SVS GROUP LLP
CHARTERED ACCOUNTANTS

September 28, 2017

Tax Policy Branch
Department of Finance Canada
90 Elgin Street
Ottaway, ON
K1A 0G5

To Whom It May Concern:

VIA E-MAIL

Re: Legislative Proposals Relating To Tax Planning Using Private Corporations

General Comments

We are providing this letter in response to the legislative proposals contained in the Department of Finance's ("the Department") July 18, 2017 policy proposals pertaining to tax planning using private corporations. In the following we will address both general and specific concerns that our firm has identified in both the policy proposal paper and the draft legislation.

There has already been considerable commentary submitted both to the Department directly and in the media that is highly critical of these proposals. These proposals were somewhat curiously released in the middle of summer with a relatively short seventy five day period for consultation. Given the drastic and sweeping nature of these changes to the Income Tax Act ("the Act") it is our hope that, at a minimum, the Department will extend the consultation period to allow for meaningful dialog and analysis of responses submitted to the Department.

Based on the content of the policy paper, the Department's technical briefing, and commentary from the Government in the media, it appears to us that many of these proposals are driven by papers published by Canadian academics that largely address the growth in the number of Canadian controlled private corporations and especially the incorporation of professionals. The conclusion the Department has drawn from these academic papers appears to be that reasons to incorporate are somehow spurious and primarily tax driven. It is unfortunate that this lens has been applied not only to professionals but also to all private businesses and incorporated farmers. There are a plethora of non-tax related reasons why incorporation of a business makes more sense now than it did a few years ago including access to capital, limitation of liability and a shift in the economy to more short-term, project driven contractual work. The inherently negative framing of this discussion by the Government unfortunately also seems to have tainted the drafting style of the proposed legislation. Despite the Government's assertions in the media to the contrary, the somewhat hostile drafting style of this legislation, brimming with uncertain factual and purpose tests, impacts every private corporation in Canada.

Taxpayers want certainty in planning their affairs. As we will explain later in our response, when the proposed income sprinkling legislation contains factual reasonability tests for labour and capital contributions with no agreed upon, easily accessible sources which to apply, a taxpayer is faced with substantial uncertainty and must bear the burden of proof in convincing a Canada Revenue Agency auditor that amounts (which will undoubtedly be faced with significant scrutiny) are reasonable in the circumstances. The logical conclusion from this is that it will only serve to stress an already overworked appeals system and the tax courts.

Many successive governments have been wary of opening the Pandora's Box that is tax reform. In our opinion one ancillary benefit of these proposals is that it appears to have engaged the

nation in a discussion on potential tax reform and we at least applaud the Government for that. As this Government has already set foot down the garden path we hope that this will lead to meaningful tax reform in Canada. It has been decades since the Carter Commission and the Act is in need of serious review. The Pierre Trudeau government presided over the last major changes to the Act in 1972. In the decades since, the Act has grown to an unwieldy collection of politically motivated tax measures and a patchwork of legislated "wins" in response to losses by the Minister that often result from technical deficiencies in the Act and the literal, *Duke of Westminster,* statutory interpretation model frequently employed by the Courts.

We believe that in addition to neutrality, any tax system should promote ease of compliance and be as efficient as possible. We find it especially disingenuous that the opening salvo of the policy paper contained a graph seemingly highlighting the supposedly low amount of compliance time required to complete a Canadian corporate tax filing. We note that this data set from 2016 would not yet include the monumental cumulative compliance burden of this Government's proposed changes to private corporation taxation and the changes previously enacted by this Government to the small business deduction and the dividend stripping rules contained in subsection 55(2). Those previously enacted changes have resulted in a <u>massive</u> increase in complexity and compliance time. For example, small business must now assess the composition of revenue to determine if any revenue was from a payor where a related party has even a miniscule equity interest. Additionally, significant compliance time is required in completing detailed and time consuming safe income calculations for virtually every private corporation wishing to pay an inter-corporate dividend. As such, we question the Department's motives in including such a chart with these proposals. Is the Government actually advocating for increased compliance time and costs? We find this curious as this seems to be at odds with both this Government's comments in previous budgets and with the actions currently being undertaken by the taxation authorities of many other jurisdictions.

Finally, there has been much discussion from the Government on the topic of tax fairness. The word "fair" is a relative term. In some of the Minister of Finance's recent comments in the media, the Government seems set to dismiss what many would consider important distinctions that don't lend to direct comparison between the employee and the family of a small business owner. With that in mind, we are hoping that another important tax fairness issue will resonate with the Department and the Government. In our considered opinion an employee, such as Susan from the example given in the policy paper, will never in his or her lifetime face the issue of double taxation (double taxation being where the same income is taxed more than once). This proposed legislation, as we will expand upon in the following commentary, is rife with pitfalls for the private corporation owner which results in double taxation that, in some instances, could amount to effective taxation rates in excess of 90%.

With the current political climate in the United States, we believe this Government is missing an opportunity to attract and retain talent from not just the United States but around the world, by increasing the compliance burden on private companies and instituting an uncompetitive high-tax regime (especially in light of the recently announced proposed tax cuts and simplification of the US tax code).

Tax On Split Income ("TOSI") Proposals – Technical Comments

Although there are other parts of the Act that deal with the splitting of income (i.e. pension splitting between potentially wealthy pensioners) the Government appears intent (based on comments in the media and comments from the Department) on focusing solely on income splitting through private corporations. If there is no persuading this Government to the contrary, we must plead for the Department to please review the means by which this is to be accomplished. The complexity of the draft legislation and the accompanying compliance burden cannot be understated. Despite assertions by the Government to the contrary, these rules require every small business owner who wishes to pay a dividend from a private corporation or sell shares of a private corporation to perform an analysis to determine if:

(a) the individual is a "specified individual" (using the new expanded definition which includes aunts, uncles, nieces and nephews);
(b) determine if there is any "split income";
(c) determine what amount of that "split income" is a "split portion" that is then subject to TOSI. This determination of what constitutes a split portion requires a reasonability judgement of the functions performed for the company by the specified individual and capital contributions. These tests are ambiguous, lacking readily accessible comparisons and potentially span a retroactive time frame for the "source business" that could extend many years into the past. The taxpayer must also remember that if the private corporation paying the dividend generates its income primarily from property (stock portfolio, real estate, other passive investments etc.) that all shareholders will be deemed to have not performed functions in respect of the company for the purposes of the reasonability test; and,
(d) apply a different set of rules to any shareholders aged 18 to 24 who will be deemed to not perform functions for the source business unless they are engaged on a regular, continuous and substantial basis.

These rules are especially difficult in the context of a traditional wasting estate freeze. As an example, Dad and Mom exchange their common shares of an operating company that they've held since incorporating the company twenty years ago for fixed value preferred shares. Daughter subsequently subscribes for the new common growth shares and actively takes over operation of the company. If Mom and Dad were both actively involved in the operations over those preceding twenty years but in the future are not, what constitutes a reasonable amount? What is the time frame to assess the labour and capital contributions over? Do we need to review the last twenty years in order to maybe determine what constitutes a reasonable amount that is not subject to tax at the top marginal rate? These shareholders are now potentially faced with dividends being taxed at the top marginal rate (+40% for other than eligible dividends) without the benefit of but a few tax credits. If you contrast this with the reasonability requirement for a wage (section 67) at least that reasonability test can be applied at a specific recent point in time (i.e. the year in which the wages were paid and services provided).

Another perplexing result of this proposed TOSI legislation is that, at face value of the wording of the draft legislation, it unfairly targets the young entrepreneur that may still be pursuing post-secondary studies. If the Government wants to accomplish "real change" and fulfill its election platform mandate of moving Canada past a resource based economy into "clean jobs", why is this Government proposing to punish the next potential Mark Zuckerberg? Let's say you're an 18 to 24 year old coding away on periodic nights in your dorm room at university and come up with the next Facebook. You then go and incorporate a private company, as you probably need to in order to provide a means to attract capital from family and friends (as there is already a challenge with attracting venture capital in Canada). Since you're attending university full time it is very likely you are not engaged on a regular, continuous and substantial basis in the business. All of

sudden you are faced with a 40%+ top marginal tax rate on a dividend without the benefit of any but two tax credits, and you would not be entitled to claim the lifetime capital gains exemption. Was this intended?

Finally, the draft legislation is extremely punitive to middle class owners of private corporations who may, perhaps unwittingly through lack of knowledge of the complex legislation, end up with dividends taxed at the top marginal rate that would be far in excess of what would otherwise be paid.

Again, if it is a foregone conclusion that the Government is proceeding with measures to address income splitting, is there not an easier alternative for the Government to accomplish its goal? We suggest, as an alternative, that the Government could accomplish many of its objectives in penalizing those who sprinkle income amongst family members by adjusting certain tax credits. The TOSI rules already contemplate that any split portion is subject to tax at the top marginal rate and is not eligible for any tax credits other than the dividend and foreign tax credits. For example, at the September 25, 2017 Canadian Tax Foundation Tax Policy Conference, Michael Wolfson presented a data set for the 2011 taxation year in which there were 986,500 taxpayers identified as Canadian Controlled Private Corporation owners. If we arbitrarily assume that 50% of those persons received a dividend from a private corporation that would amount to 493,250 taxpayers. Using that figure, if the Department of Finance was to deny the Federal basic personal amount tax credit to anyone receiving a dividend (even a dividend of $1) or reduce the basic personal amount dollar-for-dollar for any dividend from a private corporation that would result in potentially up to $860 Million (493,250 x $11,635 x 15%) in additional revenues for the Government. Now, one has to question the policy intent of punishing someone by taking away the basic personal exemption for merely owning shares of a private business and receiving a dividend; however, the Department's proposals effectively do the same.

Such a proposal would:

- discourage paying a dividend from private corporations to family members and especially those that might otherwise receive a low or no tax dividend (especially in this low income 18 to 24 year old subset);
- potentially generate three times more revenue than the government's estimate for its proposal;
- not require the insanely complex, multi-page draft TOSI legislation proposed the Department;
- provide a bright line such that taxpayers can plan their affairs without the massive uncertainty provided by reasonability tests;
- doesn't result in significant collateral damage of the proposed TOSI legislation that upends twenty years of conventional post-*Neuman*[1] tax planning and the related established corporate structures; and
- leaves few planning techniques to find holes in the application of the legislation which will undoubtedly be found in the TOSI legislation.

Another technical concern we have with the draft TOSI legislation is related to the proposals restricting access to the lifetime capital gains exemption ("LCGE"). These rules preclude a minor from claiming the LCGE, do not allow a claim by an individual in respect of any gains accruing while that individual was a minor, and do not allow an LCGE claim in respect of value accrued while the shares were held by a family trust. Many commentators have already pointed out issues related to intergenerational rollovers under section 73 and the potential retroactive denial of LCGE claims by the adult child for value accruing while that child was a minor. We would like to comment on the transitional provisions and the timeframe for making an election to trigger the LCGE. The

[1] Neuman v. M.N.R. [1998] 1 S.C.R. 770

provisions allow for a capital gain to be triggered in 2018 with a reduced 12 month holding period. Our concern is that the timeframe to accomplish this is very limited. In order for the shares to meet the definition of a qualified small business corporation share contained in section 110.6 of the Act, certain purification transactions must be accomplished before January 1, 2018 in an environment where we potentially do not have enacted legislation. Additionally, the proposals as currently worded will require an expensive and time consuming valuation exercise to be performed on QSBC shares, Qualified Farm and Fishing property to determine the gains accrued when an individual was a minor or the shares were held by a trust.

Specific Technical Concerns – Capital Gains Stripping Provisions

Before addressing some specific technical concerns with the proposed changes to section 84.1 and new section 246.1 of the Act, we would first like to address assertions by the Minister that the proposed changes are not retroactive in nature. Any assertion that these proposed changes are not retroactive in nature is patently false as these changes significantly impact the estates of any individuals that were deceased prior to July 18, 2017. Based on recent comments by Brian Ernewein at the CTF Conference on Tax Policy we believe that the Department is aware of this situation and we sincerely hope that consideration is given to transitional provisions to account for deaths occurring prior to July 18, 2017 where the estate may have been planning to implement a pipeline transaction as this is especially troublesome if the one year time frame from the date of death in which to enact a subsection 164(6) loss carryback has already elapsed.

On death, the estate of the owner of shares of a private corporation faces taxation on the same amount twice: once on death and again on the withdrawal of funds from the corporation by the estate. While we generally agree that as a principle the tightening of the legislation to disallow inter-vivos capital gains strips is warranted, we question the policy intent as it relates to post-mortem “pipeline” planning. We hope that it is not the Government’s policy intent to have the Act function to have double taxation readily apply on the death of a shareholder of a private corporation. If the Department’s draft legislation is not open to changes we hope that consideration will be given to extending the time frame for a subsection 164(6) loss carryback election to be made as in practice it is very common that due to legal issues (i.e claims brought against the estate, probate issues, taxpayers dying intestate etc.), the estate is not in a position to make that election within one year of death. In Alberta, if such a situation arises, the estate has an effective tax liability of at least 65%. Additionally, the 164(6) election does not deal with significant double taxation issues often faced by the estate. We hope that in the absence of available pipeline planning and potential section 88 “bump” planning for non-depreciable capital property, the Department will give some consideration to enacting a means by which an estate can port some of that external cost base to internally appreciated assets held within the corporation.

Perhaps our biggest concern with any of the draft legislation relates to the proposed new section 246.1. The breadth of application of this provision, based on its drafting style, is frankly staggering and in our opinion (given its application for transactions occurring on or after July 18, 2017) is already having a cooling impact on private company transactions. This legislation contains a purpose test that considers where one of the purposes of a transaction, event or series was to effect a significant reduction or disappearance of assets from a private corporation such that any part of tax otherwise payable under the Act by an individual is with respect to the portion and in consequence of distribution of property of a corporation, is avoided (read: at anything other than dividend rates). Such wording could apply to a host of transactions as virtually any transaction between a shareholder and a corporation would result in a reduction or disappearance of assets. Presumably, one of the main purposes is to prevent what the Department views as non-arm’s length transactions undertaken to give rise to capital gains for the purposes of surplus stripping. If that were solely the case, we would expect a provision more targeted towards offending

transactions; however, it appears to us that at least one of the other purposes of this provision is to give the Act a general scheme relating to surplus stripping and essentially force all amounts out of a corporation at dividend rates. We question if these policy concerns could be addressed in another much more simple fashion such as narrowing the spread between the taxation rate on a capital gain versus a dividend by either increasing the capital gains inclusion rate or lowering the dividend taxation rate.

The one conclusion that we've come to in reading the broad application of this provision is that you cannot be in business with family. As an example we'll again refer to a farming scenario: an incorporated farmer sells land held by the farming corporation for many years to a sibling (or any other family member) and this transaction gives rise to a gain on the sale. In such a scenario the farming corporation pays tax on the capital gain, the capital dividend account is reduced for the amount of the non-taxable portion of the gain and the farmer must take a dividend out (at rates potentially of 40% or higher) to ultimately extract the funds. You can contrast this with a sale to an unrelated party such as a foreign corporation or an unrelated land aggregator or an unrelated neighbour and the farm corporation ends up with a taxable capital gain. The farmer can withdraw half of that gain tax-free by way of the capital dividend account. Is the way the Department has worded this legislation truly consistent with the policy intent of the Government? It seems strange that this is directly at odds with various other provisions in the Act promoting the inter-generational transfers of farm property. An example given at the recent CTF Tax Policy Conference was also given with respect to publicly traded securities: sell them on the open market and you get a taxable capital gain, one-half of which can be paid to the shareholder tax free; sell the publicly traded securities to the shareholder to get them out of the corporation and the shareholder ends up with the amount as a much higher taxed dividend. While Department officials at the conference indicated that this is not the intent of the draft legislation, how is a taxpayer supposed to take solace in that and plan their affairs when the plain reading of the language of the legislation shows that it would certainly apply. This draft legislation could also apply to result in denial of capital gains treatment on a host of other bona-fide business transactions amongst related parties, which would not apply with arm's length parties. For example, the scope of the legislation would also apply to transferring appreciated real estate either between non-arm's length corporations or a shareholder transferring appreciated real estate to his or her corporation on taxable (anything other than a rollover) basis. Both of these scenarios would result in dividends instead of the capital gains treatment that would result on a third party sale. We urge the Department to either have a complete re-think of this legislation or significantly reign in the scope of its application.

Passive Investments Held in Private Corporations – General Comments

We question the policy intent regarding taxation of passive investments held within a corporation as a whole. While the lucrative and "family fortune" generating business of providing paid speaking engagements to associations, charities and other public bodies, seemingly never falls upon hard times, many other industries are often faced with cyclical downturns. Over the past two recessionary years in Alberta we have seen many clients have to liquidate passive investments in order to recapitalize an operating company to keep the doors open in an environment where there has been a flight of capital from the province and very tight credit market from commercial lenders. The current integration in Alberta actually results in a detriment of holding passive investments in a private corporation of up to 5% on certain income types.

One element of remuneration by way of dividends is that this does not constitute "earned income" for RRSP purposes under the Act and as such many private company owners have limited or no RRSP contribution room available. As a result, many small business owners have been saving for retirement in corporations and ultimately intending to withdraw those funds (with personal tax being assessed thereon) by way of dividend throughout retirement much akin to an RRSP. Suggestions that preferential types of individual pension plans that are somewhat akin to

Government pensions are available to small business owners ignore significant liquidity issues associated with such plans and the funding risk associated with such plans where the funder is not the ever borrowing Federal Government. It is understandable that many small business owners are quite upset at the rules changing that could impact their retirement savings that have been built up over existing rules in place for decades. While the policy paper makes mention of possible grandfathering existing passive capital pools, this will surely require extensive, complex anti-avoidance legislation in order to form a "wall" around those investments. We can foresee this being an extremely burdensome compliance activity that again we must question if the end is worth the means when what seems to be at issue is simply the supposed "headstart" that private corporations, with equity taxed at lower corporate rates, have available when compared to the unincorporated individual. There are other means to dealing with this that, again given the complexity of the rules that will be required for any of the proposed options, might provide a less costly and complex compliance regime with similar revenues for the Government. Such other means could include ideas such as:

- a forced or deemed withdrawal of equity above some sort of de-Minimis equity amount;
- simply getting rid of the small business deduction rate (perhaps combined with a reduction in the general corporate tax rate) and thus narrowing that deferral gap between the corporate and top personal rate; or,
- lowering personal tax rates.

Summary

In summary, the key concerns we have with the proposals set forth in the Department's policy paper are:

- The TOSI legislation as currently written is overly complex and impacts every private corporation in Canada. As written it will result in significant uncertainty for the taxpayer, prove to be extremely hard for the average small business to comply with and will likely result in a significant additional burden on the appeals process and tax courts;
- While we don't disagree with the policy objective of addressing a technical deficiency that has led to an increase in capital gains stripping transactions, the changes to section 84.1, and certainly the July 18, 2017 effective date for changes related to capital gains strips, has a profound retroactive impact on persons deceased prior to that date;
- The proposed section 84.1 and section 246.1 legislation will result in a huge increase of the instances of double taxation for owners of private companies resulting in tax rates potentially in excess of 65% and we do not see this as "fair";
- The breadth of application of the new section 246.1 is confounding and effectively tells taxpayers not to go into business with family members as they'll pay significantly more tax than dealing with arm's length parties; and,
- The timing of certain parts in the proposed legislation are unworkable. We are astounded with the amount of work that will need to be done in short order to try and utilize the transitional provisions that would allow certain clients to access the LCGE in 2018.

Key outcomes we would like to see out of this consultation process are:

- An extension of the timeframe to consider the impact of these proposed changes and a meaningful and objective consultation (perhaps by way of establishing an expert panel) with the business and tax professional community without any of the rhetoric that is coming from both sides of the debate;
- We would like the Government to acknowledge that income splitting is not in and of itself an "evil" premise as other parts of the Act specifically allow for it (for example pension splitting). If the Government will not reconsider the perhaps flawed policy rationale behind

solely attacking income splitting accomplished through private corporations, then we urge the Department to find a less complex and easier to administer approach to accomplish the Government's objective than the draft TOSI legislation as currently written;

- Consideration by the Department of means to alleviate the double taxation on death of shares of a private corporation through both extending the allowable timeframe to make a subsection 164(6) election and consideration of continuing to bless post-mortem pipeline transactions; and,
- The serious reigning in of the scope of the legislation or the scrapping proposed section 246.1.

We thank you for the opportunity to submit our comments. We look forward to hearing from the Department and the Minister of Finance on the outcomes of these consultations.

Sincerely,

SVS GROUP LLP

Greg Bendall, CPA, CA
Managing Partner