TAX FOR THE Owner-Manager

Editor: Joan E. Jung, Minden Gross LLP, Toronto
(jjung@mindengross.com)

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The Interaction Between the Subsection 82(3) Election and TOSI

A recent technical interpretation (document no. 2020-0856081I7, August 23, 2021) issued by the CRA examines the interaction between subsection 82(3) and section 120.4 of the ITA. This TI may be of interest both for the narrow technical question that it raises and for its guidance on how the tax on split income (TOSI) regime may interact with other provisions of the ITA.

Subsection 82(3) is designed to optimize the benefit of the married or common-law partnership status tax credit ("the spousal credit") in paragraph 118(1)(a). Provided that certain conditions are met, the spousal credit provides a tax credit to a spouse or common-law partner ("the electing spouse") who supports his or her spouse or common-law partner ("the recipient spouse"). The spousal credit declines in amount as the net income of the recipient spouse increases, and it is completely eliminated when that net income reaches a legislated maximum.

Under subsection 82(3), if the electing spouse makes the election, all taxable dividends received in a year by the recipient spouse from taxable Canadian corporations under paragraphs 82(1)(a) and (a.1) are deemed to have been received by the electing spouse and not by the recipient spouse. This election is available, however, only if the spousal credit of the electing spouse would be increased. In summary, subsection 82(3) is designed to minimize the effect of the net-income phaseout in the spousal credit.

The TOSI regime in section 120.4 adds an extra layer of complexity to the effect of subsection 82(3), because the TOSI regime denies the benefit of bracketed rates and tax credits to dividend income that is "split income" (as defined in subsection 120.4(1)) to the recipient spouse or, if the subsection 82(3) election is made, to the electing spouse. Accordingly, the application of TOSI to dividend income could affect the decision whether to make the election and could undermine the potential effectiveness of the election under subsection 82(3). Subparagraph 120.4(1)(a)(i) of the definition of "split income" includes in split income the taxable dividends that an individual received on shares of a corporation (subject to certain exclusions not relevant to the scenarios discussed in this article).

The CRA was asked to opine on whether an ordering rule governs the application of these two legislative schemes (the subsection 82(3) election and TOSI) and then to illustrate, with hypotheticals, how these sets of rules would work. The CRA concluded that, although no ordering rule in the ITA governs the interaction of subsection 82(3) and section 120.4, the text of the provisions indicates that subsection 82(3) should take precedence over section 120.4 and should be applied first. The CRA also stated that GAAR should not apply.

Accordingly, in the CRA's view, the correct method of applying the two provisions is to allocate receipt of the dividends in accordance with subsection 82(3) and then apply the TOSI regime.

The CRA examined three hypothetical examples in order to illustrate the TOSI analysis when subsection 82(3) is applied. In each example, the CRA commented on (1) how TOSI would apply to the dividends received by the recipient spouse if no election had been made, and (2) how it would apply, if the election had been made, to the dividends deemed received by the electing spouse.

First Hypothetical

The first hypothetical dealt with a recipient spouse who owned shares with less than 10 percent of the votes and FMV of all of the shares of a corporation and was not actively engaged in the business of that corporation. The electing spouse owned no shares in the corporation but was actively engaged in its business.

The CRA concluded that if no subsection 82(3) election had been made, the taxable dividends received by the recipient spouse from the corporation would not have been an "excluded amount" (as defined in subsection 120.4(1)) to the recipient spouse and would, therefore, have been split income subject to TOSI.

The CRA concluded that if the subsection 82(3) election had been made, the election would have converted taxable dividends subject to TOSI in the hands of the recipient spouse into an income inclusion that was an excluded amount to the electing spouse. In the CRA's view, one examines the application of TOSI on the basis of the share ownership and personal circumstances of the electing spouse, not the recipient spouse. In this hypothetical, the taxable dividends deemed received by the electing spouse were an excluded amount because the electing spouse had been actively engaged in the business of the corporation.

Second Hypothetical

In the second hypothetical considered by the CRA, the recipi-

ent spouse owned shares with less than 10 percent of the votes and FMV of all of the shares of a corporation controlled by his or her mother-in-law (who was actively engaged in the business of the corporation). The electing spouse owned no shares in that corporation. Neither spouse was actively engaged in the business of the corporation.

The CRA concluded that if no subsection 82(3) election had been made, the taxable dividends received by the recipient spouse from the corporation (1) would have been received from a "related business" (as defined in subsection 120.4(1)) in respect of the recipient spouse, (2) would not be an excluded amount to the recipient spouse, and, accordingly, (3) would have been split income subject to TOSI. If the subsection 82(3) election had been made, the deemed dividends received by the electing spouse would not be an excluded amount because the dividend is not from an "excluded business" (as defined in subsection 120.4(1)) or from "excluded shares" (as defined in subsection 120.4(1)) and would also, therefore, be split income subject to TOSI.

Third Hypothetical

The third hypothetical dealt with a corporation in which the recipient spouse, the electing spouse, and the brother of one of the spouses were each shareholders owning shares of a separate class of shares in a corporation. The recipient spouse, the electing spouse, and the brother, respectively, owned shares with 5 percent, 20 percent, and 75 percent of the votes and FMV of all of the shares of the relevant corporation. Only the brother, however, was actively engaged in the business of the corporation.

In the CRA's view, if no subsection 82(3) election had been made, the dividends received by the recipient spouse would have been split income subject to TOSI (by virtue of no relevant carve-outs being applicable).

The CRA accepted that the effect of making the subsection 82(3) election would have been to treat the electing spouse as having received the dividends on the shares he or she actually owned (that is, shares representing 20 percent of the votes and value of the corporation). The dividends would, therefore, be the electing spouse's income from excluded shares and not subject to TOSI. In the CRA's view, in other words, dividends that are reallocated pursuant to subsection 82(3) should be regarded, for the purposes of the TOSI regime, as being received by the electing spouse on the shares actually owned by the electing spouse, not on the shares owned by the recipient spouse. Put simply, subsection 82(3) reallocates the dividends, but it does not provide for a deeming rule that puts the electing spouse in the shoes of the recipient spouse as far as shareholdings are concerned.

Concluding Comments

This TI provides helpful insight into the complexity of applying distinct regimes within the ITA when they interact with one another. In this case, the methodology advanced by the CRA seems reasonable and pragmatic, but it seems to involve an assumption—specifically, an assumption that dividends deemed received by the electing spouse pursuant to subsection 82(3) will be received on the shares actually owned by the electing spouse (not those of the recipient spouse). This assumption, while practical, does not flow obviously from the text of the two sets of provisions. The CRA, in this circumstance, developed an approach that it found to be consistent with the policy goals of the TOSI regime (by not enabling the taxpayer to do indirectly, via the subsection 82(3) election, what he or she could not do by taking the relevant dividends directly).

Whether the policy rationale for these provisions justifies the assumption relied on by the CRA in this TI is an interpretive question with no easy answer. We note that in CRA document no. 2006-0183851E5 (May 30, 2007), the CRA took a similar position on the interaction between subsection 83(2) and paragraph 84.1(1)(b).

Given the interpretive uncertainty when it comes to determining the interaction between tax provisions that do not form part of a common legislative scheme, caution is in order: the position ultimately taken by courts can be quite unpredictable.

Philip Friedlan and Adam Friedlan
Friedlan Law
Richmond Hill, ON
philip.friedlan@friedlanlaw.com
adam.friedlan@friedlanlaw.com