[17] Canada Revenue Agency, Technical Interpretation 2018-0771861E, "TOSI: Second Generation Income" (November 2, 2018).



The CRA was asked to respond to questions in several scenarios:

Scenario A – Investment Income Paid as Dividends by Investco

Assuming Investco pays all the dividend income it receives from its marketable securities portfolio to Mrs. A, would the dividend income received by Mrs. A be considered income that is derived, directly or indirectly, from a related business?

The CRA assumed that Investco was not carrying on a business and the after-tax income earned was generated from the portfolio of marketable securities (i.e., the second generation income that would not be considered to be derived, directly or indirectly, from the related business of Opco in respect of Mrs. A).[18]

The CRA confirmed the dividends received by Mrs. A from second generation investment income would be an excluded amount as the dividend income was not derived from a related business. If Investco had a related business in respect of Mrs. A, the dividend income received by Mrs. A from the after tax income from its investment income in publicly traded corporations, would be an amount derived, directly or indirectly, from a related business. Therefore, it would not be an excluded amount under subparagraph 120.4(1)(e)(i) of the excluded amount definition.

Scenario B – Dividend-in-kind of Investment Portfolio

The CRA was asked if the dividend income received by Mrs. A. would be considered income derived, directly or indirectly, from a related business if Investco was to distribute the investment portfolio as a dividend-in-kind to Mrs. A.

The CRA provided the following numerical example in their response:

1. In year 1, Opco paid a dividend of $1,000,000 to Investco which it invested in securities of publicly traded corporations.
2. In year 2, Investco pays a dividend-in-kind to Mrs. A of its entire investment portfolio worth $1,100,000.

The CRA considered $1,000,000 of the $1,100,000 dividend-in-kind received in year 2 by Mrs. A to be derived, directly or indirectly, from a related business. The remaining $100,000 would not be considered to

[18] See CRA Technical Interpretation 2018-0768801C6 for details on how CRA would determine whether a corporation is carrying on a business.

be derived, directly or indirectly, from a related business on the assumption that Investco does not carry on a business.

Scenario C – Dividends paid by Opco to Investco prior to 2018

The CRA confirmed that its conclusions would not change if the dividends paid by Opco to Investco under Scenario A and B were all paid prior to 2018 (i.e. before the amended TOSI rules were introduced).

The above technical interpretation emphasized the importance of determining if Investco itself would be carrying on a business in order to apply the TOSI rules and the burden is on the taxpayer to prove that the activities of Investco do not amount to a business.

The CRA comments indicate that it will apply a low threshold as to whether investment activities of a corporation constitutes a business for TOSI purposes. In the Technical Interpretation 2018-0768801C6[19], the CRA laid out its approach on how it will determine whether a corporation's activities constitute a business. Specifically, it referred to the definition of "business" under subsection 248(1), which includes "*an undertaking of any kind whatever*" when considering activities of a corporation. Such low threshold for what constitutes a business is also consistent with the jurisprudence. For instance, courts have previously ruled there is a rebuttable presumption that a corporation is carrying on a business.[20] Such presumption is rebuttable based on various factors such as the number of transactions, their volume, their frequency, the turnover of the investments and the nature of investments.[21] There may be factual situations where it may be clear that a corporation does not have a business. For instance, a pure holding company that only owns the shares of an operating company may not be viewed as carrying on a business. Whereas, a holding company that owns a portfolio of marketable securities in addition to the shares of an operating company may be considered to be carrying on an investment business. Even where an investment holding company engages third party advisors to manage their portfolio of marketable securities or a rental property, the advisors may be considered to be agents of the investment company and as such their activities/labour would be attributable to an investment holding company supporting the argument that it is carrying on a business.[22]

Unless the taxpayer has a very good reason that their corporation's activities do not constitute a business, in our view, it would be a reasonable approach to first assume that a corporation is carrying on a business for TOSI purposes and then look for supportable arguments to rely on one of the exceptions under excluded amounts. As discussed later in the paper, the presumption that corporation carries on a business is useful in accessing excluded shares exception in certain scenarios.

2) Typical Estate Freeze Structure

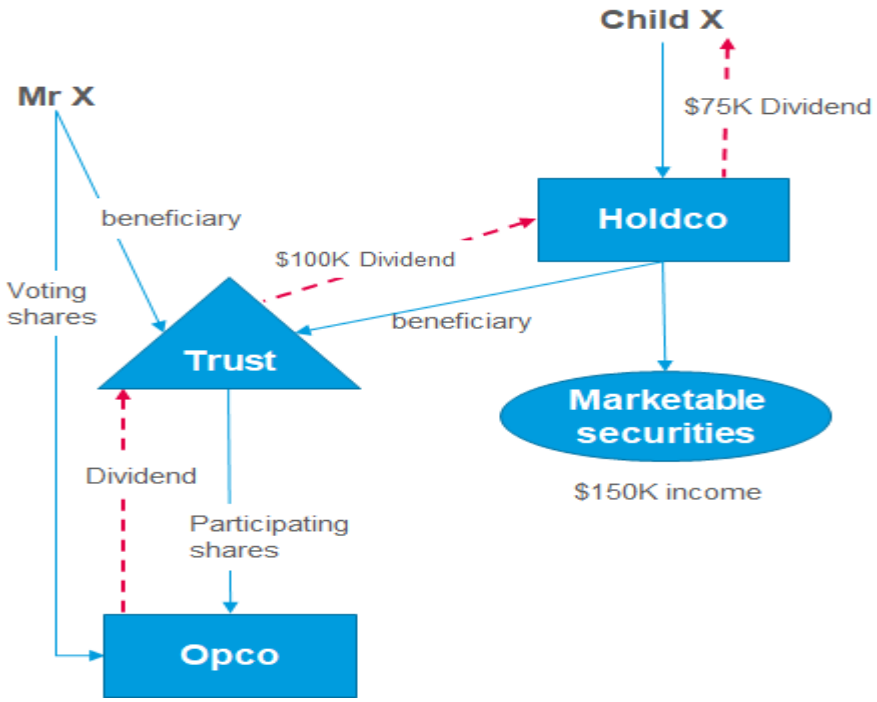
Similar concern was raised in a typical estate freeze structure, where the corporate beneficiary of a trust owns growth shares in the operating company and receives dividends from the trust resulting from dividends received from the operating company from a prior year, which the corporate beneficiary invests in shares of public companies. CRA was asked to comment whether the after tax investment income that the corporate beneficiary pays to its shareholders will not be subject to TOSI.

In Technical Interpretation 2018-0768821C6[23], the CRA addressed the above concern through the use of a hypothetical scenario where a holding company with two streams of income could stream the payout of dividends out of income from portfolio investments to a shareholder without triggering the application of the TOSI. The facts in the scenario were as follows:

1. Mr. X holds voting shares of Opco and a family trust holds all the common shares of Opco
2. Child X holds all the shares of Holdco

[19] Canada Revenue Agency, Technical Interpretation 2018-0768801C6, "Tax On Split Income" (October 5, 2018).
[20] *Canadian Marconi Co v. R, [1986] 2SCR 522,* at paragraphs 8-9.
[21] *Cragg v. MNR,* 52 DTC 1004 (Ex. Ct.)
[22] *ESG Holdings Ltd. v. The Queen,* 76 DTC 6158 (FCA)
[23] Canada Revenue Agency, Technical Interpretation 2018-0768821C6, "Tax on Split Income" (October 5, 2018).

3. Mr. X, his spouse, Mrs. X and Child X are beneficiaries of the family trust
4. Mr. X and his spouse, Mrs. X are 50 years old
5. Child X is 30 and does not participate in Opco's business in any way.
6. Holdco owns portfolio investments that generated $150,000 of investment income in the past year
7. Holdco, a beneficiary of Trust, received a dividend of $100,000 from the trust in the past year.
8. Holdco wants to pay a $75,000 dividend to Child X.



It is CRA's view that the dividend received by Child X will be split income unless it is an excluded amount. The dividend would be considered an excluded amount if it is not derived, directly or indirectly, from a related business in respect of a Child X, a specified individual. A related business in respect of Child X includes a business carried on by a corporation, if a source individual in respect of a Child X is actively engaged on a regular basis in the business activities of Opco or owns shares of Opco that represent at least 10% of its value.

Mr. X would be a source individual as he is an individual resident in Canada who is related to his son Child X and he was actively engaged in Opco's business. CRA confirmed that if Holdco was to pay the dividend to Child X out of the funds it received or previously received from Opco, the dividend would be derived, directly or indirectly, from a related business in respect of Child X. Consequently, the dividend would not be an excluded amount, and the TOSI rules would apply.

The CRA also confirmed that if Holdco paid the dividends out of its after-tax investment income, that dividend would be an excluded amount for Child X and not be subject to TOSI. In reaching its conclusion, CRA considered that if Holdco was carrying on an investment business, the business would not be a related business as no source individual in respect of Child X is actively engaged in Holdco's business or owns shares of Holdco that represent at least 10% of its value. In the case that Holdco was not carrying on a business then the dividend would also be an excluded amount in respect of Child X as the dividend could not be derived, directly or indirectly, from a related business but rather from property held by Holdco. Either way, in this scenario, the dividends would be an excluded amount under subparagraph (e)(i).

The CRA emphasized that adequate tracing and record keeping will be crucial to ensure that funds derived from the investment portfolio are used to pay dividends to Child X.

To meet the no related business exception it would be crucial that no other family members become shareholders of the holding company. If other family members are shareholders of the investment holding

company then the family members will considered to be source individuals[24] in respect of each other and since they own shares of a holding company that derives at least 10% of its value from the holding company's activities, the exception would not be met. Therefore, consideration should be given to whether a holding company for each family member should be formed as a beneficiary of the trust provided that the family is not actively engaged in the business of the operating company. This way, the holding company will not have a related business and the after-tax investment income can be paid without application of TOSI to individuals who are over the age of 18. For ease of tracing the second generation income, consideration should be given to having a separate account where the income earned on the investment portfolio is maintained separate from the account that maintains the initial capital received from the operating business.

B. Excluded Shares

Among other things, an excluded amount includes income from, or a taxable capital gain from the disposition of, excluded shares of the individual. Excluded shares are shares of individuals 25 years of age or older that meet the following three criteria:

1. less than 90 per cent of the business income of the corporation was from the provision of services in the previous year or, for a new corporation, its current tax year and the corporation is not a professional corporation;
2. the individual owns 10% or more of the votes and value in the share capital of the corporation; and
3. all or substantially all of the income of the corporation is income that is not derived, directly or indirectly, from one or more other 'related businesses' in respect of the specified individual for the relevant year.

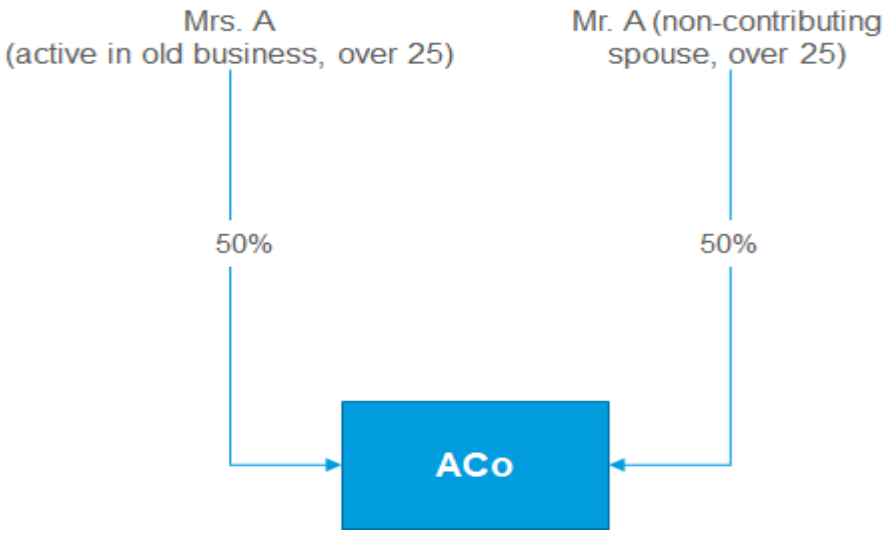
This section of the paper explores recent technical interpretations on the application of the excluded shares exception and provides planning consideration for taxpayers to fit within the excluded shares exception.

1) Sale Proceeds and Historical Retained Earnings

Where the operating corporation's business is sold or dissolved and the operating corporation converts from an active business corporation to an investment corporation, the investment corporation has accumulated historically retained earnings from the active business and has proceeds it received from the sale of the active business. These funds are invested in public securities. The investment corporation pays a dividend to its shareholders from its after-tax investment income, the CRA was asked to provided its views on the application of the related business criteria under subparagraphs (e)(i) and (g)(i) of the excluded amount exception to dividends paid to the shareholders from retained earnings generated from the sale of the business and from historic earnings from a former business.

1. In Technical Interpretation 2018-0779981C6[25], the CRA was provided the following facts based on a hypothetical scenario: Mr. A and his spouse, Mrs. A, both are over 25 years old and are residents of Canada.
2. Each own a 50% interest in ACo, which in the past carried on a business, referred to as the "Old Business".
3. Mrs. A was actively engaged in the Old Business on a regular, continuous and substantial basis for at least five prior taxation years.
4. Mr. A was neither involved in nor contributed to the Old Business.
5. ACo disposed of the Old Business two years ago.
6. The sole activity of ACo since the sale of the business has been the investment of the proceeds from sale and the ACo retained earnings.
7. ACo paid dividends in its current year to Mr. A and Mrs. A.

[24] Subparagraph 120.4(1)(c) of the related business definition.
[25] Canada Revenue Agency, Technical Interpretation 2018-0779981C6, "2018 CTF Q9 TOSI – Excluded Amount – Non-Related Business Exception" (November 27, 2018).



The CRA was asked to confirm that Mr. A and Mrs. A's shares in ACo are excluded shares in the current year if the investment activity in Aco constituted a business during its last taxation year and ACo generated positive gross revenue during that year.

The CRA concluded that the shares met the excluded shares exception and the dividends would not be split income for the following reasons:

1. ACo was not a professional corporation and less than 90% of the Aco business income was from the provision of services.
2. Mr. A and Mrs. A also satisfied the votes and value test in their individual ownership of 50% of ACo.
3. ACo's income for the last taxation year was from earning property income and not derived directly or indirectly from a related business.

The CRA was also asked to confirm the dividends received by Mr. A and Mrs. A would not be considered split income where the Aco investment activities did not constitute a business. The CRA took the position the dividend income would not be split income given the dividend was derived, directly or indirectly, from either the ACo retained earnings or from proceeds of disposition of the Old Business and not a related business "for the year".

Therefore, as long as there is no link in the current year to a related business, the split income of an individual derived from a company may not be subject to TOSI provided the activity itself is not carrying on a business.

2) Liquidation of Opco's Business

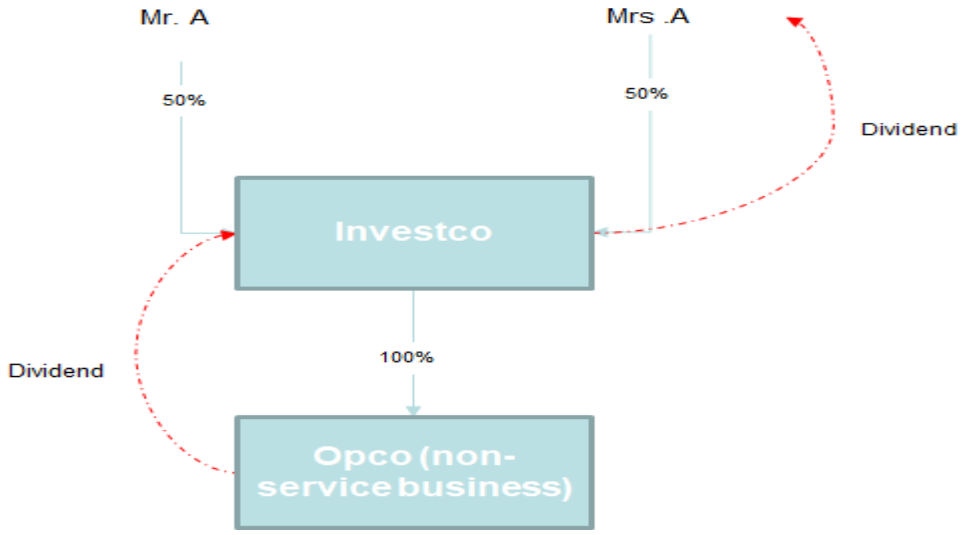
In Technical Interpretation 2019-0792011E5[26], the CRA was asked to comment on at what point in time after a holding company sold its shares of an operating company would the investment company's income from its investment portfolio that was purchased with the sale proceeds stop being considered to be "derived directly or indirectly" from the operating company's business.

This technical interpretation had the following scenario:

1. The Investco income was from Opco dividends.
2. None of the Opco's income came from services and Opco was not a professional corporation.
3. Both Mr. A and Mrs. A meet the 10% of votes and value test.
4. The Opco business would be a related business in relation to Mrs. A.
5. Mr. A was actively involved in the business and Mrs. A was not.

[26] Canada Revenue Agency, Technical Interpretation 2019-0792011E5, "TOSI Definition Excluded Shares" (June 12, 2019).

6. Investco would not have derived, directly or indirectly, income from a related business in respect of Mrs. A other than Opco business.
7. As in previous years and in Year 3, Opco paid dividends to Investco.
8. During Year 3, Investco sold the OPco shares and used the net sale proceeds to invest in a marketable securities portfolio.
9. The Investco fiscal period ends on December 31.



In order to satisfy the excluded shares definition, all or substantially all of the Investco income for the taxation year shall not be drawn, directly or indirectly, from one or more businesses in respect of Mrs. A other than business of the corporation.

The CRA clarified the reference to the taxation year is Investco's taxation year before the dividend is paid to Mrs. A. If Investco paid a dividend in Year 3, then we need to examine Year 2 to determine how the Investco income was earned. In year 2, Opco paid a dividend to Investco meaning any a dividend paid to Mrs. A was derived, directly or indirectly, from Opco, a related business in respect of Mrs. A, and the excluded shares exception is not met[27].

If in Year 4, Investco paid a dividend to Mrs. A, again the excluded share exception would not apply as the CRA confirmed that the dividends paid to Mrs. A were derived, directly or indirectly, from a related business, being receipt of dividends from Opco before the time of sale of shares and at the same time realizing a capital gain on the sale of Opco shares. The presumption in clause 120.4(1.1)(d)(i)(B) includes amounts that relate to the disposition of Opco shares since Opco did carry on business in Year 3.

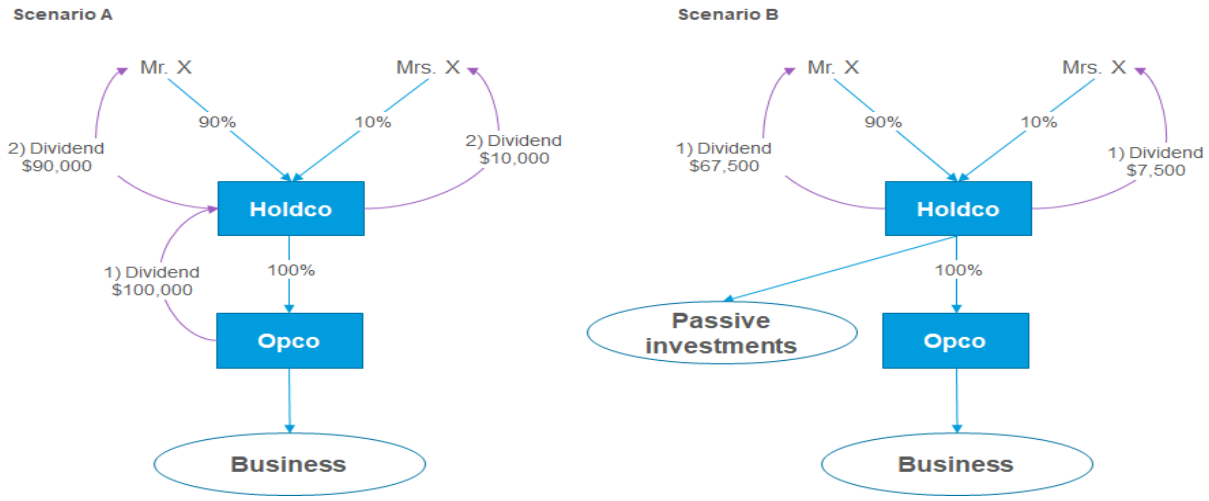
However, dividends paid to Mrs. A in Year 5 would benefit from the excluded shares exception as in Year 4, Investco would not have derived income, directly or indirectly, from a related business in respect of Mrs. A other than the Investco business.

This technical interpretation clarifies that as long as there is no related business carried on in a previous year by Opco, the dividends paid to the shareholders would meet the excluded shares definition. It would be difficult to satisfy the excluded share exception and no related business exception for Holdco corporate structures where Holdco's income is derived from the business of Opco[28]. Once the connection to a related business is severed, by either selling Opco or liquidating the Opco business, which could take two or three years depending on the circumstances, the corporation may fit into these exceptions.

[27] Paragraph (c) of the excluded shares exception is not met.
[28] Acknowledging that the excluded shares exception would not be available under paragraph (b) where shares of Opco are held indirectly through Holdco or a Trust, and paragraph (c) as income would be from a related business, being Opco's business.

3) Holdco-Opco Structure

In Technical Interpretation 2018-0768801C6[29], the CRA considered whether the shares of a holding company would qualify as excluded shares where it owns passive investment assets and shares of an operating company. The CRA was presented with the following two scenarios:



Scenario A

1. Opco shares are 100% owned by Holdco.
2. Mr. X holds 90% of the participating and voting shares of Holdco and Mrs. X, Mr. X's spouse, holds 10% of the participating and voting shares of Holdco.
3. Mr. X and Mrs. X are 35 years old and Mrs. X does not participate in the Opco.
4. Holdco has no other sources of income.
5. Opco pays a $100,000 dividend to Holdco.
6. Holdco then pays a dividend of $90,000 to Mr. X and $10,000 to Mrs. X.

The CRA held that the Holdco shares owned by Mrs. X were not excluded shares because paragraph (c) of the excluded shares definition in subsection 120.4(1) is not met. Paragraph (c) of the definition states that all or substantially all of the income of Holdco is income that is not derived, directly or indirectly, from one or more other 'related businesses' in respect of the specified individual, Mrs. X. The Holdco income was derived from Opco, a related business to Mrs. X since Mr. X holds property (being the shares of Holdco) that derive value indirectly from shares of Opco and that represent more than 10% of the Opco value. The CRA added that if Mrs. X held 10% of the shares of Opco directly (and not through Holdco) then her shares would be excluded shares.

Scenario B

1. Opco shares are 100% owned by Holdco.
2. Mr. X holds 90% of the participating and voting shares of Holdco and Mrs. X, Mr. X's spouse, holds 10% of the participating and voting shares of Holdco.
3. Mr. X and Ms. X are 35 years old, and Ms. X does not participate in the Opco business.
4. Holdco owns marketable securities that were bought with dividends received from Opco in a prior year.
5. Holdco did not receive any dividends (or other income) from Opco in its last taxation year.
6. In its last year, Holdco generated $100,000 of interest and dividend income.
7. Holdco paid a dividend of $67,500 to Mr. X and $7,500 to Mrs. X.

[29] Supra note 3.

For the purposes of this scenario, the CRA assumed the $100,000 income of Holdco was derived from a business, the purpose of which was to earn income from property. Despite the fact the Holdco funds to purchase the marketable securities portfolio came from Opco dividends, the CRA took the position the excluded shares exception would be satisfied. Specifically, the condition in paragraph (c) was satisfied as Holdco's income was not derived, directly or indirectly, from a related business (i.e., Opco's business) but from Holdco's business. In other words, the dividend received by Mrs. X was derived from the Holdco business and not from a related business in respect of Mrs. X.

4) Deceased Estate Structure

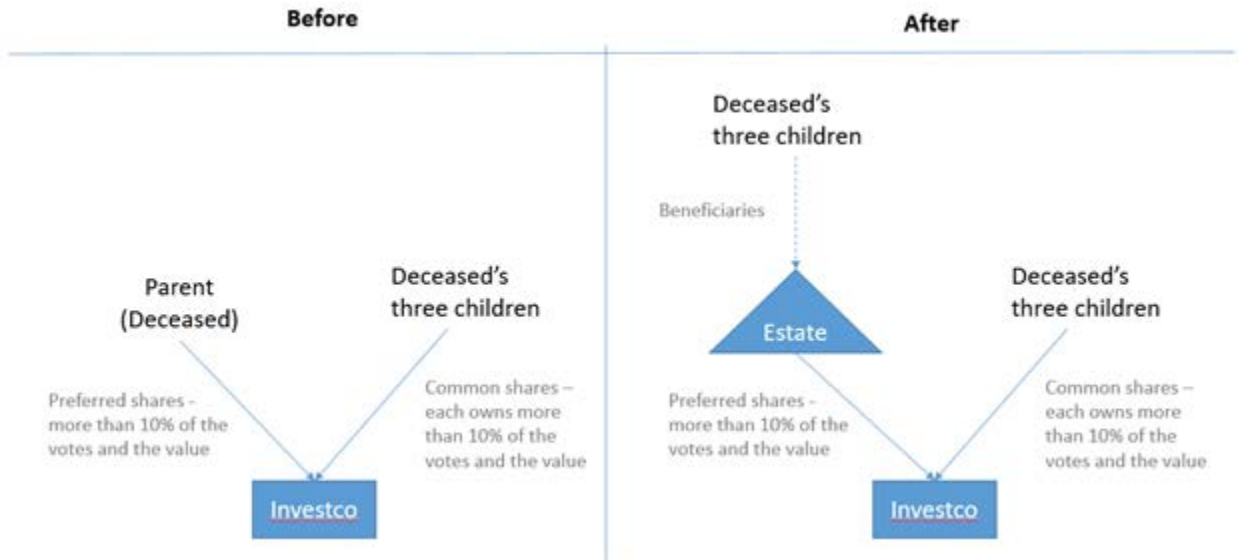
One of the requirements for shares to be excluded shares is that the specified individual must own 10% or more of the shares of a company directly and not indirectly through a trust. In Technical Interpretation 2018-0777361E5[30], the CRA confirmed that deemed dividends from shares owned by an estate would not meet the excluded share definition due to lack of direct ownership of the shares by specified individuals.

In the example given, an individual parent who was resident in Canada dies in 2018 and the deceased's estate acquired the voting preferred shares of Investco for their FMV pursuant to subsection 70(5). The preferred shares of Investco comprise more than 10% of the voting rights and FMV of Investco. The deceased's three adult children, all of whom were aged 25 or older and Canadian residents, were the only beneficiaries of the deceased's estate. Each of the adult children owned common shares of Investco that comprised more than 10% of the votes and value of Investco.

Investco carried on an investment business for a number of years and earned interest and dividend income from its investments. The initial funds used by Investco to purchase its investments came from proceeds from the sale, over 30 years prior, of the shares of an operating corporation where the deceased was active.

The Investco business is to be wound-up and all of the Investco shares are to be redeemed by Investco resulting in deemed dividends to the Investco shareholders (i.e., the three adult children and the Estate). In the case of the Estate, deemed dividends may be allocated to the estate beneficiaries (i.e., the adult children).

The CRA was asked whether the share redemption dividends would be split income.



[30] Canada Revenue Agency, Technical Interpretation 2018-0777361E5, "TOSI and Dividend Income, Including from a Trust" (November 7, 2018).

In their comments, the CRA noted that the adult children and the deceased (for 2018), are all specified individuals and source individuals. The business of Investco is considered to be a related business in respect of the deceased and the adult children. The deemed dividends from the redemption of the shares of Investco would be split income of a specified individual, unless it is an excluded amount.

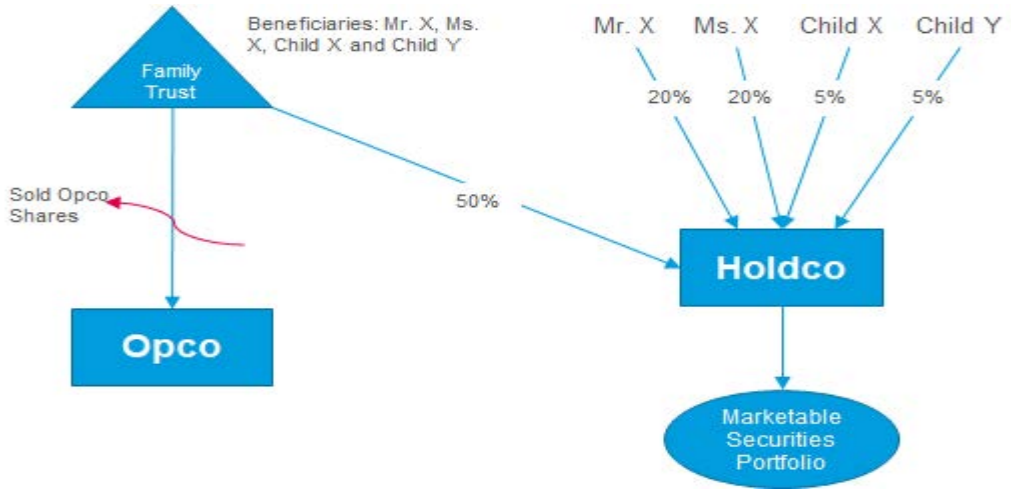
The CRA also noted the common shares held by the adult children would be excluded shares if the Investco income was from carrying on its investment business (i.e. not derived, directly or indirectly, from a related business). Accordingly, the common shares would satisfy the excluded shares exception and the income on the redemption of those shares would not be split income.

The preferred shares owned by the Estate would, however, not be excluded shares as the direct ownership requirement was not satisfied meaning any dividends arising on the redemption of the preferred shares, if allocated to the children by the estate, would be split income unless another exception applies.

Without coming to definitive conclusions, the CRA indicated that other exceptions such as "excluded business," a "reasonable return," or the "deceased person continuity" (subparagraphs 120.4(1.1)(b)(i) and 120.4(1.1)(b)(ii)) may be available to avoid TOSI application on the deemed dividend flowed to the adult children through the Estate.

5) Investment Company

This next technical interpretation illustrates how different the excluded amount exceptions could apply under a specific set of circumstances where the original operating business is sold and the proceeds of sale are reinvested by a holding company in an investment portfolio. Dividends are subsequently paid to the shareholders from the after-tax investment income of the holding company. In Technical Interpretation 2018-0778661C6[31], the CRA provided comments on the application of TOSI to each family member where Holdco was funded by sale proceeds which were invested in an investment portfolio, who paid a dividend, half of which is flowed to family members through a family trust ("**trust**") while the remainder was paid directly to them.



In this case, a trust that sold the shares of Opco (a small business corporation) and distributed the taxable capital gains to its beneficiaries, Mr. X, his spouse Mrs. X and their children Child X (age 15) and Child Y (age 22). Each beneficiary used their lifetime capital gains exemption to shelter the gain allocated by the trust.

[31] Canada Revenue Agency, Technical Interpretation, 2018-0778661C6, "Tax on Split Income" (October 5, 2018).

Subsequently, the Trust, Mr. X, Mrs. X, Child X and Child Y subscribed for 50%, 20%, 20%, 5% and 5%, respectively, in the capital stock of a newly incorporated Holdco with the proceeds of the sale. Holdco used the share issue proceeds to purchase portfolio investments. The investments generated investment income of $150,000 in the following year. The Holdco will, in turn, pay dividends to the individuals and to the Trust. The Trust will allocate the dividends received to Mrs. X, Child X and Child Y.

The CRA was asked to comment on the following:

1. Would the dividends paid by Holdco to each of Mr. X, Mrs. X., Child X and Child Y be considered split income?
2. Would the dividend paid to the trust and allocated to Mrs. X, Child X and Child Y via the Trust be considered split income?

The CRA began its analysis by noting that the taxable capital gain received by each of the family members should be an excluded amount under paragraph (d) of the definition of “excluded amount” in subsection 120.4(1). With respect to a dividend paid by Holdco to Child X, the amount will be split income pursuant to paragraph (a) of the definition of split income in subsection 120.4(1) as Child X was under the age of 18 years. With respect to Mr. X, Mrs. X and Child Y, the CRA position varied depending on whether Holdco was or was not carrying on a business.

Assuming Holdco was carrying on a business, the CRA concluded that shares of Holdco owned by Mr. X and Mrs. X would be excluded shares; consequently, dividends received from Holdco would not be split income. As for Child Y, since the child is 22 years old and holds only 5% of the shares of Holdco, the shares of Holdco would be split income. Child Y could not benefit from the arm’s length capital contribution exclusion provided in subparagraph (f)(ii) of the definition of excluded amount in subsection 120.4(1) because the Holdco shares owned by Child Y are substituted property, being shares of Opco which is a related business. Child Y may benefit from the exclusion for a safe harbour capital return in subparagraph (f)(i) of the definition of excluded amount in subsection 120.4(1). Dividend income up to an amount that is the product of the prescribed rate (currently 2%) on the fair market value of her investment in Holdco would not be split income and the amount in excess, if any, would be considered split income.

Assuming Holdco was not carrying on a business, the CRA concluded that the dividends received from Holdco would be excluded amounts for Mr. X, Mrs. X and Child Y as Holdco was not carrying on a business.

The CRA confirmed that dividend distributions received by Mrs. X, Child X and Child Y from the Trust would be split income, unless they qualify as an excluded amount. Since Child X is less than 18 years of age, none of the exclusions under the definition of excluded amount in subsection 120.4(1) would apply, thus amounts received by Child X would be split income.

With respect to Mrs. X and Child Y, if it turns out that Holdco was not carrying on a business, then Holdco would not be a related business for each of those specified individuals. Thus, the dividend distribution would be an excluded amount for Mrs. X and Child Y under subparagraph (e)(i) of the definition of that term in subsection 120.4(1) since it did not come, directly or indirectly, from a related business in respect of Mrs. X and Child Y.

Whereas, if Holdco is carrying on a business, then the dividend distribution would be derived from a related business with respect to Mrs. X and Child Y. Mrs. X may benefit from the reasonable return exclusion provided for in subparagraph (g)(ii) of the definition of "excluded amount" in subsection 120.4(1). The CRA did not comment on the application of the excluded shares exception however, it would not be available as Mrs. X did not have direct ownership of the shares of Holdco required under paragraph (b) of the excluded

shares definition in subsection 120.4(1). Child Y could only rely on the safe harbour capital return in subparagraph (f)(i) of the definition of excluded amount in subsection 120.4(1) as discussed above.

Child X and Y would not be subject to TOSI if they had simply invested their portion of proceeds from the sale of Opco into portfolio investments directly.

6) Gross Business Income Under Provision of Services

The excluded shares exemption is defined in subsection 120.4(1) as shares of a corporation owned directly by an individual that meet all of the following conditions when the income is received by the individual:

1. less than 90% of the business income of the corporation is from the provision of services in the previous tax year or, for new corporations, its current tax year (referred to as "**gross business income test**" from here on);
2. the corporation is not a professional corporation, as defined in subsection 248(1);
3. the individual owns 10% or more votes and value in the share capital of the corporation; and
4. the income of the corporation is not derived directly or indirectly from another related business for the relevant year.

i. Meaning of Business Income

The CRA Technical Interpretation 2018-0743961C6, confirmed that the terms "business income" and "income" for the purposes of the excluded shares definition would mean the gross income of the corporation rather than net income. In general, gross business income means revenues before expenses and excludes capital gains. If the corporation carries on more than one business, the test is applied to the aggregate gross business income of each business. In determining gross income, payments that can reasonably be considered reimbursements of expenses (including reimbursement for the supply of goods) are to be ignored.[32]

ii. Meaning of Provision of Services

The excluded shares definition will not apply if more than 10 percent of the business income of the corporation is "from the provision of services."[33] The taxpayers need to determine the characteristics of a service in ordinary terms, figure out what proportion, if any, of their gross business income is derived from the provision of goods, provision of services or both. However, what does the term "provision of services" even mean? It is not defined but it is used narrowly in other sections of the Act.[34] Without a definition, the term must be interpreted under general business principles. The ordinary meaning of the word "service" includes "*useful labor that does not produce a tangible commodity*".[35] In today's economy, goods and services may not be mutually exclusive (i.e. tangible vs intangible). Services can be thought of as specialized skills and knowledge/competencies that are being applied through processes and performances for the benefit of someone else. We discuss the characteristics of services and CRA Guidance on how to apply the term "provision of services" under various examples.

Theoretically, there are four main characteristics of services being intangibility, heterogeneity, inseparability and perishability.[36] We discuss these characteristics to provide additional context as to how the delineation of characteristics between goods and services can be difficult and misleading at times:

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[32] Canada Revenue Agency, Technical Interpretations, 2018-0743961C6 "STEP Question 2 – Tax on Split Income" (May 29, 2018), and 2018-0743971C6, "2018 STEP Question 6 – Excluded Shares – Holding Company" (May 29, 2018).

[33] Subparagraph (a)(i) of the excluded shares definition

[34] Kathryn Walker, "The Services Carve-Out from TOSI" (2018) 8:2 *Canadian Tax Focus* 12-13.

[35] https://www.merriam-webster.com/dictionary/service

[36] http://pdf.steerweb.org/emp1.pdf

1. Intangibility - lack of physical properties that cannot be tasted, touched, felt, and seen prior to the purchase decision.

   Tangibility or intangibility is a matter of perspective. It has been argued that: "*Customers do not buy goods or services: they buy offerings which render services which create value… the traditional division between goods and services is long outdated*."[37]

   The provision of information from a tax database service is widely considered to be a service to its subscribers, however, the same information printed in a book format would typically be considered to be a provision of goods. The user of the database is most concerned with the information regardless of the format in which it is presented. A hot stamping machine in a factory is a method of providing a substitute for labour services. With recent growth in technology, biotechnology and artificial intelligence, one may argue that tangible goods are merely platforms for the performance of human functions.

2. Heterogeneity - the relative inability to standardize the output of services in comparison to goods.

   Production of goods have generally been characterized as heterogeneous. The concept of standardization was a result of mass production achieved due to the industrial revolution, prior to which production of goods was typically a non-standardized output. Therefore, it is the manufacturing process that leads to standardization rather than a characteristic of the tangible output. Much like goods, the goal of standardization may also be achieved in various types of services offered on an everyday basis such as airlines, surgical procedures and commercial information databases and they could be as standardized as the production of aircrafts, surgical instruments and computer technology on which these services rely upon. Standardization at best is a representation of quality and efficiency achieved through a specific process undertaken in the manufacturing and processing of goods and/or service. Delivery of services can be standardized and delivered to multiple consumers at the same time. Where an undergraduate degree in a tax course is delivered to 100 students, the university is merely offering a standardized series of lectures and students receive standardized evaluations (output) at the end of the study term.

3. Inseparability of production and consumption - simultaneously produced and consumed compared with the sequential nature of production, purchaser and consumption that characterizes physical products.

   The concept of inseparability implies that producer and consumer must interact simultaneously for services to be received, and cannot be produced without consumer interaction. Until the industrial revolution, goods were usually manufactured with the involvement of the consumer such as clothes were tailored and tools were customized. Interestingly, mass customization has become a thing of the internet in the last decade whereby consumers interact with the producer of goods to buy everything from computers (Apple, Lenovo and Dell), clothing (Levi denim jeans), and other goods from online custom marketplace such as Etsy.com. In contrast, many service offerings can be produced separate from the consumers such as financial (ATMs), entertainment/streaming services (Netflix), information services (database subscription). Typically, the benefits from goods cannot be obtained unless the consumer uses/interacts with them. Therefore, it may be argued that goods are merely a channel for provision of services themselves as they may be used and consumed overtime.[38]

4. Perishability - cannot be produced ahead of time and inventoried (closely linked to the tangibility characteristic).

[37] Gummesson, Evert (1995), "Relationship Marketing: Its Role in the Service Economy," in Understanding Services Management, William J. Glynn and James G. Barnes, eds. New York: John Wiley & Sons, 244–68.)
[38] http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.529.7413&rep=rep1&type=pdf

> The ability of inventory is not exclusive to the tangible goods only. Services may be stored in buildings, knowledge and people. For example, a hotel provides an inventory of rooms for guests, an airline and a movie theatre are routinely inventoried in the units of "time" prior to flight and movie time, respectively, before the purchase and consumption. Similarly, every time the Canadian Tax Foundation plans a conference for its members and assigns various tax topics to its speakers, records the webcast of its conference for future use, it is, in effect, inventorying educational services (papers, slide decks, video recordings). Once the members internalize the value of such conferences, the Canadian Tax Foundation has essentially created a human capital that members can draw on for their benefits for future years.

In our view, the delineation between goods and services is a flawed concept, which does not align with the technological and economic realities of today's market. The CPA/CBA Joint Taxation Submission on TOSI dated March 8, 2018, concluded the difficulty of determining if there is a provision of services as "*there are many situations where the line between the provision of goods and the provision of service is blurred, particularly given the proliferation and complexity of today's service economy, and technological sophistication, for instance in the area of 'fintech'.*[39] *Many seemingly service-oriented businesses could indeed have a substantial goods-providing side of the business, and vice versa.*" We agree with this statement.

iii. CRA Guidance – Provision of Services and Business Income

The CRA has released guidance on the application of the split income rules[40] and the phrases "business income" and "provision of services". CRA has also commented that whether a business will be considered to be engaged in the provision of services will depend on the facts and circumstances of the business.[41]

A corporation that earns income from services and non-services must compute and track income separately. The non-service income must be considered when determining if the shares are excluded shares unless the non-service income is ancillary to the "provision of services" by the corporation. The reference to non-service income is in relation to a business carried on by plumbers, mechanics or other contractors that supply replacement parts or building materials.

The CRA provided the following examples to illustrate how the gross business income test is applied in the 90% provision of services test. In each example below, the fiscal period of the corporation ends on December 31 and a dividend has been paid to the individual shareholder in 2018.

CRA Example 1 - General calculation

A corporation has two businesses - management consulting services and computer hardware sales to clients. Gross business income of the corporation for the previous tax year (2017) is $2M as follows:

1. total revenue from management consulting services (2017) - $1.9M
2. total revenue from computer hardware sales (2017) - $100,000

Gross business income test: $1.9M / $2M = 95%

Since more than 90% of the gross business income of the corporation in the previous tax year was for services, the condition in subparagraph 120.4(1)(a)(i) of the definition of excluded shares is not met for 2018 tax year.

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[39] Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada, "Legislative Proposals to Address Income Sprinkling Released December 13, 2017", March 8, 2018

[40] Excluded shares Guidance from the CRA https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/federal-government-budgets/income-sprinkling/guidance-split-income-rules-adults/excluded-shares.html

[41] Canada Revenue Agency, Technical Interpretation 2018-0761601E5 "Correspondence with XXXXXXXXX re Tax on Split Income – Proposed Amendments to s. 120.4" (May 25, 2018).

The determination of whether service income is less than 90% of the corporation's total income is computed by simply dividing total service income by the corporation's total gross business income.

CRA Example 2 - New business

A newly incorporated corporation began operating in 2018. The corporation provides management consulting services and computer hardware sales to clients. Gross business income of the corporation for the current tax year (2018) is $1M as follows:

1. total revenue from management consulting services (2018) - $990,000
2. total revenue from computer hardware sales (2018) - $10,000

Gross business income test: $990,000 / $1M = 99%

Since more than 90% of the gross business income of the corporation in the current tax year was for services, the condition in subparagraph 120.4(1)(a)(i) of the definition of excluded shares is not met for 2018 tax year.

The shares of the corporation would not be excluded shares in 2019. Since the 90% test is applied to the previous tax year of the corporation when such a year exists, the 2018 tax year would be used again when determining if the shares qualify as excluded shares in 2019.

CRA Example 3 - Result of 90% test varies from one year to another

A corporation operates a plumbing business that provides plumbing repairs and maintenance services. The corporation also operates a retail store to sell parts and plumbing fixtures. The retail products are not used in providing services, but are sold separately to customers.

The gross business of the corporation for 2017 is $1M:

1. total revenue from repairs and maintenance services - $950,000
2. total revenue from parts and fixture sales - $50,000

Gross business income test for 2017: $950,000 / $1M = 95%

Since more than 90% of the gross business income of the corporation in the previous tax year (2017) was for services, the condition in subparagraph 120.4(1)(a)(i) of the definition of excluded shares is not met for 2018 tax year.

The gross business of the corporation for 2018 is $1.2M:

1. total revenue from repairs and maintenance services - $900,000
2. total revenue from parts and fixture sales - $300,000

Gross business income test for 2017: $900,000 / $1.2M = 75%

Since less than 90% of the gross business income of the corporation in the previous tax year (2018) was for services, the condition in subparagraph 120.4(1)(a)(i) of the definition of excluded shares is met for 2019 tax year.

CRA Example 4 - Incidental goods used or consumed in providing services

A corporation operates a cleaning business that provides cleaning services. The corporation does not sell cleaning products, but uses them in providing services to customers.

The gross business of the corporation for 2017 is $1M:

1. total revenue from cleaning services - $1M
2. Total cost of cleaning products used for the services - $150,000

Gross business income test for 2017: $1M / $1M = 100%

Since more than 90% of the gross business income of the corporation in the previous tax year (2017) was for services, the condition in subparagraph 120.4(1)(a)(i) of the definition of excluded shares is not met for 2018 tax year.

The amount billed with respect to goods used incidentally in the provision of services are not subtracted from the service portion of gross business income. According to the CRA, this would still be the case if an amount for the goods was listed separately on the invoice for services or on a separate invoice. Such position appears to be rigid. Would the treatment prescribed by the CRA be different if the corporation in example 4 also had a retail store (perhaps via online website), similar to example 3, which also sold cleaning supplies to non-service customers? The CRA addressed a variation of example 4 in the example below.

CRA Example 5 - Income from both services and non-services (cleaning business)

Assume the same facts as in Example 4 above, except the business also sells various supplies and equipment separately. The cleaning supplies and equipment may be sold to retail customers who are not customers of the service business, or they may be sold to customers when they are buying cleaning services.

The gross business income of the corporation for 2017 is $1M:

1. total revenue from cleaning services - $800,000
2. total revenue from the sale of cleaning supplies and equipment - $200,000

Gross business income test for 2017: $800,000 / $1M = 80%

Since less than 90% of the gross business income of the corporation in the previous tax year (2017) was for services, the condition in subparagraph 120.4(1)(a)(i) of the definition of excluded shares is met for 2018 tax year.

If goods are provided with a service and the goods are not incidental to the service, because they are provided separately for use by the customer, the sales price allocated to the goods is not included as service income in applying the gross business income test. According to the CRA, in this example, the business had sales of cleaning supplies and equipment that were not incidental to the services, since they were either sold separately or, if sold with a cleaning service, were distinct and separate from the cleaning service. Therefore, the $200,000 in sales of the cleaning supplies and equipment would not be included in the service part of the gross business income.

CRA Example 6 - Income from both services and non-services (construction business)

A corporation operates a business that includes design, construction and repair of decks. The corporation supplies all materials and labour in constructing and repairing decks. The corporation also provides deck designing services for customers who want to build their own deck.

The gross business of the corporation for 2017 is $200,000:

1. total revenue from deck construction - $175,000
    - Materials $90,000
    - Labour $85,000
2. total revenues from deck repairs: $25,000
    - Materials $10,000
    - Labour $15,000

Gross business income for services - $100,000 ($200,000 - $90,000 - $10,000)

Gross business income test for 2017: $100,000 / $200,000 = 50%

Since less than 90% of the gross business income of the corporation in the previous tax year (2017) was for services, the condition in subparagraph 120.4(1)(a)(i) of the definition of excluded shares is met for 2018 tax year.

Income from construction, repair of decks and deck designing has service and non-service components. Amounts billed for labour are considered service income, and amounts billed for materials are considered non-service income. Whereas the cleaning supplies used in providing the cleaning services were considered to be incidental to the cleaning services business in example 4 unless the cleaning supplies were sold separately to the customers as discussed in example 5 above. We are uncertain as to the rationale behind the inconsistency of what is and what is not considered to be "incidental" to the provision of service. One could only speculate, perhaps the construction business is perceived to be a capital intensive business while the cleaning business is not, resulting in a rather favorable position in their determination for the construction business.

7) Income from a Related Business for Excluded Shares

In Technical Interpretation 2019-0802331E5[42], the CRA comments on whether capital gains are to be included in the determination of income for purposes of paragraph (c) of the excluded shares definition. Paragraph (c) states that all or substantially all of the income of the corporation is income that is not derived, directly or indirectly, from one or more other related business in respect of the specified individual other than a business of the corporation. CRA commented that "income" under paragraph (c) refers to gross income and not net income or profit after expenses. Further, the income for purposes of this paragraph is an amount that would come into income for taxation purposes. Consequently, if capital gains are to be included, what would constitute "gross income" in relation to a particular capital gain and more specifically, should the amount from capital gains include allowable capital losses incurred during the relevant year. CRA confirmed that it is the amount of taxable capital gains from the disposition of property that is to be included in determining the "gross income" of a corporation under paragraph (c) of the excluded shares exception. In their view, the offsetting taxable capital gains against allowable capital losses results in computing net gains is akin to calculating net income from the disposition of property. In keeping with the intent that income refers to the gross income, only taxable capital gains and not allowable capital losses should be included in determining the gross income under paragraph (c) of the excluded shares definition.

8) Partnership with Corporate Partners

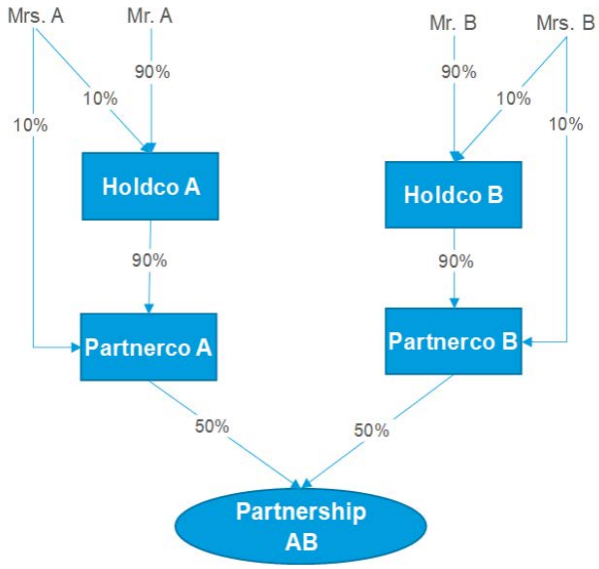
CRA was asked to comment on the application of the excluded shares exception to individual shareholders of corporate partners. In Technical Interpretation 2019-0813021E5[43], the CRA was asked to provide clarification on the application of paragraph (c) of the excluded shares exception to shares held by Mrs. A and Mrs. B in Partnerco A and Partnerco B, respectively. Paragraph (c) of the excluded shares exception states that all the income of the corporation for the year is not derived, directly or indirectly, from one or more related businesses in respect of the specified individual.

The facts and assumptions are as follows:

1. Partnership AB carries on an active business in Canada and its income is not derived from the provision of services;
2. Partnerco A and Partnerco B (collectively Partnercos) were corporations that were not professional corporations.
3. The only Partnerco source of income was partnership income that they received based on their interests in Partnership AB;
4. The shareholders of Partnerco A are Holdco A and Mrs. A, who own 90% and 10% respectively of votes and value of shares of Partnerco A;

[42] Canada Revenue Agency, Technical Interpretation 2018-0802331E5 "TOSI and Excluded Shares" (May 24, 2019).
[43] Canada Revenue Agency, Technical Interpretation 2019-0813021E5 "TOSI and Excluded", (August 9, 2019).

5. Mr. A and Mrs. A own 90% and 10% of the shares of Holdco A, respectively;
6. Mr. A and Mrs. A are married and both are over 25 years of age;
7. The shareholders of Partnerco B are Holdco B and Mrs. B, who own 90% and 10% respectively of votes and value of shares of Partnerco B;
8. Mr. B and Mrs. B own 90% and 10% of the shares of Holdco B, respectively;
9. Mr. B and Mrs. B are married and both are over 25 years of age;
10. Mr. A and Mrs. A are not related to Mr. B and Mrs. B;
11. Mrs. A and Mrs. B. were specified individuals. Mr. A was the spouse of Mrs. A and Mr. B was the spouse of Mrs. B.
12. Both Mr. A and Mr. B were source individuals to their respective spouses.



The CRA clarified that the business of Partnership AB constituted a related business in respect of both Mrs. A and Mrs. B (specified individuals) because Mr. A and Mr. B (source individuals) had indirect ownership interests in Partnership AB. As such, 100 percent of the Partnercos income was derived directly from a related business in respect of Mrs. A and Mrs. B – the business of Partnership AB.

The CRA confirmed that the Partnership AB business was also the Partnercos business. This was due to the legal nature of the partnership relationship: partners agree to carry on business in common and, as a result, each partner is considered to carry on the partnership's business. As partners of Partnership AB, the Partnercos were considered to carry on Partnership AB's business and, therefore, earned 100 percent of their income from their own business, and therefore satisfied the third element in the excluded shares exception.

The CRA concluded that, provided the other two criteria in the excluded shares test were satisfied, Mrs. A's and Mrs. B's shares in the Partnercos were excluded shares and, therefore, the TOSI rules would not apply to Mrs. A's and Mrs. B's income from, and capital gains from the disposition of the shares of the Partnercos. The CRA also noted that the answer would not change if specified individuals were related (siblings).

The TOSI rules continue to evolve and partnerships add another layer of complexity to the analysis. The governing partnership laws establish the relationship between the relevant parties. This determination is critical to the application of the TOSI exceptions to specific partnership fact patterns.

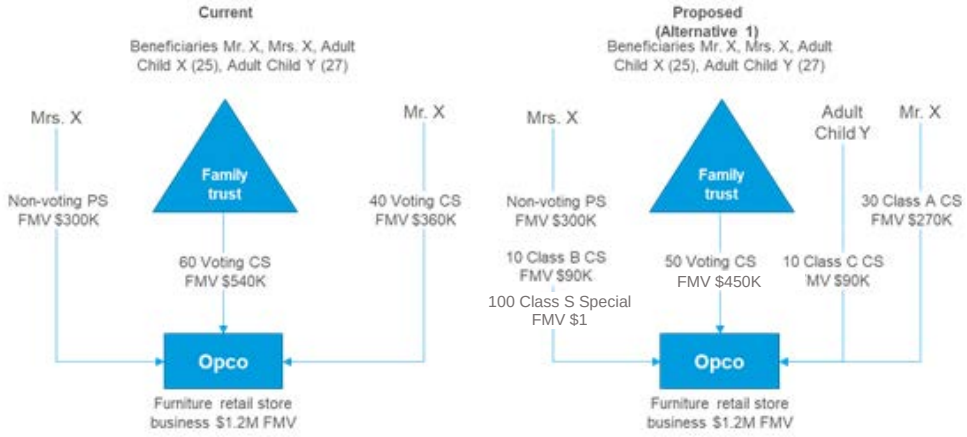
9) Planning Scenarios[44]

Opco Planning

In the Technical Interpretation 2018-0771811E5[45], the CRA confirmed that paragraph (b) of the definition of excluded shares under subsection 120.4(1) does not require the specified individual to hold one class of shares having 10% of the votes and value. Therefore, it appears that the dividends do not actually have to be paid on the shares that have the actual votes and value, so long as the shareholder meets these tests in aggregate.

Consider the following scenario where the technical interpretation may be useful in tax planning for family business:

1. Opco is in the retail furniture sale business;
2. Opco is considered to be a small business corporation as defined under subsection 248(1);
3. Opco's FMV is $1,200,000;
4. Mr. X and Mrs. X are married and they have two adult children – child X (25) and child Y (27);
5. Mr. X, Mrs. X and adult child Y have never been actively engaged in the business;
6. Adult child X has been actively engaged in the business for over 5 years;
7. Mrs. X owns non-voting fixed value preferred shares with FMV of $300,000;
8. Mr. X owns 40 voting common shares with FMV of $360,000;
9. Family trust owns 60 voting common shares with FMV of $540,000;
10. The beneficiaries of the family trust are Mr. X, Mrs. X, child X and child Y;
11. All family members are residents of Canada for income tax purposes.



Under the current structure, any dividends and/or capital gains realized on the disposition of shares owned by Mr. X should not be TOSI as he would meet the excluded shares exception as summarized below:

1. Opco earns all of its income from sale of goods and it is not a professional corporation;
2. He owns more than 10% of votes and value in Opco;
3. Opco does not derive its income directly or indirectly from another related business in respect of the specified individual.

Mrs. X cannot rely on the excluded shares exception because she does not own any voting shares in Opco.

[44] The scenarios were inspired from discussions with multiple tax practitioners including from a presentation by Moodys on TOSI

[45] Canada Revenue Agency, Technical Interpretation 2018-0771811E5 "120.4 – Excluded Shares", (August 21, 2018).

Adult child X and Y cannot rely on the excluded share exception because they do not own shares directly in Opco. However, adult child X can rely on the excluded business exception because she is actively engaged in the business.

Subject to non-tax considerations, the following planning steps may be undertaken in respect of Mrs. X and adult child Y such that they own at least 10% of the votes and value directly in Opco to qualify under the excluded shares exception:

> Planning for Mrs. X:
>
> Alternative 1: Opco will reorganize its share capital. Mr. X will exchange his existing 40 voting shares for two separate classes of shares, 30 Class A voting shares and 10 Class B voting shares on a tax deferred basis under subsection 86(1). Mr. X will transfer 10 Class B voting shares to Mrs. X pursuant to the spousal rollover under subsection 73(1). The transaction will result in the application of attribution rules for income, losses, capital gains and capital losses earned on the 10 Class B voting shares transferred under subsections 74.1(1) and 74.1(2). Opco should not pay dividends on 10 Class B voting shares to avoid application of such attribution rules.
>
> Corporate attribution rules under subsection 74.4(2) should not apply since Opco is a small business corporation as defined under subsection 248(1).
>
> Alternative 2: the family trust will transfer 10 voting shares to Mrs. X at cost pursuant to subsection 107(2). Subsequent to the transfer, pursuant to subsection 86(1), Mrs. X will exchange her 10 voting shares for 10 Class B common shares of Opco.
>
> Mrs. X will subscribe to 100 Class S Special shares, which are non-voting discretionary dividend shares with a fixed redemption value of $1. Despite the redemption amount being $1, the CRA may argue that the fair market value of these shares is higher than $1.
>
> Planning for adult child Y:
>
> The family trust can transfer 10 voting shares to adult child Y at cost under subsection 107(2). Subsequent to the transfer, pursuant to subsection 86(1), adult child Y will exchange her 10 voting shares for 10 Class C common shares of Opco.

Subsequent to the above planning steps:

1. Future dividends declared and/or a capital gain in respect of 10 Class C common shares owned by the adult child Y should not be TOSI as the excluded shares exception is met;
2. Future dividends declared and/or capital gains in respect of 100 Class S Special shares owned by Mrs. X should not be TOSI as the excluded shares exception is met (she owns at least 10% of votes and value through other shares in Opco);
3. Future deemed dividends paid on redemption and/or a capital gain in respect of non-voting preferred shares owned by Mrs. X should not be TOSI as excluded shares exception should be met (she owns at least 10% of votes and value through other shares in Opco);
4. Future dividends declared and/or a capital gain in respect of 50 voting common shares owned by the family trust and allocated to Mr. X, Mrs. X and adult child Y should be subject to TOSI (see #7 below where capital gains be exempt). The excluded shares exception is not met due to the lack of direct ownership of these shares by the beneficiaries.[46]
5. Future dividends declared and/or a capital gain in respect of 50 voting common shares owned by the family trust and allocated to adult child X should not be subject to TOSI as excluded business exception is met;
6. Future dividends declared and/or a capital gain in respect of 10 Class C common shares owned by adult child Y should not be TOSI as excluded shares exception is met.

[46] Supra note 31.

7. Any future taxable capital gains on the shares owned by the family members directly or capital gains allocated by the family trust should not be TOSI as long as Opco shares are qualified small business corporation shares on the disposition date[47].

Estate Freeze

Consider a scenario where the objective is to freeze Opco and provide future growth to a family trust while being able to income split with a non-active spouse.

Facts:

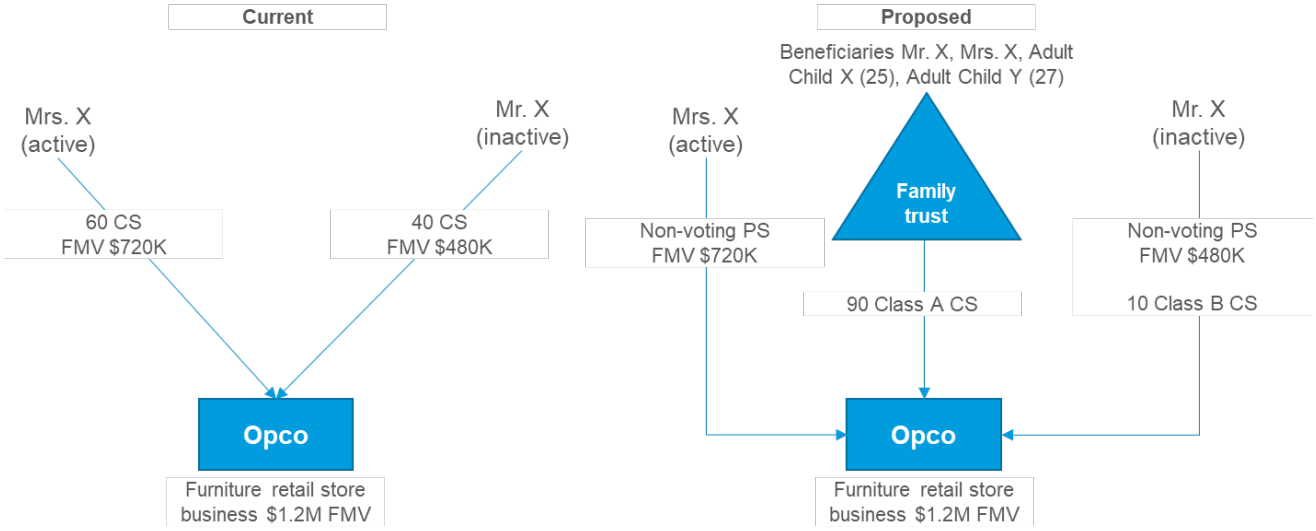
1. Opco is in the retail furniture sale business;
2. Opco is considered to be a small business corporation as defined under subsection 248(1);
3. Opco's FMV is $1,200,000;
4. Mr. X and Mrs. X are married and they have two adult children – child X (25) and child Y (27);
5. Mrs. X is actively involved in the business of Opco and has been at least 5 years;
6. Mr. X, adult child X and child Y have never been actively engaged in the business;
7. Mrs. X owns 60 common shares with FMV of $720,000;
8. Mr. X owns 40 common shares with FMV of $480,000;
9. All family members are residents of Canada for income tax purposes.

Under the current structure, any dividends and/or capital gains realized on the disposition of shares owned by Mr. X should not be TOSI as he would meet the excluded shares exception as summarized below:

1. Opco earns all of its income from sale of goods and it is not a professional corporation;
2. He owns more than 10% of votes and value in Opco;
3. Opco does not derive its income directly or indirectly from another related business in respect of the specified individual.

Under the current structure, any dividend distributions and/or capital gains realized on the disposition of shares owned by Mrs. X should not be TOSI because she is actively engaged in the business and has been for at least 5 years. In addition, the excluded shares exception is also available to Mrs. X.

To maintain the ability to retain the excluded share exception for Mr. X (non-active spouse); he needs to continue to own at least 10% of the common shares of Opco personally providing him with 10% votes and value.



Planning steps:

1. Pursuant to subsection 86(1), Mrs. X and Mr. X will exchange their respective common shares of Opco for fixed value non-voting preferred shares;

[47] See paragraph (d) of excluded amount definition under 120.4(1)

2. The family trust will subscribe to 90 Class A common shares of Opco for a nominal amount;
3. Mr. X will subscribe to 10 Class B common shares of Opco for a nominal amount. This share subscription ensures that Mr. X continues to hold at least 10% of votes and values in Opco personally.

   Alternatively, Mr. X could have instead subscribed to non-participating voting shares in Opco only however, once Opco's value increases beyond $4,800,000 ($480,000 / 10%) or if he redeems his fixed value preferred shares, he would no longer meet the 10% value test required under excluded shares exception.

Under the planning steps, 90% of the Opco shares were frozen while Mr. X retained 10% of the growth shares in Opco to maintain excluded share exception. Subsequent to the planning:

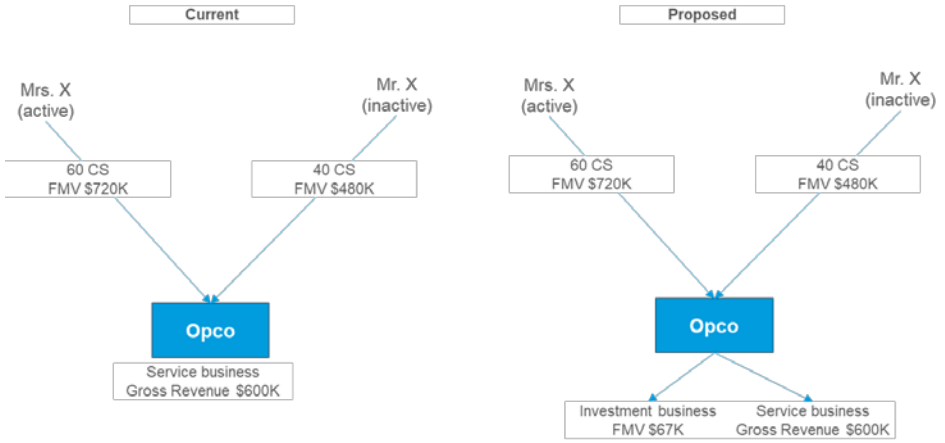
1. Future dividends declared and/or capital gain on 90 Class A common shares owned by the family trust and allocated to Mr. X, adult child X and adult Y should be subject to TOSI (see #6 below where capital gains be exempt). The excluded shares exception is not met due to the lack of direct ownership of these shares by the beneficiaries.[48]
2. Future dividends declared and/or a capital gain in respect of 90 Class A common shares owned by the family trust and allocated to Mrs. X should not be subject to TOSI as the excluded business exception is met;
3. Future deemed dividends to Mrs. X from the redemption of her fixed value preferred shares should not be TOSI as the excluded business exception is met;
4. Future deemed dividends to Mr. X from the redemption of his fixed value preferred shares should not be TOSI as excluded shares exception is met;
5. Future dividends paid to Mr. X on 10 Class B common shares should not be TOSI as the excluded share exception is met;
6. Any future taxable capital gains on the shares owned by the family members or allocated by the family trust should not be TOSI as long as Opco shares qualifies as qualified small business corporation shares on the disposition date[49].

Conversion of Service Company

The paragraph (a) of the excluded shares definition requires that a corporation should earn less than 90% of its business income from provision of services. Consider a scenario where an Opco carries on a business that earns all of its income from services, failing to meet paragraph (a) of excluded shares definition. The objective is to income split with an inactive shareholder of Opco by qualifying its shares as excluded shares.

Facts:
1. Opco carries on a service business and is not a professional corporation;
2. Opco is considered to be a small business corporation as defined under subsection 248(1);
3. Opco's FMV is $1,200,000. It earns gross revenues of $600,000 annually.
4. Mr. X and Mrs. X are married;
5. Mrs. X is actively involved in the business of Opco and has been for at least 5 years;
6. Mr. X has never been actively engaged in the business;
7. Mrs. X owns 60 common shares with FMV of $720,000;
8. Mr. X owns 40 common shares with FMV of $480,000;
9. Both Mr. X and Mrs. X are residents of Canada for income tax purposes.

[48] Supra note 31.
[49] See paragraph (d) of excluded amount definition under 120.4(1)



Since Mrs. X is actively engaged in Opco's business, any dividend distributions and/or capital gains realized on the disposition of Opco shares owned by her X should not be TOSI due to the excluded business exception.

Mr. X and Mrs. X do not meet the excluded shares exception because all of Opco's gross business income is from provision of services, thus failing to meet paragraph (a) of excluded shares definition, which requires less than 90% of the business income of Opco should be from the provision of services. As previously discussed, the CRA interprets the term "business income" in the excluded share definition to be gross business income. Therefore, if less than 90% of the gross business income of Opco for the last taxation year was from provision of services, the excluded share definition exception can be met. In other words, Opco's needs to earn at least ~$67,000 (representing 10.1% x $667,000 total gross revenues) of gross business income from provision of non-services for its shares to qualify as excluded shares for the subsequent year. Once qualified, Opco can pay any amount of dividends to Mr. X (inactive spouse) without being subject to TOSI.

Tax planning

The activity of earning income from property can constitute to be income from business.[50] Accordingly, where Opco actively earns investment income, it should form part of the gross business income test for the purposes of calculating income from the provision of services.[51] In this case, planning should be undertaken such that Opco derives at least 10.1% of its total income from investment being $67,000 as mentioned above.

Steps

1. Mr. X or Mrs. X can lend sufficient funds to Opco that will generate $67,000 of investment business income annually (representing over 10% of the total gross business income).
2. Unless Opco continues to be a small business corporation, the loan should carry an interest rate equal to the prescribed rate (currently 2%) to avoid the application of the corporate attribution rule under subsection 74.4(2).

Alternatively, Opco may borrow the required funds from a bank.

Although Opco's investment income is considered income from business, it will be taxed as specified investment business[52] income under subsection 125(7). In addition, investment income exceeding $50,000 per year will cause a grind of the small business deduction[53] and may endanger Opco's status for qualified small business corporation[54].

[50] See discussion in characterization of income section above
[51] See provision of services section for a summary of CRA guidance for details
[52] Unless more than 5 full-time employees are involved to earn the investment income
[53] Paragraph 125(5.1)(b)
[54] Subsections 110.6(1) and 248(1) "small business corporation"

C. Excluded Business

Specified individuals aged 18 and over will not be subject to TOSI in the year on income from or taxable capital gains realized on the disposition of property to the extent it is derived, directly or indirectly, from an excluded business[55].

A business will be an excluded business where a specified individual is actively engaged on a regular, continuous and substantial basis in the activities of the business either in the current taxation year, or in any five prior taxation years. The phrase "actively engaged on a regular, continuous and substantial basis" is not defined in the Act. Without limiting the generality of this provision and for greater certainty, the Act does provide a bright line test that deems a specified individual to be actively engaged on a regular, continuous and substantial basis if the individual works in the business at least an average of 20 hours per week during the portion of the year in which the business is carried on.

There may be circumstances where the bright line test may be inapplicable and the interpretive uncertainty will continue to exist for taxpayers to determine whether the individual's activities in the business constitute regular, continuous and substantial basis. The CRA has provided guidance on this phrase in IT Bulletin 268R4 in the context of farm property rollover[56], which would equally apply to interpreting this phrase. In addition, CRA has specifically outlined in its technical interpretations on this exception that it is a question of fact whether an individual is actively engaged on a "regular, continuous and substantial basis" in the activities of the business and that will depend on the facts and circumstances of each case. CRA also said that it will consider the following factors in analyzing whether the individuals' involvement in the business meet the "regular, continuous and substantial basis" test:

1) The individual's involvement in the business i.e., the time and energy that the individual devotes to the business.
2) The individual's involvement in the management and/or current activities of the business.
3) The individual's skills and training in relation to the business.
4) The nature of the business itself.

CRA has provided its views on how the excluded business exceptions will apply in certain situations.

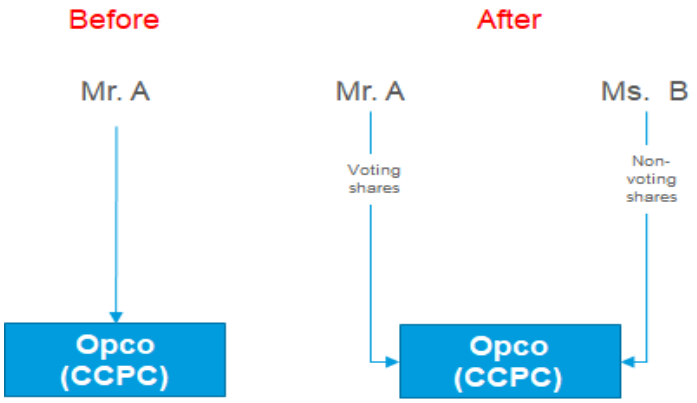
1) Actively Engaged in the Business in Five Prior Years

CRA clarifies how the "the five year test" in the definition of excluded business is to be applied. The CRA confirms that to qualify for the five year test, these five prior years can occur before the TOSI rules became effective on January 1, 2018. Their view is consistent with the policy intent of the legislation that certain individuals not be subject to TOSI on income they derive from a business after they have retired or decreased their involvement in the business. Further, the CRA confirms that the specified individual does not need to be related to the source individual in the previous years for the purposes of the five year test.

In Technical Interpretation 2018-0783741E5[57], the CRA was provided with a situation where Mr. A is the sole shareholder of an Opco that carries on an active business. Ms. B has worked as a full-time employee for approximately 40 hours per week from 2001 to 2006 inclusive. In 2018, Mr. A and Ms. B were married and shortly thereafter Ms. B acquired non-voting shares of Opco.

The CRA was asked whether the business in this particular situation is considered to be an "excluded business" such that the dividend income received by Ms. B from Opco is not subject to TOSI because of her previous employment with Opco.

[55] Subparagraph 120.4(1)(e)(ii) of the excluded amount definition
[56] Supra note 1
[57] Canada Revenue Agency, Technical Interpretation 2018-0783741E5, "TOSI and the Meaning of Excluded Shares" (February 27, 2019).



The CRA commented that it is a question of fact whether an individual is engaged on a "regular, continuous and substantial basis" in the business. In this case, the CRA focused on the bright line test to conclude that the excluded business exception was met. In their application of the bright line test, the CRA commented that there is no requirement in the wording of the legislation that the prior taxation years must be consecutive, nor is there a requirement that the specified individual must be related to the particular source individual at the time such qualifying activities are performed. The five-year test is intended to ensure that individuals who have made significant labor contributions to the business over a number of years will continue to be exempt from the TOSI after the individual has retired from, or reduced their involvement in the business.

The CRA concluded that on the assumption that Ms. B has been actively engaged on a "regular, continuous and substantial basis" in the business activities of Opco for at least five years, the five-year test would appear to be met. CRA does not provide a firm response in this situation that the five-year test is met under the bright line deeming rule.

Where spouses or children (over the age of 18 years) have worked in the business for an average of 20 hours per week prior to the introduction of these rules, payroll records will need to be examined to show that the individuals met the five year test in the prior years so that the income is not considered to be split income.

Further, if the business owner has children, consideration should be given to whether a child should work for the business for an average of 20 hours a week for five years. This will allow the child to start building on the five years to ensure that any future income paid to the child after the age of 17 will not be subject to TOSI in respect of that business. The bright line test does not specify that the child needs to be an adult to work an average of 20 hours per week nor does it say how active the child has to be in the business. However, proper records should be maintained to proof that the child indeed work in the business. Records such as payroll, timesheet, job description that outlines the job responsibility of the child and perhaps depending on the nature of the business the work produced by the child, for example, if the child worked in a software business and assisted with marketing or developing the programming then proof of the work/assignments he/she completed should be documented. This documentary evidence could also build support for reasonable rate of return exception (discussed later in the paper).

2) Maternity Leave

There may be situations where in the current year the bright line test is not met and depending on whether the individual has prior work history to determine if the five year test is met, the individual can show that they were actively being engaged on a regular, continuous and substantial basis in the business based specific facts and circumstances. In Technical Interpretation 2018-0770911E5[58], CRA was asked whether dividends paid on shares held by a spouse who normally worked on average more than 20 hours per week in the corporation's business, but in the current year was unable to work due to maternity leave, would the

[58] Canada Revenue Agency, Technical Interpretation 2018-0770911E5, "Revised Income Sprinkling Rules" (September 26, 2018).

spouse be considered to be actively engaged on a regular, continuous and substantial basis in the activities of the business.

The CRA commented that "there are certain situations where the average work commitment could be considered as being "regular, continuous and substantial" even if the bright-line deeming rule is not met. Accordingly, the fact that an individual was unable to work for a portion of a year in which the business operated due solely to the adoption or birth of a child would not, in and by itself, mean that the individual was not otherwise considered to meet the regular, continuous and substantial requirement for that year. However, such a determination will depend on the facts and circumstances of each case.

While no specific conclusion was reached, the CRA acknowledged that the spouse could qualify for the excluded business exception based on further facts. The CRA also commented that additional information was required to determine if other exceptions such as excluded shares or reasonable return could apply.

There are still uncertainties as to how CRA will interpret the phrase "actively engaged on a regular, continuous and substantial basis" in the activities of the business, especially where the bright line test is not applicable. The CRA has mentioned in the passing in its guidance document that it will consider the reasonable return factors in determining whether an individual is actively engaged in the activities of the business. Please see the reasonable return section of this paper for details, including Appendix II for suggestions on preparing evidence to support excluded business exception in case of a CRA audit.

3) Seasonal Business

This next technical interpretation discusses how the phrase actively engaged on a "regular, continuous and substantial basis" in a situation where the business is seasonal would apply. In Technical Interpretation 2019-0799901C6[59], the CRA was asked if the spouses would meet the regular, continuous and substantial basis test where a husband and wife carry on a business through a corporation owned by them. Both husband and wife contribute an equal amount of effort but the business only requires 10 hours of work per week on average, with each spouse contributing 5 hours.

In this scenario, the bright line test was not met and CRA was asked if the spouses would meet the regular, continuous and substantial basis test. CRA concluded that in this scenario, it would be a question of fact and it will depend on the spouses contributions to the business based on their time and energy spent on the business activities along with the nature of the business to determine whether the husband and wife would meet the excluded business exception for the year or continue to meet such test in any subsequent taxation years.

Where specified individuals are unable to meet the 20 hours per week requirement then the determination of actively engaged in "regular, continuous and substantial basis" will be derived based on facts and circumstances.

4) Multiple Businesses in a Corporation

The excluded business definition states that the specified individual must be actively engaged on a regular, continuous and substantial basis in the business. This means that where a corporation is carrying on multiple businesses in one corporation and the individual is actively engaged in one of these businesses, that the individual must receive the income from that business in order for this exception to apply. In Technical Interpretation 2018-0761601E5[60], the CRA was presented with a fact pattern wherein Opco operates two separate businesses, a construction business and a property management business. Spouse B works 25 hours per week in the property management and does not work in the construction business. The CRA was asked if funds had to be traced from the property management business to determine if dividends received by Spouse B would be an excluded amount.

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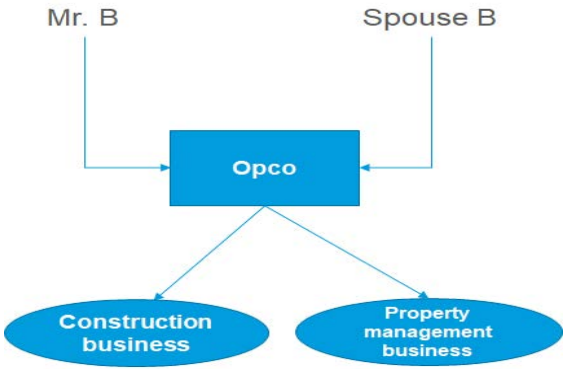
[59] Canada Revenue Agency, Technical Interpretation 2019-0799901C6, "STEP 2019 – Question 3 – TOSI and Hours Worked" (June 7, 2019).

[60] Canada Revenue Agency, Technical Interpretation 2018-0761601E5, "Correspondence with XXXXXXXXXXX re tax on split income – proposed amendments to s. 120.4" (May 25, 2018).



The CRA concluded that the property management business will be an excluded business of Spouse B given that Spouse B is actively engaged in a regular, continuous and substantial basis in the property management business for more than 20 hours per week. Dividends received by Spouse B out of income from the property management business would not be split income.

Provided Spouse B has not worked in the construction business during the relevant taxation year or in any five prior taxation years, the construction business will not be an excluded business of Spouse B. Any dividends received by spouse B and paid out of income from the construction business will be subject to TOSI.

Separate records should be maintained for each business and funds traced to show that the distributions to Spouse B came from the property management business.

The CRA also commented that the burden of proof will rest with the taxpayer to prove that the individual worked at least 20 hours a week in the business by maintaining records such as timesheets, schedules or logbooks showing the number hours worked by the individual in a given year. Where the individual receives a salary, the information contained in the payroll records would be sufficient documentation to prove that the individual met the bright line test. Assertions that the bright line test in prior years has been met will be evaluated by the CRA for reasonableness after considering the following factors:

1. the type of business and duties performed as they related to the main activities of the business;
2. the individual's education, training and experience; and
3. any particular knowledge, skills or know-how that the individual possessed.

Where a corporation carries on more than one business, it is crucial that the dividends paid to the specified individual are sourced from the business in which the specified individual is actively engaged. Issues may arise in determining whether a corporation is carrying on the same business or two separate businesses, especially in determining whether a corporation's activities are separate businesses as opposed to separate divisions of the same business.

Determining whether a corporation is carrying on the same business or two separate businesses depends on the "degree of interconnection, interlacing or interdependence and the extent of the unity embracing the business operations. The fact that business operations of a taxpayer are different in nature, for example, manufacturing and selling, does not preclude the business from being the same business if there is sufficient interconnection, interlacing or interdependence between the operations"[61]. For certainty that a corporation is carrying on one or more businesses, an analysis of the facts and review of court decisions and CRA's views in IT-206R should be considered. There are several court cases and articles that have been written on the same or separate business that should be reviewed when applying the excluded business exception to a corporation that may operate one or more businesses[62].

[61]Canada Revenue Agency, Paragraph 2 of IT-206R- Separate Businesses

[62] Sourcing of Business Income, 1987 Corporate Management Tax Conference Report by Bruce M. McLean; *Du Pont Canada Inc. V. R.*, 2001 2 CTC 315 (FCA), *MNR v. Eastern Textile Products, Ltd*, 57 DTC 1070; *Bay-Adelaide Garage Limited* v. MNR. 51 DTC 310; *Utah Co. of the Americas v. Minister of National Revenue*, 1959 CTC 496 (Ex. Ct); *Frankel Corp v. MNR* 1959 CTC 244 (SCC); *H.A. Roberts Ltd. v. MNR* 1996 CTC 369 (SCC).

In situations where the corporation has more than one business, consideration should be given to whether dividends should be paid annually, instead of periodically, once it has been determined that dividends are coming from the source business that has net income to distribute. Consideration should also be given to whether different share classes should be issued to the specified and source individuals to be able to stream dividends based on separate businesses.

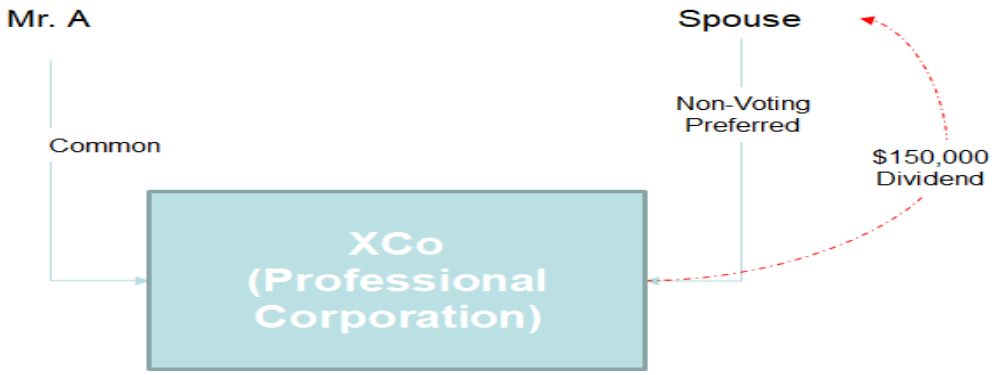
In the scenario that the CRA commented on, it would be prudent to restructure the shareholdings of Mr. B and his spouse to allow for different dividend entitlement by undertaking a share exchange so that Mr. B holds Class A common shares and his Spouse B owns Class B common shares. This will allow streaming of the dividends from the property management business to Spouse B and dividends from the construction business to Mr. B. However, if the Opco is sold in the future, it may be difficult to identify the sale proceeds that are attributable to each line of business. Potentially, a reasonable allocation based on the profitability of each business can be used as a proxy, which could be challenged by CRA.

Alternatively, one of the businesses can be transferred to another corporation so that each business would be operated in separate corporations.

5) Involvement in the Business by a Shareholder

In Technical Interpretation 2019-0799911C6[63], the CRA was asked to confirm that dividends paid by a company to the spouse who is employed part-time in the business would be split income. The facts presented are as follows:

1. Mr. A carries on a professional practice through a professional corporation, XCo, and owned all the voting common shares of XCo.
2. Mr. A's spouse owns non-voting preferred shares of XCo and works as a part-time receptionist for XCo. A's spouse works at least 20 hours per week.
3. A similar part-time receptionist working similar hours would be paid a salary of $18,000 a year.
4. Both A and A's spouse are residents of Canada.
5. A's spouse receives dividend income of $150,000 from XCo.



The CRA confirmed that A's spouse meets the bright line deeming rule as she works for XCo on average at least 20 hours a week throughout the portion of the year the business operates and the dividend income will not be subject to TOSI. CRA based its position on the fact XCo is a related business in respect of the A's spouse as A is actively engaged on a regular basis in the activities of XCo.

The CRA stated in their comments that, in the absence of the bright line deeming rule, consideration should be given to involvement of A's spouse in the business by examining time, energy and work put into the business. The greater the involvement by A's spouse in the management and/or current activities of the

[63] Canada Revenue Agency, Technical Interpretation 2019-0799911C6, "STEP 2019 Q4 – TOSI and Meaning of Excluded Business" (June 7, 2019).

business, the more likely that the A's spouse will be considered to be engaged on a regular, continuous and substantial basis in the business.

Since the bright line test is meant to be objective, it is important to maintain documents that show family members involvement in the business. Provided that the family members meet at least an average of 20 hours a week requirement, the amount of dividends that can be made to the shareholder family does not have to be reasonable or equivalent to the amount contributed to the business.

This CRA view provides an opportunity for professional services corporations to potentially split income with their spouses and their children by getting them involved in the business and getting them to work at least 20 hours a week and pay them reasonable salary for the work. For example, they could work as a receptionist or conducting bookkeeping for the business. Once this has been established, the active or source individual will be able to income split with the family members and rely on the excluded business exception.

D. Inheritance Continuity Exception

The excluded amount exception is extended to individuals 18 years of age and over and between spouses in two deeming rules in subparagraph 120.4(1.1)(b) and (c)(ii) - the inheritance exception and the deceased spouse exception.

The inheritance exception deems an individual to have met the excluded business exception where the individual has inherited property from the deceased and the deceased was actively engaged on a regular, continuous and substantial basis in the activities of the business throughout any five prior taxation years. Similarly, if a spouse inherits property from a deceased spouse or common law partner and if the split income received by the deceased in his/her last taxation year is an excluded amount then the income received by the spouse from the inherited property will also be entitled to the excluded amount exception.

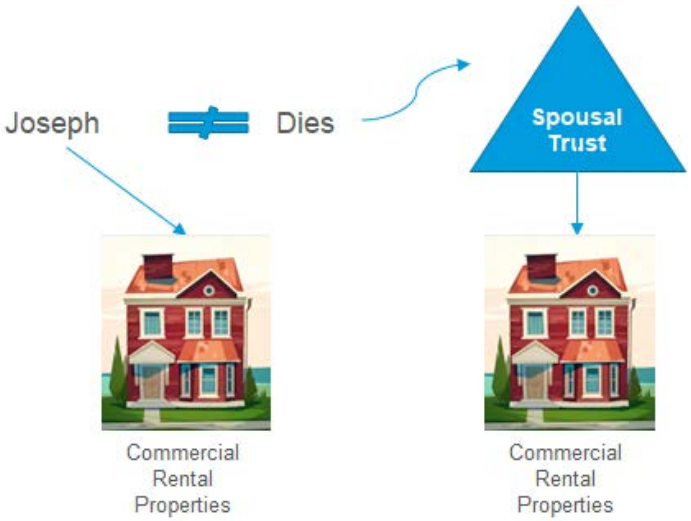
1) Assets Left to Testamentary Spousal Trusts

In Technical Interpretation 2018-0765811C6[64] the CRA was asked to comment on the inheritance continuity exception where real estate was left by the deceased to a spousal trust for the benefit of a spouse.

Joseph, the deceased, left commercial properties in a spousal trust with the instruction that the net income from those properties was to be paid to his spouse, Jocelyne. The CRA was asked to comment on whether the income from the spousal trust will be split income in three separate scenarios being:

1. Julien, the son of Joseph and Jocelyne, is the trustee of the spousal trust and will manage the trust's rental activities.
2. Julien is not a trustee, is self-employed and will manage the trust's rental activities.
3. Julien is not a trustee and is an employee of the trust.

[64] Supra note 23.



In their analysis, the CRA determined the income could be split income if it was either income from a related business in respect of Jocelyne or income from the business of renting property where an individual related to Jocelyne was actively engaged on a regular basis. Notwithstanding these rules, the amount could be an excluded amount if the amount would have been an excluded amount in respect of Joseph in his last taxation year before death by virtue of the continuity deeming rule in subparagraph 120.4(1.1)(c)(ii).

The distribution would have been excluded amount in in respect of Joseph since the income was not derived, directly or indirectly, from a related business in respect of Joseph by virtue of subparagraph (e)(i) of the excluded amount definition. Since Joseph owned the commercial rental properties directly, and even the assumption that Joseph derived income from a business that business could not be classified as a related business in respect of himself.

Where the deceased leaves assets to either his/her spouse or testamentary spousal trusts, the inheritance continuity rule will allow the spouse to escape the TOSI rules.

2) Interaction between Inheritance Continuity Exception and Excluded Shares Exception

The CRA was asked to comment on how the deeming provisions in subparagraph 120.4(1.1)(c)(ii) interact with the excluded shares exception where the surviving spouse owns shares directly in a corporation but the deceased spouse shares are held through a trust or a holding corporation. In Technical Interpretation 2019-0799961C6[65], the CRA was asked the following questions:

1) Would the exception in subparagraph 120.4(1.1)(c)(ii) apply where the deceased spouse qualified under the excluded shares exception based on direct ownership of shares, and the surviving spouse holds the shares through a holding company or trust?

2) Does the surviving spouse's indirect ownership arrangement need to be imputed to the deceased in determining whether he or she would have qualified for an exemption from the TOSI rules?

3) How would the exception in subparagraph 120.4(1.1)(c)(ii) apply where the spouse qualifies for the excluded shares exemption, but the specified individual does not directly own shares in the corporation?

The CRA illustrated the application of the deeming rule in subparagraph 120.4(1.1)(c)(ii) with a hypothetical example based on the facts below:

1. A is the deceased spouse who owned shares of Canco, a private corporation.
2. The shares of Canco were excluded shares of A throughout A's last taxation year before death.

[65] Canada Revenue Agency, Technical Interpretation 2019-0799961C6, "2019 STEP – Q5 TOSI and Spouse age 65+", (June 7, 2019).

3. A's Spouse is a beneficiary of a Canadian resident trust that owns a class of shares of Canco.
4. A and A' spouse are residents of Canada.
5. Canco carries on a business that was a related business of A and is a related business of A's Spouse.
6. Common shares of Canco owned by the trust were acquired during A's lifetime and were not acquired for the benefit of A's spouse as a consequence of A's death.
7. Canco will pay dividends to the trust which, in turn, will distribute the dividend to A's spouse
8. The dividends paid to A's spouse will be split income and will not meet the excluded shares exception as the spouse does not directly own the shares of Canco[66] and therefore, does not meet the ownership required.
9. Also, the CRA assumed that none of the other exceptions under the excluded amount applied to the dividends.

Accordingly, the dividend income received by the spouse will be split income unless the deeming rule under subparagraph 120.4(1.1)(c)(ii) applies. This means if dividend income had been included in computing A's income for the last taxation year before his death, the dividend income would have been an excluded amount. In the last taxation year, Mr. A would have qualified for the excluded shares exception, determined as follows:

1. A owned Canco shares throughout A's last taxation year before death.
2. Canco shares held by A met the excluded share requirement (i.e., less than 90% of the business income of Canco was from the provision of services, Canco is not a professional corporation, and A has 10% of votes and value in Canco and Canco's business income is not derived, directly or indirectly from a related business). CRA will consider the dividend income that was notionally included in computing A's income for purposes of subparagraph 120.4(1.1)(c)(ii) to be income from excluded shares.

Based on the foregoing, the CRA concluded that the dividend income would have been an excluded amount in respect of A if the amount had been included in computing A's income in A's last taxation year as income derived from excluded shares. Accordingly, the dividend income paid to the specified individual from the trust should be deemed to be excluded amount pursuant to subparagraph 120.4(1.1)(c)(ii).

This interpretation clarifies that if the deceased's shares qualified as excluded shares before his/her death, the shares inherited by the specified individual will continue to an excluded amount under subparagraph 120.4(1.1)(c)(ii) even though the inherited shares do not satisfy the criteria in paragraph (b) of the excluded shares definition in 120.4(1) owned by the specified individual. CRA commented that this example is to illustrate the general approach to applying subparagraph 120.4(1.1)(c)(ii) in the context of excluded shares in straightforward structures involving a basic and common share ownership. It is unclear whether the same approach could apply to more complex structures, including holding company structures. The CRA advised that the taxpayer seek confirmation of whether this general approach would apply to their particular fact situation. The CRA also stated that they would apply GAAR where artificial transactions are undertaken to achieve a similar but inappropriate result.

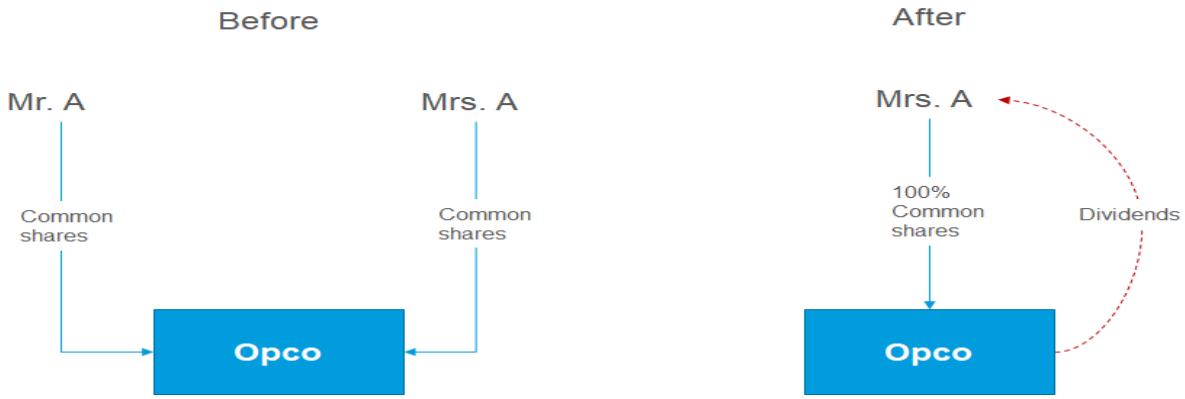
3) Multiple Deaths

At the 2019 STEP Roundtable, the CRA was asked to clarify how the rules in subsection 120.4(1.1) would apply where there have been multiple deaths as outlined in the example.

1. Mr. A and Mrs. A own all the shares of Opco
2. Opco operates a service business
3. Mrs. A is actively engaged in the business for at least five years
4. Mr. A has not been actively engaged in the business
5. Mrs. A dies and Mr. A inherits all her shares through her will

[66] Pursuant to subsections 104(13) and (19) the dividend income distributed to the specified beneficiary will retain its character in the specified individual's hands. Accordingly, pursuant to subparagraph (a)(i) of the split income definition, the dividend income will be split income unless the excluded amount exception applies.

6. After Mrs. A's death, distributions received by Mr. A from Opco would not be split income as Opco would be deemed to be an excluded business in respect of Mr. A, even though Mr. A is not actively engaged in the business pursuant to spousal death exception.

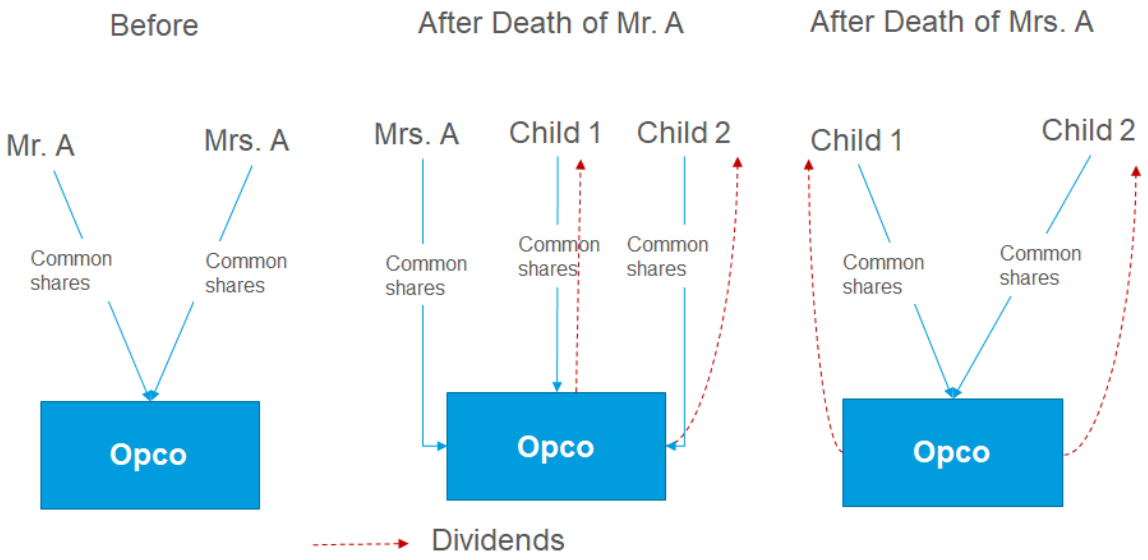


The CRA was asked to comment on how the deeming rules apply, if Mr. A subsequently dies and gifts Opco shares to his children. Specifically, will these deeming rules deem the same contributions as Mrs. A to have been made by the children or do the deeming rules apply only in reference to Mr. A's contribution. CRA confirmed that the continuity rule in the deeming provisions will apply to the dividend income the children receive from Opco and the dividend income would not be subject to TOSI. Specifically, the children inherit Opco's shares as consequences of Mr. A's death. The deeming provision will apply to deem each of the children to be actively engaged on a regular, continuous and substantial basis in Opco's business throughout those five prior taxation years since Mr. A was deemed by the same deeming provisions to have met this requirement.[67]

The CRA was asked to comment on the application of the deeming provision where the children received shares as consequence of the death of their parents. The following hypothetical example was provided by the CRA which builds upon the facts stated above:

1. Mr. A and Mrs. A have two children, who are not actively engaged in Opco's business
2. In Year 1, Mr. A dies and in his will he bequests half of his shares of Opco to each of his two children
3. In Year 2, Mrs. A dies and in her will she bequests half of her shares of Opco to each of her two children
4. As a result, each child would have received half of Opco shares from Mr. A and the other half from Mrs. A

[67] Subparagraph 120.4(1.1)(b)(ii) of the Act.



The CRA concluded that the children would not be entitled to the excluded business exception for the shares inherited from Mr. A as Mr. A was not actively engaged on a regular, continuous and substantial basis in the Opco business throughout the five previous taxation years before his death and therefore was not entitled to the excluded business exception. Consequently, any dividends received by the children on the shares inherited from Mr. A initially, will be subject to TOSI.

Beginning with the taxation year in which the children inherit the shares from Mrs. A as a consequence of her death, the deeming provision will apply to deem each child to have been actively engaged on a regular, continuous and substantial basis in Opco's business throughout the five prior taxation years. Accordingly, any dividends received by the children from Opco, once they inherited the shares from their mother, would not be subject to TOSI as the excluded business exception would apply.

The TOSI rule restricts the ability of a family to income split during the life of the actively engaged shareholder, however, the above deeming provisions present an opportunity to income split after death.

E. Pension Splitting Exception

The pension splitting exception will allow a spouse who is 65 years of age to split income with his or her spouse or common law partner if the split income would be an excluded amount of the spouse who is 65 years old. These deeming provisions provide an opportunity to split income with spouses if certain conditions are met.

The CRA provided the following example on how the pension splitting exception would apply[68].

1. Spouse A and Spouse B own respectively 95% and 5% of all the shares of Investco.
2. Spouse A is over the age of 65 and Spouse B is age 60.
3. Investco carried on an active business for over 25 years.
4. Investco wound down the active business many years ago and now owns a marketable securities portfolio that require sporadic management decisions and investment activity.
5. During the period Investco was carrying on an active business, Spouse A was involved full-time in different aspects of the management and operation of the business.
6. Spouse B was never involved in the Investco business.
7. Spouse A is now retired.
8. Investco pays substantially all of its net investment income each year as dividends to Spouse A and Spouse B to augment their retirement income.

[68] Example 12 of CRA Guidance on the application of the split income rules for adults. https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/federal-government-budgets/income-sprinkling/guidance-split-income-rules-adults.html

Dividends received by Spouse A would not be subject to TOSI as the shares held by Spouse A would qualify under the excluded shares exception. Dividends received by Spouse B would not be subject to TOSI on the basis that, had Spouse A received these dividends, it would be an excluded amount in Spouse A's hands and Spouse A is over the age of 65.

Baby boomers who own shares of a corporation and approach the age of 65 have the opportunity to income split with their spouses provided that the spouse is a shareholder of the corporation. Consideration should be given to whether the shareholdings in the corporation should be restructured to include the spouse as a shareholder on the case that the spouse is not a shareholder already of the corporation to take advantage of the pension splitting exception.

F. Preferred Beneficiary Election

In Technical interpretation 2018-0759521E5[69], the CRA was asked to comment on the application of TOSI where a preferred beneficiary election includes taxable dividends pursuant to subsection 104(19) designation. Subsection 104(19) preserves the characteristics of taxable dividends when allocated to an individual by the trust so that the individual is able to access the gross-up and dividend tax credit. This preservation is for all purposes of the Act, except for Part XIII, and there is no specific exclusion from TOSI for designations under subsection 104(19).

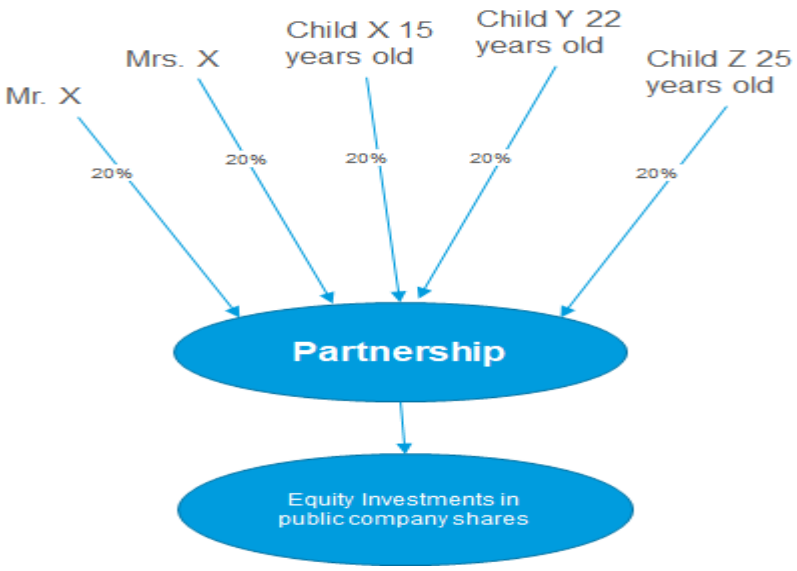
Consequently, under subparagraph 120.4(1)(a)(i) of the split income definition, split income includes taxable dividends received by an individual in respect of the capital stock of a corporation and therefore, would include dividends paid to preferred beneficiaries pursuant to subsection 104(19).[70]

G. Passive Income Earned In a Partnership

Before discussing the CRA views on the treatment of partnership income and TOSI, it would be useful to discuss basic taxation principles of a partnership for context. Partnerships are treated as flow through entities for Canadian income tax purposes whereby all income is calculated at the partnership level as if the partnership was a separate person and allocated to, and taxed in the hands of its partners. Various sources of income and losses earned through the partnership pass to the partners and retain their character.

In the Technical Interpretation 2018-0768831C6,[71] the CRA considered a fact scenario involving a partnership where five individuals who are members of the same family – parents and their three children (X, Y and Z), hold a partnership. The partnership generates and distributes investment income from a portfolio of marketable securities to the parents and their children. Children have not contributed to or been involved in the partnership. The parents dealt with the investment broker that manages the investments in the partnership.

[69] Canada Revenue Agency, Technical Interpretation 2018-0759521E5, "2019 STEP – Q5 TOSI and Spouse age 65+", (June 7, 2019).
[70] CRA's views was also confirmed in the Canada Revenue Agency's, Technical Interpretation 2019-0798501C6 "Question 13 of the 2019 STEP Roundtable", (June 7, 2019).
[71] Canada Revenue Agency, Technical Interpretation 2018-0768831C6, "Tax on Split Income and Partnership, (October 5, 2018).



In their analysis, the CRA referred to paragraph 96(1)(f) that income from a partnership to the partners maintains its nature and characteristics. Further, where a partnership earns income from public company shares (such as dividends and capital gains), such income is exempted from TOSI rules by the virtue of paragraphs 120.4(1)(a) and (e) of the split income definition. Consequently, the TOSI rules do not apply to the partner for such income. The CRA provided a cautionary note that subsections 103(1) or 103(1.1) may be applicable in the given situation if it is determined that allocation of the partnership's income among its members is not reasonable in the circumstances. In addition, certain of the attribution rules (such as those in section 74.1) as well as subsection 96(1.8) could apply if the relevant conditions for application of these legislative provisions were met.

It appears that CRA's analysis is incomplete, as they did not consider paragraph (b) of the split income definition. The paragraph (b) of the definition provides that where the income is earned as part of a "related business", the income allocated by the partnership could be split income. Therefore, where a partnership's income is generated from dividends and capital gains from public company shares, the partners should consider: 1) whether its investment activities constitute a "business"; and if applicable, 2) does the business of the partnership qualify as a "related business" as defined under 120.4(1). The common law principles should be applied in determining whether the partnership is carrying on a business (see characterization of income section above for our commentary in this regard). The technical interpretation is generous and presents a tax planning opportunity for unlimited income splitting with inactive family members where dividend income and capital gains are derived from public company shares through a partnership. Nonetheless, it would be prudent to monitor the partnership's investment activities to ensure their activities do not constitute a business in case the CRA rescinds their technical interpretation. Without a business, there cannot be a "related business" hence the application of split income definition is avoided.

H. Passive Income Earned in a Trust

Income from Public Company Shares

In the Technical Interpretation 2018-0765801C6[72], the CRA concluded that where a trust earns income from public company shares (such as dividends and capital gains), such income would not be split income under clause subparagraph (a)(i) and clause (c)(ii)(A) of split income definition.

It appears that CRA's analysis is incomplete, as they did not consider clause (c)(ii)(C) of the split income definition. The clause (c)(ii)(C) of the definition provides that where the income is earned as part of a "related business", the income allocated by the trust could be split income. Therefore, where a trust's

[72] Canada Revenue Agency, Technical Interpretation 2018-0765801C6, "Tax on Split Income" (October 5, 2018)

income is generated from dividends and capital gains from public company shares, the trust should consider: 1) whether its investment activities constitute a "business"; and if applicable, 2) does the business of the trust qualify as a "related business" as defined under 120.4(1). The common law principles should be applied in determining whether the trust is carrying on a business (see characterization of income section above for our commentary in this regard). The technical interpretation is generous and presents a tax planning opportunity for unlimited income splitting with inactive family members where dividend income and capital gains are derived from public company shares through a trust. Nonetheless, it would be prudent to monitor trust investment activities to ensure their activities do not constitute a business in case the CRA rescinds their technical interpretation. Without a business, there cannot be a "related business" hence the application of split income definition is avoided.

Rental income

In the Technical Interpretations 2018-0765811C6[73], the CRA commented on whether rental income allocated to a trust beneficiary (specified individual) would be split income. In their analysis, the CRA referred to clause (c)(ii)(C) of the split income definition in subsection 120.4(1). Since the rental income was derived from the investment properties directly owned by the trust, and not from any other related business in respect of the beneficiary, the CRA considered it necessary to determine whether the trust carries on a related business in respect of the beneficiary. To make this determination, a two-part test is required under clause (c)(ii)(C) of the split income definition: 1) is the trust carrying on a business; and 2) does the business of the trust qualify as a "related business" as defined under 120.4(1). The common law principles should be applied in determining whether the trust is carrying on a business (see characterization of income section above for our commentary in this regard). If the trust is found to be carrying on a business, which qualifies as a related business, TOSI would apply (unless exceptions under excluded amount apply).

Even if the trust does not carry on a business, the rental income of a trust can still be considered split income by virtue of clause (c)(ii)(D) of split income definition. The clause provides where a related person in respect of the trust's beneficiary is actively engaged on a regular basis in earning the rental income for the trust, the distributions to the beneficiary would be split income and subject to TOSI (unless an exception under excluded amount applies). If clause (c)(ii)(C) of split income does not apply (i.e. there is no related business as discussed above), and the individual beneficiary is 18 years or older, subparagraph (e)(i) of excluded amount definition will exempt the beneficiary from TOSI. Therefore, the clause (c)(ii)(D) of split income definition is invariably designed to capture all minor individual beneficiaries (less than 18 years of age) earning rental income from a trust as they would not be qualify under subparagraph (e)(i) of excluded amount definition.

I. Reasonable Return

Individuals will not be subject to TOSI on income that is derived from a related business if the amount of income they receive is a reasonable return having considered all the relevant contributions of the individual to the related business. This exception applies to individuals who are 25 years of age and older.

What is considered a "reasonable return" and how does one determine this "reasonable return"? There is no guidance in the Act as to what constitutes "reasonable return". The CRA has provided a list of criteria that they will use to evaluate labour contribution, property contribution, risk incurred and historical payment in the application of the reasonable return exception to split income. These criteria are detailed in the CRA Guidance document released together with the TOSI rules on December 13, 2017.[74] Below is a summary of the criteria that CRA will considered in evaluating the reasonable return exception, together with relevant examples.

[73] Canada Revenue Agency, Technical Interpretation 2018-0765811C6, "Tax on Split Income" (October 5, 2018).
[74] https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/federal-government-budgets/income-sprinkling/guidance-split-income-rules-adults.html

1) Labour Contribution

The CRA will review the following labour contribution factors by the specified individual in respect of their labour contributions to the business:

1. The nature of the tasks performed;
2. Hours required to complete the tasks;
3. A competitive salary/wage for the tasks in relation to businesses of similar size and industry;
4. Education, training and experience;
5. Degree of activities and nature of activities in relation to those of a business of a comparable nature and size;
6. Time spent on the activity in comparison to time spent in other activities or undertakings;
7. Particular knowledge, skills or know-how that the individual possessed;
8. Business acumen; and
9. Past performance of functions.

Based on the factors above, it appears that the CRA is trying to determine the amount that should be paid to an employee in a similar business performing similar functions. This is analogous to the reasonable test required under section 67.

In the CRA Guidance Example 11, amounts paid to Spouse B from Spouse's A professional corporation ("**PC**") were considered reasonable. Spouse B works less than an average of 20 hours per week and assist with bookkeeping for Spouse A's PC. Spouse A and B, both over the age of 25 years, are shareholders of the PC and own separate class of shares. PC pays a dividend to Spouse B. The amount of the dividend approximates but is higher than the amount that was paid to the arm's length bookkeeper. The CRA stated that while the dividend amount is high, the amount is still comparable to the amount that was paid to an arm's length person.

2) Property Contribution

The CRA will review the following factors in considering if the specified individual has invested any capital in the business:

1. The amount of capital contributed to the business;
2. The amount of loans to the business;
3. The fair market value of property (both tangible and intangible property) transferred to the business, including technical knowledge, experience, skill, or know-how;
4. Whether the individual has provided property as collateral for loans or other undertakings;
5. Whether other sources of capital or loans are readily available;
6. Whether comparable property are readily available;
7. Whether property is unique or personal to the individual;
8. Opportunity costs; and
9. Past property contributions.

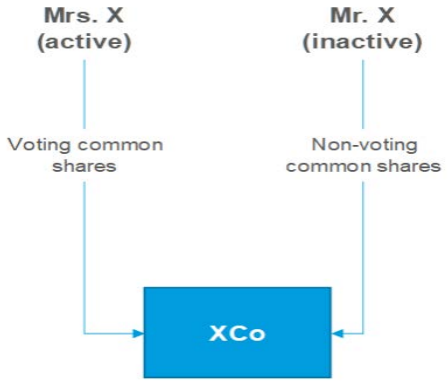
3) Risk Assumed

The CRA will consider the following factors in determining if the specified individual received reasonable compensation for risks assumed for the business:

1. Whether the individual is exposed to the financial liabilities of the business, whether through guarantees of mortgages, loans or lines of credit or otherwise;
2. Whether the individual is exposed to statutory liabilities related to the business;
3. Extent of the risk that contributions made by the individual to the business may be lost, whether in whole or part;

4. Whether any risk is indemnified or otherwise limited in the circumstances, whether by agreement or otherwise;
5. Whether the individual's reputation or personal goodwill is at risk; and
6. Past or ongoing risk assumption.

In Technical Interpretation 2018-0771851E5,[75] the CRA confirmed that a risk assumed by the individual taxpayer by mortgaging their family home to start a business would be a factor in determining whether a return is reasonable under TOSI rules, even after the loan has been repaid so that the risk no longer exists.



In the scenario provided, Mr. X and Mrs. X, who are both over 25 years of age, loaned funds obtained by mortgaging their family home to start a business. Mr. X subsequently received a dividend from the business, in a taxation year after the loan was repaid by the business. The CRA confirmed that, it would take into account all relevant factors at the time, based on the relative contributions of Mr. X and Mrs. X to the business, including the initial risk assumed by Mr. X in providing the start-up capital to the business in determining whether the dividend received by Mr. X would be a reasonable return under the TOSI rules. The CRA, further, confirmed that the undistributed retained earnings of the business would not be a relevant factor in making reasonable return determination, since the retained earnings would not represent capital contributed by Mr. X or Mrs. X to the business.

In CRA Guidance Example 2, a child formed a company to run a business in the hospitality industry. Due to the high risk involved, the financing to operate the business came from the child's mother, friends and the child's own resources. Both family and friends enjoyed a higher than usual interest rate of return. The child was the sole shareholder of the company and the mother had no involvement in the business. The CRA took the position that the interest received by the mother would be TOSI unless it was an excluded amount which it was because it is a reasonable return based on the property contributed and the risk assumed by the mother by lending money to her child's company.

4) Historical payments

The last criteria, the CRA will review the historical payments paid to the specified individual:

1. Payment of any kind previously paid to the individual, including:
    - salary or other remuneration or compensation;
    - dividends;
    - interest;
    - proceeds; and
    - fees.

2. Benefits and deemed payments (as may be reasonably required in the circumstances)

[75] Canada Revenue Agency, Technical Interpretation 2018-0771851E5 "TOSI: Meaning of Reasonable Return (November 2, 2018)"

The factors above are designed to identify a pattern of compensation paid to the specified individual overtime. This information may be useful in determining whether an amount paid in a year exceeds the historical average without a reasonable explanation.

Overall, the reasonable return criteria outlined by the CRA is intended to ensure that specified individuals receive compensation that would be paid to an arm's length party in similar circumstances. The CRA has stated in their guidance that it does not intend to generally substitute its judgment of what would be considered a reasonable amount where the taxpayers have made a good faith attempt to do so based on the reasonableness factors. This is easier said than done, as in practice, the CRA may have difficulties administering this subjective exercise during an audit.

V. CONCLUSION

There is still a great deal of ambiguity and uncertainty in the application of the exceptions to the TOSI rules. Both the business community and their advisors encourage the CRA and the Department of Finance to continue with providing guidance to ensure a fair and equitable application of the split income rules as implemented on January 1, 2018.

Section 120.4 - Tax on split income [TOSI]

(1) Definitions The definitions in this subsection apply in this section.

"arm's length capital", of a specified individual, means property of the individual if the property, or property for which it is a substitute, was not

(a) acquired as income from, or a taxable capital gain or profit from the disposition of, another property that was derived directly or indirectly from a related business in respect of the specified individual;

(b) borrowed by the specified individual under a loan or other indebtedness; or

(c) transferred, directly or indirectly by any means whatever, to the specified individual from a person who was related to the specified individual (other than as a consequence of the death of a person).

"excluded amount", in respect of an individual for a taxation year, means an amount that is the individual's income for the year from, or the individual's taxable capital gain or profit for the year from the disposition of, a property to the extent that the amount

(a) if the individual has not attained the age of 24 years before the year, is from a property that was acquired by, or for the benefit of, the individual as a consequence of the death of a person who is

(i) a parent of the individual, or

(ii) any person, if the individual is

(A) enrolled as a full-time student during the year at a "post-secondary educational institution" (as defined in subsection 146.1(1)), or

(B) an individual in respect of whom an amount may be deducted under section 118.3 in computing a taxpayer's tax payable under this Part for the year;

(b) is from a property acquired by the individual under a transfer described in subsection 160(4);

(c) is a taxable capital gain that arises because of subsection 70(5);

(d) is a taxable capital gain for the year from the disposition by the individual of property that is, at the time of the disposition, "qualified farm or fishing property" or "qualified small business corporation shares" (as those terms are defined in subsection 110.6(1)), unless the amount would be deemed to be a dividend under subsection 120.4(4) or (5) if this definition were read without reference to this paragraph;

(e) if the individual has attained the age of 17 years before the year, is

(i) not derived directly or indirectly from a related business in respect of the individual for the year, or

(ii) derived directly or indirectly from an excluded business of the individual for the year;

(f) if the individual has attained the age of 17 years but not the age of 24 years before the year, is

(i) a safe harbour capital return of the individual, or

(ii) a reasonable return in respect of the individual, having regard only to the contributions of arm's length capital by the individual; or

(g) if the individual has attained the age of 24 years before the year, is

(i) income from, or a taxable capital gain from the disposition of, excluded shares of the individual, or

(ii) a reasonable return in respect of the individual.

"excluded business", of a specified individual for a taxation year, means a business if the specified individual is actively engaged on a regular, continuous and substantial basis in the activities of the business in either

(a) the taxation year, except in respect of an amount described in paragraph (e) of the definition "split income"; or

(b) any five prior taxation years of the specified individual.

"excluded shares", of a specified individual at any time, means shares of the capital stock of a corporation owned by the specified individual if

(a) the following conditions are met:

(i) 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 (or, if no such taxation year exists, for the taxation year of the corporation that includes that time) was from the provision of services, and

(ii) the corporation is not a professional corporation;

(b) immediately before that time, the specified individual owns shares of the capital stock of the corporation that

(i) give the holders thereof 10% or more of the votes that could be cast at an annual meeting of the shareholders of the corporation, and

(ii) have a fair market value of 10% or more of the fair market value of all of the issued and outstanding shares of the capital stock of the corporation; and

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

“reasonable return”, in respect of a specified individual for a taxation year, means a particular amount derived directly or indirectly from a related business in respect of the specified individual that

(a) would, if this subsection were read without reference to subparagraph (f)(ii) or (g)(ii) of the definition “excluded amount”, be an amount described in the definition “split income” in respect of the specified individual for the year; and

(b) is reasonable having regard to the following factors relating to the relative contributions of the specified individual, and each source individual in respect of the specified individual, in respect of the related business:

(i) the work they performed in support of the related business,

(ii) the property they contributed, directly or indirectly, in support of the related business,

(iii) the risks they assumed in respect of the related business,

(iv) the total of all amounts that were paid or that became payable, directly or indirectly, by any person or partnership to, or for the benefit of, them in respect of the related business, and

(v) such other factors as may be relevant.

“related business”, in respect of a specified individual for a taxation year, means

(a) a business carried on by

(i) a source individual in respect of the specified individual at any time in the year, or

(ii) a partnership, corporation or trust if a source individual in respect of the specified individual at any time in the year is actively engaged on a regular basis in the activities of the partnership, corporation or trust related to earning income from the business;

(b) a business of a particular partnership, if a source individual in respect of the specified individual at any time in the year has an interest—including directly or indirectly—in the particular partnership; and

(c) a business of a corporation, if the following conditions are met at any time in the year:

(i) a source individual in respect of the specified individual owns

(A) shares of the capital stock of the corporation, or

(B) property that derives, directly or indirectly, all or part of its fair market value from shares of the capital stock of the corporation, and

(ii) it is the case that $0.1A \leq B + C$

where

A is the total fair market value of all of the issued and outstanding shares of the capital stock of the corporation,

B is the total fair market value at that time of property described in clause (i)(A), and

C is the portion of the total fair market value of property described in clause (i)(B) that is derived from shares of the capital stock of the corporation.

"safe harbour capital return", of a specified individual for a taxation year, means an amount that does not exceed the amount determined by the formula

A × B

where

A is the rate equal to the highest rate of interest prescribed under paragraph 4301(c) of the *Income Tax Regulations*
in effect for a quarter in the year; and

B is the total of all amounts each of which is determined by the formula

C × D/E

where

C is the fair market value of property contributed by the specified individual in support of a related business at the time it was contributed,

D is the number of days in the year that the property (or property substituted for it) is used in support of the related business and has not directly or indirectly, in any manner whatever, been returned to the specified individual, and

E is the number of days in the year.

"source individual", in respect of a specified individual for a taxation year, means an individual (other than a trust) who, at any time in the year, is

(a) resident in Canada; and

(b) related to the specified individual.

"specified individual", for a taxation year, means an individual (other than a trust) who

(a) is resident in Canada

(i) in the case where the individual dies in the year, immediately before the death, and

(ii) in any other case, at the end of the year; and

(b) if the individual has not attained the age of 17 years before the year, has a parentresident in Canada at any time in the year.

"split income", of a specified individual for a taxation year, means the total of all amounts (other than excluded amounts) each of which is

(a) an amount required to be included in computing the individual's income for the year

(i) in respect of taxable dividends received by the individual in respect of shares of the capital stock of a corporation (other than shares of a class listed on a designated stock exchange or shares of the capital stock of a mutual fund corporation), or

(ii) because of the application of section 15 in respect of the ownership by any person of shares of the capital stock of a corporation (other than shares of a class listed on a designated stock exchange),

(b) a portion of an amount included because of the application of paragraph 96(1)(f) in computing the individual's income for the year, to the extent that the portion

(i) is not included in an amount described in paragraph (a), and

(ii) can reasonably be considered to be income derived directly or indirectly from

(A) one or more related businesses in respect of the individual for the year, or

(B) the rental of property by a particular partnership or trust, if a person who is related to the individual at any time in the year

(I) is actively engaged on a regular basis in the activities of the particular partnership or trust related to the rental of property, or

(II) in the case of a particular partnership, has an interest in the particular partnership directly or indirectly through one or more other partnerships,

(c) a portion of an amount included because of the application of subsection 104(13) or 105(2) in respect of a trust (other than a mutual fund trust or a trust that is deemed to be in existence by subsection 143(1)) in computing the individual's income for the year, to the extent that the portion

(i) is not included in an amount described in paragraph (a), and

(ii) can reasonably be considered

(A) to be in respect of taxable dividends received in respect of shares of the capital stock of a corporation (other than shares of a class listed on a designated stock exchange or shares of the capital stock of a mutual fund corporation),

(B) to arise because of the application of section 15 in respect of the ownership by any person of shares of the capital stock of a corporation (other than shares of a class listed on a designated stock exchange),

(C) to be income derived directly or indirectly from one or more

related businesses in respect of the individual for the year, or

(D) to be income derived from the rental of property by a particular partnership or trust, if a person who is related to the individual at any time in the year is actively engaged on a regular basis in the activities of the particular partnership or trust related to the rental of property,

(d) an amount included in computing the individual's income for the year to the extent that the amount is in respect of a debt obligation that

(i) is of a corporation (other than a mutual fund corporation or a corporation shares of a class of the capital stock of which are listed on a designated stock exchange), partnership or trust (other than a mutual fund trust), and

(ii) is not

(A) described in paragraph (a) of the definition “fully exempt interest” in subsection 212(3),

(B) listed or traded on a public market, or

(C) a deposit, standing to the credit of the individual,

(I) within the meaning assigned by the *Canada Deposit Insurance Corporation Act*, or

(II) with a credit union or a branch in Canada of a bank, and

(e) an amount in respect of a property, to the extent that

(i) the amount

(A) is a taxable capital gain, or a profit, of the individual for the year from the disposition after 2017 of the property, or

(B) is included under subsection 104(13) or 105(2) in computing the individual's income for the year and can reasonably be considered to be attributable to a taxable capital gain, or a profit, of any person or partnership for the year from the disposition after 2017 of the property, and

(ii) the property is

(A) a share of the capital stock of a corporation (other than a share of a class listed on a designated stock exchange or a share of the capital stock of a mutual fund corporation), or

(B) a property in respect of which the following conditions are met:

(I) the property is

1 an interest in a partnership,

2 an interest as a beneficiary under a trust (other than a mutual fund or a trust that is deemed to be in existence by subsection 143(1)), or

3 a debt obligation (other than a debt obligation described in any of clauses (d)(ii)(A) to (C)), and

(II) either

1 in respect of the property an amount is included in the individual's split income for the year or an earlier taxation year, or

2 all or any part of the fair market value of the property, immediately before the disposition referred to in clause (i)(A) or (B), as the case may be, is derived, directly or indirectly, from a share described in clause (A).

(1.1) Additional rules—specified individual For the purpose of applying this section in respect of a specified individual in respect of a taxation year,

(a) an individual is deemed to be actively engaged on a regular, continuous and substantial basis in the activities of a business in a taxation year of the individual if the individual works in the business at least an average of 20 hours per week during the portion of the year in which the business operates;

(b) if an amount would—if this section were read without reference to this paragraph—be split income of a specified individual who has attained the age of 17 years before the year in respect of a property, and that property was acquired by, or for the benefit of, the specified individual as a consequence of the death of another person, then

(i) for the purpose of applying paragraph (b) of the definition “reasonable return” in subsection (1), to the extent that the particular amount referred to in that paragraph is in respect of the property, then the factors referred to in that paragraph in respect of the other person are to be included for the purpose of determining a reasonable return in respect of the individual,

(ii) for the purposes of this subparagraph and the definition “excluded business” in subsection (1), if the other person was actively engaged on a regular, substantial

and continuous basis in the activities of a business throughout five previous taxation years, then the individual is deemed to have been actively engaged on a regular, substantial and continuous basis in the business throughout those five years, and

(iii) for the purpose of applying paragraph (g) of the definition "excluded amount" in subsection (1) in respect of that property, the individual is deemed to have attained the age of 24 years before the year if the other person had attained the age of 24 years before the year;

(c) an amount that is a specified individual's income for a taxation year from, or the specified individual's taxable capital gain or profit for the year from the disposition of, a property is deemed to be an excluded amount in respect of the specified individual for the taxation year if

(i) the following conditions are met:

(A) the amount would be an excluded amount in respect of the specified individual's spouse or common-law partner for the year, if the amount were included in computing the spouse or common-law partner's income for the year, and

(B) the spouse or common[-]law partner has attained the age of 64 years before the year, or

(ii) the amount would have been an excluded amount in respect of an individual who was, immediately before their death, the specified individual's spouse or common-law partner, if the amount were included in computing the spouse or common-law partner's income for their last taxation year (determined as if this section applies in respect of that year);

(d) for greater certainty, an amount derived directly or indirectly from a business includes

(i) an amount that

(A) is derived from the provision of property or services to, or in support of, the business, or

(B) arises in connection with the ownership or disposition of an interest in the person or partnership carrying on the business, and

(ii) an amount derived from an amount described in this paragraph; and

(e) for the purposes of this section, an individual is deemed not to be related to their spouse or common-law partner at any time in a year if, at the end of the year, the individual is living separate and apart from their spouse or common-law partner because of a breakdown of

their marriage or common-law partnership.

(2) Tax on split income There shall be added to a specified individual's tax payable under this Part for a taxation year the highest individual percentage for the year multiplied by the individual's split income for the year.

(3) Tax payable by a specified individual Notwithstanding any other provision of this Act, if an individual is a specified individual for a taxation year, the individual's tax payable under this Part for the year shall not be less than the amount by which the amount added under subsection (2) to the individual's tax payable under this Part for the year exceeds the amount determined by the formula

A + B

where

A is the amount deducted under section 118.3 in computing the individual's tax payable under this

Part for the year; and B is the total of all amounts each of which is the amount that

(a) may be deducted under section 121 or 126 in computing the individual's tax payable under this Part for the year, and

(b) can reasonably be considered to be in respect of an amount included in computing the individual's split income for the year.

(4) Taxable capital gain If a specified individual who has not attained the age of 17 years before a taxation year would have for the taxation year, if this Act were read without reference to this section, a taxable capital gain (other than an excluded amount) from a disposition of shares (other than shares of a class listed on a designated stock exchange or shares of a mutual fund corporation) that are transferred, either directly or indirectly, in any manner whatever, to a person with whom the specified individual does not deal at arm's length, then the amount of that taxable capital gain is deemed not to be a taxable capital gain and twice the amount is deemed to be received by the specified individual in the year as a taxable dividend that is not an eligible dividend.

(5) Taxable capital gain of trust If a specified individual who has not attained the age of 17 years before a the taxation year would be, if this Act were read without reference to this section, required under subsection 104(13) or 105(2) to include an amount in computing the specified individual's income for the taxation year, then to the extent that the amount can reasonably be considered to be attributable to a taxable capital gain (other than an excluded amount) of a trust from a disposition of shares (other than shares of a class listed on a designated stock exchange or shares of a mutual fund corporation) that are transferred, either directly or indirectly, in any manner whatever, to a person with whom the specified individual does not deal at arm's length, subsections 104(13) and 105(2) do not apply in respect of the amount and twice the amount is deemed to be received by the specified individual in the year as a taxable dividend that is not an eligible dividend.

Appendix II - Best Practices for Accountants - Documentary Evidence

The following are the best practices in respect of creating and maintaining the documentary evidence when relying on selected TOSI exceptions:

1. Excluded shares
    - Provision of services - Where a business earns income from selling both goods and services, the client should review its current accounting/bookkeeping systems and modify, as needed, to ensure revenues are tracked separately for goods and services provided. In addition, the client should review their current invoicing practices and ensure that goods and services are billed out as separate line items, where possible.
    - Votes and values test - a working paper with a detailed share capital table should be created. The share capital table should list all the shareholders, the number of shares owned by each shareholder and a summary of share attributes for each class of share authorized by the corporate governance documents (articles of incorporation, amalgamation, amendments, shareholder agreements) should be included.
    - Source of income - A corporate ownership structure should be created depicting/illustrating ownership of all related businesses in respect of the specified individuals. The income of the corporation should be tracked separately from any income derived from another related businesses (such as in a holdco/opco structure) in the year.

2. Excluded business
    - Prepare a working paper that corroborates the average 20 hours/week test for the year. Supporting documentation may include payroll records, current year timesheets and tax returns. The working paper should be updated on an annual basis. Please refer to the suggestions under the labour contribution below for details of relevant documentation that may be used in supporting the working paper.
    - Where the bright line average 20 hours/week test is not met, a memo to file should be prepared to support the factual actively engaged on a regular, continuous basis and substantive basis test. The memo may include factual comments about the business performance for the year and any impact on the business due to unusual internal/external factors, extenuating facts and circumstances that affected specified individual's participation in the business (sick or maternity leave). Other reasons may include the unique nature of the business activities itself where very little effort is required for ongoing sales (such as online business).

3. Reasonable return
    a) Labour contribution[76]
        - Maintain timesheets, schedules, or logbooks. These may be retained by either an individual or a business to establish the number of hours the individual worked in a given year;
        - Maintain payroll records (T4 slips, paystubs) where the specified individual receives a salary or wages from the business. In addition, formal performance reviews should be undertaken and documented on an annual basis at a minimum.
        - Where family office businesses are concerned, the family involvement should be formally documented such that each specified individual has an official job title, job description, business cards, a profile on a company website and social media (i.e. Linkedin). Employment contract should be drawn up which include the details such as job title, salary/hourly wage amount, standard working hours per week, reporting supervisor, vacation and benefits available, etc.
        - Remuneration of the owner-manager to include salaries/hourly wages to create payroll documentary evidence, as mentioned above, for substantiation purposes.

[76] Canada Revenue Agency, Technical Interpretation 2018-0761601E5 "Multiple Businesses (May 25, 2018)"

Where the average 20 hour test is met (as determined at the year-end) for excluded business purposes, unlimited dividends may be paid in addition to the salary.[77]

- For pre-2018 labour contributions, the CRA will consider the following criteria to assess reasonableness that 20 hour per week threshold was met in the prior years:
  - The type of business and duties performed as they relate to the main activities of the business;
  - the individual's education, training and experience;
  - Any particular knowledge, skills or know-how that the individual possessed
- Going forward, the ongoing maintenance of such records in respect of any family members involved in the business will ensure that businesses are able to comply with the new rules and obtain the benefits of available exclusions, even as family members leave the business.

b) Property contribution
- Prepare a historical asset schedule for any asset contributed by any specified individual for the business. The FMV of property (tangible or intangible) transferred to the business, including technical knowledge, experience, skill, or know how. The schedule should be updated on a regular basis as part of the year-end compliance and/or bookkeeping engagement.
- Prepare a historical loan continuity schedule for any amounts advanced by any specified individuals to the business.
- Where a specified individual has transferred property to the business by forgoing an arm's length alternative investments and expected rate of return available at the time should be documented to demonstrate opportunity costs. Opportunity cost represents the benefits an individual, investor or business misses out on when choosing one alternative over another. The economic formula to calculate opportunity cost = return on best forgone option - return on chosen option. Assume that specified individual foregoes investing in the stock market (paying 12% return annually) by contributing the capital into the business. If the business decrease in value, the specified could end up losing money rather than enjoying the expected 12% return.

c) Risks assumed
- Keep on file any past or ongoing personal guarantees of mortgage, loans or lines of credit by any specified individuals
- Keep on file any past or ongoing agreement through which any specified individuals provided, any indemnification of risks for the business
- Document if and how any specified individual's personal goodwill is at risk for the business

Where accountants and tax professionals advise business owner-managers clients, controls should be put in the workflow to identify payments to specified individuals that may be subject to TOSI. For example, control sheets and checklists used to prepare tax compliance filings (such as T1 and T5 slip) may be used to flag payments that are generally caught under split income definition under the TOSI rules. In our experience, some practitioners are undertaking TOSI impact study engagements to identify TOSI risks, discussing internal reorganization options available to mitigate TOSI application, and formalizing internal documentation procedures required for the purposes of relying on TOSI exceptions where applicable.

[77] Canada Revenue Agency, Technical Interpretation 2019-0799911C6 – "2019 STEP Q4 (June 7, 2019)"

Appendix III – TOSI Index

TOSI Definitions	TOPICS	CRA RULINGS AND CRA GUIDANCE INFORMATION[78]	REFERENCE DATE	DESCRIPTION OF ISSUES ADDRESSED
All	TOSI for Adults - CRA Presentation to CPA Canada	2018-0773811C6	December 3, 2018	Introduction of new TOSI rules in a deck from the CRA
Specified individuals	Adult child	CRA guidance example: 1, 4, 4A, 5, 5A, 5B, 6, 7	13-Dec-17; 10-Jul-19	Amounts paid to adult children
	Adult relatives	CRA guidance example: 3 to 3C, 11, 12	13-Dec-17; 10-Jul-19	Amounts paid to Spouse
	Adult relatives	CRA guidance example: 2, 4B, 8, 10	13-Dec-17; 10-Jul-19	Amounts paid to other adult family members
Split income	Publicly traded shares	2018-0768831C6	October 5, 2018	Whether taxable dividends received by a partnership in respect of shares of a class listed on a designated stock exchange and taxable capital gains realized on disposition of those shares and attributed by the partnership to an individual are subject to TOSI
	Passive income earned by a testamentary trust	2018-0765801C6	October 5, 2018	Whether TOSI would apply to distributions from a spousal testamentary trust that are derived from trust income in respect of portfolio investments acquired by the trust upon an individual's death
	Preferred beneficiaries	2018-0759521E5	July 6, 2018	Is tax on split income applicable to income designated under 104(14) - preferred beneficiary election?
	Salary payments	CRA guidance example: 5B	13-Dec-17; 10-Jul-19	Whether an amount paid as salary to an individual under 25 years of age will be subject to TOSI

[78] https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/federal-government-budgets/income-sprinkling/guidance-split-income-rules-adults.html

Excluded amount	QSBC shares	CRA guidance example: 7	13-Dec-17; 10-Jul-19	Taxable capital gain on the sale of QSBC shares by a parent to an adult child
		2018-0778661C6	Oct 5, 2018	Taxable capital gain on the sale of QSBC shares flowed through a family trust to beneficiaries
	Safe harbour return of capital	2018-0778661C6	Oct 5, 2018	Whether TOSI would apply to dividends received from a holding corporation where specified individuals (including one who is 22 years of age) purchased shares of the holding corporation with funds received from a family trust after the sale of shares of a related business
Excluded business	Actively engaged in a business	CRA guidance example: 3A, 4B	13-Dec-17; 10-Jul-19	Spouse working in a family-owned business for an average of 20 hours per week during the year
		CRA guidance example: 4	13-Dec-17; 10-Jul-19	Dividends paid to adult children active in the family business
		CRA guidance example: 6	13-Dec-17; 10-Jul-19	Dividends paid to adult children active in the family business, involving an estate freeze
	Actively engaged in a business for less than 20 hours per week	CRA guidance example: 5	13-Dec-17; 10-Jul-19	Dividends paid to grandchild (age 19) working in a family business for 350 hours in a year
		CRA guidance example: 9	13-Dec-17; 10-Jul-19	Spouses working in a side business requiring less than 20 hours per week
	Actively engaged in prior years	2018-0783741E5	February 27, 2019	The five-year test under the excluded business exception to TOSI rules does not require the five years of qualifying activities to occur over consecutive taxation years or immediately prior to when the relevant income is received from a related business. The five years do not need to occur at a time when the specified individual is related to a particular source individual.

	Multiple businesses; Burden of proof required	2018-0761601E5	May 25, 2018	Application of excluded business where multiple businesses are carried on in one corporate entity; burden of proof required if formal records of the work are not available.
	Part-time employment	2018-0770911E5	September 26, 2018	Whether the excluded business exception to TOSI would apply to dividends received on shares held by a specified individual, where the individual was able to work in the business for only part of the year due to a maternity leave.
		CRA guidance example: 7	13-Dec-17; 10-Jul-19	Retiring parent sells Opco shares to adult child (aged 25) who worked in the business less than an average of 20 hours per week during the year. The CRA applies actively engaged test on a facts and circumstances basis.
		CRA guidance example: 5A	13-Dec-17; 10-Jul-19	Adult child works in the family business on a full-time basis during summer months (600 hours in a year) during the taxation year.
	Seasonal business	CRA guidance example: 4A	13-Dec-17; 10-Jul-19	Dividends paid to adult child active in the seasonal family business
	Dividends paid can exceed arm's length remuneration for the services rendered	2019-0799911C6 - 2019 STEP Q4	7-Jun-19	Spouse on achieving 20 hours threshold could receive large dividends as excluded amounts. Spouse received $150K/year dividend while providing services of a receptionist where arm's length salary would be $18K/year.
Excluded shares	Business income and income	2018-0780081C6	November 27, 2018	CRA confirms that for the purposes of meeting the condition in subparagraph (a)(i) in the of the definition "excluded shares" in subsection 120.4(1) of the ITA, it is a question of fact whether income of a corporation is derived from a business or property.

		2018-0744031C6	May 29, 2018	Where a business has no business income because it derives income from property, would the corporation's shares qualify as excluded shares
		2018-0765791C6	Oct 5, 2018	The CRA compare and provide assumptions in their response to Q7 of the 2018 STEP CRA Roundtable (2018-074403) and examples 10 and 12 of the CRA Guidance. The CRA also confirms that a corporation can carry on a business the purpose of which is to derive income from property.
		2018-0743961C6 - 2018 STEP Q5	May 29, 2018	The terms “business income” and “income” under subparagraph (a)(i) and paragraph (c) in the definition of "excluded shares" are references to gross income rather than net income.
	Capital gains included in gross income	2019-0802331E5	May 24, 2019	Taxable capital gains are to be included in determining the income of a corporation under paragraph (c) of the "excluded shares" definition. 2. Only the amount of a corporation's taxable capital gains for the year, without considering offsetting allowable capital losses, if any, is to be included.
	Deemed Dividend received by Estate and allocated to beneficiaries	2018-0777361E5	November 7, 2018	Involves a deemed dividend from an investment holding company. The preferred shares and common shares are owned by the estate and children of the deceased (also beneficiaries of the trust), respectively. CRA addresses 1. Whether the TOSI rules will apply to a deemed dividend received by individuals on the redemption of their common shares in an investment holding company. 2. Whether TOSI

				will apply to a deemed dividend received by an estate and allocated to the beneficiaries.
	Exception Not Available to Family Trust Beneficiaries	2018-0761601E5	May 25, 2018	Where a family trust owns shares, beneficiaries of the trust would not meet the excluded shares exception because the condition in paragraph (b) would not be met. This condition requires that an individual own shares of the corporation.
	Holding company qualifying as "excluded share"	2018-0743971C6 - 2018 STEP Q6	May 29, 2018	"Excluded shares" do not normally include shares of a holding corporation since 90% of the income would be derived from a related business in respect of the individual.
	Holding company	2018-0768801C6	October 5, 2018	Where Holdco owns passive investments that were acquired using dividends from Opco, and Holdco's income is derived from its own business, the Holdco shares could be considered excluded shares. CRA also confirmed that a corporation with no business cannot be excluded shares.
	Provision of services - Services vs. non-service business	2018-0761601E5	May 25, 2018	Application of excluded shares rule to a hair salon and pizzeria businesses; comments on provision of services
	Provision of services - Holding company	2018-0745871C6 - CALU 2018 Q6	May 8, 2018	The shares of a transportation company do not qualify as excluded shares because it only earns income from the provision of services. The definition of excluded shares should generally not include shares of a holding corporation since 90% of

				the income would be derived from a related business in respect of the individual.
	Provision of services	CRA - Tax on split income – Excluded shares	10-Jul-19	Examples of scenarios where the gross business income test and provision of services test applies
				Example 1 - general methodology of the calculation where a corporation provides management consulting services and sells computer hardware
				Example 2 - More than 90% of business income attributable to the provision of services in the first year of a new business.
				Example 3 - Result of 90% test varies from one year to another
				Example 4 - Incidental use or consumption of goods in the provision of services
				Example 5 - how to calculate income from provision of services where a business derives income from both service and non-services - cleaning business
				Example 6 - how to calculate income from provision of services where a business derives income from both service and non-services - construction business
		2018-0743961C6 - 2018 STEP Q5	May 29, 2018	General commentary on provision of services where a business derives income from both the provision of services and non-services

	Related business - windup of a related business	2018-0779981C6 - 2018 CTF Q9	November 27, 2018	Dividend derived directly from sales proceeds or retained earnings from former business that was wound up in the previous year, the dividend will not be considered to have been derived from a related business for the year because the business was not carried on during the year, and thus the dividend would be an excluded amount.
		2018-0778661C6	October 5, 2018	General commentary where Holdco, solely invested in marketable securities, paid a dividend, half of which flowed to family members through a family trust while the remainder was paid directly to them. The CRA provides treatment of the dividends under two scenarios 1) assuming Holdco is carrying on a business and 2) assuming Holdco is not carrying on a business. The CRA does not expand its analysis on what activities of the Holdco would constitute a business for TOSI purposes.
		2019-0792011E5	June 12, 2019	The CRA was asked to expand on comments made in two technical interpretations (2018-0771861E5 and 2018-0779981C6) dealing with the TOSI in situations involving funds received from an operating corporation (Opco) and held by its parent, a holding corporation (Investco). The CRA was asked in this technical interpretation that at what point in time after Investco sold the Opco shares would Investco's income from investments that were bought with the sale proceeds stop being "derived" from Opco's business (related

				business). The first year after the year in which no dividends are received from Opco, the shares of Investco are excluded shares.
	Share ownership	2018-0771811E5	August 21, 2018	The CRA confirms that multiple classes of shares held by a specified individual can be considered in aggregate for purposes of the voting and fair market value threshold tests in the definition of excluded shares.
		CRA guidance example: 8	13-Dec-17; 10-Jul-19	Dividends paid from an a corporation, Investco, which would down its investment business many years ago
Related Business	Related business includes interest in a trust	2018-0768811C6	October 5, 2018	The "property" referred to in clause (c)(i)(B) of the definition of "related business" in subsection 120.4(1), among other things, include shares of a corporation, interest in partnership and trusts (discretionary or non-discretionary).
	Second generation income	2018-0768821C6	October 5, 2018	If a holding company pays dividends with the after-tax income earned from its portfolio investments, the dividends would be an excluded amount since the amount is not derived from a related business, regardless of whether or not the company carries on a business separate from its investment portfolio.

	Second generation income	2018-0771861E5	November 2, 2018	CRA confirms that income or gains earned from the passive investment of dividends received by Investco from a related business of a specified individual will not be considered to be derived directly or indirectly from the related business for the purposes of the excluded amount exception under TOSI, provided Investco does not have its own business.
	Partner carries on business of partnership	2019-0813021E5	August 9, 2018	A corporate partner carries on the business of the partnership for TOSI (and other) purposes
	Carrying on a business	2018-0768801C6; Response to 9(c)	October 5, 2018	The question of whether or not a corporation is carrying on a business whose purpose is to earn income from interest and dividends is a question of fact that can only be resolved following an exhaustive analysis of all the present facts and circumstances in relation to a given situation A corporation can carry on a business the purpose of which is to derive income from property.
		2018-0743961C6	May 29, 2018	any commercial activity carried on by a corporation (or partnership or trust) will or should be considered a business
Reasonable return	Dividends/Salary paid to an adult under age 25	CRA guidance example: 5, 5A, 5C	13-Dec-17; 10-Jul-19	Dividends received by an adult via family trust (under 25 years) is subject to TOSI as he never contributed property in support of the business, thus the distribution will not be safe harbour capital return, or a reasonable return on contributions of arm's length capital. If the grandchild was 25 years or older, the amounts would not be TOSI since they

				would be a reasonable return.
	Contribution of property, risk assumed	2018-0771851E5	November 2, 2018	The risk assumed by an individual on the start-up of a business by mortgaging their home for the purposes of financing the initial capital, may be considered in determining whether an amount subsequently received by the individual from the business represents a reasonable return TOSI, even after the loan has been repaid so that the risk no longer exists.
	Funding start-up business	CRA guidance example: 2	13-Dec-17; 10-Jul-19	Where a parent finances a start up business of Adult child's corporation via loan with interest higher than average market rate because the adult child could not obtain financing elsewhere due to the risk of the business, the interest is a reasonable return for TOSI purposes.
	Dividends paid to an adult over age 25 - contribution of labour	CRA guidance example: 11	13-Dec-17; 10-Jul-19	Dividend amount paid to a spouse was reasonable amount where the spouse works for the professional corporation business comparable to the amount that would be paid to an arm's length person for the same service
	Business succession	CRA guidance example: 7	13-Dec-17; 10-Jul-19	Parent sells QSBC shares to adult child (over 25 years) and taxable capital gain is not subject to TOSI because shares were QSBC which are excluded amount under par. (d) of excluded amount definition in subsection 120.4(1). The child was not involved in the business before the sale transaction. The

				dividend paid to the child is not subject to TOSI be because excluded business, reasonable return and excluded share tests are met.
	Risks assumed in a professional corporation	CRA guidance example: 3C	13-Dec-17; 10-Jul-19	Spouse owns non-voting shares of a professional corporation and is permitted to own voting shares due to governing provincial law. The spouse is a guarantor to a line of credit issued to the corporation and dividends received by the spouse is not subject to TOSI because they would be a reasonable return based on the risks assumed.
	Amount paid to Spouse from a PC considered reasonable	CRA guidance example: 11	13-Dec-17; 10-Jul-19	Spouse B provides bookkeeping services to Spouse A's PC. Spouse B works full time in the business but Spouse works less than 20 hours per week. The PC pays a dividend to Spouse B which is higher than the amounts previously paid to an arm's length bookkeeper for the same service. The dividend paid is not subject to TOSI because it is a reasonable return to Spouse B as the amount is comparable to the amount that would be paid to an arm's length person for the same service.
Enforcement	GAAR	2018-0779981C6 - 2018 CTF Q9	November 27, 2018	If it is determined that any transaction either alone or as part of a series has been undertaken primarily to obtain the "excluded amount" exemption under subparagraph 120.4(1)(e) in a, manner that would frustrate the object, spirit and purpose of section 120.4, the CRA would seek to apply the GAAR.

Other	Rental income from spousal testamentary trust	2018-0765811C6	October 5, 2018	If it is established that Spousal Trust does not carry on a business, the trust distribution would be an excluded amount in respect of Mrs. X under subparagraph (e)(i) of the definition "excluded, the trust distribution would be deemed to be an excluded amount under subparagraph 120.4(1.1)(c)(ii).
	Over 65 years - retired shareholders	CRA guidance example: 12	13-Dec-17; 10-Jul-19	Spouse A and Spouse B own respectively 95 % and 5% of all the issued and outstanding shares of Investco. Spouse A is over age of 65 and Spouse B is age 60. Investco carried on an active business, for over 25 years in which Spouse A worked full-time. Investco wound down that business many years ago and now owns a portfolio of passive investment assets that require sporadic management decisions and investment activity. Investco carried on an active business for over 25 years. Dividends paid to Spouse A are not subject to TOSI because Spouse A meets the “excluded shares” definition. Dividends paid to Spouse B are deemed to be an excluded amount because they would be an excluded amount if received by Spouse A, who has attained the age of 65—this is provided by subparagraph 120.4(1.1)(c)(i).
	Over 65 years - deeming rule through a trust	2019-0799961C6 - 2019 STEP Q5	June 7, 2019	Example of the flow-through of the par. 120.4(1.1)(c) excluded amount exclusion through a trust

	TOSI and Preferred Beneficiary Election	2019-0798501C6 - 2019 STEP Q13	June 7, 2019	Does paragraph (c) of the "split income" definition in subsection 120.4(1) apply in regard to income allocated pursuant to a preferred beneficiary election?
	TOSI and Preferred Beneficiary Election	2019-0798511C6 - 2019 STEP Q14	June 7, 2019	1) Can CRA explain its reasoning for its comments regarding subsection 104(19) in document 2018-0759521E5? 2) Will CRA grant relief for previous years in which a preferred beneficiary election was made?