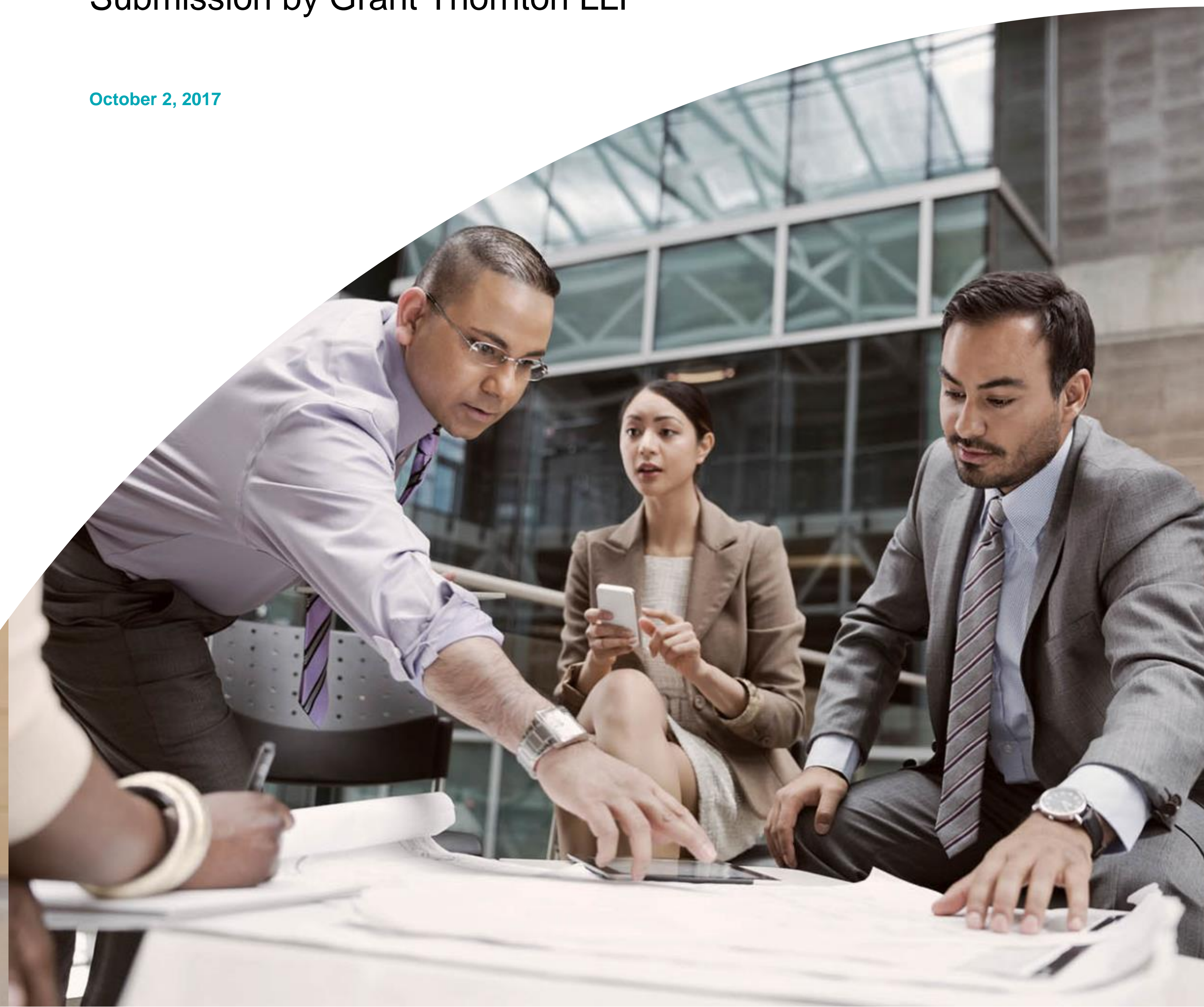
Grant Thornton
An instinct for growth™

Tax Planning Using Private Corporations

Submission by Grant Thornton LLP

October 2, 2017



Contents

Summary Letter 3
Part I: Income Sprinkling 6
Part II: Converting a Private Corporation's Regular Income into Capital Gains 23
Part III: Holding Passive Investments Inside a Private Corporation 40
Part IV: Impact statements 50
Part V: Summary and Recommendations 68
Part VI: About Grant Thornton 75

Audit • Tax • Advisory
© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Grant Thornton
An instinct for growth™

Grant Thornton LLP
50 Bay Street, 12th Floor
Toronto, ON M5J 2Z8
Canada
T +1 416 366 4240
F +1 416 3604944
www.GrantThornton.ca

Minister of Finance
The Honourable Bill Morneau
Department of Finance Canada
90 Elgin Street
Ottawa, Ontario K1A 0G5

House of Commons
Parliament Buildings
Ottawa, Ontario K1A 0A6

Sent via email: fin.consultation.fin@canada.ca

October 2, 2017

Dear Mr. Morneau,

Re: Submission Addressing July 18, 2017 Proposals – Tax Planning Using Private Corporations

We are pleased to enclose our submission with respect to the proposals released by the government on July 18, 2017 concerning "Tax Planning Using Private Corporations". More specifically, the government released a consultation paper[1] as well as draft legislation and draft explanatory notes[2] (collectively "the Proposals") which focused on three areas (i.e., income sprinkling, passive investment portfolio, and converting income into capital gains) which the government believes enable some owners of private corporations to gain unfair tax advantages. The government is seeking input on these Proposals and has invited stakeholders to provide submissions until October 2, 2017.

---

[1] "Tax Planning Using Private Corporations", Department of Finance, Canada, July 18, 2017, Available: https://www.fin.gc.ca/n17/data/17-066_1-eng.asp)

[2] Legislative Proposals Relating to the Income Tax Act, the Income Tax Act Regulations and Explanatory Notes, Department of Finance, July 2017, Available: https://www.fin.gc.ca/drleg-apl/2017/ita-lir-0717-eng.asp). Note, draft legislation and explanatory notes were only provided for income sprinkling and converting income into capital gains.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Grant Thornton
An instinct for growth™

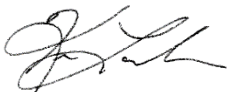
Grant Thornton LLP (Canada) appreciates the opportunity to provide its views and concerns as well as those of its clients (i.e., through the inclusion of their impact statements in Part IV of this submission) with respect to these Proposals. In the discussion to follow, we have set forth our views and concerns regarding the likely adverse impacts on taxpayers, technical deficiencies or uncertainties that we have noted with the Proposals as they are currently drafted and also provide suggestions. For ease of reference, our discussion is presented in the following manner:

- Part I: Income Sprinkling (Tax on Split Income & Lifetime Capital Gains Exemption)
- Part II: Converting a Private Corporation's Regular Income Into Capital Gains
- Part III: Holding Passive Investments Inside a Private Corporation
- Part IV: Impact Statements
- Part V: Summary and Recommendations
- Part VI: About Grant Thornton

Grant Thornton would be pleased to discuss this submission further and would welcome the opportunity to work with the government to pursue ways to refine the Proposals.

Please do not hesitate to reach out to Heath Moore or Linda Woo should you have any questions or comments about the contents of this submission. We remain committed to working with you.

Sincerely,



Kevin Ladner
Executive Partner and Chief Executive Officer

Heath Moore
National Tax Services Leader

Audit • Tax • Advisory
© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Part I

Income Sprinkling

Part I: Income Sprinkling

Summary Description of Proposals

Tax on Split Income

Currently, tax on split income ("TOSI") or "kiddie tax", applies on certain types of income (i.e., "split income" received by an individual who has not attained the age of 17 years old before the beginning of the year (a "minor"), and who is a Canadian resident and has a parent that is resident in Canada. If the TOSI rules apply, the minor will be subject to income tax at the highest personal tax rate that would otherwise be payable on the split income received.

The current rules do not prevent dividend sprinkling with adult family members. Once the child reaches 18 years of age, the TOSI rules will not apply. In addition, income that has been previously subject to the attribution rules or TOSI, can be reinvested by the minor and the subsequent income from reinvestment is taxed in the hands of the minor at their normal marginal rates.

In addition to the existing rules, it is now being proposed, in simple terms, that any split income paid to adult family members, and any income earned on that which has been previously subject to the attribution or TOSI rules, will now be subject to the TOSI regime and taxed at the highest applicable marginal rate, subject to a complex and uncertain set of carve out rules based on "reasonableness". The proposals also expand the definition of split income to now include income from certain types of debt obligations and gains from the disposition of property after implementation date the income from which is split income.

These changes are expansive and in our view represent a significant and material policy shift from previous legislation. The intended effect of the proposals will be achieved to the extent that corporate owners in the top personal tax bracket will be unable to sprinkle income with family members who are performing no notable business functions or do not meet one of the "reasonableness" criteria, but it is our opinion that there will also be many unintended consequences to owners of small and medium sized businesses who are involved in less quantifiable or measureable bona fide business transactions. These unintended effects are discussed further in the sections below.

The proposals, if enacted, will apply for 2018 and subsequent taxation years. The current rules will continue to apply throughout 2017.

Lifetime Capital Gains Exemption

Currently, Canadian residents are entitled to claim the lifetime capital gains exemption ("LCGE") in order to reduce a capital gain realized on the disposition of qualified small business corporation ("QSBC") shares and qualified farm or fishing property. Personal trusts also possess the ability to designate taxable capital gains to beneficiaries so that if the qualifying capital property is held in a family trust when sold, the beneficiaries are able to use their LCGE to reduce the taxable capital gains. The ability to set up corporate structures that involve family members and use a family trust in this manner has the impact of effectively multiplying the LCGE and minimizing the overall capital gains realized on disposal of these shares even though the family members may not have formally invested in, or otherwise contributed to, the value of the business.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Currently, the use of the LCGE is limited where a minor makes a disposition to a non-arm's length purchaser. Where a minor disposes of private corporation shares to a non-arm's length person, the gain is taxed at the top marginal rates as a non-eligible dividend (the minor also loses the 50% inclusion rate). This is in line with the existing TOSI legislation which only target minors.

As part of the changes to the TOSI legislation, it has been proposed that access to the LCGE be limited in the following ways:

- No LCGE may be claimed in respect of capital gains that are realized, or that accrue, before the taxation year in which the individual attains the age of 18 years old;
- No LCGE may be claimed on gains that accrue during the time that property is held by a trust, unless the trust qualifies as an "eligible LCGE trust"; and,
- A reasonableness test would be required in determining whether the LCGE applies in respect of a capital gain. To the extent the gain from the disposition of property is included in an individual's split income, the LCGE would not apply in respect of the capital gain from the disposition.

These proposals will apply to dispositions occurring after 2017. However, a grandfathering rule is proposed to enable the filing of an election (the "transitional election") to crystallize the LCGE in 2018.

Tax Policy Concerns and Technical Issues

Before we discuss the specific issues relating to these proposals, we would first like to address three overarching concerns that exist with these proposals– "family unit", "subjectivity" and "complexity":

Family Unit

Subjectivity

Complexity

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

1. Family Unit

Income sprinkling is not a new concept to the Canadian taxation system. As noted in the Paper, the Income Tax Act (Canada), RSC 1985, c. 1 (5th Supp.), as amended (referred to in this submission as the "Act") contains various provisions to curtail the use of income sprinkling. For example, section 67 of the Act provides that only 'reasonable' amounts can be deducted when a corporation pays a salary or management fee that benefit another person including a family member. In 1999, the government implemented the TOSI rules in order to limit income sprinkling with minors. When the TOSI rules were implemented, it was a conscious decision by the government at the time to target specified individuals under 18 years of age as opposed to all family members. By not including adult family members in these rules the government did not create a loophole through which taxpayers could take false advantage, they simply continued to allow taxpayers to engage in a tax planning strategy that was already in place.

Over 50 years ago, the Royal Commission on Taxation[3] acknowledged the contribution each family member makes to the family's finances, and recommended that the "family unit" be the appropriate taxing unit. However, by extending the application of TOSI to adults, and applying a "reasonableness" test, the government has removed the ability for a family to income split among adults who are not active in the business and have thereby disregarded the reality that the family is the basic economic unit, that family members particularly spouses/common-law partners who are not active in the business contribute to the success of the family business, and the fact that

3 "Report of the Royal Commission on Taxation", Queen's Printer (Ottawa, 1966), Vol. 3

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

spouses/common-law partners have property rights with respect to such family business assets.

The colloquial term “family business” implies the whole family is typically involved in some respects in the business. The relationship between a business and business owner is not the same as the relationship between the employee and the employer. Typical private business owners do not work a standard 40 hour week and their families must therefore compensate. To evaluate a family member’s contribution to a business primarily on the basis of formal hours worked within the business and capital contribution does not factor all of the necessary elements. Additionally, it appears overly simplistic to assess the risk assumed by a family member simply on the basis of any formal guarantees they might have made. A spouse in particular assumes no smaller amount of risk simply through not being involved in the day-to-day operations of the business.

> *“My wife became a French Immersion teacher and supported me and my business for the first few years. She now stays at home and invests her time bringing up our kids. While she isn't an "active employee", she is the reason my company exists. And now I can't pay her dividends?”*
>
> Owner, Software Company

The government itself has also been inconsistent on its views in the past on income sprinkling particularly with a spouse or common-law partner. For example, individuals have been able to split their pension income with their spouse or common-law partner and, an RRSP annuity, a RRIF and certain other forms of annuities, in the case of individuals age 65 or over, since 2007. In addition, a “Family Tax Cut” was introduced in 2014 which allowed individuals with children under the age of 18 to notionally transfer up to $50,000 to a spouse or common-law partner to access a non-refundable credit.[4] Also, family law has historically taken the position that both spouses make an equal contribution to the marriage, which implores the question as to why the tax system would not take the same position. The importance of consistency within the tax system is important as it facilitates a taxpayer’s understanding of the rules in which they must inhabit.

[4] This provision has since been repealed.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

2. Subjectivity

The proposed expansion of the TOSI rules and the related narrowing of access to the LCGE will impact any private business owner where a related party is receiving income, directly or indirectly, from the business in some manner. The only limit to this expansive application is through the reasonableness tests that have been proposed.

> While the concept of "reasonableness" is not new within the Act, we submit that in the context of the proposed rules, the multitude of points of judgment and assessment of reasonableness will be beyond the scope of most taxpayers and potentially that of the Canada Revenue Agency ("CRA").

Without significant additional guidance, it is our view that there is a risk that the CRA will assess and treat taxpayers differently across the country. With the myriad of business arrangements that exist in practice it becomes much more difficult and perhaps impractical to provide guidance for every possible circumstance in determining what is to be considered reasonable in the circumstances. For example, consider the following: taxpayers will now be required to determine (and similarly the CRA to be able to assess)

- what a reasonable retirement income is for an owner whose children have taken over the business but still rely on him informally to help guide the future growth of the business; or
- what a reasonable income is for a female owner who has built her business from nothing but has now made the decision to step back from the daily operations so that she may spend more time with her young children; and
- what a reasonable return on investment would be for an aging parent who has invested in their child's business because the child was unable to secure external financing.

We submit that too many circumstances exist to provide meaningful guidance that is understandable and perhaps more importantly, provides certainty and predictability to both taxpayers and the CRA. Without certainty and predictability in the tax system, business owners may incur significant costs and time objecting and appealing CRA assessments where there are material disagreements over an assessment of reasonableness. This will most certainly lead to an additional burden on the court system as the determination of how this should be applied will undoubtedly rest there.

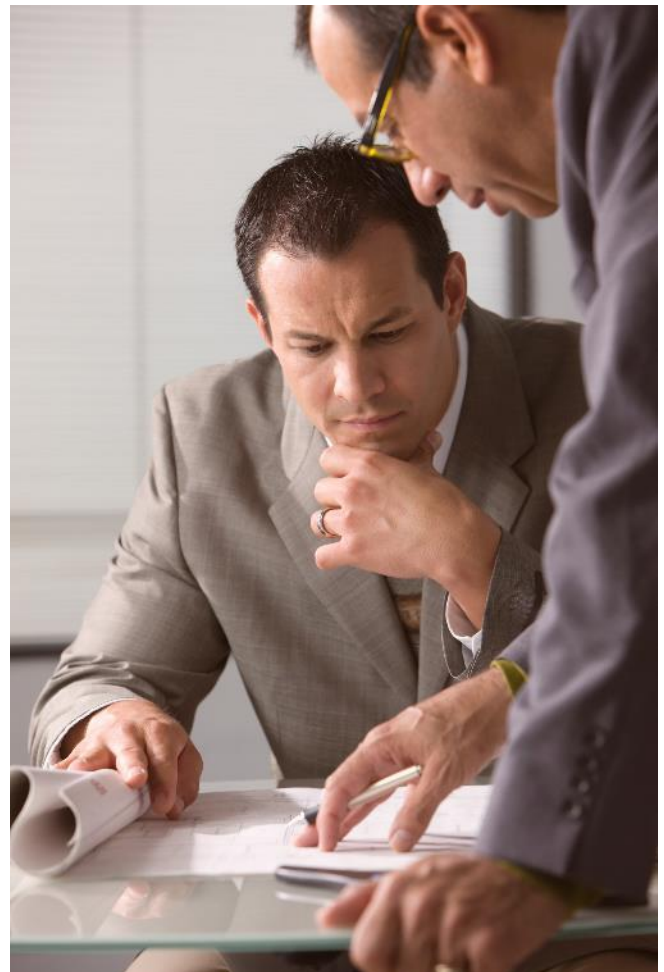
© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

3. Complexity

One of the major tenets of effective tax legislation is simplicity, particularly where it applies to a large percentage of taxpayers. The importance of simplicity lies in the fact that taxpayers need to be able to understand the rules under which they are operating in order to be able to comply with them. The proposed income sprinkling legislation is by no means simple, and this complexity will have a number of effects on the corporate tax compliance process in Canada:

1. The tax compliance process will become more costly for all parties involved. As taxpayers attempt to navigate the proposed changes they will need to rely more heavily on their external advisors – which will result in greater costs to the business owner. Furthermore, the CRA's costs will also increase as more auditors will be required to ensure compliance with these rules.
2. The administration and compliance process will become more onerous for taxpayers as a result of the record keeping that will be involved to prove reasonableness. This will be more important for corporate owners retiring or near retirement because they will be required to prove what a reasonable income would be based on the full period that they have been involved with the business, as well as provide backup for any previous returns and remuneration taken.
3. Additional administrative and financial costs will also result due to the need for a valuation of the private business shares at various points in time. The proposed TOSI rules will require such valuations take place in order for a taxpayer to prove the reasonableness of any financial returns they have received on their investment. Additionally, the proposed LCGE rules will require a valuation to take place in the event that a taxpayer wishes to take advantage of the 2018 transitional election or when a shareholder turns 18 years old. Furthermore, this valuation will be required regardless of how small or large the business is.

In summary, the subjectivity and complexity issues are important as they highlight the true impact that these changes will have on the landscape of the Canadian taxation system.



© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Analysis of the "Reasonableness" Test

The expansion of the TOSI rules will potentially impact a wide range of taxpayers by taxing what could in some cases be a substantial portion of their overall income at the highest marginal tax rate. The only limitation to the impact of this proposal is through the application of the reasonableness tests that have been included, and a thorough examination as to the effects and implications of this test is therefore integral to the technical discussion surrounding this proposal.

The test itself will consider factors such as labour and capital contributions made to the business, risks assumed, and any previous returns or remuneration that have been taken. It is proposed to that the rules apply differently based on the age of the adult individual:

- For individuals aged 18 to 24 years old, the individual must essentially be working full-time in the activities of the underlying business. In the case that the individual has contributed capital to the corporation, the amount of the return will be limited to the prescribed rate of return (currently 1%).
- For individuals aged 25 years or older (including a spouse or common law spouse) the individual will be mostly restricted to reasonable amounts based on what they would be paid for their services as an arm's length employee, or a reasonable rate of return on any capital contributed.

Anti-avoidance rules have also been included with respect to both the labour and capital contribution portion of the reasonableness test. If the principal purpose of the business was to derive income from property, or 50% or more of the income is from property, an individual is deemed not to have performed any labour function. Furthermore, an individual is deemed not to have contributed assets if the contribution came from split income or from a loan or guarantee by a related person.

There is a great deal of subjectivity in evaluating a specified individual's contribution to a business. We have attempted to address some of these here:

1 Emphasis on labour component

The application of the reasonableness test will likely rest heavily on the labour contribution component as this appears to be the simplest way in which to evaluate a specified shareholder's ongoing contribution. This means that, where an individual becomes less involved in the day-to-day operations of the business (i.e. their labour contribution decreases as a result of less hours worked), their overall contribution value will also decrease. This can be problematic when unexpected circumstances arise - for example, maternity leave, a disability or illness, etc. In these cases, and certainly others as wells, the specified individual's overall contribution to the business is potentially at risk when simply assessing based on labour alone, in which case, it may be viewed that such an individual is receiving an unreasonable amount under the TOSI rules. Also, in a family business where one family member earns a higher salary than the other in a particular year, will this be determinative of an unreasonable amount in respect of the dividends paid in that year? This uncertainty and lack of the ability to provide a bright-line test will undoubtedly lead to unintended results.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

2 Treatment of capital gains

The reasonableness test and related TOSI legislation appears to treat capital gains in the same manner as dividend or interest income. We question whether this treatment is appropriate, given that the underlying transactions are by their nature completely different. An income distribution will represent a return on investment but the value of a share and the resulting capital gain is meant to reflect the growth of the overall business. To include capital gains in the TOSI rules creates additional complexities with regards to the determination of how much of the overall growth of a corporation can be allocated to and between shareholders. Furthermore, the ability of a taxpayer to prove this allocation in any sort of manner seems unrealistic as there would be minimal formal documentation that would prove a specific shareholder's share of the growth of the business from time to time. The uncertainly in relation to determining reasonableness of an income amount is further compounded by the requirement to undertake valuations of the shares at various points in time during the period of direct or indirect ownership of the shares.

3 External benchmarks

Currently, there is limited information available to taxpayers in relation to external comparative benchmarks. In practice, it is often very difficult to compare one private corporation to another, even within the same industry, due to size, territorial scope, profitability, family and professional management involvement, external versus internal capital, etc. Income ranges are generally not comparable based on these factors. Furthermore, in terms of assessing what a reasonable amount of income would be to a specified shareholder, it does not seem appropriate to make the comparison strictly to that of an arm's length employee as the nature of the relationship between employee and employer is completely different from that of a business and business owner and related family members. Therefore, in the absence of an appropriate comparative the subjectivity involved with the test will only increase and create more uncertainty.

4 The concept of reasonableness

The overall concept of reasonableness and, in particular, the comparison to an arm's length may not be appropriate in the determination of value or income amount because a business by its very nature is formed with the intention of generating returns and income that surpass what the business owner could expect to make as an employee. Thus, the implementation of a test which results in a shareholder only being able to withdraw an amount of income or value based on what they have contributed into the business does not encompass the true nature of the entrepreneurial spirit.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

"How would this government have measured our "contribution" to the success of our family business? My T4 would have suggested that I made little or no contribution. Yet I know that to be totally untrue. The contribution that a family member makes to a family business cannot be easily measured by a T4 or by a CRA auditor deciding whether or not a family member's contribution was "reasonable" in the circumstances. In fact, most people would say that my contribution to our family business was completely unreasonable as no "arm's length" unrelated person would have done the same."

Ms. Angela Maltese, CPA, CA, CFP
Tax Partner, Grant Thornton LLP

5 Definition of "specified shareholder"

The use of the term "specified shareholder" is problematic and implicates a number of individuals that the proposals could not possibly have intended to effect. Based on the definition, an individual who is related to a corporate owner will likely be considered a specified shareholder and connected individual with regards to the corporation. This implication may not have an immediate effect, but where the corporate owner solicits financing from family members in order to assist the business through a tough financial period, there is the risk that TOSI will apply to any income earned by the related party investors.

6 Risk to retired shareholders

There are specific issues with regards to the potential risk that retired business owners would face as a result of these proposals. The risk is that, while many business owners will hold retirement funds within their corporations, it is generally uncommon for private businesses to pay retirement income to an arm's length employee. This raises a specific issue with regards to the benchmarking ability for retirement income. Without a reasonable benchmark there is a higher risk that retirement income will be deemed unreasonable and taxed at the highest rate. The impact to taxpayers nearing retirement should not be overlooked, this is a sensitive sector of the population and any tax impacts that would reduce the amount of income available on retirement may have the unintended effect of adding costs to an already overburdened social services sector.

7 Reporting

There appears to be a lack of clarity as to who will bear the burden of determining the amount that is subject to TOSI and how this income will be reported. Consideration should be given to whether this income will be reported on an information slip, and to who will be responsible for preparing this slip. A lack of clarity in this regard will surely result in taxpayer errors and therefore, greater policing required by the CRA.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Summary

In summary, instead of proceeding with these proposals, we recommend that the existing rules in section 120.4 be maintained with the exception that they will now also apply to individuals up to the age of 24 years old.[5] Most of the income splitting that is of concern to the government appears to be here. This would significantly decrease any perceived benefits available to owners of private corporations yet recognize the valid and often unrecognized contributions spouses and common law partners provide to a family business and while also eliminating the complexity in the proposed rules.

The removal of the extended definition of related party under the proposed TOSI rules would again eliminate unintended results, simplify the proposed rules, and would recognize in practice that income splitting with such extended family members is rare and where this does occur, that the parties generally act as unrelated in any event.

(Un)Intended Implications of TOSI Proposals on Businesses

Effect on Succession Planning

Effective succession is an integral part of planning for any private business. We note that succession planning transactions will be impacted by the proposals in the following ways:

- Impact on “wasting freeze” transactions as part of a succession plan: To carry out this transaction, a shareholder would typically exchange his/her common shares for redeemable, retractable preferred shares equal to the fair market value (“FMV”) of the common shares. When the preferred shares are redeemed, a dividend to the shareholder would result. This type of transaction has become extremely common place to support a successful succession plan for private corporations. The impact the proposals will have on this type of transaction is that, if those taking over the operations of the business become “specified” shareholders and “connected” individuals (as defined in the draft legislation) prior to the exchange taking place, there is a risk that a portion of the dividends paid on the redeemed preferred shares would be subject to the TOSI rules in the future. Or alternatively, the dividends could simply be viewed as unreasonable in the future if the labour provided to the corporation has decreased.

[5] This can easily be accomplished by amending any reference to “age “17” in the definition of “specified individual” in subsection 120.4(1) of the Act, to “age 24”.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

- Impact on share sale transactions for promissory note consideration: In order to carry out this transaction, a shareholder would typically sell their shares in exchange for a promissory note equal to FMV that would be payable over time. As with the wasting freeze situation, if those taking over the operations of the business become "specified" shareholders and "connected" individuals (as defined in the draft legislation) prior to the sale taking place, there is a risk that a portion of the capital gain on sale would be deemed to be a dividend under subsection 120.4(4) and therefore subject to TOSI.
- Impact on retained earnings being used as retirement funding: It is not uncommon for retired business owners to use the earnings of their business as a way of funding their retirement. Upon retirement, their contribution to the business will have changed for purposes of the reasonableness test. Because of this change in contribution, TOSI may apply. This risk is higher where the business owner has retired, and upon his/her retirement the company has ceased its original business and essentially takes on a new one that primarily earns investment income; thus the "source business" has changed.

  The concept of the source business is important as the reasonableness test is based fully on what is reasonable with regards to the source business. Where the source business is deemed to be that of investing, it is likely that the dividends received by the retired shareholders would be subject to TOSI and taxed at the highest rate.

The impact that the proposals will have on succession planning is important because it may affect whether a taxpayer simply sells his/her shares of the private corporation to an arm's length third party as opposed to developing and grooming the next generation to essentially take over the business. From an economic standpoint, changes such as these have a far larger implication that is beyond the potential taxation revenue that can be earned on a succession transaction.

Audit • Tax • Advisory
© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Potential Reorganization Required

The impact that the proposals would have on private business owners is substantial, particularly for the small and medium sized business owners. These business owners typically incorporate with a very simple share structure where only one class of shares is issued. As a result, the same amount of dividends must be paid to each shareholder which risk TOSI applying if one of the shareholders is not involved in the business and does not meet the criteria as set out in the reasonableness test.

In order to remedy this unintended result, a reorganization of the capital of the corporation would need to take place to create varying classes of shares which could be issued to different shareholder. This would facilitate the distribution of different dividends to shareholders depending on their level of involvement with the business. Where the shareholders of a private corporation comprises of many generations of family members, this could result in complex share issuances. Furthermore, if these proposals are enacted, such reorganization would need to take place prior to the end of 2017 due to the proposed effective date of the proposals of January 1, 2018. This does not provide shareholders with a great deal of time to reorganize their affairs especially where there may be third party owners involved in the business.

Application of Proposals to Unincorporated Business

The income sprinkling proposal notes that income and capital gains from partnerships and trusts will be included in the definition of split income. By including partnership income in this definition, individuals may unknowingly find themselves subject to TOSI simply due to the fact that they were involved in an unincorporated business with a related party.

This is because all that needs to occur for there to be a partnership is for two people to be carrying on a business with a common view to profit. Therefore, by the very nature of this definition, a husband and wife who simply purchase a house with the intention of renovating and reselling it for profit, could be seen to be operating a partnership and the activity of purchasing, renovating and selling it could be considered “an adventure or concern in the nature of trade” (as defined in subsection 248(1) of the Act). As a result of this partnership status and the complexities related to the definition of a specified shareholder, both the husband and the wife may be subject to TOSI on the profits from the sale of the house.

This transaction is not likely one that the government was intending to affect with these proposals, but due to the broad definitions for split income and specified individual, it is one that is unfortunately caught. Given that this type of transaction is not uncommon and the taxpayers engaging in these transactions are likely not well versed in the Canadian tax laws, the effects of the proposed TOSI legislation should consider this.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Technical Issues with LCGE Proposals

Subsection 110.6(12)

Proposed subsection 110.6(12), which provides the manner in which the LCGE is to be reduced where an ineligible capital gains transaction occurs, has the potential to impact a taxpayer's use of the LCGE in unintended ways.

More specifically, paragraph (d) of subsection 110.6(12) causes the amount of LCGE that is "deductible by an individual" to be reduced by "twice the amount of the taxable capital gain". The result of this wording is that, in years where multiple capital gains have occurred, and certain of those gains are eligible under the LCGE because they fall outside the paragraphs in subsection 110.6(12), and certain gains are ineligible because they fall under subsection 110.6(12), a taxpayer may find themselves unable to apply the LCGE against the eligible gain due to the fact that two times the amount of the ineligible gain has been disallowed in that year.

We recommend that the proposals be amended to so that it reflects the specific taxable capital gain that this subsection is meant to apply to as opposed to the total amount of LCGE deductible by an individual as it is currently worded.

Effect on Qualified Farm or Fishing Property

Qualified farm and fishing property has historically been subject to unique treatment under the Act. Under the proposals there may be issues in terms of how the gains on disposal of such property will now be treated. The potential issue arises because qualified farm and fishing property is eligible to be transferred between family members at an amount that is less than FMV. This means that such property is able to be transferred throughout generations on a tax deferred basis, and the ability to do so has been a long standing principle of Canadian tax policy. As there is no exception for qualified farm and fishing property under subsection 110.6(12), paragraphs (c) and (e) of that subsection could have the effect of reducing the LCGE on the sale of qualified farm and fishing property by the amount in which the FMV exceeds the cost amount.

This result does not seem to be in line with the overall tax treatment of such property throughout the Act. We therefore recommend that qualified farm and fishing property be excluded from the proposals.

Treatment of Graduated Rate Estates ("GREs")

Under the proposals, only "eligible LCGE trusts" will retain the ability to allocate capital gains that are eligible for the LCGE to its beneficiaries. This provision clearly limits the effectiveness of trusts to be used as a tax planning tool, and it also poses additional concern on the ability of an estate to distribute capital property to its beneficiaries. As a result of this limitation, any gains that accrue on capital property while it is being held by the estate of a deceased taxpayer will not be eligible for the LCGE. We recommend that the definition of an eligible LCGE trust be expanded to include GREs to ensure that post-mortem transactions are treated consistently throughout the Act.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Transitional/Grandfathering Rules

The proposals, if enacted, will apply to gains that occur after 2017. Transitional rules however, have been provided with the intention of allowing eligible taxpayers to elect to dispose of certain eligible property on a day in 2018 and realizing any accrued taxable capital gains for purposes of claiming the LCGE. Certain amendments however, should be considered in order to ensure that the transitional period is executed in the most effective manner:

- In order for a taxpayer to be eligible for the transition election, any share reorganization or purification required to ensure that the corporation qualifies as a QSBC will need to commence prior to the end of 2017. These dates do not provide taxpayers sufficient time, especially when one considers the uncertainty that exists regarding these proposals and whether these changes will be implemented in their current form. As a result of this uncertainty, we recommend that the transitional period be amended to take place in a calendar year that provides a reasonable amount of time from the date of Royal Assent of the legislation.
- The proposed election includes a late-filing penalty that appears to be especially punitive when compared to other existing late-filing penalties. It is estimated that the monthly penalty imposed would be approximately $1,393 to trigger the maximum LCGE for the transitional election. This appears to be excessive given that other late-filing penalties for elections in the Act are generally less than $200 per month.
- If a taxpayer elects to have a deemed disposition take place under the transitional rules, and an alternative minimum tax (“AMT”) is triggered, the taxpayer may not be in a position to recover the AMT in the future depending on their circumstances. This would seem punitive given that the purpose of the transitional election is to provide relief. In our view, any gains resulting from the elective disposition of the QSBC shares in 2018 should be exempt from the AMT regime.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Suggestions and Recommendations

Before proceeding with the implementation of these proposals, we recommend the following:

A. Expand Existing TOSI Regime to up to 24 Years Old: Instead of proceeding with these proposals, we recommend that the existing rules in section 120.4 be maintained with the exception that it will now also apply to individuals up to the age of 24 years old. Most of the income splitting that is of concern to the government appears to be here. This would significantly decrease any perceived benefits available to owners of private corporations yet recognize the valid and often unrecognized contributions spouses provide to a family business, while also eliminating the complexity in the proposed rules.

   The removal of the extended definition of related party under the proposed TOSI rules would again eliminate unintended results, simplify the proposed rules and would recognize in practice that income splitting with such extended family members is rare and where this does occur, that the parties generally act as unrelated in any event.

B. Application of the Reasonableness Test: We recommend that further guidance be provided as to how the government intends to apply the reasonableness test and ensure that the subjectivity, the technical issues that may impact unintentional taxpayers, and the vast application and wide-reaching effects, are addressed.

C. Subsection 110.6(12): Subsection 110.6(12) can have a negative impact where a taxpayer has multiple dispositions and realizes multiple capital gains in a given year – some of which are eligible for the LCGE and some of which are not. We recommend that the proposals be amended to reflect the specific taxable capital gain that this subsection is meant to apply to, as opposed to the total amount of LCGE deductible by an individual as it is currently worded.

D. Treatment of Qualified Farm or Fishing Property: Qualified farm or fishing property is eligible to be transferred between generations for an amount that is less than FMV. This will result in additional tax consequences under the LCGE proposals. This result does not seem to be in line with the overall tax treatment of such property throughout the Act. We therefore recommend that qualified farm and fishing property be excluded from the proposals.

E. Treatment of Graduated Rate Estates (GREs): Currently, GREs are not included in the definition of an “eligible LCGE trust” for purposes of the LCGE proposals. This appears to be overly punitive for deceased taxpayers and their beneficiaries. We recommend that the definition of an eligible LCGE trust be expanded to include GREs to ensure that post-mortem transactions are treated consistently throughout the Act.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

F. Transitional/Grandfathering Rules:

1. Transitional Period - In order for a taxpayer to be eligible for the transitional election, certain steps will need to be carried out prior to the effective date of the proposals. These dates do not provide taxpayers with sufficient time, especially when one considers the uncertainty that exists regarding these proposals and whether these changes will be implemented in their current form. As a result of this uncertainty, we recommend that the transitional period be amended to take place in a calendar year that provides a reasonable amount of time from the date of Royal Assent of the legislation.

2. Late-Filing Penalty - The imposition of a late-filing penalty for the transitional election available under the LCGE proposals appears to be overly punitive and inconsistent with the penalties imposed for other late-filed elections in the Act. We recommend that this penalty be revisited and reduced accordingly.

3. AMT - The potential imposition of AMT is unnecessarily punitive for taxpayers who are trying to organize their affairs to comply with the proposals. We therefore recommend that the government consider exempting any AMT that may arise as a result of the transitional election.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Part II

Converting a Private Corporation's Regular Income into Capital Gains

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Part II: Converting a Private Corporation's Regular Income into Capital Gains

Summary Description of Proposals

Section 84.1 of the Income Tax Act (Canada), RSC 1985, c. 1 (5th Supp.), as amended (referred to in this submission as the "Act") is an anti-avoidance rule that prevents an individual from avoiding tax that would ordinarily arise on a taxable dividend by removing corporate surplus through a non-arm's length transfer of shares. More specifically it applies when an individual sells shares of a corporation to a non-arm's length corporation, the two corporations are "connected" (as defined in the Act) immediately after the sale, and the individual receives non-share consideration (such as cash or a note receivable) for the shares in excess of, the greater of two amounts - the adjusted cost base ("ACB") of the shares and the paid up capital ("PUC") of the shares. If section 84.1 is applicable, the non-share consideration received by the individual in excess of the greater of these two amounts will be treated as a taxable dividend.

The Consultation Paper ("the Paper") notes that section 84.1 as it is currently worded could be circumvented by carrying out transactions that are not caught by its specific terms. Currently, section 84.1 prevents surplus stripping to the extent that the cost to an individual of his or her share(s) represents capital gains realized that were eligible for the lifetime capital gains exemption ("LCGE") or represented pre-1972 surplus. In other words, the capital gains were effectively tax-free to the non-arm's length seller. It does not apply where the related parties had realized capital gains that effectively formed part of the cost of the shares and the individual could establish that a capital gains exemption had not been claimed in respect of those gains.

The Paper expresses concern regarding surplus stripping and proposes two measures: to extend the application of section 84.1, and introduce a new anti-avoidance provision (i.e., proposed section 246.1).

The Government also notes in the Paper that it recognizes that section 84.1 can result in an impediment to the transfer of a business from one generation to another within a family. The Paper suggests certain "hallmarks" that might apply to intergenerational transfers and has invited comments regarding whether, and how, it would be possible to better accommodate genuine intergenerational business transfers while still protecting against potential abuse of any such accommodation.

The proposed amendments to section 84.1 are intended to prevent individual taxpayers from using non-arm's length transactions that result in an increase in the adjusted cost base ("ACB") of corporate shares in order to avoid the application of section 84.1 on a subsequent transaction. This would be accomplished by expanding the circumstances under which subsection 84.1(2) will apply. Subsection 84.1(2) will be amended to reduce the ACB of a taxpayer's share, or substituted share, by the total of all capital gains realized in respect of previous dispositions of the share, or a share for which it was substituted, by the taxpayer and any non-arm's length individual; this cost base reduction will apply regardless of whether a LCGE was claimed on a previous disposition.

New section 246.1 is an anti-avoidance provision and will apply where the individual receives amounts from a person who is not at arm's length, and it can reasonably be considered that one of the purposes of the transaction or series of transactions was to effect a significant reduction or disappearance of assets of a private corporation in a manner that avoids tax. If this section applies, the individual is deemed to have received a taxable dividend.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

The changes to section 84.1 and new section 246.1, if enacted, would apply to any dispositions that occur, and amounts that are received or become receivable, respectively, on or after July 18, 2017.

Tax Policy Concerns and Technical Issues

Although the changes to section 84.1 were intended to target those who have structured their share sale transactions in order to use the legislation in a manner that was unintended by the government, the proposed changes will result in a far more serious impediment to the legitimate transfer of family businesses from one generation to the next or to another related party and will result in a tax system which favours an arm's length third-party sale. A policy that creates an environment where it is more advantageous for a taxpayer to dispose of their private company shares to a third party (such as a public entity or even a foreign entity) does not support the small to medium sized business community within Canada – a group the government has claimed to be trying to help.

The Government notes in the Paper that it "is interested in the views and ideas of stakeholders regarding whether, and how, it would be possible to better accommodate genuine intergenerational business transfers while still protecting against potential abuses of any such accommodation". Yet, the proposed changes to section 84.1 take a broad brushstroke that further discriminates against "genuine intergenerational business transfers." There has to be a better way to address the government's concerns. In our experience of working with thousands of small and medium enterprises from coast to coast, we can confirm that abuses of the current section 84.1 are incredibly few and far between.

These proposals also adversely impact post-mortem tax planning strategies that exist to prevent double taxation from occurring on the death of an individual who holds shares of a private company. Without such tax planning strategies, the estate will pay tax on the deemed disposition of the shares at the time of death, and again when the company is eventually wound up. Double taxation as a result of death seems unnecessarily punitive as the deceased is not attempting to pay less tax; furthermore, death is an inevitable occurrence that is a part of life. Although previous governments have permitted post-mortem tax planning strategies under section 84.1 there does not appear to be any accommodation for this under the new proposals.

Section 246.1 is a general anti-avoidance provision to target tax planning which circumvents the current tax rules which were designed to prevent the conversion of a private corporation's surplus into tax-exempt, or lower-taxed, capital gains. The proposed wording is broad and ambiguous and appears to potentially include transactions that would have previously been considered to have occurred in the ordinary course of business. This has created a lot of uncertainty, which is further compounded by the fact that the draft explanatory notes do not contain any examples of the type of situations that the government intended this provision to apply to. This, along with the retrospective application (which is discussed later on), creates an impossible environment for taxpayers to organize their affairs.

We have set out below concerns regarding the likely adverse impacts on taxpayers, and various technical deficiencies or uncertainties that we have noted with the proposals as they are currently drafted:

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Section 84.1

Post-Mortem Planning

When an individual dies, he/she is deemed to dispose of all of his/her capital property at fair market value (“FMV”)[6], including private company shares, and the estate is deemed to acquire the capital property at a cost equal to the FMV at the time of death; in other words, the estate has an adjusted cost base (“ACB”) equal to that FMV. If the capital property are shares of a private company, there can often be double taxation in the absence of tax planning because the same economic gain that was taxed in the hands of the deceased may be taxed again in the hands of the private company (and its shareholders) when the company's assets are ultimately disposed of and the net proceeds are distributed to shareholders.

[6] Pursuant to subsection 70(5) of the Act.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

The following two strategies are typically used to provide relief from the double taxation:

1. Subsection 164(6) capital loss carry-back planning - This provision generally allows a capital loss realized in an estate to be carried back and claimed in the deceased's final tax return to offset all or a large portion of the capital gain that arose on the individual's death. The overall net result is that tax on the dividend in the estate arises on the windup of the private company. However, because the dividend tax rate is much higher than the capital gains tax rate, a pipeline strategy (discussed below) is typically preferred.

   Using a simple example to illustrate, assume Mr. A dies owning shares of an operating company ("Opco") which have a FMV of $1 million dollars and a nominal ACB and paid-up capital ("PUC"). On his death, Mr. A will have a deemed disposition for proceeds of $1 million and realize a capital gain of $1 million. The shares will pass to his estate with an ACB of $1 million. If, within the first year end of the estate, these shares are redeemed, the estate will realize the following:

   i. A deemed taxable dividend of $1,000,000[7], and
   ii. A capital loss of $1,000,000 – this is because the proceeds of disposition received on the disposition of the shares owned by the estate will be $nil[8] but the ACB of these shares will be $1 million (as a result of the deemed disposition on Mr. A's death).

   Because the resulting capital loss is within the first year end of the estate,[9] subsection 164(6) will permit this capital loss to be carried back to the terminal return and applied against the capital gain reported on the deemed disposition of the shares.

2. Pipeline Planning - A new corporation is used to create a so-called "pipeline" of debt or high PUC shares that allows assets to be distributed to the estate (or its beneficiaries) without additional tax payable. The overall net tax result is that only capital gains tax is paid on the death of the individual. The steps involved in a basic pipeline planning are as follows:

   i. Mr. A is the sole shareholder of Opco.
   ii. Mr. A dies and is deemed to dispose of his Opco shares immediately before death at their FMV, the FMV will be the ACB of the shares to the estate.

---

[7] Pursuant to subsection 84(2) of the Act.

[8] Pursuant to paragraph (j) of the definition of "proceeds of disposition" in section 54.

[9] Assuming it is a "graduate rate estate" as defined in subsection 248(1) of the Act.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

iii. The estate transfers the Opco shares to a new corporation, Newco, in exchange for shares of Newco and a promissory note equal to the FMV of Opco at the time of Mr. A's death.

iv. Opco pays inter-corporate dividends to Newco, which in turn, uses the funds to repay the note to the estate.

The pipeline plan allows funds from Opco to be distributed to the estate tax-free by way of inter-corporate dividends to Newco which then repays the promissory note to the estate.

One advantage of using a pipeline is to allow the income to be taxed at capital gains rates instead of dividend tax rates, while still avoiding the double tax that can arise on the death of the shareholder. This particular advantage has increased in recent years as the government has chosen to increase the income tax rate differential between capital gains and dividends, presumably for policy reasons that they feel are fair and appropriate in all circumstances other than when dealing with the death of a shareholder of a private corporation.

The proposed changes however, will now result in the higher dividend tax rate applying instead of the lower capital gains tax rate for pipeline structures. The impact of the proposals to these post-mortem strategies is best illustrated through a numerical example.

Example:

Assume Mr. A owns shares in an Opco, having a fixed value of $10,000,000. The ACB and PUC of the shares held by Mr. A is nominal. Mr. A has retired for some time now and has transitioned the management of the business to his son. If Mr. A dies and leaves the shares to his son under his will, the estimated tax consequences to Mr. X and his estate on his death, under the current rules and the proposed rules would be as follows:

Current Rules

Prior to July 18, 2017, Mr. A would realize a capital gain of $10,000,000 in his final terminal return, and his estate would have an estimated income tax liability of approximately $2,676,500.[10]

To avoid the double tax that would otherwise arise, the estate or Mr. A’s son would implement a pipeline plan whereby the estate or Mr. A’s son would transfer the Opco shares to a new company (“Newco”), and receive in return a promissory note or shares of Newco with high PUC equal to the ACB of Mr. A’s shares plus the capital gain realized on death. The promissory note, or amounts on the reduction of the PUC, could be paid out over time without any additional tax to the estate or Mr. A’s son. The pipeline strategy would enable the value inherent in Opco’s shares to be realized by (and taxed in) Opco over time so that the after-tax income or taxable gains may be distributed to

[10] $10M x 50% x 53.53% (assuming the highest marginal tax rate for an Ontario resident) and Opco shares do not qualify for the lifetime capital gains exemption.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Mr. A's son. This type of planning was generally acceptable.[11]

Proposed Section 84.1

Under proposed section 84.1, the pipeline strategy can longer be used to avoid the double tax on death because the ACB of the shares to the estate for purposes of section 84.1 will be reduced by the capital gain deemed to be realized by Mr. A on death.[12] As a result, the estate will still have tax payable of approximately $2,676,500[13] on the capital gain realized on the deemed disposition however, an additional $4,530,000[14] of tax will be payable by the estate or Mr. A's son as the shares are redeemed over time. In other words, the total taxes payable in respect of Mr. A's shares will potentially increase from $2,676,500 to $7,206,500, an increase from approximately 27% to over 72%.

If the shares are redeemed prior to being distributed to Mr. A's son the estate would have a capital loss. However, if the estate distributed the shares first to Mr. A's son and the shares are then redeemed, Mr. A's son will have capital losses which would be "suspended" [15] until he is no longer "affiliated" with Opco (for example, Opco is liquidated or the son sells the shares of Opco to an arm's length third party, or the son dies). Thus, the son may not be able benefit from these capital losses until years later. In addition, it appears that a portion of the capital loss may be denied under subsection 112(3.2), to the extent that Opco elects that a portion of the deemed dividends on redemption be treated as capital dividends.

If the estate were to instead, carry out the subsection 164(6) capital loss carry-back planning, the double tax can be avoided and the capital gain triggered on death can be reduced; however, the estate will have an immediate tax liability of $4,530,000 compared to the tax that would have otherwise been payable under the existing rules, or if Mr. A's son chooses to instead; sell Opco to a third party. Although this provides a better

[11] Subject to concerns regarding the possible application of subsection 84(2) of the Act if the business of Opco is wound up or discontinued upon or shortly after implementation of the post-mortem plan. These concerns were generally satisfied by requiring a "continuity of the business" period of at least one year.

[12] It is assumed that the estate will be considered to have acquired the shares from a non-arm's length person (i.e., Mr. A).

[13] As a result of the proposed amendments to subsection 120.4(4), all or a portion of Mr. A's capital gain from the disposition of the shares on his death is likely to be deemed to be a taxable dividend because Mr. A was not "active" in Opco's business before he died. As a result, the tax payable on Mr. A's death will be increased from $2,676,500 to potentially $4,530,000; proposed subsection 120.4(4) applies to deem twice the amount of Mr. A's taxable capital gain to instead be a taxable dividend.

[14] $10M x 45.3%. Assuming that the deemed dividends are taxable at the top marginal personal tax rate for Ontario.

[15] Pursuant to subsection 40(3.4) of the Act - because Mr. A's son still owns the common shares of Opco

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

result than double taxation, there are practical issues with using this strategy:

- The capital loss must be generated within the first year of death. This timing may not be practical – issues such as complicated estate administration, or pending/potential estate litigation may exist and are beyond the control of the estate. In many cases there are shareholder agreements or other contractual agreements in place that cannot be changed, and do not allow for the transactions necessary to give rise to a capital loss.
- Opco may not have liquid assets to redeem the shares and financing restrictions may impact the Opco's ability to borrow to redeem the shares.
- The subsection 164(6) election can only be used if the estate qualifies as a graduated rate estate (as defined in the Act) which may not always be the case.
- Subsection 164(6) planning generally requires the shares to be disposed of, which does not accommodate the intergenerational transfer of private companies within families. This is particularly the case where there are other shareholders in the company. This serious restriction is not the case where pipeline planning can be undertaken.
- Subsection 164(6) planning generally does not accommodate "bump" planning that is made available under paragraph 88(1)(d) of the Act. This paragraph was put in place to specifically address the government's tax policy concerns surrounding double taxation where the underlying assets of the company have accrued gains. Pipeline planning very easily accommodates bump planning. In the past it has been possible to roughly model bump planning in situations where the subsection 164(6) planning is to be undertaken by triggering gains in an internal reorganization prior to executing the subsection 164(6) planning. However, this planning is complicated, costly, and requires the consent of other shareholders. As well, the proposed tax on split income rules, proposed section 246.1, and the expected changes to the taxation of passive income within a corporation all create significant concerns about the effectiveness of this "pseudo-bump" planning in subsection 164(6) situations.
- Subsection 164(6) planning is completely ineffective where the capital gain on death is taxed as a dividend as a result of the proposed "tax on split income" rules. This is a serious technical deficiency, particularly where the private company earns income from property.

Simply put, even if there were no tax rate differential between pipeline planning and subsection 164(6) capital loss planning, pipeline planning would be a preferred method to avoid double-taxation of private company shares on death because it is a superior and much more adaptable planning technique in all but the most basic of situations. As business realities become increasingly complex, subsection 164(6) planning is simply not a sufficient tool to avoid double taxation on death.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Inter-Vivos Share Transfers

If a business owner wishes to transfer all or a portion of the business to his/her children or to another family member, he/she would typically carry out a series of transactions to ensure the total after-tax cost is equal to that which would have been paid if the business was sold to an arm's length third party. Such transactions were generally accepted and considered typical planning in respect of genuine related party business transfers. However, proposed amendments to section 84.1 will now result in additional tax costs and penalize business owners if such transactions are carried out, thus discouraging business owners from selling the business to family members.

The tax implications on a sale of shares to a family member compared to a sale to an arm's length third party as a result of the amendments to section 84.1 are illustrated below.

Example 1

Mr. A owns shares of a corporation ("Opco") which manufactures light fixtures. Mr. A wants to retire and pass on the business to his son and daughter (both over 25 years of age and currently involved in the business). Mr. A plans to fund his retirement with the proceeds received from the sale of his business to his children. Opco is currently valued at $20,000,000 and the ACB and PUC of the shares is nil or nominal. Mr. A's children currently do not have the personal funds or available resources to purchase Mr. A's shares.

- Prior to July 18, 2017 if Mr. A does an internal share exchange and triggers a capital gain of $20,000,000 (and does not claim the LCGE), and then transfers the Opco shares to a holding company ("Newco"), incorporated by his children, he can receive in return a promissory note of $20,000,000. Mr. A will recognize a capital gain of $20,000,000 and will have taxes payable of approximately $5,353,000.[16] Note, this is a worst result than would have occurred on a sale to an arm's length corporation, as Mr. A is required to forego a lifetime capital gains exemption ("LCGE") claim of $835,000.
- Under the new proposed rules, however, Mr. A will have no "hard ACB" for purposes of section 84.1 since his ACB was derived from a capital gain in respect of a previous disposition by him (i.e., the internal share exchange). Therefore, if Mr. A receives a $20,000,000 promissory note, that amount will be deemed to be a taxable dividend and will be subject to tax of as much as $9,060,000[17] (potentially on top of the $5,353,000 already paid if the reorganization described above was undertaken in advance of July 18, 2017).
- If Mr. A was to, instead, sell the business to an arm's length third party, he will be able to shelter some of the capital gain with his LCGE of $835,000

---

[16] $20,000,000 x 50% x 53.53% (the highest marginal tax rate for an Ontario resident).

[17] $20,000,000 x 45.3% (the highest marginal tax rate for ineligible dividends for an Ontario resident). It is also assumed that Opco does not have a GRIP balance (previously-taxed retained earnings that were subject to the "high" corporate tax rate).

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

and the total taxes owing would be approximately $5,130,000.[18]

Example 2

Assuming the same facts as in the prior example, except that Mr. A sells the shares of Opco directly to his children, and receives a $20,000,000 promissory note as consideration and the children subsequently transfer the shares of Opco into a new holding company ("Newco"), and repay the promissory note to Mr. A over time using Opco's earnings.

Current Rules

- Prior to July 18, 2017 when Mr. A sells the shares to his children, he will recognize a capital gain of $20,000,000 and will pay total taxes of approximately $5,353,000.[19]
- Opco must generate, over time, $27,210,900 of pre-tax earnings to fully fund the payment of the $20,000,000 promissory note plus taxes of approximately $7,210,900.[20]
- Thus, the total combined tax paid by Mr. A and Opco will be $12,563,900 (i.e., $5,353,000 paid by Mr. A and $7,210,900 paid by Opco). This represents an effective tax rate of approximately 46%.
- Alternatively, if Mr. A sold the shares to an arm's length third party, the same total tax of $12,563,900 would be paid (i.e., Mr. A would pay tax of $5,353,000 on the capital gain (or possibly less if he used his LCGE) and the third party purchaser could fund the purchase price with $7,210,900 of pre-tax earnings of Opco. In this case the only "penalty" to Mr. A for selling the shares to his children versus to a third party is the lost ability to use his LCGE.

Proposed section 84.1

- When the children transfer the Opco shares to Newco and take back a $20,000,000 promissory note so that the earnings of Opco could help fund the purchase price to Mr. X, the children will be deemed to have received a taxable dividend of $20,000,000 and pay tax of $9,060,000.[21] This is because the ACB of their shares would have been reduced from $20,000,000 to nil as a result of the proposed amendments to section 84.1. Therefore, $9,060,000 of additional tax would be paid compared to a sale of the Opco shares by Mr. A to an arm's length third party. This represents total

[18] $20,000,000 - LCGE of $835,000 x 50% x 53.53%.

[19] 20,000,000 x 50% x 53.53% (the highest marginal tax rate for an Ontario resident).

[20] $27,210,900 x 26.5% (Ontario corporate tax rate).

[21] $20,000,000 x 45.3% (the highest marginal tax rate for ineligible dividends for an Ontario resident). It is also assumed that Opco does not have a GRIP balance (previously-taxed retained earnings that were subject to the "high" corporate tax rate).

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

taxes of $21,623,900 (i.e., $5,353,000 paid by Mr. A, $7,210,900 paid by Opco, and $9,060,000 paid by the children). This represents an effective tax rate of approximately 108%. This does not factor in the corporate and personal taxes that will have to be paid on income required to help the children fund their $9,060,000 tax bill.

- If the children were to instead fund the purchase personally (i.e., not using the funds from Opco), the children would need to receive net after-tax distributions from Opco of $20,000,000 over time. Assuming salaries were paid to the children (and ignoring payroll taxes) approximately $43,038,500[22] would need to be earned by the children (the total taxes paid would be $23,038,500). This is significantly more than the $27,210,900 that Opco would need to have earned to fund the purchase price under the current rules.

These two examples illustrate how the tax results on a sale to a family member under the pre-July 18, 2017 tax rules is more favourable for a third party arm's length sale compared to a sale to a related party (i.e., family member). They also illustrate how the proposals make it even more favourable to do an arm`s length sale. Without any relief, families may be discouraged from transferring the family business between family members because the inherent gains will either become effectively fully taxable as dividends or will be double taxed as a consequence of a future disposition of assets by the corporation.

"The new proposals also create a significant double-tax exposure on our deaths, with no way to plan around that 80%+ tax hit. They also make it very difficult for us to involve our children in ownership. By creating this punitive treatment during retirement, a tax bill on death that would likely bankrupt our estates, and serious roadblocks to transitioning the business to the next generation, the only real logical alternative is for us to sell off the hotel to a third party – likely a public company or a non-resident. Simply put, this does not seem right. I cannot understand why tax policy would be developed that pushes small businesses like ours, after two generations, into extinction."

Co-owner, Hotel

[22] $20,000,000/(1-53.53%) (the highest marginal tax rate for an Ontario resident).

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Intergenerational Transfers

The proposed changes could adversely affect legitimate intergenerational transfers of businesses due to the significant amount of taxes required on a sale of a business to a family member compared to a sale to an arm's length third party. The government indicated in Budget 2017, as well as in the Paper, that it would "consider whether there are features of the current income tax system that have an inappropriate, adverse impact on genuine business transactions involving family members". The Paper suggests various hallmarks that ensure a "genuine intergenerational transfer" of a business and for which the same tax treatment can be provided as for a sale to an arm's length corporation. These include:

- the vendor ceasing on the transfer to have factual and legal control of the transferred business;
- the intent of the new owner to continue the business as a going concern long after its purchase;
- the vendor not having any financial interest in the transferred business; and
- the vendor not participating in the management and operations of the business.

Unfortunately, these hallmarks are not necessarily representative of what typically occurs in many arm's length sale transactions involving private corporations. For example, a vendor does not always sell a controlling interest in the corporation, and even where a controlling interest is sold, it is typical for the vendor to have an ongoing "financial interest" (i.e., "vendor take back" financing, etc.) or management role (i.e., to assist with the transition) in the business. Accordingly, these hallmarks would likely be very difficult for families to meet in practice.

"After 25 years, we made the decision to transition the business to our son, who is currently the GM and has worked in the business for over 18 years. Since the plan has always been for the value in the business to help support our retirement, we intended to sell the business to him, taking advantage of the capital gains tax exemption. Since the sale details have not yet been completed, and the proposed legislation (as I understand it) would be effective as of the date of publication, that move may no longer be financially feasible and/or may result in a much less comfortable retirement for us. Our other option would be to tell our son, "Sorry," and sell the business to someone outside the family. That would allow us to use the exemption, but would rule out our son as a potential buyer. This seems to be punitive to families while generating no additional tax revenue."

Owner, Sign Company

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

To preserve neutrality, tax should not be a deciding factor when a business owner is considering who to sell to. Allowing for intergenerational transfers would help with succession planning and encourage businesses to remain in the family. In this regard, the government should conduct a proper consultation and include stakeholders to develop the appropriate legislation so that business owners are not penalized on a genuine intergenerational transfer of shares. There are examples currently available such as the Quebec legislation which can be used as a starting point. We recommend that this consultation be completed before the July 18 proposals are implemented and that the potential impact of amendments to proposed subsection 120.4(4) should also be addressed as these proposals would also introduce further impediments to such transfers.

"Modified" ACB

The calculation in paragraph 84.1(2)(a.1) of the Act, which provide a rule for determining a taxpayer's ACB for purposes of section 84.1, is amended under the proposals. Taxpayers will now be required to track information of prior capital gains if the shares were once owned by a non-arm's length party in order to calculate their "modified" ACB. The objective of the modified ACB is to ensure that a taxpayer cannot extract corporate surplus as a return of PUC or non-share consideration to the extent the ACB relied upon previously realized non-arm's length capital gains.

Prior to July 18, 2017, a taxpayer was only required to know how much they paid to acquire their shares and, where they purchased the shares from a non-arm's length party, whether the non-arm's length party used his/her LCGE or if the shares had an accrued gain on V-Day.

The concern, is that the information needed to perform the modified ACB calculation may not be readily available (for example, the information required may relate to transactions that occurred many years ago and is no longer available). Furthermore, the calculation of the modified ACB may not be straightforward particularly where the shares in question are substituted shares, or arose from an amalgamation or share exchange, or multiple purchases and sales of the shares were involved. In this regard, existing non-arm's length cost base not subject to the current rules in section 84.1 need to be grandfathered.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Section 246.1

Proposed section 246.1 is an anti-avoidance provision that applies to the portion of the amount received or receivable, directly or indirectly, by an individual as part of a transaction or series of transactions to be included in the individual's income as a taxable dividend if the following conditions are met:

- the individual is resident in Canada;
- the amount was received or receivable, directly or indirectly in any manner whatever, from a person with whom the individual was not dealing at arm's length;
- as part of the transaction or series, there is a disposition of property or an increase or a reduction of paid-up capital in the capital stock of shares of a corporation; and
- one of the purposes of the transaction or series was to effect a significant reduction or disappearance of assets of a private corporation in a manner such that any part of tax otherwise payable by the individual with respect to the portion, and in consequence of any distribution of property of a corporation, is avoided.

The draft explanatory notes however, do not provide any further information or guidance on the application of this provision thus, creating significant uncertainty regarding its scope. Without any context the particular wording of this section, in isolation, raises some questions or concerns. More specifically:

1. “Portion of an Amount Received or Receivable”- It is not clear what the “portion of an amount received or receivable” specifically refers to - does it refer to the receipt of such consideration itself or the subsequent distribution to satisfy the consideration? For example, assume a shareholder sells an asset to his company and receives a promissory note as consideration. Based on the textual wording both the receipt of the note as well as the cash received on repayment of the note could be re-characterized as a taxable dividend under this provision. This could also potentially result in double taxation if the subsequent repayment of the note is taxed as a dividend since a capital gain would have been triggered on the sale of the property.
2. “Significant reduction or disappearance of assets” - In order for this provision to apply, one of the purposes of the transaction or series must be to “effect a significant reduction or disappearance of assets” of a private corporation. The word “significant” is somewhat ambiguous. As well, the draft explanatory notes indicate that section 246.1 is “intended to prevent the distribution of corporate surplus (in general, unrealized corporate value less liabilities) to an individual”. However, it is not clear how “unrealized corporate value” can be distributed. There is also no guidance on the meaning of “reduction or disappearance of assets”- does the provision refer to specific identifiable assets? aggregate gross assets? or aggregate net asset value?
3. “Avoided” - The draft explanatory notes accompanying proposed section 246.1 states that in general terms, an individual is to be considered to have satisfied the purpose test of “avoiding any part of tax otherwise payable with respect to any amount received or receivable if the amount of tax payable by the individual is less than the amount of tax that the individual would have had to pay in respect of the receipt or receivable had the corporation instead paid a taxable dividend immediately before the transaction”. The word “avoided” is ambiguous and it is not clear from this note whether it would apply to an absolute reduction of tax, or to a tax deferral.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

The uncertainties regarding the application of this new section can be illustrated in the following example.

Example

Assume two brothers incorporate their bakery business (“Opco”). On incorporation, each brother subscribes for 1,000 common shares of Opco for $10,000. Each brother also makes a loan of $100,000 to the business to Opco. Opco is profitable and invests some of its profits in marketable securities. Opco now has a capital dividend account balance (“CDA”) of $20,000 due to the capital gains realized on the sale of some of its marketable securities. Opco would like to distribute the after-tax proceeds to the brother as follows: (i) $100,000 to each of them as a repayment of their shareholder loans, (ii) $10,000 to each of them as a capital dividend, and (iii) $10,000 to each of them as a return of PUC.

Based on a textual reading of proposed section 246.1, the provision could apply to treat all of these distributions as a taxable dividend, including the return of PUC and repayment of the shareholder loan which essentially represents a return of after-tax capital contributed by both brothers. The purpose test in paragraph 246.1(2)(d) would be satisfied in these circumstances because amounts the were received by the brothers from a non-arm’s length person (i.e., Opco) as part of the series of transactions in which there was a disposition of property (i.e., the marketable securities by Opco and the cash distributed) and a reduction of the PUC in the stock of shares of a corporation (i.e., Opco). Also, as part of the series, there was a reduction of the assets of Opco and neither brother would otherwise pay any tax on the distributions.

> *“Company A owes $XXX and Company B owes $XXX to its shareholders. These loans arose because the shareholder injected after-tax funds into the corporation or retained after-tax funds in the corporation. Any attempt to tax repayments of these loans would be to tax dollars that have already been taxed, once again creating a situation of gross unfairness to the corporations and its shareholders.”*
>
> President, Packaging Company

On top of this, the CDA of Opco will be reduced by the untaxed portion of any taxable capital gains the corporation realized as part of the series of transactions. Proposed new subsection 246.1(3) provides that where a private corporation pays a capital dividend to an individual and it is recharacterized under new subsection 246.1(1) as a taxable dividend, subsection (3) provides for a reduction in the payer corporation’s CDA. Therefore, proposed subsection 246.1(3) would eliminate the $20,000 of CDA generated on the sale of the marketable securities.

This is likely not what was intended, the proposed rules should not apply to such ordinary, legitimate transactions. However, this example is just one of many possible examples that highlight the uncertainty presented by the broad wording of the proposed rules, and the difficulty and uncertainty that will be encountered in applying them in practice and without any further guidance.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Need for grandfathering/transitional relief

The changes to section 84.1 and new section 246.1, if enacted, would apply to any dispositions that occur, and amounts that are received or become receivable, respectively, on or after July 18, 2017. The fact that these proposals apply effective immediately upon the announcement date of July 18, 2017 raises a number of concerns because of the lack of transitional relief or grandfathering.

These measures represent significant changes to previous tax policy and the manner in which these changes are proposed results, in some instances, in retroactive application. Furthermore, taxpayers are not able to take corrective actions for transactions which were undertaken previously based on accepted rules and practices which are now affected by these proposals. Accordingly, we recommend that the following transitional measures be provided.

- Pre- July 18, 2017 Capital Gains - Proposed changes to section 84.1 should not apply to capital gains realized on a disposition that occurred prior to July 18, 2017. Although the proposed amendments to section 84.1 are applicable for dispositions of a share by an individual to another non-arm's length corporation that occur on or after July 18, 2017, the amendments to the calculations of the modified ACB[23] would take into account any capital gain realized on a previous disposition of the share (or share for which the share was substituted) by a non-arm's length person after 1984. It would be difficult and potentially impossible for taxpayers to obtain information on these previous dispositions particularly if the transactions occurred many years ago. Accordingly, we recommend that the application of the proposed changes to section 84.1 be amended such that it does not apply in respect of capital gains realized on a disposition which occurred prior to July 18, 2017.
- "Series of transactions" Which Began Pre- July 18, 2017- Proposed Section 246.1 should not apply where a "series of transactions" began before July 18, 2017. The concern is that that any "distributions" made on or after July 18, 2017 could be considered to form part of a series of transactions that began prior to July 18, 2017 and therefore, result in other transactions that are part of that series to now be caught under this rule even if those transactions occurred prior to the announcement date. Accordingly, we recommend that proposed section 246.1 not apply in respect of amounts received for a transaction or event, or a series of transactions or events, that began prior to July 18, 2017.

[23] $20,000,000/(1-53.53%) (the highest marginal tax rate for an Ontario resident).

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Suggestions and Recommendations

Based on the discussion above, we provide the following suggestions or recommendations:

- Application of Section 84.1to Post-mortem planning: We believe an estate should not have to pay significantly more tax than what would be payable had the deceased sold the shares to an arm's length third party. We therefore, recommend the proposed changes to section 84.1(and, similarly, the proposed change to subsection 120.4(4)) not apply in respect of shares that are acquired as a consequence of a taxpayer's death. And if the 164(6) loss carry back strategy is the only option to avoid double taxation on death, we recommend that at a minimum, very significant improvements be made to this provision to address the current issues, as discussed previously, to make the use of this strategy more broadly available/accessible.
- Paragraph 84.1(2)(a.1) Modified ACB: The modified ACB rules are an unnecessary complication. To the extent the government is concerned that taxpayers will attempt to avoid section 84.1 by, for example, involving an arm's length person to act as a facilitator for a sale to a related party, the existing general anti-avoidance rule would apply and would be a sufficient recourse.
- Intergenerational Transfers: There are examples currently available such as the Quebec legislation which can be used as a starting point along with consultation with the various stakeholders to develop the appropriate legislation so that business owners are not penalized on a genuine intergenerational transfer of shares. We recommend that this consultation be completed before the July 18 proposals are implemented and that the potential impact of amendments to proposed subsection 120.4(4) should also be addressed as these proposals would also introduce further impediments to such transfers.
- Application of 246.1: Section 246.1 is too broadly worded and appears to have possible application to many ordinary-course business transactions. The draft explanatory notes that were issued also do not provide any examples of where the government believes that section 246.1 would apply. As a result, there is uncertainty regarding its scope and application. We suggest that the application of section 246.1 be limited to the intended abuse and that further guidance on the specific consequences be provided.
- Grandfathering/Transitional Relief: Any amendments should be introduced prospectively and/or with appropriate transitional rules or grandfathering provisions so that the treatment of existing and historical transactions are not, in effect, unfairly modified without notice to taxpayers. More specifically, we recommend that the application of the proposed changes to section 84.1 be amended such that it does not apply in respect of capital gains realized on a previous disposition prior to July 18, 2017. We also recommend that proposed section 246.1 not apply in respect of amounts received in respect of a transaction or event, or a series of transactions or events, that began prior to July 18, 2017.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Part III

Holding Passive Investments Inside a Private Corporation

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Part III: Holding Passive Investments Inside a Private Corporation

Summary Description of Proposal, Tax Policy Concerns and Technical Issues

As reflected in Part C of the Consultation Paper ("the Paper"), the government is considering approaches that will result in investments held within a corporation to be taxed in a similar manner as investments held personally by, for example, salaried employees. More specifically, the government is proposing to eliminate the ability for corporate owners to obtain what they believe to be a "tax advantage" as a result of holding passive investments inside their private corporations.

Corporate income is taxed at lower rates compared to personal income, as a result of a policy decision to provide more money to businesses to help them grow. However, when a corporate owner uses earnings taxed at the lower corporate income tax rates to fund passive investments held within the corporation, an advantage can result as the starting capital from which to invest will be higher; corporate owners can further benefit by retaining the passive investments in their corporation.

The proposal is intended to apply to corporate owners who are setting aside a portion of their corporate profits and investing it in passive investments as opposed to the business; the proposal is not intended to impact corporations with no passive investment income. The new regime would essentially replace the current regime of refundable taxes on passive investment income to ensure that the combined corporate and personal taxes on passive investment income earned through a corporation would be the same as if the individual earned the income personally.

The underlying premise of the proposal is that employees and corporate owners should be subject to the same amount of income tax. Interestingly, this does not appear to be supported by current tax laws as reflected in the Income Tax Act (Canada), RSC 1985, c. 1 (5th Supp.), as amended (the "Act"). Throughout the Act, there is a distinction between income from employment and income from business. For example, employees are taxed on a cash basis whereas business income is taxed on an accrual basis, and deductions available to employees in respect of employment income are very limited compared to business income. Accordingly, we believe the proposal represents a major shift in tax policy given that previous governments and legislation have acknowledged the differences between income from business versus income from employment.

The government has not yet released proposed legislation but will be designing new rules over the coming months to address this; however, the Paper has outlined two broad approaches for consultation – the "1972 Approach" and the "Deferred Taxation Approach" which we have analyzed below.

The 1972 Approach

When the existing refundable tax on annual passive investment income was implemented in 1972, an additional refundable tax in respect of ineligible investments was also implemented (this additional tax however, was repealed shortly after its implementation). This additional refundable tax on ineligible investments was created to resolve the same issue that is being discussed today. This additional refundable tax in effect imposes a general income tax rate on earnings not used for business operations.

The government however, stated in the Paper that it is "not actively considering" this alternative due to its complexity and liquidity issues with the payment and refund mechanism. Accordingly, we have not analyzed

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

or explored this approach any further other than to note that it may be an oversimplification to credit the former government's decision to remove this additional refundable tax on ineligible investments, shortly after implementation, due to the complexity of the specific approach as opposed to the effectiveness of the overall concept. More simply put, if the issue was the specific approach it would seem reasonable to assume that the government, or any of the governments that have since followed, would have made adjustments to the 1972 legislation, or developed replacement legislation that would have served the same purpose. In the absence of any replacement legislation, it is likely the overall concept is what the government deemed to be too complex to make implementation worthwhile.

The Deferred Taxation Approach

The deferred taxation approach will leave the current system in place but remove the refundable component of the tax where income used to fund the passive investments were taxed at the lower corporate rates. The advantage of the deferred taxation approach over the 1972 approach is that it will not result in any additional taxes being levied and therefore, would not result in the same liquidity issues.

The removal of the refundability component of the investment tax could however, result in liquidity issues over time.

In order to align the tax treatment of the passive income distributed as dividends with the tax treatment of the earnings that are used to fund the passive investments, two methods have been proposed – the "Apportionment Method" and the "Elective Method". We have analyzed each of these alternatives further in the discussion below.

1. Apportionment Method

Under the "apportionment method", the after-tax investment income of a corporation would be allocated to three pools based on prior year-end balances, and the dividends paid to shareholders would therefore be designated from each of these three pools. The three pools would differentiate between business income taxed at the small business rate, business income taxed at the general rate, and amounts contributed by shareholders that have already been taxed at the personal level.

Because no legislation has been drafted, it is difficult to provide any commentary on potential technical issues. It would appear though that the biggest issue with the apportionment method is the sheer complexity of it and the requirement to track the income for each pool. In the simple example provided in the Paper, the allocation process appears to be relatively straightforward, but this example does not encompass the complexities that may arise due to the corporate structure or transactions that take place in practice. Thus, prior to proceeding with the implementation of the apportionment method, we recommend that the following concepts be considered/explored further:

- The proposal mentions the treatment of income, but does not discuss the treatment of losses. Therefore, consideration should be given as to how losses would be allocated amongst the three pools.
- The proposal mentions the general treatment of investment income, but does not discuss the treatment of foreign exchange gains and losses.
- The proposal mentions the treatment of after-tax amounts contributed by a shareholder, but fails to mention how borrowings from arm's length or other related parties might be treated.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

How reorganizations such as amalgamations, butterfly reorganization affect the corporation's pool balances should be considered.

- The proposal appears to indicate that the pool balances would be calculated at year end. This should be further explored as an annual valuation may be overly simplistic for balances that are changing on a more regular basis such as monthly and even daily.
- Where there is more than one corporation in the corporate structure, it will be important to assess whether dividends from one private corporation to another will retain their character.

When considering these issues one can easily imagine how the compliance requirements for the "apportionment method" could quickly spiral and become incredibly onerous. Accordingly, we recommend that this method not be pursued any further as both the costs of the compliance and the complexity involved greatly outweigh the "perceived" fairness to be obtained.

2. Elective Method

The advantage of the proposed elective method is the simplicity of its application. Under this method, a corporation would be able to choose between the default method whereby all passive income earned in the corporation would be subject to non-refundable taxes and dividends distributed from such income would be treated as non-eligible dividends. Alternatively, the corporation could elect out of the default method and obtain eligible dividend treatment but lose access to the small business deduction.

Despite the simplicity in its application, the same considerations in the above discussion for the "apportionment method" will still need to be addressed prior to proceeding with the implementation of the "elective method". Additionally, since this method provides a taxpayer with a choice of methods, further discussion will need to occur in order to determine whether a taxpayer's choice of methods will be permanent, or whether the taxpayer will be able to change the election (and if so, how often?) as well as the consequences that may flow from this.

While this method offers simplicity, and would ease the overall compliance burden for taxpayers, we believe that this method does not present a solution that is nuanced enough to result in fairness amongst taxpayers – a concept that has been indicated to be a priority of the current government. The lack of fairness is because it would impose a blanket increase in tax on private corporations without consideration of the complexities involved in determining whether an investment is generating passive income or active business income (this is discussed below).

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

The Problem of Integration & Advantages of Deferral

The analyses in the Paper presumes that there is "perfect integration". In reality though, under-integration exists in almost every province, making it less advantageous to hold investments in a private corporation than it would be to earn that investment income personally. In other words, active business income/investment income earned in a private corporation and paid out to the individual shareholders as a dividend is almost always taxed higher than if the employed individual had earned the income personally.

The following table highlights the impact of under-integration in each of the provinces in 2017:

Province	Income Taxed at Small Business Rate[24]	Income Taxed at General Rate[25]	Investment Income[26]
British Columbia	(0.63%)	(1.66%)	(4.47%)
Alberta	(0.63%)	(2.24%)	(5.03%)
Saskatchewan	0.58%	(1.18%)	(3.64%)
Manitoba	(1.04%)	(4.26%)	(6.19%)
Ontario	(0.02%)	(1.97%)	(2.44%)
Quebec	(0.92%)	(2.69%)	(1.65%)
New Brunswick	(0.21%)	0.51%	(4.78%)
Nova Scotia	(0.13%)	(5.69%)	(5.70%)
Prince Edward Island	(0.92%)	(3.24%)	(5.97%)
Newfoundland and Labrador	(0.07%)	(8.53%)	(5.29%)

[24] The effects of integration have been calculated using the highest marginal Canadian income tax rates for 2017.

[25] The effects of integration have been calculated using the highest marginal Canadian income tax rates for 2017.

[26] Portfolio dividends subject to Part IV tax have been integrated.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

For example, an individual resident in Ontario who is a shareholder of a private corporation that earns say $100,000 of active business income in his/her corporation (taxed at the general corporate tax rate) and then distributes the after-tax amount to himself/herself as a dividend will have $1,970 less cash than if he/she had earned the $100,000 personally.

Under-integration is not consistent with the concept of fairness that is being advocated by the government in the Paper, which is the fundamental principle of this proposal. When the effects of under-integration are considered, the advantage to be obtained by the shareholder from holding passive investments in their private corporation is mitigated significantly. Many business owners incorporate their business for commercial reasons (such as limited liability).

The Paper states that the current system does not achieve its objective of removing incentives to hold passive investments within a corporation and that this leads to unfair tax results whereby a corporate owner may prefer to retain business income, for passive investment purposes, within his or her corporation, rather than to pay it out and invest directly.

In reality, funds are often retained in a corporation for business reasons such as saving for future expansion, managing the cyclical nature of the business, etc. However, it will be necessary to retain funds in the corporation and invest a greater after-tax amount in order to try to balance some or all of the under-integration disadvantage. The ability to invest after-tax active business income in a corporation, and defer the individual level of tax until a future dividend is paid, may not fully offset the disadvantage of under-integration as this will depend on the return on investment, the investment period, etc.

"Our livelihood is dependent on a number of factors well beyond our control. This includes things like weather and crop disease. It also includes things like the state of the forestry market. Because we are susceptible to such uncontrollable risks, we like to set aside "rainy day" money in our business. We invest this in conservative investments, and use it to help us when times are tough. We would have been bankrupted in 2001 and 2007 were it not for the funds that we had set aside to cover the tough years. It makes no sense to me that tax policy would punish us for being financially responsible. Those were tough years but we kept the business going and our staff employed solely because we had invested excess profits from earlier years. If we had been forced to pull those profits out to invest in RRSPs or otherwise, we would not have been able to survive."

Owner, Nursery

It is important that the government consider the true impact of under-integration, particularly given the complexity of the methods being proposed, to eliminate what is perceived as an advantage to corporate owners.

Defining Active versus Passive Income

The Paper unfortunately has provided limited guidance as to how active business income will be differentiated from passive income under this proposal. Given the

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

significant increase in the tax and compliance costs under the apportionment and elective methods, it does not seem adequate to rely on the distinctions which currently exist in the Act.

Therefore, we recommend that specific definitions for active business income and passive income be developed in the context of these proposals and that the following considerations be made when doing so:

- Currently all capital gains are treated as passive income, regardless of whether the capital property being disposed of is being used for business or investment purposes. This lack of differentiation is currently offset by the fact that capital gains are only 50% taxable, and the non-taxable portion is eligible to be paid out tax-free to the shareholder. In the context of the proposed changes though, where the non-taxable portion of capital gains would be denied to a corporate owner holding passive investments in their private corporation, it will be important to distinguish between the disposition of assets used in an active business and those held purely for investment purposes.
- A method for differentiating between “passive investments” that are held as part of the needs of the business and those that are held for the purpose of generating wealth for the shareholder should also be developed. A business may have many reasons for holding investments. For example, excess cash needed for capital investment, business expansion, or covenant requirements over the long term is better off being invested and earning income in order to combat the effects of inflation. In order to adequately serve the purpose of these proposals, a thoughtful definition of active business income will be required.
- On a broader scale, irrespective of whether the passive investments held in a corporation will be used at any point to serve the operational needs of the individual business, it is not unreasonable to think that these investments still serve the purpose of stimulating the economy by supporting growth and job creation within other businesses. The determination here is not black and white, and a comprehensive discussion as to whether “income from property” should always be considered to be passive will need to occur.
- A method for dealing with transactions between related corporations should also be developed. As it has been noted, it is not uncommon for corporate structures to take on complex forms and transactions. It will be important to consider whether inter-corporate transactions will retain their original form as being active or passive, or whether the nature of the income will change depending on the entity and the activities the entity is engaged in.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

The Concept of Fairness between Employee and Corporate Owner

As mentioned earlier, the government's intent with this proposal is to promote "fairness" between the employee and the corporate owner within the landscape of the Canadian tax system. The employee and corporate owner however, are two very different taxpayers and promoting policy that treats the two as equal appears to us to be overly simplistic.

The differences between the employee and the small business owner are lengthy and easily identifiable. Corporate owners are inextricably linked to both the success and failure of their businesses, while the employee assumes far less risk with regards to their employment. Other specific differences are exemplified by the fact that small business owners must:

- Pay the employer portion of health care premiums and CPP for employees, as well as for themselves.
- Provide employees with government mandated vacation leave, while often foregoing their own vacation time due to time and monetary restrictions.
- Fully fund their retirement savings without any employer contribution. This difference should not be overlooked as employees often receive material employer funded pensions and/or contributions to their RRSP's without any taxable benefit being imposed.
- Retirement savings for business owners, are subject to volatility and risk of the capital markets. Many employer funded pensions are indexed to inflation and are not subject to the same level of investment risk and volatility.

Based on these profound differences, a tax policy that is focused on equality between the employee and the corporate owner is one that intrinsically misses the mark.

"I operate a small accounting services and bookkeeping practice in Burlington Ontario. I think it is completely unfair to compare a small business owner to an employee earning the same amount. Mr. Trudeau and Mr. Morneau are not considering RISK into their equation. It's apple and oranges. Small Business Owners are incurring all the RISK. I am not talking specifically about Doctors or Lawyers or other professionals that were allowed to incorporate to use tools available to them to lower their tax bill. But rather entrepreneurs like myself and many of my clients who fight day in and day out to manage and grow their business, to invest in their business, staff, technology, products, services and innovation. Small business owners do not clock in at 8 am and out at 5 pm. They are always aware that at any point the pipeline could dry up and are having to constantly work all the time on sales and customers and profitability. This is not the same as an employee who works hard (don't get me wrong) but certainly not the same skill set or RISK adverse."

Leader & Managing Partner, Accounting Services

Furthermore, the Act currently treats employment income differently from business income i.e., it provides those earning business income with particular advantages (such as the ability to deduct a wide range of expenses from income) in order to

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

compensate for the added risks assumed with a business.

While the concept of fairness can be obtained in multiple ways, a policy which attempts to treat the two as being the same without factoring in these different risk profiles, will only serve to reduce "fairness" between the two – thus, having the opposite effect of the government's intention.

Is the Complexity Worth the Benefit?

If it is determined, that, after an appropriate consultation period which involves a broad range of relevant stakeholders, that the perceived advantage provided to business owners of being able to reinvest income that has been taxed at the small business rate is one that must be addressed in some manner, it is recommended that the government pursue a solution that is less onerous from an administrative and compliance standpoint to the business owner.

The "apportionment method" would result in the business owner having to track the sources of income generated by the business and then allocating those amounts on an annual basis to three separate pools. Although, this appears to be a relatively simple concept, it is not difficult to imagine a scenario in which this tracking process can become incredibly complex. Business structures can take on a myriad of forms and can involve multiple related and associated corporations. In the case of related companies where dividends are flowing through, the compliance process can be cumbersome as one would have to determine whether dividends paid from one corporation to another are paid out of active or passive income. A large private corporation may have the resources required to manage this compliance, but a typical small to medium sized business owner who is fully immersed in the operations of the business, would very likely be overwhelmed.

In addition to the burden that results from tracking the amounts once they have been classified, the process of determining whether the amount is active or passive presents its own challenges. The funds that are earned by a business, but not immediately reinvested in the business, can serve many purposes - the amounts can be set aside to fund the retirement plans of the shareholders, they can be held to minimize the impact of the inevitable ebbs in the economy, to fund long-term future business expansion, or held as collateral for external financing. It is also not uncommon for the funds to be held for all of these purposes at different points in time. Given the link between the business and the business owner it becomes incredibly difficult to make a decision at one single point in time that would specify that certain funds are to be used for business purposes and certain funds are to accumulate for the benefit of the shareholder. This complicates the proposed apportionment and elective methods even further as these methods, in their current form, do not address the fact that investments can switch from being passive to active many times while they are held by the corporation nor do they account for the flexibility of capital that business owners require.

Effect on Taxpayer Behaviour

The concept of neutrality generally means that a good tax policy should not overly influence the decision making of a taxpayer. If the refundable component of the investment tax is removed it would seem plausible that the following taxpayer behaviours might result:

- As these proposals only apply to private corporations resident in Canada, corporate owners may be motivated to adjust their business structure. This could result in an increase in private corporations "going public", as well as an increase in the number of private corporations leaving Canada for a more "friendly" and less onerous tax environment.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

- From an economic standpoint, there is no question that a policy such as this, will influence corporate owners to spend instead of save. Furthermore, there is the potential that the types of investments that corporate owners will take on may be “riskier” (i.e. joint ventures of partnerships that will be able to flow business income through to the corporation). Both of these results could have a profound economic effect.

Suggestions and Recommendations

The government has outlined a number of questions relating to its proposal and is requesting specific feedback. We have attempted to provide some views on the proposals, but because of the limited time period provided (i.e., a 75-day consultation period), it is not possible to provide commentary on all of the issues that would result from such amendments.

In summary, we feel various design issues still need to be addressed, that the Proposals are not fair and will unnecessarily add another layer of complexity to our already complex tax system and may result in unintended consequences by taxpayers. If the government decides to proceed with drafting legislation to implement these proposals, we recommend that:

- An Advisory Panel be formed to thoroughly study, in consultation with stakeholders, the policy, design issues and the consequences of the Proposal and ensure that that they do not create a tax environment that stifles economic activity within Canada.
- A reasonable transition period be incorporated into the legislation so that taxpayers are provided with sufficient time in which to reorganize their affairs with minimal consequences.
- The majority of the compliance burden is minimized by including a provision that would restrict the legislation from applying to corporations earning taxable income below a certain threshold.
- Consider a ratio by which corporations holding a certain amount of passive assets versus active assets would be exempt from the rules because there is a business need to hold at least some passive investments (i.e., to manage the cyclical nature of the business, etc.).

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Part IV

Impact Statements

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Part IV: Impact statements

This proposed legislation is of major significance to private businesses, the backbone of the Canadian economy. Regardless of size, each business will be affected in some way. To illustrate this, we have included statements from business owners on the devastating impact these changes may have on private business owners, their business, family, employees, and communities in which they operate.

Impact statement 1

"As a small business owner I am literally losing sleep and very very concerned about this proposed change to tax policy.

At the public policy level, this proposed tax policy change is completely contrary to the Prime Minister Trudeau's promise to make the lives of middle class Canadians better. And completely at odds with their apparent support for young entrepreneurs, support and desire for more female entrepreneurs and business owners, as well as the apparent support for growth of Aboriginal businesses as well in our country. It will damage the social and economic health of people and communities. And I won't even get into the lack of support for "mature" entrepreneurs like me and then they do this.

And in the middle of the night, I think of my own business and my future. I am 58 years old and am in my 35th year of working very very hard. Yes, I am doing what I love to do and hope to do so for 12 more years. But I am also doing it because I need to, given the economic reality in our region and that fact there just aren't any "jobs" for people like me. These proposed tax changes will significantly impact my ability to retain value in my little corporation so that I can retire and potentially sell my business and crystallize additional value. Any bureaucrat or politician that thinks starting a small business at the age of 54 is romantic, risk free, lucrative, and that one can hide scads of money is out of touch with reality. It's hard work, it's a grind, it's self-financed, there's no paid vacations, and there are no safety nets. Period."

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Impact statement 2

“I started my business 18 years ago after graduating from Waterloo, and I had a choice to make - begin in Canada or move to the US. I chose Canada in part because of the corporate tax rules in place - while I couldn't deduct interest expense on my house, I did have very specific opportunities, if successful, to capitalize on my success.

My now wife became a French Immersion teacher and supported me and my business for the first few years. She now stays at home and invests her time bringing up our kids. While she isn't an "active employee", she is the reason my company exists. And now I can't pay her dividends? Meanwhile, the income splitting rules have been canceled.

I've paid millions of dollars in tax through the hundreds of employees I've employed. I've worked hard under the existing set of rules to maximize both the revenue I've earned for myself, but also for my employees and for Canada. To change the rules with minimal notice throws my entire life savings and plans into disarray. Frankly, I would have made a different choice with my vote if I had known this was part of the plan, and I worry future generations of Canadians will choose to build their businesses elsewhere.

I understand the need to raise tax revenues. I've been working to raise revenue my entire life. But don't punish the very people that employ the vast majority of Canadians. Drive us away, and you'll have a much bigger hole to fill.”

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Impact statement 3

“I am a tax partner in Thunder Bay, Ontario (but have practiced across Canada) and I grew up in a small business located in Thunder Bay, Ontario. In fact, my family’s business is now in its 3rd generation and is currently owned and run by my younger sister and brother.

I had no choice but to work in our family business starting at the age of 7 years old. I was not paid a reasonable wage, in fact, many of my hours working in the business were unpaid as my family struggled to make ends meet while they ran a business, raised a young family and my father suffered with a terminal illness.

When I turned 16 years old, I was offered a job to work at Eatons at an hourly wage higher than what I was paid in our family business, but I was forbidden to do so by my father and uncle who relied on me to help the business survive as they could not afford to pay me what Eaton’s paid. Our family business struggled for many years and it was on the verge of bankruptcy multiple times. My family depended on me to help them make ends meet and the business to survive. I am not alone. The same was true of my sister, my brother, my cousins and my aunts and uncles. We all made sacrifices that went beyond the purely monetary to help the business survive.

Today the business is successful, but it came at a cost. We did not have expensive vacations, or even vacations by today’s standards at all. My father would open the store on Christmas day to help out that family that forgot to buy the Christmas turkey or a loaf of bread.

My parents told me they could not afford to send me to university and that I would need to earn scholarships to do so. I attended university and worked in our family business at the same time. My younger sister and brother did not attend university. They ran the business with my mom after my father died at a young age.

How would this government have measured our “contribution” to the success of our family business? My T4 would have suggested that I made little or no contribution. Yet I know that to be totally untrue. The contribution that a family member makes to a family business cannot be easily measured by a T4 or by a CRA auditor deciding whether or not a family member’s contribution was “reasonable” in the circumstances. In fact, most people would say that my contribution to our family business was completely unreasonable as no “arm’s length” unrelated person would have done the same. Is a CRA auditor even qualified to make such a subjective determination? In my opinion, this will lead to arbitrary decisions being made by government employees who have little or no experience in this regard, but who will hold a tremendous amount of authority, power and control.

The business recently underwent a significant multi-million dollar renovation doubling the size. This would not have been possible with the government’s recent proposals to increase the tax on passive investments in a corporation. It took the business more than 25 years to save and invest sufficient extra funds to eventually do this major renovation. Today the business employs more than 40 people contrasted against the 1960s when it only employed 4 or 5 people tops. The renovation resulted in more jobs being added and has contributed to the Thunder Bay economy. Under the government’s recent tax proposals it would not have been possible for my

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

family to save sufficient funds to be able to undertake this major renovation. In fact, had the renovation not occurred, my sister and brother had already decided that they would retire.

What happens now when my brother and sister eventually decide to retire? The business is now in its 3rd generation and before the government's recent tax proposals they had already decided that they would transition the business to their children, the 4th generation in the family. Under the government's recent tax proposals there is a significant tax cost to selling the business to a family member as opposed to an unrelated third party of at least a 20% differential. In fact, the tax cost is exponentially higher when one considers that a family member selling the business to another family member would not be able to claim the capital gains exemption. It is rare to have a business survive to the 4th family generation, yet the government's recent proposals make it virtually impossible to do so. This is completely unfair to family owned small businesses who have been the backbone of the Canadian economy for decades of years. I know only too well that without family involvement most of these businesses would simply not survive the transition to the next owner.

I also question why large businesses are being treated more fairly than small businesses by the government??? Why should there be a tax penalty for being a shareholder in a small business who receives a dividend when they do not make a labour or capital contribution to the business as opposed to when it is a large business. In fact, with a large businesses, it is highly unlikely that a shareholder would ever make any kind of a labour or capital contribution to the business outside of the initial cost of their investment. Why should small business be treated differently? And why should a shareholder of a small business be penalized and treated worse than a shareholder of a large business? Is this fair?

Taken as a whole, these proposals will ultimately lead to fewer small businesses, less investment, fewer jobs, and will hurt the Canadian economy. The major impacts are long term, not short term. In the history of my career as a tax accountant spanning more than 20 years, I have never witnessed such significant changes to our taxation system and the taxation of private corporations, in particular. These proposals border on major tax reform and warrant widespread fulsome discussion prior to enactment. The Government should withdraw these proposals immediately and establish a Commission to study the effects of taxation on small business. This should be followed up with true consultation. Only then should there be legislation drafted for discussion with the public and in Parliament."

Impact statement 4

"I am not truly informed with regards to all the upcoming tax changes for business owners. However, should the government penalize business owners with money in the bank? I certainly don't think so, even if it is held currently as a tax shelter. Self-employed people don't have the luxury of a retirement plan matched through an employer and neither are they allowed to collect EI. Any cushion of funds is a necessity. If the government taxes these retained earnings at higher rates, they would only be looking at short term gain. Down the road, the past business owners will be needing assistance for living allowances, instead of getting by independently on their savings.

These are my thoughts on the short sighted government's plan."

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Impact statement 5

“Capital Dividends

During our most recent fiscal period ended April 30, 2017, we had real estate transactions that triggered capital gains of $XXX in Company A and $XXX in Company B. As you know, only half of capital gains are taxable both inside and outside a corporation. Therefore, as required, we paid tax at the “investment income” rate of 50.17% on $XXX (50%) of the capital gain in Company A and $XXX (50%) of the capital gain in Company B. The government’s stated goal with respect to these proposed tax changes is to improve the fairness of tax treatment of income earned inside and outside a corporation. Since capital gains are 50% taxable both inside and outside a corporation, the only fair solution is to continue to allow the non-taxable 50% portion to be distributed to the shareholders tax free as a capital dividend. Any attempt to tax this otherwise tax free income would be grossly unfair to corporations and its shareholders.

Shareholder Loans

Company A owes $XXX and Company B owes $XXX to its shareholders. These loans arose because the shareholder injected after-tax funds into the corporation or retained after-tax funds in the corporation. Any attempt to tax repayments of these loans would be to tax dollars that have already been taxed, once again creating a situation of gross unfairness to the corporations and its shareholders.”

Impact statement 6

“We purchased a very small business in Kelowna, in 1991. At the time, it employed 1 person other than the owner. At the outset, the business was not only our new careers, but also a MAJOR part of our retirement plan. Given the favourable capital gains tax exemption for small businesses, our plan was to grow the business substantially, investing in new and better equipment, and hiring more employees. We did exactly that, employing between 7 and 10 employees at any given time, helping to stimulate the local and provincial economies, and giving back to the community through countless donations of money and donations in kind; like most small businesses do every day.

After 25 years, we made the decision to transition the business to our son, who is currently the GM and has worked in the business for over 18 years. Since the plan has always been for the value in the business to help support our retirement, we intended to sell the business to him, taking advantage of the capital gains tax exemption. Since the sale details have not yet been completed, and the proposed legislation (as I understand it) would be effective as of the date of publication, that move may no longer be financially feasible and/or may result in a much less comfortable retirement for us. Our other option would be to tell our son, “Sorry,” and sell the business to someone outside the family. That would allow us to use the exemption, but would rule out our son as a potential buyer. This seems to be punitive to families while generating no additional tax revenue.

The Prime Minister’s comments last week seemed to lump small business owners into what he referred to as the wealthiest Canadians, furthering the common “myth” that small business owners are all wealthy. Nothing could be further from the truth! I don’t think we are much different from thousands of other owners who put their financial well being on the line, taking very little salary along the way, in an attempt to build something that would take care of them later in life. Not only is that now being threatened, but the value of even owning a small business, for those like our son, is being called into question.”

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Impact statement 7

William D. Casey
Member of Parliament, Cumberland-Colchester
Nova Scotia, Canada

September 4, 2017

"Dear Mr Casey,

I sincerely appreciate you and your assistant taking the time to visit our medical staff to discuss Bill Morneau's paper, "Tax Planning Using Private Corporations" and its inevitable effect on our physicians and health care in Canada. I understand that you have received many perspectives with respect to this document and I would appreciate your time in considering my own.

As a 43 year old Chief of Surgery with over a decade of leadership in health care, I never thought that I would consider looking elsewhere for work and raise my family. But in lieu of your party's perceived lack of understanding of my value, ability to build a pension, and practice and lead in this health care environment, I have started looking. Recruiters and institutions from other countries have contacted me. I don't want to go, but you may leave me no other choice.

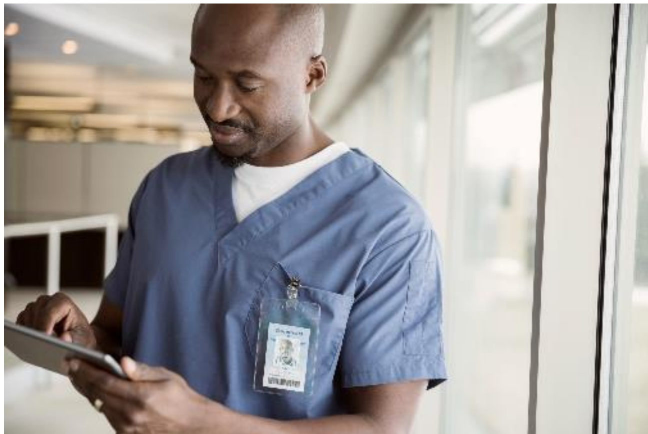
Is the presumed $200 million dollars your party will collect with this tax reform really worth the incredible backlash you will create in our country? Do you really understand the significance of the ripple effect this will create? Why is your party continuing to penalize successful individuals – would one not normally reward those who work hard for you in order that they continue to be successful?

We can debate whether Mr Morneau's document is actually fair (actually only affecting part of the 1% top earners in Canada – physicians making up 12% of the top 1% as of data from 2006), and whether introducing it during the summer when most small business owners, their accountants, financial advisors, and lawyers were on vacation while giving only 75 days for consultation period. (Interestingly, it took a consultation period between 1966-1971 to decide simply whether capital gains should be taxed…5 years!) How would politicians react if we told them that in order to do their job, they would need to sacrifice 13 years with an opportunity cost of $500,000 only to take away their ability to provide their own pension and provide education for their family, all while being undervalued by the people they serve? Furthermore, if income splitting is so offensive to Mr Morneau, why is he not considering changing this ability for retirees and individuals who receive early pensions? This is not a philosophical concern about taxation, it is a targeted assault.

The "Loophole" spin in the media also undermines your party's credibility. The incorporation of these specific tax shelters were strategically engineered and consciously added to the Tax Act with a two year period of debate between 1981-83, ironically by your Liberal party. In 1995, professional corporations for physicians were specifically discussed as a means to avoid increasing fee-for-service units of pay, and provide the ability for professionals to have their make their own pensions. Has anyone considered what it would cost for Canadians to pay for 88,000 physicians' pensions? Incredible…

The impact on physicians' ability to pay back their education debt, build a pension to retire at an appropriate age (consider the average age of a federal employee or teacher retiring compared to a physician…), and pay for their children's education is a very real threat. It has been shown from multiple sources that a physician starting out in their specialty after 10-13 years of training (with the student most efficiently following this career path starting at age 28-30), is $400,000-$500,000 behind those who started a job immediately out of school. The impact on these

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.



individuals starting a family and living with the stress of debt cannot be understated. If this plan for taxation on private business is passed, your party will be undoing their own solution from 1983. The resultant ripple effects on these individuals are difficult to prove and might be described as dramatic by some, but they will be real and they will ultimately affect not only physicians and other small business owners…but also the middle class (who will understand their fate in acquiring health care in due course…). Your party is demonstrating how very little they value one of the best resources our country produces – and many other countries have already been contacting me and my colleagues as our value is not lost on them.

Considering the other end of the spectrum, many physicians have approached me as their chief to inform me that this tax plan will force them to retire. The number of physicians aged 65 and older has quadrupled since 1975, and this cohort made up 12% of physicians in Canada in 2009 (up from 9% five years earlier). With 1 in 5 physicians over the age of 60 in Canada, and considering that many primary care physicians of this vintage have 3500-4000 patients as compared to their younger colleagues who care for 1500-2000 patients, we will experience a true crisis in health care that we have not seen since before the days of Tommy Douglas and the Canada Health Act. Are you ready to consider urgent strategies to deal with this crisis? As one of your top recruiters for health care talent in Nova Scotia, how am I going to recruit physicians here with the tax environment that your party has created?

As a Chief of Surgery/Site Chief, I fear the biggest issue will be the recruitment and retention of physicians in our country. In the mid 1990's, it is estimated that 1-2% of physicians left Canada due to issues with pay equity. Think about that. For instance in Nova Scotia, there are 2500 physicians. If 25 physicians leave our province – which they will - consider the impact… Physicians are already being recruited to leave, the BEST physicians in my experience. Furthermore, we are currently the #2 recruiter for International Medical Graduates (IMG) in the world. We will quickly descend the list as other countries with a better ability to earn an income will win out. More patients without a doctor and longer wait lists, is this what your party wants for Canada?

In conclusion, this taxation strategy is a short-sighted attempt to acquire funds for today while avoiding the bigger discussions for solutions of the bigger problems that will truly provide sustainability, necessary funds, and value to the people who do take risk and provide for others in our society. The ripple effects…physicians will leave or retire, waitlists will increase and there will be more people without a doctor, patients will suffer…small business will start to die with profound effects on all provinces, people will lose jobs, and the costs will far outweigh the funds your party is trying to acquire. Although I firmly agree with a social support net for our country, your party is knocking down the pillars that are currently holding it up and the results in healthcare and small business will be disastrous."

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Impact statement 8

"I feel like an argument can be made that the proposed changes are unfair to females, and actually counter to other laws/practices. I say "females", only because historically, most small businesses are controlled by males while females are more likely to be stay-at-home mom's. I would argue that these spouses who stay at home, regardless of gender, are key to the success of the business, even if they are never actively involved in its day-to-day operations. I'm sure there are many business owners who couldn't spend the VAST amount of time a business demands without the support of a spouse doing everything else except running the business: taking care of the kids, home, household finances, repairs, etc. Why would the government want to punish these spouses, typically women?

As I say, this may be counter to other laws and practices. I'm not a lawyer, but it's my understanding that during divorce proceedings, both spouses are entitled to the value of a business.

In my opinion, these spouses are as vital to the success (and therefore profit and generated tax revenue) of businesses."

Impact statement 9

"My wife and I are both self-employed business owners. This is a major and significant change that is happening very quickly.

My wife is incorporated and has spent the last several years saving for maternity leave in her company. Because we are both self-employed we have no employer or government maternity assistance.

We have a 6 month old baby at home and my wife is currently using that savings to support her maternity leave which has been planned and budgeted for in the company. This change hugely impacts her and our family. She worked hard, and saved, and planned for our future using legal tax strategies. Our budget no longer works if we have to take all of our savings as income at one time at a higher tax rate and lose a significant portion of that savings to taxes."

Impact statement 10

"I do not have all the data to support my opposition and how it will exactly affect me and my business. All I can do is share my experience from the last 18 years of trying to build a business in British Columbia that gainfully employs and provides opportunity to workers in the community and across Canada indirectly through our vendors and suppliers.

I am that guy, that small business owner that had to grind it out year after year risking everything to build a business. I started Atomic Company C in 1999. We are a manufacturer of XXXX. We sell our products across Canada and into the USA and some overseas.

For the first 10 years as I said, I had to grind it out taking almost zero in wages or compensation, working at times 6 months straight with no days off, countless

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

sleepless nights, stress, sacrificing my health, living off my savings, all to develop and invest in my company, tools, marketing and most importantly my employees.

Fortunately over the 7-8 years our company has grown and become recognized as leading manufacturer of indoor kids play centres in North America. In the most recent year I have just invested into a $4 Million manufacturing plant in Surrey, BC as we are looking to increase our productivity and grow our employee base. As the owner of Company C, I have had to put personal guarantees on all of loans and credit with vendors and banks. While the business has grown, the risk remains and is even greater now as we take on more risk and debt to grow. Still to this day, as the owner of the company working 7 days a week is more common than it is uncommon. I have yet to take a 2 week vacation and I am now 43 years of age.

I strongly feel that there needs to be some upside to business owners that take on this kind of risk, play by the rules and pay their taxes and employees before we ever see a dime. We play the long game, believing in the light at the end of the tunnel. We invest and plan our retirements around the sacrifices we make to see our business succeed. I have no safety net, no EI insurance to fall back on if I fail. I believe this is the argument most business owners are making.

So in summary, I oppose any tax changes that make it more difficult to start or grow businesses in Canada or BC. We need a government that supports the investment of Small Businesses in our Country and Provinces so we can keep people working and compete with the rest of the world in export."

Impact statement 11

"My husband and I are small business owners. We are not 'cheating the system' by sheltering income under our current tax scheme.

We have no corporate pension plans. We therefore appreciate the opportunity to save for our future retirement through our corporation. As CA and CFA charter holders we have invested in our respective educations and careers and are proud to be a high income earners. My spouse and I also pay our fair share of income tax. We each receive a salary from our active business of >$140k annually….from which we help our children pay for their university educations (and avoid student loans). My spouse was diagnosed with young onset Parkinson's disease several years ago. Fortunately he has managed his symptoms well with medical treatment and medications and has been able to continue to work. However without a private group medical plan as we might have access to in a larger corporation, government position or the like, we have annual medical costs specially relating to his disease of over $20,000 annually.

This is not a sad story this is a positive one!! We are delighted with our good fortune in life and it come from hard work and a positive outlook.

It is however discouraging and insulting to hear that the federal Liberals feel that a situation like ours is problematic and needs to be resolved with the tax amendments proposed.

Here is an example of negative community impact:

Small businesses in Victoria have helped support the University of Victoria business program for many years. (Just ask them!) I have served on the board of the UVic Foundation for almost nine years. I have hired co-op students from the University of Victoria over many years. As a former business student I am

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

delighted to give back and support these young people, even though there are many inefficiencies in bringing in student for short term, full time employment. Co-op student salaries are one of our business's very few 'discretionary' expenses and thus will be the first place I will look to cut back on costs should we face higher income taxes. I will not be alone. It would be interesting to hear from the post-secondary institution community that rely on small businesses to support summer students, and co-op students and how increased tax burden might impact their programs."

Impact statement 12

"I operate a small accounting services and bookkeeping practice in Burlington Ontario.

I think it is completely unfair to compare a small business owner to an employee earning the same amount. Mr. Trudeau and Mr. Morneau are not considering RISK into their equation. It's apple and oranges.

Small Business Owners are incurring all the RISK.

I am not talking specifically about Doctors or Lawyers or other professionals that were allowed to incorporate to use tools available to them to lower their tax bill. But rather entrepreneurs like myself and many of my clients who fight day in and day out to manage and grow their business, to invest in their business, staff, technology, products, services and innovation.

Small business owners do not clock in at 8 am and out at 5 pm. They are always aware that at any point the pipeline could dry up and are having to constantly work all the time on sales and customers and profitability. This is not the same as an employee who works hard (don't get me wrong) but certainly not the same skill set or RISK adverse.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Example: I suddenly come into half a million dollars.

Option 1 Invest in GIC

- No Risk, no work or hours required on my part
- Small return

Option 2 Buy Stock

- Some risk and some work required on my part if I intend to buy / sell and trade myself.
- Slightly bigger return

Option 3

- Invest the entire 500K in a small business
- HUGE risk, huge work and investment of time and energy required on my part to ensure success.
- If returns are equal to GIC (why bother? May as well stay home and relax and get the same return)
- If returns are equal to Stock Trading (why bother? take a little bit more risk and gamble on the stock market, will be way less headache and time)

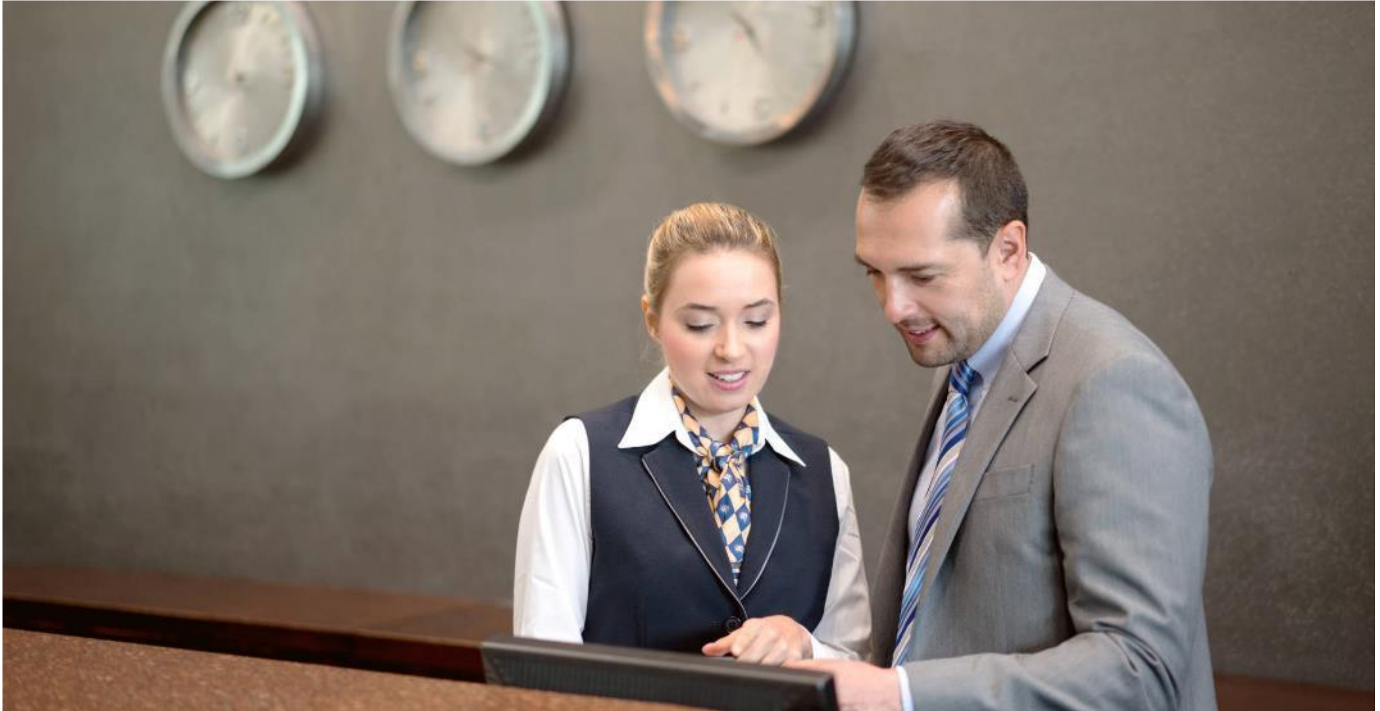
So for anyone in their right mind to go into business for themselves with 500K the returns have to be higher than option 1 and 2 in order to take the very big RISK and to invest hours upon hours upon hours in the business to make it successful. And the current Tax system has some options to make this appealing to an entrepreneur. Changing this is wrong.

So please Mr. Trudeau and Mr. Morneau, do not penalize the majority for the minority who may abuse or push the envelope with aggressive tax planning strategy, figure out how to get the abusers and big businesses to pay their fair share of taxes. It's cruel and wrong to punish the risk takers, the drivers of small businesses, the innovators!

Although you have specifically mentioned high income earners such as Doctors and Lawyers, their RISK is even higher in my opinion. If for any reason god forbid they cannot practice their profession due to an illness or an injury, they can't delegate to anyone. So their income potential has just vanished. At least other small businesses can invest heavily in workflow and processes to ensure business continuity in the event of an illness or injury to the business owner.

And for the handful of Doctors who think these new measures are good because they naively believe the Federal Government is going to spend more on health care, all I have to say is WOW and I have some land to sell you in Antarctica! (to good to be true). Mr. Trudeau and Mr. Morneau have not once made mention of how they plan on spending the new revenue! Certainly no mention of health care.”

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.



Impact statement 13

“My name is XXXX. Along with my sister, XXXX, we own a small hotel in Sidney, British Columbia. We have also developed some commercial rental space on our property in the same building as our hotel rooms. Through our business we support the tourist industry, small retailers, independent professionals, and a local restaurant. We also give back to the community in terms of our time and our money. We work very hard and earn a reasonable income.

Between the two of us combined, we certainly do not earn anywhere near the $200,000 in annual income that the Finance Minister has referred to regularly over the past several months. The business could not afford to pay that level of income to us as a result of debts taken on to pay our father’s tax bill on death. We are clearly a small business and we are incredibly concerned about the recent tax proposals.

Under these proposals, income that we draw from the business in retirement, after more than fifty full time years on the job, would be subject to the highest marginal rate of tax, with no access to personal tax credits. If we reinvest this income, all future earnings on those amounts will also be subject to this punitive tax treatment. The new proposals also create a significant double-tax exposure on our deaths, with no way to plan around that 80%+ tax hit. They also make it very difficult for us to involve our children in ownership.

By creating this punitive treatment during retirement, a tax bill on death that would likely bankrupt our estates, and serious roadblocks to transitioning the business to the next generation, the only real logical alternative is for us to sell off the hotel to a third party – likely a public company or a non-resident. Simply put, this does not seem right. I cannot understand why tax policy would be developed that pushes small businesses like ours, after two generations, into extinction.”

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Impact statement 14

"My name is XXXX. I own Company D, a tree nursery on the Saanich Peninsula on southern Vancouver Island. I have worked on the nursery for almost my whole life: my parents started the business and I began to buy it from them about ten years ago. We will be completing the last buyout payments next year. In our nursery, we produce about 12 million seedlings a year and employ 12 full time workers and up to 80 seasonal workers. We work very hard and earn a good income, but we are certainly not the "1%".

I am very concerned about the recent tax proposals. Specifically, I am concerned about the proposals that target the earning of passive income within a corporation. This proposal concerns me because of our past experiences, and also because of our future dreams. Our livelihood is dependent on a number of factors well beyond our control. This includes things like weather and crop disease. It also includes things like the state of the forestry market. Because we are susceptible to such uncontrollable risks, we like to set aside "rainy day" money in our business. We invest this in conservative investments, and use it to help us when times are tough. We would have been bankrupted in 2001 and 2007 were it not for the funds that we had set aside to cover the tough years. It makes no sense to me that tax policy would punish us for being financially responsible. Those were tough years but we kept the business going and our staff employed solely because we had invested excess profits from earlier years. If we had been forced to pull those profits out to invest in RRSPs or otherwise, we would not have been able to survive.

As mentioned, I am also concerned about our ability to keep the business going, and growing, in the future. We do not own the land that we operate the business on. We would like to buy that someday, but do not want to leverage ourselves and risk our home in order to do so. Accordingly, we are saving within the business so that we can put down a reasonable down payment when the time comes. I don't understand why tax policy would punish us for saving for future growth and opportunities. If we are not able to buy that land when it becomes available, and someone else does, it puts our whole business at risk. It just seems crazy that tax rules would be put in place that would not only dissuade us from doing this, but would punish us for doing this."

Impact statement 15

"The proposed tax changes from the Department of Finance represent the most significant, and potentially negative, set of new rules for all Canadian businesses including those of us in the lumber business. Although each proposed change is intended to achieve a tax purpose, the Department of Finance is not recognizing the real impact this will have on the entrepreneurial spirit, the ability and appetite to take on business risk and, in our case, the ability to keep Canadian businesses within Canadian families.

What is not being properly recognized is the risk entire families take to create, build and own businesses in this country. There is truly an entire family sacrifice to the business as it is not simply the effort of the "owner-manager" of the business that is important. It is truly a family endeavour. The proposed income splitting and capital gains exemption rules simply ignore this consideration.

Business owners need to devote incredible amounts of time and energy in their business. In some cases, this is a joint effort between spouses where both "show up" each day to the office. However, in many cases this means one spouse needs to care for, and manage, the family to allow the other spouse to run the

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

business. There were many, many years where Company E was a 24/7 commitment for me. Long hours during the work week and into the weekend were required to build the business and ensure we could survive the cyclical nature of the industry, keep our people employed and manage the complexities of the business world. My wife, Chris, had to keep our family going without me and her effort in this regard allowed me to run the business. It was absolutely a joint effort to build Company E!

The proposed changes from Finance effectively end income splitting using dividends. Historically, if I paid a salary to my spouse (which is a deductible expense to the company) it would have to be "reasonable" to be allowed. Therefore, unless she was sitting in the office each day, I could not pay her a salary. However, I could pay her a dividend on the shares of the company. A dividend is based on share ownership and has never been subject to a reasonableness test. This has been supported by the Canadian courts. However, the proposed rules suggest that I cannot pay her a dividend that is taxed at her marginal tax rate unless she is making an "in the office" and measurable contribution that is "reasonable." This would suggest to spouses across this country that their efforts aren't relevant to family businesses. That their contribution of time isn't important or valued. This is far from reality as her contribution has been fundamentally important in a number of ways relative to building our family business. If she owned shares of Royal Bank the rule doesn't apply but if she owns shares of Company E she is treated differently. This is also reflected in her ability to claim the enhanced capital gains exemption should the business be sold (or if we were to pass away and have a deemed disposition of the shares).

The change in the income splitting rules also do not reflect the risk taken on by the entire family... it is NOT just risk to me alone. Business owners and their families' entire livelihoods are at risk every day. We take on this risk for the opportunity to create value, build a business and provide opportunities for future generations, our employees and our communities. We personally guarantee business debt. We risk our capital. We risk our homes and our accumulated retirement savings. If the business does not survive (which is common in my industry and many others across the country), it is not just me that loses my home and my livelihood. My entire family...my wife, my children...lose their home and their livelihood. This level of risk is not something employees generally face. This whole family risk is not reflected in the proposed income splitting changes.

However, the biggest impact on my business and our industry is the way these rules will change our ability to keep the business within the family and the ability for me to build my own retirement savings.

Company E is a 3rd generation (soon to be a 4th generation) business. As you know, the lumber industry is volatile and very cyclical. The price of softwood lumber, interest rates, currency exchange rates all dictate whether we have a chance to be profitable or if we lose money. The business also requires large and ongoing capital investments. In good times, the bank is happy to help us finance this but, in tougher times, capital is harder to come by. We employ a large number of people in Elmsdale, NS. When times are tough for the business, we keep these hard working people employed. We have run literacy education and other programs to help ensure our people are employable as technology continues to change the way we operate. That is our responsibility. We are part of our community, we invest in our community and we help others prosper. Our drive to do this stems from the fact that we are a family business. We aren't a large Chinese conglomerate only focused on profit. We are focused on the

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

community in which we live and do what is best for our friends and neighbours in our community.

Intergenerational transfers of businesses in this country… keeping these businesses within families… has been hugely important to our communities, our culture as a country and our economy. It has allowed our company to do important things for the small community of Elmsdale, NS. How many other family businesses are there like ours in countless other small communities across this country? This is now being challenged by the proposed rules.

If the new rules are enacted, the following will occur…

1. It will be more costly, from an income tax perspective, for me to sell Company E to my son than it would be to a Chinese corporation. That is, if I sell the company to my son, we will pay tax at what is effectively the dividend rate (47% in NS) as opposed to the capital gain rate (27% in NS). However, if I sold my company to China, I would only pay tax at the capital gain rate of 27% and would also be able to claim my capital gains exemption. It would represent a huge tax savings to me. How is policy that promotes me selling my business to non-family based, large Canadian and foreign companies good policy for the Canadian economy?

2. If I were to die, my estate would effectively pay tax at the dividend tax rate as we cannot use various strategies to avoid double tax (yes, my accountant tells me that's a real thing) and preserve the capital gain rate. Put another way, if I die owning Royal Bank, I will pay 27% tax on the capital gain and have full cost base in my shares. If I die owning Company E, I am either forced to pay tax at the dividend rate of 47% or my estate can sell the company to a third party to be able to benefit from the 27% capital gain rate. Again, this policy means keeping the business within my family is, at the very least, a 20% higher tax cost than selling to a Chinese company. Again, I'm not clear on the policy objective behind this as it clearly appears to differ from what I believed was important to us in Canada from an intergenerational transfer perspective. The Department of Finance does not seem to be talking about this reality.

I have no one who is going to build a pension for me. I can't rely on EI. I have no benefits that I do not provide to myself and my employees. So, in addition to the risk my family takes every year as we run our business, I am responsible to completely fund my retirement. I also need to be able to fund the cyclical nature of my business when the banks decline to do so' which, unfortunately, is all too common when the markets are depressed.

The proposals allude to changing whether we are able to retain passive assets in our company or whether the tax system will be changed to limit the benefit of doing so. As a business owner, my self-funded pension relies on my ability to save money from after tax profit of the business. If I were to remove the profit from the company, I would be subject to a higher personal tax rate which would, in turn, reduce my ability to fund retirement. However, it is just a deferral. As those assets earn income it is taxed immediately in the company and when I eventually retire and begin to withdraw the funds, I'm taxed on the withdrawal as a dividend. We take meaningful personal and family risks running our business, we employ a large number of people and help drive our economy. I cannot understand why Finance believes that my ability to retain profit in the business to completely self-fund my retirement is offensive. Especially when you consider that I will pay tax when I eventually spend the money.

If I would have not been able to build sufficient retirement assets by keeping profit in my company,

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

that also impacts my ability to keep the business in the family. That is, it will cause some business owners to sell their business to a third party to realize on the value of the business (also allowing them to get their capital gains exemption and the actual capital gains tax rate) rather than passing the business to their children. This will be more relevant when they cannot build sufficient retirement savings otherwise.

Furthermore, I mentioned my business is cyclical. The ability to retain profit and invest it in passive assets in the company allows me to weather these cycles. It allows me to self-finance the business in tough times when the banks are less than eager to do so. Taking away my ability to do so is a recipe for business failure. If I can't build passive assets to self-finance, what will the company do when the price of softwood lumber takes its next downturn or when the US imposes higher duties and tariffs?

My overall concern with these proposals is that they do not reflect the risk we take on as business owners, our responsibility to completely self-fund our retirement or our ability to retain profit to manage business cycles, risk and investment. It does not reflect the entrepreneurial spirit of this country where people should be incented to take risk, work hard and build businesses. Why would anyone do so if they are being taxed at the highest possible levels every way you turn? Comparing a business owner to an employee does not reflect the reality of the differences between the two. Furthermore, and maybe most troubling, is that these proposals may actually cause families to choose to sell their businesses to third parties rather than keeping those businesses in the family. When my estate's tax on death on my RBC shares is potentially less than my tax my would pay on my Company E shares, there is something wrong with the system."

Impact statement 16

"Our business began as a retirement project by my father-in-law in 1990. As the business grew, my husband and I worked for it during our time off of our regular jobs. Myself, as an administrator of Children's Aid Society, and my husband as a licensed bricklayer, very well-paying jobs, with security, benefit packages, vacation, and retirement plans.

When we took over the business in 2003, we used our personal line of credit to keep it afloat. To date, we have still not been able to pay it off. After working 16 hour days, 7 days a week, while raising two children, we have grown our business to over 25 employees (and growing), providing fair wages, benefits and bonuses. We have grown from a 500 square foot warehouse to 7 acres of property with millions of dollars of machinery and trucks. We have also donated a lot to charities and have sponsored many local sports.

Our priority has always been to pay our employees and vendors before we pay ourselves. We took pride in this. Unfortunately, because of our type of business, we would only take wages, if our finances allowed it, which was not often. We always thought that if we work hard enough to make our business a success, it would be worth it. We left all profits in the business to grow and make a future for our family and our employees.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

The Government says that they want to help small business owners, but this will not be the case for us. With all of our hard work, discipline, sacrifice and perseverance, we grew our small business into a very successful corporation. We are finally getting to the point where we may be able to take some profits, but we are going to be penalized because we kept our money in our business to succeed and grow, hiring more employees and paying millions of dollars in freight, fuel, repairs and maintenance, supplies, and taxes, which only benefited the economy. I was always told that if you work hard enough you will be rewarded. I guess this is not the case.

I think that the Government has to take a long, hard look at what they are proposing and who will be affected by it. If a small, family-operated business succeeds and becomes a corporation, that is the result of hard work, long hours, and many sacrifices by all family members, it should be rewarded at some point. Either at retirement or at a point in the business where there is an actual profit."

Impact statement 17

"As the owner of a self-supporting scientific research and development company I feel the proposed changes to investment of company capital to be unacceptable. It is my fiduciary requirement of running a corporation to ensure the ongoing success of my company and work in its best interest.

It is imperative that we have significant working capital within the company and irresponsible to think it should not be invested in the most fruitful and secure manner.

As research cannot be scheduled as to completion date, never mind deriving income from its results, it can take many years of research to bring a project to fruition. Typically we make a sale every three to five years or so. This means we have to exist on the proceeds of that sale for the next unknown number of years, not allowing us to invest it freely is ridiculous. Does this mean not even any investment from term deposits?

As I understand the government is proposing that it can only be invested back into the company. Well, it always has been, but it's not like hiring extra personnel or buying new equipment is going to make the company more money or get the job done any faster.

It's like hiring 9 women to have a baby in 1 month. Research and development just doesn't work that way."

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Part V
Summary

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Part V: Summary and Recommendations

The Canadian tax system helps support our country's competitive position in the global economy and provide incentives for business owners to take risks and invest in our economy. We recognize that the government has a responsibility to improve the tax fairness for all Canadians and ensure that there are no abuses to the system.

In Budget 2017, the government signaled its intention to address specific tax planning strategies involving the use of private corporations - strategies which it believes result in high-income individuals gaining tax advantages that are not available to most Canadians. Following through on this, the government issued a consultation paper outlining these perceived issues as well as proposed policy responses (the "Paper")[27] together with draft legislation and draft explanatory notes[28] on July 18, 2017 (collectively the "Proposals"). In summary, the Paper focused on three specific areas:

- Income sprinkling;
- Converting a private corporation's regular income into capital gains; and
- Holding passive investments inside a private corporation.

We have reviewed these Proposals and set out below our comments or observations as well recommendations.

[27] "Tax Planning Using Private Corporations", Department of Finance, Canada, July 18, 2017, Available: https://www.fin.gc.ca/n17/data/17-066_1-eng.asp)

[28] Legislative Proposals Relating to the Income Tax Act, the Income Tax Act Regulations and Explanatory Notes, Department of Finance, July 2017, Available: https://www.fin.gc.ca/drleg-apl/2017/ita-lir-0717-eng.asp). Note, draft legislation and explanatory notes were only provided for income sprinkling and converting income into capital gains.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Shift in Policy

The government has characterized the intent of the Proposals as closing "loopholes". However, the term loophole is misleading as it implies ambiguity or omission that evades or frustrates the intent of the statute.[29] We submit that the tax planning strategies the government is proposing to change are not loopholes but rather tax policy features, which produced results that they were supposed to achieve when they were enacted. Over time however, with the growing gap between corporate and personal income tax rates and the increase in the use of private corporations, these laws may have come to be used in ways that the current government considers inappropriate.

In addition, the government has publicly stated (and as reflected in the Paper) that these proposals are aimed at the "high income individuals" or the "wealthy". The Proposals however, will in fact, affect a wide variety of private business owners, including the lower and middle class business owners.

Complexity of Proposals

These Proposals are complex and if enacted will add to an already complicated tax system making it more difficult for taxpayers to interpret and comply with the tax rules. Instead of changing the tax system on a piecemeal basis with Proposals like these, such changes should be considered in the broader context of the overall tax system with the goal of simplicity, efficiency, fairness and competitiveness.

The Proposals represent a shift in tax policy and will affect many business owners who have arranged their financial affairs based in part on existing longstanding tax laws, which the government has similarly known about and allowed. Accordingly, implementation of such Proposals should follow due process, including transparency and stakeholder consultation allowing for open analysis, collaborative efforts and debate on the most effective approach. Furthermore, there should be an appropriate phase-in period with transitional rules to provide affected taxpayers a reasonable amount of time to bring their affairs in line with the new policy.

Consultation Period

The government has invited the public to express their concerns on these Proposals by providing a 75-day consultation period. Although we have appreciated the time provided, we are of the view that such limited timeframe is insufficient to properly deal with the complexities and breadth of these tax policy changes. Accordingly, we respectfully request an extension of the consultation period to allow for a deeper review of the impact of the Proposals.

[29] A "loophole" is defined in the Black's Dictionary as "an allowed legal interpretation or practice unintentionally ambiguous due to a textual exception, omission, or technical defect, evades or frustrates the intent of a contract, law, or rule".

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Recommendations

We have also summarized below our specific observations on the current Proposals for consideration. Please note that the detailed analysis and discussion are provided in more detail in the other sections:

1. Income Sprinkling (Tax on Split Income & Lifetime Capital Gains Exemption)

   a. Extend Existing TOSI Regime to up to 24 Years Old: Instead of proceeding with these proposals, we recommend that the existing rules in section 120.4 be maintained with the exception that they will now also apply to individuals up to the age of 24 years old. Most of the income splitting that is of concern to the government appears to be here. This would significantly decrease any perceived benefits available to owners of private corporations yet recognize the valid and often unrecognized contributions spouses provide to a family business and would also eliminate the complexity in the proposed rules.

      The removal of the extended definition of related party under the proposed TOSI rules would again eliminate unintended results, simplify the proposed rules and would recognize in practice that income splitting with such extended family members is rare and where this does occur, that the parties generally act as unrelated in any event.

   b. Application of the Reasonableness Test: We recommend that further guidance be provided as to how the government intends to apply the reasonableness test and ensure that the subjectivity, the technical issues that may impact unintentional taxpayers, and the vast application and wide-reaching effects, are addressed.

   c. Subsection 110.6(12): Subsection 110.6(12) can have a negative impact where a taxpayer has multiple dispositions and realizes multiple capital gains in a given year – some of which are eligible for the LCGE and some of which are not. We recommend that the proposals be amended to reflect the specific taxable capital gain that this subsection is meant to apply to as opposed to the total amount of LCGE deductible by an individual as it is currently worded.

   d. Treatment of Qualified Farm or Fishing Property: Qualified farm or fishing property is eligible to be transferred between generations for an amount that is less than FMV. This will result in additional tax consequences under the LCGE proposals. This result does not seem to be in line with the overall tax treatment of such property throughout the Act. We therefore recommend that qualified farm and fishing property be excluded from the proposals.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

e. Treatment of Graduated Rate Estates (GREs): Currently, GREs are not included in the definition of an "eligible LCGE trust" for purposes of the LCGE proposals. This appears to be overly punitive for deceased taxpayers and their beneficiaries. We recommend that the definition of an eligible LCGE trust be expanded to include GREs to ensure that post-mortem transactions are treated consistently throughout the Act.

f. Transitional/Grandfathering Rules:

   i. *Transitional Period* - In order for a taxpayer to be eligible for the transitional election, certain steps will need to be carried out prior to the effective date of the proposals. These dates do not provide taxpayers with a lot of time, especially when one considers the uncertainty that exists regarding these proposals and whether these changes will be implemented in their current form. As a result of this uncertainty, we recommend that the transitional period be amended to take place in a calendar year that provides a reasonable amount of time from the date of Royal Assent of the legislation.

   ii. *Late-Filing Penalty* - The imposition of a late-filing penalty for the transitional election available under the LCGE proposals appears to be overly punitive and inconsistent with the penalties imposed for other late-filed elections in the Act. We recommend that this penalty be revisited and reduced accordingly.

   iii. *AMT* - The potential imposition of AMT is unnecessarily punitive for taxpayers who are trying to organize their affairs to comply with the proposals. We therefore, also recommend that the government consider exempting any AMT that may arise as a result of the transitional election.

2. Converting a Private Corporation's Regular Income into Capital Gains

a. Application of Section 84.1to Post-mortem planning: We believe an estate should not have to pay significantly more tax than what would be payable had the deceased sold the shares to an arm's length third party. We therefore recommend the proposed changes to section 84.1(and, similarly, the proposed change to subsection 120.4(4)) not apply in respect of shares that are acquired as a consequence of a taxpayer's death. And if the 164(6) loss carry back strategy is the only option to avoid double taxation on death, we recommend that at a minimum, very significant improvements be made to this provision to address the current issues, as discussed previously, to make the use of this strategy more broadly available/accessible.

b. Paragraph 84.1(2)(a.1) Modified ACB: The modified ACB rules are an unnecessary complication. To the extent the Government is concerned that taxpayers will attempt to avoid section 84.1 by, for example, involving an arm's length person to act as a facilitator for a sale to a related party, the existing general anti-avoidance rule would apply and would be a sufficient recourse.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

c. Intergenerational Transfers: There are currently examples available such as the Quebec legislation which can be used as a starting point along with consultation with the various stakeholders to develop the appropriate legislation so that business owners are not penalized on a genuine intergenerational transfer of shares. We recommend that this consultation be completed before the July 18 proposals are implemented and that the potential impact of amendments to proposed subsection 120.4(4) should also be addressed as these proposals would also introduce further impediments to such transfers.

d. Application of 246.1: Section 246.1 is too broadly worded and appears to have possible application to many ordinary-course business transactions. The draft explanatory notes that were issued also do not provide any examples of where the Government believes that section 246.1 would apply. As a result, there is uncertainty regarding its scope and application. We suggest that the application of section 246.1 be limited to the intended abuse and that further guidance on the specific consequences be provided.

e. Grandfathering/Transitional Relief: Any amendments should be introduced prospectively and/or with appropriate transitional rules or grandfathering provisions so that the treatment of existing and historical transactions are not, in effect, unfairly modified without notice to taxpayers. More specifically, we recommend that the application of the proposed changes to section 84.1 be amended such that it does not apply in respect of capital gains realized on a previous disposition prior to July 18, 2017. We also recommend that proposed section 246.1 not apply in respect of amounts received in respect of a transaction or event, or a series of transactions or events,that began prior to July 18, 2017.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

3. Holding Passive Investments Inside a Private Corporation

The government has outlined a number of questions relating to its proposal and is requesting specific feedback. We have attempted to provide some views on the proposals but because of the limited time period provided (i.e., a 75-day consultation period), it is not possible to provide commentary on all of the issues that would result from such amendments.

In summary, we feel various design issues still need to be addressed, that the Proposals are not fair and will unnecessarily add another layer of complexity to our already complex tax system and may result in unintended consequences by taxpayers. If the government decides to proceed with drafting legislation to implement these proposals, we recommend that:

a. An Advisory Panel be formed to thoroughly study, in consultation with stakeholders, the policy, design issues and the consequences of the Proposal and ensure that that they do not create a tax environment that stifles economic activity within Canada.

b. A reasonable transition period be incorporated into the legislation so that taxpayers are provided with sufficient time in which to reorganize their affairs with minimal consequences.

c. The majority of the compliance burden is minimized by including a provision that would restrict the legislation from applying to corporations earning taxable income below a certain threshold.

d. It may also be effective to create a ratio by which corporations holding a certain amount of passive assets versus active assets would be exempt from the rules.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Part VI

About Grant Thornton

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Part VI: About Grant Thornton

Grant Thornton LLP is a leading Canadian accounting and advisory firm providing audit, tax and advisory services to private and public organizations. Our goal is to help our clients, colleagues and communities thrive. We help dynamic organizations unlock their potential for growth by providing meaningful, actionable advice through a broad range of services. Together with the Quebec firm Raymond Chabot Grant Thornton LLP, Grant Thornton in Canada has approximately 4,000 people in over 80 offices across Canada. Grant Thornton LLP is a Canadian member of Grant Thornton International Ltd, whose member and correspondent firms operate in over 100 countries worldwide.

© Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

Grant Thornton LLP is a leading Canadian accounting and advisory firm providing audit, tax and advisory services to private and public organizations. Our goal is to help our clients, colleagues and communities thrive. We help dynamic organizations unlock their potential for growth by providing meaningful, actionable advice through a broad range of services. Together with the Quebec firm Raymond Chabot Grant Thornton LLP, Grant Thornton in Canada has approximately 4,000 people in over 80 offices across Canada. Grant Thornton LLP is a Canadian member of Grant Thornton International Ltd, whose member and correspondent firms operate in over 100 countries worldwide.

grantthornton. ca