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September 29, 2017

Department of Finance Canada
90 Elgin St
Ottawa, ON K1A 0G5

Attention: The Honourable William Francis Morneau

Dear Minister Morneau:

Re: Tax Planning Using Private Corporations

We are providing a response to the paper issued by the Department of Finance on July 18, 2017. Previously we provided a submission which advocated that an independent commission be convened to study the proposed changes. We are now providing further specific comments regarding items contained in the paper.

The paper proposes that small business owners who own private corporations have received unfair income tax advantages in the past. However, we gain a sense from the paper that the government now wants to unfairly punish small business owners to balance out the previous perceived advantages. This is reminiscent of academics who may overstate their argument in their attempt to "swing the pendulum" to a more neutral position. However, the proposed changes are not simply an academic exercise. If the proposed changes are enacted, there will be a significant negative impact for "middle class" small business owners with private corporations.

The overarching theme of the paper is fairness. It further argues that equality of taxation for the middle class wage earner and the 1% business owner is fair. Is this the correct argument? Is equal always fair? Accounting professionals regularly address this when providing succession planning advice. Dividing assets equally may not be fair for the child who has been active in the business. Employees and self-employed individuals are treated differently under the *Income Tax Act* (the Act). Employees are much more restricted with regards to the types of expenses that may be deducted. Presumably this is viewed as fair.

The Act itself is partly a political document. It has been crafted in a way to encourage or discourage certain behaviours in our economy. For example, capital gains are only taxed at one-half. Presumably this encourages capital investment. Capital cost allowance also is usually higher than amortization under generally accepted accounting principles. Presumably this encourages investment in depreciable property. Perhaps it could be argued that small business owners of private corporations should be allowed to have some income tax benefits to encourage a thriving small business sector. Owners of private corporations assume more risk than wage earners and shareholders of public companies.

The proposed changes with regards to income sprinkling and passive investments are too complex. We understand that the pursuit of fairness will lead to a certain amount of complexity. However, there comes a point where the Act becomes too complex. Certain recommendations from the Carter commission were not implemented due to complexity. Some may have been implemented for only a short period of time. Taxpayers may begin to simply ignore complex rules with the thought that the Canada Revenue Agency (CRA) cannot audit everyone.

The increased complexity will lead to increased compliance costs. Taxpayers are already dealing with additional costs relating to sections 55 and 125. They may reach a limit for increasing costs. Again, they may simply choose to ignore the proposed changes if enacted.

The paper refers to the middle class and the very wealthy or highest income earners. We believe it would be helpful to define what is meant by these terms. The assumption is that the proposed changes will only affect the very wealthy. However, we believe that the changes will have a significant impact on all small business owners with private corporations, including middle class business owners.

We suspect that those who are very wealthy could be more mobile and choose to relocate to another country. This option likely is not available to the majority of small business owners. However, a significant number of our best and brightest may choose to leave Canada. This will negatively affect our economy.

We will provide our comments regarding the three main areas contained in the paper – income sprinkling, passive investments and converting income into capital gains.

Income Sprinkling

- The proposals are too complex. There must be a simpler way to address the issue.
  - Tracking labour and capital contributions and previous remuneration for the entire period of share ownership will become onerous. It would be extremely difficult to analyze this for a company that has existed since some time in the 1980s or earlier.
- The reasonableness standard becomes highly subjective. The shareholder's sense of what is reasonable will most certainly differ from the CRA's. This likely will lead to increased caseloads in the tax courts.
- The proposed legislation will effectively be applied retroactively where a share freeze was previously implemented. A significant portion of the preferred shares could be owned by a spouse who was inactive in the company. The proposed changes will lead to taxation at the highest rate for the preferred share redemptions. This is a punitive result and is unfair. If there had been only one active shareholder from the start of the company, he or she may have been able to structure his or her affairs so that the dividends on subsequent redemption were taxed at a lower rate.
  - If the proposed legislation remains relatively unchanged when presented to parliament, there needs to be provision for a transition period to allow for reorganization of existing share ownership without income tax consequences. In inactive spouse should be able to transfer share ownership to the active spouse at cost without subsequent attribution. Trusts should be allowed to wind up with transfers of shares to the active shareholder. Where the trust was wound up in the transition period, the shares will continue to qualify for the capital gains deduction while the shares were owned by the trust. The transition period may need to be longer than one year given the increased workloads for accountants and lawyers.
- The reasonableness tests do not make good sense.
  - What happens if the individual has already received a reasonable wage? In fact, an active shareholder could receive an extremely high wage and it will not be challenged by the CRA.
  - Linking a dividend on a common share to assets contributed makes no sense. Private companies are rarely financed by high amounts of paid-up capital in the shares. Common shares are usually issued for nominal amounts. When assets are contributed, the shareholder would usually receive a combination of note receivable and preferred shares. Any payment for assets contributed should be tied to the note receivable and preferred shares not the common shares.

Often the only other risk assumed is the personal guarantee for debt. All common shareholders would likely participate in this risk. The risk lies with personal assets rather than the common shareholdings. So one is left with the original capital contributed for those common shares. One should be able to receive significant dividends for a capital contribution of $50.
    - The proposed reasonableness tests may border on the absurd. There could be situations where no shareholders (of a related group) are very active in the business and no shareholders have contributed significant amounts of capital. Are all dividends subject to the highest rate? If one assumes that they would have had incomes in excess of $200,000 anyway, it may not matter. However, we suspect that this is not the case for the majority of shareholders of private corporations.
- With regards to multiplication of the capital gains deduction (CGD), our experience indicates that this is predominantly performed through fully discretionary family trusts. If the government finds this offensive, we suggest that the proposals should be restricted to allocation of gains from a family trust. The vast majority of business owners would not have significant common share ownership by children who are inactive in the business. Typically, common share ownership would be restricted to children who are active in the business.
    - The transitional provisions allow for 2018 elections on underlying capital gains. Shareholders of private corporations will be faced with a dilemma. They may be unable to determine if they would ever sell the shares of the company to an arm's length party. Many exits from the business occur as asset sales. The valuation of the shares will be costly. Penalties will be significant if the valuation is not agreed to by the CRA. The elections could trigger alternative minimum tax and affect means tested income such as Old Age Security. The proposed election will have a far more significant impact than the repeal of the CGD in 1994 for all capital gains. We believe this is unfair for owners of private corporations.
    - The paper proposes that any capital gains that accrue before the individual attained the age of 18 will not be eligible for the CGD. Farmers currently have the ability to transfer land, family farm partnership interests and shares of a family farm corporation at cost to the next generation. We think it is unfair to now exclude underlying gains that existed while that child was under the age of 18 when he or she subsequently sells the asset. There are situations where assets will be transferred from a 75 year old parent to a 50 year old child. It will be onerous to attempt to value the asset at the time that the child was 18. Furthermore, the Act already contains an anti-avoidance provision for multiplication of capital gains related to qualified farm property. This is contained in subsection 69(11). If the current proposals are enacted, they should not apply to a subsequent disposition of qualified farm property.
- We understand that the Carter commission proposed taxation of the family unit. This should resolve income sprinkling issues with spouses and minor children.
    - Taxation of the family unit will be fair for all taxpayers including middle class wage earners.
    - To reduce complexity, the Department of Finance could limit the tax on split income (TOSI) to adult children ages 25 and younger. This would eliminate the vast majority of income splitting with adult children who are not active in the private corporation.

Passive Investments

- We believe that the existing approach is the correct one. We do not need to move to a system where income from passive assets is taxed at a rate of 70%.
- Table 7 contained in the paper shows that, under the current system, the after tax value is less than 5% more for funds generated by a private corporation when compared to funds generated by a wage earner. On an annual basis, governments receive no more income tax from the private company. There seems to be a notion that private corporations and their shareholders should pay a total of 70%

income tax on investment income to provide equality with wage earners. Are the added complexity and compliance costs worth chasing after less than a 5% difference that has no appreciable impact on government revenues?

- The paper includes the following statement when referring to the 1972 approach: "In announcing the change, the Minister of Finance cited concerns that the provision was 'complex and difficult,' at a time when the *Income Tax Act* was not as detailed as it is today." It strikes us that the current proposal is equally complex and difficult with a more detailed Act.
  - One will need to track income from passive assets owned prior to and after December 31, 2017. This will be difficult as new assets are added and comingled with old assets.
  - One will need to track whether the passive asset was derived from income subject to the small business limit or income subject to the general rate.
- Why have passive assets owned by public companies not been addressed by the Department of Finance? Is it because other jurisdictions do not have taxes to discourage retention of passive assets? Is there a concern that public companies would seek to relocate to other jurisdictions or that profits would be shifted to other jurisdictions? It is unfair to attack passive assets owned by one type of company, but not another.
  - It would be possible for a public company to hold passive assets indefinitely. These assets may never be distributed to shareholders or reinvested in active assets.
  - By contrast, the vast majority of passive assets of private companies will be distributed to individuals. We suspect that the vast majority of private corporations are owned by spouses. On the death of the last spouse, the shares will be deemed to be disposed at fair market value. The company will either be wound up in the first year of the estate or the beneficiaries will utilize a pipeline strategy. The result of either is the removal of assets to the individual level. Some of the beneficiaries will be the middle income wage earner. Some of the funds will be spent in our economy.
  - Taxation can be deferred for passive assets in a private company. They will not be eliminated. It is simply a matter of timing.
  - Passive assets of a private company will eventually be transferred to individuals. This is not a certainty with a public company.
- Some shareholders of private corporations have intentionally chosen to remunerate themselves with dividends. They choose not to pay into the Canada Pension Plan. This removes the ability to contribute to Registered Retirement Savings Plans. Their private corporation is their retirement pension. We believe it is unfair to remove the ability to utilize a private corporation as a retirement savings vehicle.
  - More recently, you have stated that the proposals will encourage reinvestment in the business. We think this is unlikely. If shareholders of private companies are saving for retirement, they may simply choose to withdraw excess cash and continue to save the after tax dollars. The funds will not be immediately spent in the Canadian economy.
- The paper assumes that the growth in passive assets has occurred to benefit wealthy professionals. We think that there are other possible reasons for the growth.
  - The farm economy has been quite successful in the past few years. However, those that endured the late 1980s and early 1990s know that the farm receipts could decline for a variety of reasons including market forces for grain prices, weather and pests. Many will prudently want to retain passive assets to assist them with weathering the bad years. After a poor year, they will need cash to seed the next crop, continue to make loan payments and continue to live. Cash requirements could easily be $1 million.
    - Some farmers will establish investment companies so that the shares of the operating company will continue to qualify for intergenerational rollover. Invariably one of their first questions will be with regards to lending funds back to the operating com-

pany in the case of a bad year. Passive assets are held for reasons other than income tax deferral. We do not believe the current tax system should be changed to penalize farmers and other business owners who save for contingencies.
  - Baby boomers are increasingly exiting business operations as they grow older. If there is no successor in the family, they may be selling assets to a purchaser. The previous active assets are converted into passive assets. These shareholders should be allowed to gradually withdraw passive assets to minimize income tax in retirement. They should not be subject to 70% taxation to simply appease some perceived notion of equality with wage earners.

Converting Income into Capital Gains

- It seems to us that the proposals were primarily trying to address the use of "pipeline" strategies during one's lifetime where one is simply converting dividends into capital gains with one's own private corporations. We can see how the Department of Finance would find this offensive. If desired, we believe that the proposals should be limited to preventing the use of "pipeline" strategies during one's lifetime. We believe that "pipeline" strategies should still be available for use as a post mortem strategy.
- Your letter at the start of the paper states that your next step is "addressing tax planning strategies, closing tax loopholes and making sure all Canadians pay their fair share . . ." Including tax planning strategies with tax loopholes indicates that tax planning is a bad thing. However, jurisprudence has established that a taxpayer should be able to organize one's affairs in order to minimize taxes. Tax planning strategies are not inherently bad. The vast majority simply address minimization of income taxes.
- Using "pipeline" strategies post mortem is not about utilizing loopholes or trying not to pay one's fair share of income tax. The Act requires a deemed disposition for shares at fair market value on the death of the owner where the shares are not bequeathed to spouse. The "pipeline" strategy simply attempts to eliminate double taxation that would otherwise occur. This is not an attempt to not pay one's fair share. It eliminates having taxpayers paying double their fair share.
  - There are times when corporations cannot be wound up within one year after death. The government seems content with taxpayers paying more than their fair share in these situations.
  - It is very likely that middle income wage earners are beneficiaries of shares of private companies. Should they also not benefit from the use of a particular strategy to eliminate double taxation?
- The proposals will also prevent certain succession planning. Shareholders of private corporations will continue to be able to sell shares to arm's length corporations, record a capital gain and claim the CGD. Previously shareholders of private corporations could sell shares to a child's private corporation and record a capital gain as long as the CGD was not claimed. The proposals will prevent this. Succession will become much more difficult. Shareholders of private corporations are encouraged to sell to arm's length parties. This is unfair.
- The new section 246.1 is too broad. It needs to be refined so that taxpayers understand where it applies. Currently there is much confusion.
  - Some suggest that this section will apply to a farmer transferring personally owned farmland to the family farming company. He or she would claim the CGD and receive a shareholder's loan for the transfer. Commentators have indicated that the receipt of the shareholder's loan will be a taxable dividend to the transferor. Is this the intent of 246.1? It makes little sense to us that the transfer of a tax paid asset to a company could result in recharacterization of the proceeds as dividends.

- § If 246.1 applies to the transfer of farmland, it logically could also apply to the transfer of farm partnership interests and routine section 85 rollovers. Again, we do not think 246.1 should recharacterize the resulting shareholder's loan as a taxable dividend.

We consent to the disclosure of our submission in whole or in part.

Yours truly,

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