

Revisions to the Tax on Split Income (the "Kiddie Tax")

Budget 2014 proposes to amend the *Income Tax Act* (Canada) (the "**Tax Act**") in a manner that would retroactively expand the application of the Tax on Split Income (the so-called "kiddie tax") to certain partnership and trust arrangements. The proposed expansion of the Tax on Split Income would further frustrate efforts by taxpayers subject to high marginal tax rates from shifting income to individuals subject to lower marginal tax rates.

Current application of the Tax on Split Income

The Tax on Split Income is an anti-avoidance measure that taxes "split income" ("**Split Income**") in the hands of "specified individuals" ("**Specified Individuals**"), each as defined in the Tax Act, at the highest federal marginal tax rate (currently, 29%).¹ The Tax on Split Income is intended to (and generally does) discourage taxpayers from trying to shift income to lower-taxed minor individuals (often their children or grandchildren) through the use of intermediary entities such as private companies, partnerships and trusts.

A Specified Individual for a particular year is defined under the Tax Act to include (i) a person who has not obtained the age of 17 years before the particular year, (ii) was at no time in the particular year a non-resident of Canada, and (iii) has a parent that is resident in Canada at any time in the particular year.

¹ The provinces and territories also generally tax Split Income earned by Specified Individuals at high marginal tax rates.

Under the current regime, Split Income of a Specified Individual includes, among other things:

- taxable dividends received in respect of unlisted shares of a corporation (other than shares of a mutual fund corporation) ("**Unlisted Shares**"), whether received directly or indirectly through a partnership or trust;
- shareholder benefits that are required to be included in the income of a Specified Individual in respect of Unlisted Shares or shares of a mutual fund corporation;
- capital gains attributable to the disposition of Unlisted Shares, directly or indirectly, to a person with whom the Specified Individual does not deal at "arm's length" for the purposes of the Tax Act;
- income from a partnership or trust that is derived from providing property or services to, or in support of, a business carried on by a person related to the Specified Individual or certain other entities in which the related person participates.

Certain amounts are excluded from the Tax on Split Income where the Specified Individual has acquired the income-generating property, or property giving rise to a capital gain, as the case may be, as a consequence of the death of a Specified Individual's parent or, in certain circumstances, one or more other persons.

Budget 2014 Proposal

The existing definition of Split Income does not include amounts allocated to a Specified Individual from a partnership or trust that is derived from business or rental activities conducted with third parties. The Government alleges that certain taxpayers have been using partnership and trust structures to inappropriately split income with Specified Individuals without being subject to the Tax on Split Income.

The Government cited the example of a partnership (in which an adult and a Specified Individual, either directly or indirectly, are

partners) that provides services to an "arm's length" client. Although the adult partner in such an example might provide all or substantially all of the services to the client, the Specified Individual could be allocated a disproportionate amount of the income from the partnership and have it taxed at the Specified Individual's (lower) marginal tax rate.

The Government does not explain why existing anti-avoidance measures could not address such planning opportunities. For example, provisions of the Tax Act allow the Canada Revenue Agency to disregard certain agreements to allocate partnership income between non-arm's length parties in unreasonable proportions. Similarly, agreements to allocate partnership income in a particular manner can be disregarded where the principal reason for the allocation may reasonably be considered to be the reduction or postponement of tax that might otherwise have been or become payable under the Tax Act.

Nevertheless, Budget 2014 proposes to address the perceived gap in the Tax on Split Income regime by amending the definition of Split Income to include income that is, directly or indirectly, paid or allocated to a minor from a trust or partnership if:

- the income is derived from a source that is a business or a rental property; and
- a person related to the Specified Individual is (i) actively engaged on a regular basis in the activity of the trust or partnership to earn income from a business or rental property, or (ii) has, in the case of a partnership, an interest in the partnership (whether held directly or through another partnership).

Such a measure is expected to eliminate the planning opportunity described above by deeming an allocation from such a partnership to be Split Income of a Specified Individual that is subject to tax at the highest marginal tax rate.

These proposals will apply to the 2014 and subsequent taxation years. No grandfathering or relieving measures have been included in the Budget documents in respect of income that may have been earned by a Specified Individual between January 1, 2014 and the date of the Budget, February 11, 2014. Accordingly, Specified Individuals that have already received or been allocated amounts in 2014 that are affected by these proposed amendments may be retroactively subject to the Tax on Split Income.

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[a cautionary note](#)

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