2 November 2018 External T.I. 2018-0771851E5 - TOSI: Meaning of Reasonable Return

subsequently eliminated start-up risk can be taken into account/retained earnings irrelevant/CRA does not substitute its judgment

Mr. and Mrs. X (both over 25) incorporate XCo, subscribe a nominal amount for non-voting and voting common shares, respectively and lend the proceeds of a mortgage on their home to XCo as start-up capital (the "Loan"). Mr. X has no involvement in XCo's business, which is highly speculative. Several years later, XCo repaid the Loan and they repaid the mortgage.

1. Notwithstanding such repayment, can Mr. X continue to look to the reasonable return exception having regard to the risks he initially assumed on the start-up of XCo's business?

2. Can Mr. X look to the undistributed retained earnings of XCo as capital that is at risk for purposes of the reasonable return exception, assuming that he did not receive any dividends?

Respecting Q.1, CRA stated:

If the terms and conditions of the Loan were not sufficient to adequately compensate Mr. X and Mrs. X for the risk they assumed when mortgaging their home and providing the Loan to XCo, the relative risk that was assumed by each of them in mortgaging their home and providing the Loan could be taken into account in determining whether a dividend received by Mr. X after the repayment of the Loan is a reasonable return in respect of Mr. X (among the other factors noted above). …

[T]he CRA 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 … .
Re Q.2:

The focus of the inquiry into whether an amount is a reasonable return in respect of a specified individual is on the relative contributions of the specified individual and each source individual in respect of the specified individual. Since the undistributed retained earnings of XCo would not, in the scenario presented above, represent capital contributed directly or indirectly by either Mr. X or Mrs. X, the existence of such undistributed retained earnings would not be relevant in assessing their relative contributions to the related business carried on by XCo.

5 October 2018 APFF Roundtable Q. 9, 2018-0768801C6 F - Tax on Split

inactive spouse could receive excluded amount dividends from Holdco if its income was from an active business of reinvesting Opco dividends

2018 STEP Roundtable Q.7 indicated that the shares of a holding company (or of a company generating no business income) cannot qualify as excluded shares for purposes of the split income rules. CRA noted that if the company instead has "a business whose principal purpose is to derive income from property, including interest, dividends, rents and royalties, such as investment management corporations" then "the condition in subparagraph (a)(i) of the definition of "excluded shares" in subsection 120.4(1) would be satisfied."
For example:

- Mr. and Mrs. X (both age 35) respectively hold 90% and 10% of the voting common shares of Holdco

- Holdco holds all the shares of Opco in whose business Mrs. X has no involvement
- Holdco in its preceding year did not receive any dividends from Opco and it holds passive investments (acquired some time ago out of dividends received from Opco) which, in the previous year, generated interest and dividends of $100,000,
- Holdco now pays a dividend (representing much of the previously received income) pro rata to Mr. and Mrs. X.

CRA considered that Mrs. X's shares are "excluded shares" if such $100,000 of income was "derived from the carrying on of a business the purpose of which is to earn interest income and dividends … notwithstanding the fact that the capital used in the acquisition by Holdco of the property used in carrying on its business was derived from dividends received from Opco." As the dividend received by her would constitute an "excluded amount" per s. (g)(i) of the definition thereof, she would not be subject to the split income tax thereon.

CRA went on to indicate where Mr. and Mrs. X (both age 35) respectively hold 90% and 10% of the voting common shares of Holdco, whose only source of revenue is dividends on its shares of Opco (wholly-owned by it), which Holdco dividends pro rata to Mr. and Mrs. X, with Mrs. X not being involved in the Opco business, her shares would not be "excluded shares" because "the total income of the corporation would come from another related business in respect of a specified individual (other than a business carried on by the holding corporation)."

However, if Holdco in its preceding year did not receive any dividends from Opco and it holds passive investments (acquired some time ago out of dividends received from Opco) which, in the previous year, generated interest and dividends of $100,000, a portion of which is now dividended pro rata to Mr. and Mrs. X, her shares are "excluded shares" if such $100,000 of income was "derived from the carrying on of a business the purpose of which is to earn interest income and dividends … notwithstanding the fact that the capital used in the acquisition by Holdco of the property used in carrying on its business was derived from dividends received from Opco." As the dividend received by her would constitute an "excluded amount" under s. (g)(i) of the definition thereof, she would not be subject to split income tax thereon.

5 October 2018 APFF Roundtable Q. 13, 2018-0778661C6 F - Tax on Split Income

returns to a spouse and older children from a Holdco in which they reinvested their Opco capital gains exemption could qualify as excluded amounts

A family trust ("Trust") distributed the taxable portion of its gain on the sale of qualified small business corporation shares (of Opco) to its beneficiaries (Mr. and Mrs. X, and their children, Child X and Y, aged 15 and 22) who claimed the s. 110.6 deduction. The Trust and its beneficiaries then used their sales proceeds to subscribe for the shares of a newly-incorporated holding company (Holdco): Trust – 50% of the Holdco shares; Mr. and Mrs. X – 20% each; and Child X and Y – 5% each). Holdco generated $150,000 from investing these funds in the stock market and paid a $100,000 dividend pro rata to its shareholders with Trust, in turn, distributing its $50,000 dividend to Mrs. X and Child X and Y.

Are the dividends paid by Holdco to Mr. and Mrs. X and Child X and Y, and distributed by Trust to the latter three subject to split income tax? CRA indicated:

- The dividend paid by Holdco to Child X clearly would be added to the child's split income given the age of under 17.

- If it were determined that Holdco did not carry on a business, then the dividends received from Holdco would be "excluded amounts" for Mr. X, Mrs. X and Child Y under s. (e)(i) thereof.
- If Holdco instead was carrying on a business and, thus, a related business respecting Mr. X, Mrs. X and Child Y, the shares of Mr. and Mrs. X would be excluded shares given that they had the greater than 10% shareholdings described in s. (b) of the excluded share definition, under s. (a) of that definition Holdco's income was from property, and under s. (c), all or substantially all of Holdco's income was from its own business. However, Child Y would not hold excluded shares given a shareholding of only 5%.
- A similar analysis applied to the distribution by Trust.

27 November 2018 CTF Roundtable Q. 9, 2018-0779981C6 - TOSI–Excluded Amount - Non-Related Bus. Exception

"derivation" for TOSI purposes of dividends from previously earned income from a related business

Mr. and Mrs. A (both over 25) are equal shareholders of ACo, which two years previously sold the Old Business in which Mrs. A had been actively engaged on a regular, continuous and substantial basis for many years – but Mr. A, not at all. Since then, ACo's sole activity has been the investing of the proceeds.

Where ACo's investment activities did not constitute a business, will a dividend declared in the current year to Mr. and Mrs. A be considered to be an excluded amount?

CRA indicated that, as the Old Business had been wound up in a previous taxation year and ACo had no other related business, the dividends received were "excluded amounts" under (e)(i).

In another scenario, Mrs. and Mr. A (both over 25) are the respective sole shareholders of Opco (carrying on a non-services operating business) and Serviceco (earning income in Year 1 from Opco, but without Mr. A being actively involved in its business). In Year 2, Serviceco does not render any services and its activities are insufficient to constitute a business.

Where Serviceco's Year 1 after-tax income is paid as a dividend to Mr. A in Year 2, would it be an "excluded amount" per (e)(i)?

CRA indicated that, as Serviceco earned its Year 1 income from the provision of services to Opco (i.e., derived amounts from Opco's business) and the dividend paid in Year 2 can also be said to have derived directly or indirectly from the provision of services to Opco in Year 1 (and thus to be derived directly or indirectly from Opco's business, being a related business), the Year 2 dividends would not be excluded amounts.

12 June 2019 External T.I. 2019-0792011E5 F - TOSI definition excluded shares

two years were required to pass before proceeds from the sale of a related business could generate excluded share income for TOSI purposes

Investco held all the shares of Opco, which was the only related business in respect of the specified individual. In Year X and prior years, Opco (which, like Investco, had a calendar taxation year) paid dividends to Investco. In Year X, Investco sold all the shares of Opco.

Will CRA consider funds thereafter held by Investco and derived from Opco to be derived, directly or indirectly, from a related business in respect of a specified individual for the purposes of the definition of "excluded shares"?

After noting that “under … clause 120.4(1.1)(d)(i)(B) … an amount derived directly or indirectly from a business includes an amount that arises in connection with the ownership or disposition of an interest in the shares of … the corporation that carries on the business, that is, Opco,” CRA indicated that in Year X4, that the specified individual would not be eligible for the excluded share exception respecting a dividend from Investco since, for the last taxation year of Investco, it derived, directly or indirectly, income from a related business in respect of the specified individual by receiving dividends from Opco and also by realizing a capital gain on the Opco share sale (and similarly, in Year X3, dividends were received by Investco in its previous year from the related business).

However:

If, during its X5 taxation year, Investco paid a dividend to the specified individual, the specified individual could benefit from the excluded shares exemption, because, for Investco's last taxation year, Investco did not derive, directly or indirectly, income from a related business in respect of the specified individual (other than an Investco business).

2 November 2018 External T.I. 2018-0771861E5 - TOSI: Second generation income

dividends generated from the investment of dividends received from a related business (or gains from such investments) are not themselves derived from that business

Mr. and Mrs. A (both over 30) respectively own 100 voting and 100 non-voting common shares of Investco which wholly-owns Opco (with a non-services business). Only Mr. A is actively engaged in Opco’s business on a regular, substantial and continuous basis. Historically, Opco has dividended its earnings to Investco, with Investco then investing in dividend-bearing shares of publicly-traded corporations (the “portfolio”).

If Investco pays all of its portfolio dividend income to Mrs. A, would the dividend income received by Mrs. A be considered income that is derived directly or indirectly from a related business for s. 120.4 purposes? CRA stated:

Dividends paid by Investco out of its after-tax income from its investments in publicly-traded corporations would not be considered to be derived, directly or indirectly, from the related business of Opco in respect of Mrs. A. Therefore, if Investco does not have a related business in respect of Mrs. A, the dividends it pays to Mrs. A that are derived from income and gains earned from its investments in publicly-traded corporations would be an “excluded amount” in respect of Mrs. A under subparagraph (e)(i) of … “excluded amount” … .
CRA then addressed an example where, in Year 1, Opco pays a $1M dividend to Investco and Investco then invests that dividend in shares of publicly-traded corporations. In Year 2, Investco pays a dividend-in-kind to Mrs. A of its entire stock portfolio which, at that time, has an aggregate FMV of $1.1M (for an accrued gain of $0.1M).

Before concluding that only $1.0M of the $1.1M dividend-in-kind received by Mrs. A would be derived from the related business of Opco in respect of Mrs. A (so that if Investco did not have a

related business in respect of Mrs. A, $0.1M of the amount would not be derived from such a business), CRA stated:

The portion of the FMV of the distributed stock portfolio that represents the initial investment of the dividends paid by Opco to Investco would be considered to be derived, directly or indirectly, from the related business of Opco in respect of Mrs. A. However, gains earned by Investco as a result of the investment of those dividends would not be considered to be derived, directly or indirectly, from the related business of Opco in respect of Mrs. A.

5 October 2018 APFF Roundtable Q. 11, 2018-0768821C6 F - Tax on Split Income

dividends derived from stock portfolio of Holdco excluded because stock portfolio not a related business or not a business

Mr. X holds all the voting shares of Opco, a family trust ("Trust") holds all the participating shares of Opco, and Child X (age 30 and not involved in the Opco business) holds all the voting participating shares of Holdco, which generated $150,000 of passive income in the prior year from stock market investments. Holdco (which along with Mr. and Mrs. X, and Child X, is a Trust beneficiary) also received in the prior year a $100,000 distribution of a dividend that Trust had received from Opco, and now wishes to pay a $75,000 dividend to Child X (the "Dividend"). Would it be possible for Holdco to pay the Dividend on the basis that it was derived from income on the stock market investments rather than from Opco, so as to avoid the split income tax?

After noting that Mr. X was a source individual respecting Child X, assuming that Mr. X satisfied the active engagement condition with respect to Opco's business, and further finding that if "Holdco will pay the Dividend to Child X out of the funds from the $100,000 dividend received from Opco or from any dividends previously received from Opco, then … the Dividend would thus have come, directly or indirectly, from a related business - that of Opco - in respect of Child X." so that the Dividend would be added to the split income of Child X, unless it constituted an excluded amount by virtue of another exclusion, CRA then stated:

[I]f it can be determined that Holdco will pay the Dividend to Child X out of its after-tax income from its stock market investments, then that dividend would be an excluded amount for Child X and would not be included in calculating the child's split income.

…[I]f it were determined that Holdco carries on a business whose primary purpose is to earn income from its stock market investments, that business would not qualify as a "related business" …[as] no source individual in respect of Child X satisfies the active engagement condition or the ownership condition with respect to Holdco. Consequently, the Dividend would be an "excluded amount" in respect of Child X… .

On the other hand, if it were determined that Holdco does not carry on a business, then the Dividend would also be an "excluded amount" in respect of Child X by virtue of subparagraph (e)(i) of the definition … [since] there must be … a business carried on by an entity. …

Based on the foregoing, Holdco must adequately monitor its funds derived from stock market investments in order to determine whether those funds were used to pay the Dividend.

25 May 2018 External T.I. 2018-0761601E5 - Correspondence with XXXXXXXXXX re Tax on Split Income

where spouse works in only one of two businesses, excluded amount determination requires "separate accounting for each business and a tracing of funds"

The spouse (Spouse B) of the shareholder of a corporation with a construction and property management business works 25 hours in the property management business, but not in the construction business. Must the flow of funds be traced from the property management business to Spouse B to ensure they are "excluded amounts"? After noting that the property management, but not the construction, business thus would be an excluded business of Spouse B,

[A]ny income of Spouse B that is derived directly or indirectly from the property management business will be income from an excluded business of the spouse and will not be split income subject to TOSI. Any income of the spouse that is derived directly or indirectly from the construction business will not be income from an excluded business of the spouse and will be split income subject to TOSI unless another exclusion applies. This will require separate accounting for each business and a tracing of funds.