



**Question 7: TOSI and Inherited Property**

Does subparagraph 120.4(1.1)(b)(ii) apply in two fact scenarios?

**Background**

Mr. X owns 100,000 voting preference shares of a corporation (“Investco”).

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The common shares of Investco are non-voting and are held by a discretionary *inter vivos* trust (the “Family Trust”). The settlor of the Family Trust is Mr. X. The trustees of the Family Trust are Mr. X and two arm’s length third parties. The beneficiaries of the Family Trust include Ms. X, Ms. Y and Ms. Z. Ms. X is Mr. X’s spouse. Ms. Y and Ms. Z are the children of Mr. X and Ms. X.

The Family Trust acquired its common shares of Investco as a result of an estate freeze.

The terms of the Family Trust include the restrictions described in subsection 74.4(4). But for such restrictions, subsection 74.4(2) would have applied to Mr. X as a result of the freeze.

None of the other attribution rules in sections 74.1 to 74.3 and subsection 75(2) will apply.

Mr. X, Ms. X, Ms. Y and Ms. Z are now all over age 18.

Each of Mr. X, Ms. X, Ms. Y and Ms. Z is a “specified individual.”

Investco’s business is carried on by Mr. X and Ms. Y. Mr. X and Ms. Y are each a “source individual” and Investco’s business is a “related business” with respect to Mr. X, Ms. X, Ms. Y and Ms. Z.

“Specified individual, “source individual” and “related business” have the meaning assigned by subsection 120.4(1).

Mr. X has worked in Investco’s business on average for more than 20 hours per week a year for more than five years.

In Year 1, Mr. X passes away. Pursuant to the terms of Mr. X’s will, Mr. X leaves one preference share to Ms. Y, one preference share to Ms. Z and 999,998 preference shares to Ms. X.

In Year 2, Investco pays a dividend on its common shares. The Family Trust pays the dividend to Ms. Z in the year and makes a designation in respect of Ms. Z under subsection 104(19). The Family Trust deducts the amount of the dividend from its income under subsection 104(6) and the amount is included in Ms. Z’s income as a dividend received on the Investco common shares under subsections 104(13) and (19).

The amount of the dividend included in Ms. Z’s income will be split income and will be subject to the tax on split income (TOSI) under subsection 120.4(2) unless such amount is an “excluded amount” in respect of Ms. Z.

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Under subsection 120.4(1), where an individual has attained the age of 17 years before the year, an “excluded amount” includes an amount derived directly or indirectly from an “excluded business” of the individual.

An “excluded business” of a specified individual is defined under the same subsection and includes a business if the specified individual is actively engaged on a regular, substantial and continuous basis in the activities of the business in any five prior taxation years.

Under paragraph 120.4(1.1)(a), an individual may be deemed to be actively engaged in a business in a taxation year where the individual works at least an average of 20 hours per week during the portion of the year in which the business operates.

Paragraph 120.4(1.1)(b)(ii) expands the scope of the deeming rule in paragraph 120.4(1.1)(a) in certain circumstances for inherited property.

Because Mr. X worked on average at least 20 hours per week during the portion of the year the business operates for more than 5 years, Investco’s business is an excluded business of Mr. X.

- A. Would the taxable dividend deemed to be received by Ms. Z be an excluded amount because it is an amount derived directly or indirectly from an “excluded business” of Ms. Z taking into consideration the application of the deeming rule in subparagraph 120.4(1.1)(b)(ii)?
- B. Assume the same facts as Question 7(A), except that Mr. X leaves all of his preference shares to Ms. X and the terms of the Family Trust dictate that, on the death of Mr. X, the trustees of the Family Trust are subject to an absolute obligation and must wind-up and distribute the trust property (i.e. the Investco common shares) equally to Mr. X’s children in satisfaction of their capital interest.

As a result, and pursuant to the terms of the trust, the dividend paid by Investco in Year 2 will be received directly by Ms. Z on the Investco common shares distributed to her on the winding-up of the Family Trust following the death of Mr. X.

Would the CRA consider the acquisition of shares by Ms. Z to be “as a consequence of the death” of Mr. X for the purposes of paragraph 120.4(1.1)(b)?

### **CRA Response (A)**

In general, paragraph 120.4(1.1)(b) provides a continuity rule for inherited property. It applies to amounts that would, absent the application of the provision, be split income of a specified individual who has attained the age of 17 years before the year in respect of property that was acquired by or for the benefit of the specified individual as a consequence of the death of another person.

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Subparagraph 120.4(1.1)(b)(ii) provides that for purposes of the definition of excluded business, if a deceased person was actively engaged on a regular, substantial and continuous basis in the activities of a business throughout any five previous taxation years, then the individual is deemed to have been engaged on a regular, substantial and continuous basis throughout those five years.

Where subparagraph 120.4(1.1)(b)(ii) applies, an individual's income on inherited property will qualify as an "excluded amount" to the extent that an amount, had it been received by the deceased person, would have been from an "excluded business" because the deceased person was actively engaged on a regular, continuous and substantial basis in the activities of the related business in any five previous taxation years.

Based on the facts, the relevant amount for purposes of paragraph 120.4(1.1)(b) is the amount of the taxable dividend deemed to be received by Ms. Z under subsection 104(19) on the common shares of Investco owned by the Family Trust.

If subparagraph 120.4(1.1)(b)(ii) applies, the amount of the taxable dividend deemed to be received by Ms. Z, would be an excluded amount from an excluded business of Ms. Z because she would be deemed to have been actively engaged on a regular, substantial and continuous basis in Investco's business, based on Mr. X having worked at least an average of 20 hours per week for a period exceeding 5 years during his lifetime.

In order for subparagraph 120.4(1.1)(b)(ii) to apply to the dividend, however, that amount must, *inter alia*, be in respect of property that was acquired by or for the benefit of the specified individual as a consequence of the death of another person as required by paragraph 120.4(1.1)(b).

In general, whether property is acquired as a consequence of the death of another person is in part a question of fact to be determined based on the circumstances of each case.

Subsection 248(8) includes an extended definition of when property is considered to be acquired as a consequence of death that is not relevant to the circumstances of this question.

Because the dividend is in respect of the common shares of Investco, subparagraph 120.4(1.1)(b) would not apply because such shares are owned by the Family Trust and were not acquired by or for the benefit of Ms. Z as a consequence of the death of Mr. X.

As a result, the taxable dividends deemed to be received by Ms. Z on the common shares of Investco will not be an excluded amount by reason of being an amount derived directly or indirectly from an excluded business in respect of Ms. Z.

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The taxable dividend may fall within another category of excluded amount. If not, then the taxable dividend will be included in computing Ms. Z's split income and will be subject to the TOSI.

### **CRA Response (B)**

As discussed, in order for subparagraph 120.4(1.1)(b)(ii) to apply to an amount, the amount must be in respect of property that was acquired by or for the benefit of the specified individual as a consequence of the death of another person as required by paragraph 120.4(1.1)(b).

As well, whether property is acquired as a consequence of the death of another person is in part a question of fact to be determined based on the circumstances of each case.

In this case, the amount of the dividend received by Ms. Z was in respect of the Investco common shares acquired by her by distribution on the winding-up of the *inter vivos* Family Trust.

In general, we have taken the position that property received from an *inter vivos* trust, the terms of which require without condition the trust to distribute the property to an individual on the death of another person, can be considered to be property that was acquired as a consequence of the death of the person.

Based on the facts, the Investco common shares received by Ms. Z from the Family Trust under the terms of the trust that require such shares to be distributed to her on the death of Mr. X will be considered in the circumstances to be property that was acquired by her as a consequence of the death of another person (her father) for purposes of paragraph 120.4(1.1)(b).

Accordingly, subparagraph 120.4(1.1)(b)(ii) should apply in the circumstances to the amount of the dividend received by Ms. Z on the Investco common shares for purposes of determining whether such amount was derived directly or indirectly from an excluded business of Ms. Z and will deem Ms. Z to have been actively engaged on a regular, substantial and continuous basis in Investco's business based on Mr. X having worked at least an average of 20 hours per week a year for a period exceeding 5 years during his lifetime. As a result, Investco's business will be an excluded business of Ms. Z and the amount of the dividend received on the Investco common shares will be an excluded amount and not subject to TOSI as an amount derived from an excluded business.

A different result would apply, however, where it is reasonable to infer in the circumstances that the terms of the trust were arranged to inappropriately benefit from paragraph 120.4(1.1)(b) and subparagraph 120.4(1.1)(b)(ii) in light of the stated object and purpose of those provisions to provide continuity rules for inherited property, including by reason of the application of the GAAR.

**Question 8: TOSI – Excluded Business**

The definition of an excluded amount in subsection 120.4(1) of the Act allows an exemption from the application of tax on split income (TOSI) provided the dividend be derived directly or indirectly from an excluded business of the individual for the year. Pursuant to the definition in subsection 120.4(1), “excluded business” means a business of the specified individual if the specified individual is actively engaged on a regular, continuous and substantial basis in the activities of the business.

ABC Co. is owned 100% by a family trust, of which Mr. and Mrs. A are both beneficiaries. ABC Co. historically carried on a trucking business from incorporation in 1990, and each of Mr. and Mrs. A were actively engaged on a regular, continuous and substantial basis throughout all of the years of its operations.

The business operations were sold in 2018, and the proceeds have been invested inside ABC Co. ABC Co. now carries on an investment business. Mrs. A is active in the investment business but Mr. A is not.

As Mr. and Mrs. A, who are both over 24 years old, do not own shares of ABC Co. directly, they will not meet the “excluded share” exception.

Will the excluded business exception apply to Mr. A, given that he had previously been actively engaged on a regular, continuous and substantial basis in the trucking business carried on by ABC Co. for more than five years, notwithstanding that the trucking business has ceased and the proceeds from the sale of its assets have been invested in ABC Co.’s investment business?

**CRA Response**

Under the TOSI rules in section 120.4 of the Act, TOSI will apply to tax the “split income” of a “specified individual” at the highest marginal rate unless the amount is an “excluded amount”.

In the above scenario, ABC Co.’s trucking business operations have completely ceased and its assets sold and reinvested (presumably along with the historical retained earnings) in an investment business carried on by ABC Co. The investment business is a “related business” in respect of Mr. A (a specified individual) for a taxation year since Mrs. A (a “source individual” in respect of Mr. A) is actively engaged on a regular basis in the activities of ABC Co. related to earning income from the business.

Where the family trust makes a subsection 104(19) designation in a particular taxation year of the trust in respect of all or a portion of a taxable dividend it received from ABC Co. (for a taxation year of ABC Co. after its trucking business ceased), such amount would be deemed, *inter alia*, to be a taxable dividend received on a share by Mr. A and/or Mrs. A, as the case may

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be, in his/her taxation year in which the family trust's particular taxation year ends. Such income would be "split income" of Mr. A unless an excluded amount exception applies.

The investment business currently being carried on by ABC Co. is not the same business as the trucking business formerly carried on by it. Any taxable dividend that Mr. A is deemed to receive is considered to be derived directly or indirectly from such investment business. If Mr. A is not actively engaged in the investment business during the particular taxation year or in any five prior taxation years, the amount will not be an excluded amount under subparagraph (e)(ii) of that definition because such amount will not be income derived directly or indirectly from an "excluded business" of Mr. A for the year. Consequently, the taxable dividend designated by the trust in respect of Mr. A pursuant to subsection 104(19) will be split income subject to TOSI unless another excluded amount exception applies.

Further information would need to be provided to determine whether such income received would represent a "reasonable return" in respect of Mr. A or whether another excluded amount exception could apply.

### **Question 9: TOSI – Excluded Amount and the Non-Related Business Exception**

For individuals age eighteen or over, income which is not derived directly or indirectly from a related business in respect of the individual is an "excluded amount" (subparagraph (e)(i) of the definition of that term in subsection 120.4(1)). Where a specified individual (the "Individual") receives a dividend from a corporation (the "Corporation") which, in the past, carried on a related business, but did not do so during the year, would the dividend be an "excluded amount" under this provision in the following situations.

- A. The business ceased in a prior year, and is no longer operated by anyone.
- B. The business was sold to an unrelated corporation in a prior year and is still active, but no source individual in respect of the dividend recipient was active in the business in the year of the dividend.
- C. The business was sold to an unrelated corporation in a prior year and is still active, but a source individual in respect of the dividend recipient was active in the business in the year of the dividend (for example, a former owner related to the Individual is employed by the new owners in the business, perhaps for a transitional period).

Assume in all three situations:

- the corporate income that supports the dividend is derived, directly or indirectly, from the related business carried on by the Corporation in the past; and
- the Corporation did not derive, directly or indirectly, income from a related business in respect of the Individual other than the related business carried on in the past.

**CRA Response (A)**

Consistent with the CRA’s response to Question 9 at the Round Table of the 2018 CTF Annual Conference (“Question 9”), generally, yes.

As discussed in our response to Question 9 the expression “derived directly or indirectly from a business” has a broad meaning. However, in the circumstances discussed, the dividend will not be considered to have been derived from a related business for the year because the business was not carried on in the particular year.

As a result, the dividend received by the Individual would accordingly constitute an “excluded amount”.

**CRA Response (B)**

Consistent with the response to question (A), generally, yes.

As was the case in question (A), it is our view that the dividend received by the Individual would be considered to be derived directly or indirectly from a related business, being the related business carried on in the past.

However, similar to question (A) we are also of the view that in circumstances where the business was sold to an unrelated corporation in a prior year and is still carried on, but no source individual in respect of the dividend recipient was active in the business in the year of the dividend, then a dividend received by the Individual in that subsequent year will not be considered to have been derived from a related business for the year because the related business was not carried on in the particular year.

As a result, the dividend received by the Individual would accordingly constitute an “excluded amount”. This response assumes that the source individual no longer retains any ownership of the business. If that is not the case, paragraph (c) of the definition of “related business” may be applicable and could result in the application of the tax on split income.

**CRA Response (C)**

Based on the information provided, generally, no.

It is our view that the dividend received by the Individual would be considered to be derived directly or indirectly from a related business. In the circumstances provided, where the business was sold to an unrelated corporation in a prior year and is still carried on, and a source individual was active in the business in the year of the dividend, the business carried on by the unrelated corporation may constitute a related business for the year. Pursuant to subparagraph (a)(ii) of the

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definition of “related business” in subsection 120.4(1), if the source individual is considered to be actively engaged on a regular basis in the activities of the unrelated corporation related to earning income from the business, then the business that continues to be carried on by the unrelated corporation would qualify as a related business for the year.

Therefore, in the circumstances described, the dividend paid by the Corporation will not meet the requirements to be considered an “excluded amount” under subparagraph (e)(i). The business carried on by the unrelated corporation will constitute a related business until the source individual is no longer actively engaged on a regular basis in the activities of the unrelated corporation.

Notwithstanding the above, it should be noted that depending on the facts and circumstances of the Individual, another exception from the tax on split income may apply.

