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The Honourable William F. Morneau
Minister of Finance
Department of Finance Canada
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Dear Minister Morneau,

Re: "Tax Planning Using Private Corporations" – Deloitte's comments

We are writing to provide our comments on the July 18, 2017 consultation paper entitled "Tax Planning Using Private Corporations".

We appreciate the fact that the Government has released these proposals in the form of a consultation paper. We believe that this approach - which affords stakeholders the opportunity to provide input based on their experience and practical insights - will foster a greater understanding of the issues being addressed and will ultimately help to develop tax policy that will build a stronger, more competitive Canadian economy.

Deloitte is the largest professional services firm in Canada and we work with thousands of Canadian small, medium and large private companies on an ongoing basis. This document represents the thoughtful views of our private company tax experts who gained their expertise through extensive work with clients in the private company space.

Deloitte is also participating in other submissions and discussion fora on these proposals, including the papers being submitted by the Chartered Professional Accountants of Canada and the Joint Committee on Taxation of The Canadian Bar Association and Chartered Professional Accountants of Canada. As such, this document does not purport to address all of the relevant issues, but rather, some of the more urgent issues.

The proposals currently under consideration are significant and will have an impact on a very large number of taxpayers. The changes being contemplated are dramatic. They cover a large number of issues and have a compounding effect when analyzed in combination. Our major concerns with the proposals are discussed below. They reflect our careful analysis of the consultation paper and our discussions with our clients across Canada. We have organized our comments as follows:

1. General policy considerations – our concerns
2. Income sprinkling measures
3. Holding passive investments inside a private corporation
4. Capital gains

EXECUTIVE SUMMARY

Our concerns with the proposals are reflected in four overarching recommendations:

- As the proposals amount to tax reform in the area of private company taxation, and not merely the closing of “loopholes”, we urge the Government to enter into a more comprehensive consultation with Canadians, including an advisory panel to fully evaluate the implications of alternative courses of action.
- As many elements of the proposals are complex and are anticipated to lead to significant increases in the cost of compliance for Canadians, we recommend a concerted effort to narrow the application of the provisions to more efficiently target what are considered offensive transactions.
- To enable Canadians to plan their financial futures with confidence, we recommend that the retrospective effect of the proposals be removed.
- To ensure Canada’s competitive position is maintained, we recommend a full assessment of the impact of the proposals on the competitiveness of Canadian private enterprise

In addition to these broad recommendations, we would like to highlight the following key specific recommendations which we feel are the most urgent to address in the immediate future. These, among others, are discussed in more detail throughout our submission:

- The Government should abandon the passive income proposals for the reasons that similar proposals were abandoned during 1972 tax reform.
- Spouses should be excluded from the income sprinkling provisions, thereby mitigating a large portion of the inequity and complexity associated with these provisions.
- An intergenerational or other family business transfer should be subject to the same tax treatment as the sale of shares of a family-owned enterprise to an unrelated party.
- The retrospective aspects of the proposed legislation, particularly as they relate to sections 246.1 and 84.1 should be eliminated.
- The inherent punitive double taxation that would result on the death of a taxpayer who owns CCPC shares should be corrected.

1. GENERAL POLICY CONSIDERATIONS – OUR CONCERNS

We are concerned with portrayal of the proposals as merely closing loopholes that are available to the wealthy. The dramatic changes to a tax regime that has been in place for decades for private corporations can more accurately be described as tax reform proposals which would impact all private corporations in Canada, regardless of size and level of wealth. Given the broad scope of these amendments and the concerns expressed by the business community, we respectfully submit that a 75-day consultation period in the middle of summer is insufficient. Rather, we would recommend that the Government treat this as tax reform in this area and use this occasion as an opportunity to form an advisory group with broad representation to develop recommendations that take into account the anticipated impact on the broader economy.

Our second concern relates to Canada’s competitiveness. Canada’s personal income tax rates are comparatively high and the high marginal rates are applicable at comparatively low income thresholds - in particular relative to our largest trading partner, the United States. This existing concern makes it challenging to attract and retain top talent in Canada, including entrepreneurs who can contribute significantly to Canada’s innovation and growth agenda and create opportunities for themselves, their employees and others. Directionally, the United States is targeting further reductions in both personal and corporate tax rates that, if achieved, will increase the competitive differential. These potential reductions include reductions in the tax rates paid by private businesses and private business shareholders. The U.S. intention was confirmed in the September 27, 2017 outline of the

government's tax reform platform.¹ Canada's private corporation proposals will increase the tax owing by Canadian entrepreneurs. This higher tax, coupled with the uncertainty created by retrospective application of certain changes, will exacerbate an existing challenge and will not contribute to Canada's innovation and growth agenda.

One of the premises of the proposals is fairness and equal treatment of an employee and an entrepreneur who carries on business through a corporation. No one would disagree with the principle of equity - that taxpayers in the same circumstances should be subject to the same rules. However, the employee versus entrepreneur comparison is flawed, in that these two categories of taxpayer are not generally facing the same circumstances. Typically, entrepreneurs are putting capital at risk (both directly and indirectly through personal guarantees), funding their own benefits (including maternity leave and retirement), future business expansion, contingency reserves to keep the business operating through downturns, finding financing and creating jobs for others. Hence, the comparison can be seen as unfair in many cases.

Proposals that reduce the rewards of risk-taking by entrepreneurs in Canada would appear to be inconsistent with Canada's innovation and growth goals as they could have the unintended consequence of reducing both risk-taking and innovation.

Other general concerns include the complexity of the proposals, the uncertainty that they will create and the related cost of compliance. Our existing tax regime for private corporations is already quite complex and includes many areas of uncertainty. The relatively recent changes to subsection 55(2) of the Income Tax Act (the Act) are an example of an amendment adding tax complexity and uncertainty to what used to be a simple payment of an intercompany dividend. The private corporation proposals regarding income sprinkling have a reasonableness test that would appear to require a transfer pricing type of analysis to determine the financial and labour compensation of related parties. The passive investment proposals contemplate the introduction of multiple new tracking pools in order to pay a dividend. As well, the anti-avoidance rules in proposed section 246.1 of the Act appear to be extremely broad and would create tremendous uncertainty for business, with potentially retrospective effect (as explained below). Adding this increased level of complexity and uncertainty across all private companies seems problematic and could have a detrimental effect on fostering economic growth, especially for small private companies that simply cannot afford an increase in compliance costs.

These general policy considerations are discussed further below in the specific comments and recommendations regarding the proposals.

2. INCOME SPRINKLING MEASURES

General policy concerns

The income sprinkling proposals introduce significant changes to the current tax regime which already contains a number of provisions to prevent what is considered inappropriate income splitting between family members. The proposals, if implemented as introduced, could have retrospective application – a result that we believe is punitive since income earned and tax planning put into place under a different regime will suddenly be subject to different rules.

¹ "Unified Framework for Fixing our Broken Tax Code", developed by the Trump administration, the House Committee on Ways and Means, and the Senate Committee on Finance.

The retrospective nature of the legislation runs counter to the concept of integration if the dividends are taxed as noted in the proposals. In fact, the combined corporate and personal tax rate on the business income will approach 60% in many provinces. Grandfathering provisions that allow dividends to be paid out of the pre-2018 pool of after-tax corporate income to adult specified individuals without attracting tax on split income (TOSI) could mitigate this unfair result.

The Canadian tax system is already complex, and in many cases requires people to pay for the service of specialists simply to comply with the existing laws. The proposed approach to income sprinkling will only increase the level of complexity for taxpayers who own Canadian-controlled private corporations (CCPCs). The ability of small business owners to comply with the proposed rules will depend on the availability of resources to deal with added complexities such as the analyses required to determine the value of capital and labour contributions. General compliance costs will increase for most small businesses, and it may be difficult for smaller, low-margin businesses to afford these increases.

General technical concerns

In general, many of what we believe to be unintended results of these proposals stem from the elimination of the age ceiling in the current definition of a specified individual and, in particular, the inclusion of a spouse as a specified individual.

The definition of split portion outlines the relevant factors to consider when determining whether a particular amount exceeds what would have been paid to an arm's length party. One of those relevant factors is the "assets contributed, directly or indirectly, by the individual in support of the source business". It is not unusual for a specified individual who is not otherwise active in the business to purchase shares from another party. Unfortunately, as the legislation is currently drafted, it does not appear that the purchase price paid for those shares would be taken into account when determining whether an amount paid to the specified individual is reasonable and therefore not a split portion. In our view, this factor should be expanded to account for any consideration paid for the shares, regardless of whether or not the funds are actually contributed to the business.

Certain of the definitions create complexity. For example, the definitions of split income, excluded amount and split portion are circular. Whether an amount is included in split income depends on whether it is an excluded amount. Whether an amount is included as an excluded amount depends upon whether it is a split portion and, finally, whether an amount is considered a split portion depends on whether it is included in split income.

Certain elements of the proposals are vague and may lead to uncertainty in interpreting the law. For example, the reasonableness tests contained in the proposals are broadly worded and subject to diverse interpretation. Words such as "regular, continuous and substantial basis" in the test for determining the labour contribution of an 18 to 24-year-old are unclear - does the test require full-time activity? What would be considered "substantial"? How would specialized skills be taken into account? They may be of significant value but not require regular continuous and substantial activity. A test that is more specific, more easily applied with certainty, and that also reflects the value of a contribution would be preferable.

There are also significant practical challenges with respect to substantiating, tracking and quantifying historical contributions, risks assumed and previous payments for purposes of the reasonableness tests.

Finally, the application of proposals with respect to intergenerational transfers will be challenging, particularly when it comes to measuring the relative contributions by the next generation. For example, clause 120.4(1.1)(e)(ii)(C) appears to be a relieving provision that allows an individual who inherits property to step into the shoes of the deceased with respect to labour and capital contributions, risks assumed and previous payments. How do you measure those inherited factors from possibly many years ago when compared to other members of the same generation who are actively involved in the business now?

Succession/sale of a business

The expanded definition of specified individual to include certain adults leads to several unintended results where there is an intergenerational transfer of a business or an outright sale of the business to a third-party. For the most part, the unintended results described in the examples below would not occur under the existing legislation which narrowly defines a specified individual to be a minor child. This is due to the fact that a minor child is rarely in the position of vendor. The following are a few common situations to illustrate these points.

Example 1

A father started a business several years ago, grew that business and retired, leaving the business to his children to operate. During the years he was actively involved in the business, he drew a salary commensurate with the services rendered. However, due to declining health, he has not been actively involved in the business for the last several years. Fortunately, either by luck or good management, the value of the business has grown significantly over the years resulting in a significant amount of goodwill.

The father implemented an estate freeze several years ago, exchanging his common shares for high value preferred shares having a low paid-up capital (PUC). New common shares were then issued to a family trust. The plan was to eventually have the family trust distribute the common shares to the children and the corporation redeem the preferred shares over time to fund the father's retirement. The redemption of the preferred shares will trigger a deemed dividend equal to the difference between the redemption proceeds and the PUC of the shares redeemed.

It is unclear how the father's contribution will be determined given his lack of active involvement in recent years. It is quite possible that a significant portion of the deemed dividend received on the redemption of the preferred shares will be subject to TOSI. Although it might be logical to assume that the entire value of his preferred shares is the result of his contribution, the legislation does not provide such clarity and comfort.

Example 2

This example involves the same fact pattern as Example 1, except that the father has determined that the children are either not capable of, or not interested in, operating the business. He does not want to sell the business as he would like it to stay in the family. As a result, he has recruited professional management to operate the business and has distributed the common shares from the family trust to the children who will remain inactive in the business.

In addition to his own issues regarding the redemption of his preferred shares, under the proposed rules, his children would have no way to extract funds from the corporation in a tax effective manner as long as their father is alive. They cannot draw a salary as they are not providing services to the business. Any dividends paid on the common shares will be subject to TOSI. As a result, the combined corporate and personal tax approaches or even exceeds, 60% on any distribution, assuming that any

income earned by the corporation is subject to the general tax rate. Essentially, the next generation cannot extract funds from the corporation without paying a punitive rate of tax.

Example 3

Common shares were originally issued equally to Mr. and Mrs. A. Mr. A has been active in the business since its inception while Mrs. A has been employed elsewhere. An estate freeze was implemented, whereby Mr. and Mrs. A exchanged their common shares for high value/low PUC preferred shares and new common shares were issued to a family trust. The plan was to fund their retirement by redeeming the preferred shares over time.

Under the proposed rules, it would appear that any deemed dividend received by Mrs. A on the redemption of her preferred shares would be subject to TOSI even though she subscribed for the common shares on incorporation when they had no value and has owned them throughout the period of value accretion. She would be penalized by virtue of her ties to her family's business.

Example 4

This example uses the same fact pattern as Example 3, except that Mr. and Mrs. A intend to sell their preferred shares to their children as part of an intergenerational transfer of the business. Mr. and Mrs. A intended to benefit from the use of their available capital gains exemptions.

Under the proposed rules, Mrs. A would not be able to utilize her capital gains exemption. In addition, pursuant to subsection 120.4(4), any gain realized by Mrs. A on the disposition of her preferred shares to non-arm's length parties (i.e., the children) would be taxed as ineligible dividends at the highest personal tax rate. To be clear, under the expanded definition of specified individual, Mr. and Mrs. A are both specified individuals. Therefore, subsection 120.4(4) could possibly apply to both of them. Fortunately for Mr. A, it is quite likely that his capital gain will qualify as an excluded amount due to his active involvement in the business and would therefore not be subject to this provision. Mrs. A's capital gain, on the other hand, would likely not be an excluded amount; as such, she would be required to include in her income the entire gain (rather than only the taxable capital gain) as an ineligible dividend to be taxed at the highest personal tax rate.

It is important to note that a sale of shares to an arm's length third party will not lead to the same result. In this case, the gain realized by Mr. A will be not only be excluded from split income so that only 50% of the gain will be taxable, he will be able to shelter at least a portion of the taxable capital gain with his lifetime capital gains exemption (LCGE). Mrs. A's gain will still be considered split income but only the taxable portion of the gain will be subject to tax at the highest personal tax rate. In essence, these new rules severely penalize intergenerational transfers by significantly increasing the tax burden when compared to an arm's-length sale to a third-party.

The quantum of this additional tax burden should not be underestimated. This can best be illustrated by way of another example.

Example 5

Assume that Mr. and Mrs. A are Ontario residents and are equal shareholders in a successful private corporation that they had started many years ago. Mr. A has been active in the business while Mrs. A has not. They have the opportunity to sell their shares to either their son or to a third party for \$5 million. The sale proceeds will be used to fund their retirement, so minimizing income tax on the transaction is critical. In the year of the transaction, each of Mr. and Mrs. A have \$180,000 of taxable income, excluding any income realized on this transaction.

If they sell to their son, subsection 120.4(4) will apply to recharacterize Mrs. A's \$2.5 million gain into an ineligible dividend subject to TOSI, but Mr. A will be eligible for capital gains treatment and the LCGE. This will result in a combined income tax liability for both Mr. A and Mrs. A of \$1,703,440.

If they sell to the third party, Mr. A will include in his income 50% of the \$2.5 million capital gain and shelter much of it with his LCGE. Mrs. A, unfortunately, will still be subject to TOSI, but only on the taxable portion of her \$2.5 million capital gain. In this case, Mrs. A's capital gain is not recharacterized as an ineligible dividend as the transaction is between arm's length parties. As a result, their combined income tax liability is \$1,240,065. In summary, if Mr. and Mrs. A sell to their son, they will have \$3,656,560 after tax to fund their retirement. They will be left with \$4,119,935 if they sell to the arm's length party.

Example 6

This example highlights an anomaly in the proposed rules. Pursuant to subparagraph 120.4(1.1)(e)(i), if a person is otherwise in the top tax bracket, the split income rules do not apply. The logic is that there is no need to apply TOSI to any split income because it will already be taxed at the highest personal tax rate.

Assume that common shares are equally owned by Mr. and Mrs. A. At first glance, that seems to make sense. However, this carve out can lead to presumably unintended results under certain circumstances. In this case, Mr. and Mrs. A are equal shareholders of a private corporation that carries on the family business. Mrs. A has been actively involved in the business while Mr. A has been employed elsewhere. Both have taxable income of \$150,000, excluding any income from the sale of their business. The business is sold for \$8 million to their son and Mr. and Mrs. A. will each realize a capital gain of approximately \$4 million.

Mr. A's capital gain would be split income pursuant to subsection 120.4(4) while Mrs. A's capital gain will not. In the year of sale, Mr. A's other taxable income is approximately \$150,000 so he is not in the highest tax bracket. As a result, the split income rules would apply and twice Mr. A's taxable capital gain will be included in his income as an ineligible dividend and taxed at the top personal rate. However, if Mr. A were to withdraw an additional amount from his registered retirement savings plan (RRSP) to increase his taxable income so that he is in the top tax bracket, the split income rules would not apply. As a result, he will only be required to include the taxable portion of his capital gain in his income, thereby significantly reducing his tax burden. Using the numbers in this example, if Mr. A were to withdraw \$80,000 from his RRSP so that he would be in the highest tax bracket, he would reduce his tax liability on the \$4.0 million capital gain from \$1,812,000 to \$1,070,600.

Example 7

There also exists apparent inequity around the limitations to the availability of the LCGE contained in proposed subsections 110.6(12) and (12.1). These changes would effectively deny the exemption to all family members whose gain from the sale of property is subject to TOSI. Consider a scenario where Mr. A, Mrs. A and their three children own an equal number of shares in their small business and Mr. A is the only family member who is actively engaged in running the day-to-day operations. The family availed itself of legitimate tax planning at the time in determining the structure of ownership. Where a share sale is imminent but not immediate, the family may choose to take advantage of the one-time 2018 election to crystallize the LCGEs (provided the children are over 18 and they are otherwise eligible to do so). This may give rise to alternative minimum tax (AMT). If a share sale is not imminent, the imposition of AMT may be prohibitive and the family may forgo the one-time election. Under this scenario, if the company is sold for proceeds of less than \$4,175,000, Mr. A would not be

able to benefit from a full LCGE on his portion of the proceeds. Absent the historical structuring of the business ownership equally among the family members, he would otherwise be able to access the full exemption.

Second generation income

The proposed legislation introduces the concept of second generation income as split income. Essentially, second generation income includes income that was either subject to TOSI, the attribution rules or capital dividends paid to a specified individual who has not yet attained the age of 24 before the year in question. In some cases, it may be justifiable to include in split income certain income earned on income initially subject to TOSI and the attribution rules on the basis that that the second generation income was earned on "tainted" capital. It does not, however, make sense where a specified individual has used the "tainted capital" to seed his/her own private corporation from which he/she will receive dividends that would not otherwise be subject to TOSI.

The reasoning for the third element is not clear. Under the existing rules combined with the proposals, capital dividends can be paid to a specified individual without triggering TOSI. It is not apparent why income earned on the invested capital dividend should be considered the split portion of split income simply because the capital dividend is paid to a specified individual who has not yet attained the age of 24 before the year.

The inclusion of second generation income in the definition of split income may also prove problematic where a private corporation receives life insurance proceeds, creating a balance in its capital dividend account (CDA). If the connected individual is still alive, any capital dividend paid to a specified individual who has not yet turned 25 is considered second generation income, so any income earned on the invested capital dividend will be subject to TOSI.

Finally, the addition of second generation income to subparagraph (g) of the definition of split income in subsection 120.4(1) is problematic in that it forever "taints" any investment income earned on proceeds from the disposition of shares by a specified individual. Essentially, this income will always be subject to the highest personal tax rate even if the connected individual passes away. This appears to be contrary to the general scheme of the proposed rules which apply TOSI to split income received by a specified individual as long as the connected individual is alive.

Estate planning

The recharacterization of a taxable capital gain as an ineligible dividend pursuant to subsection 120.4(4), combined with the effective elimination of pipeline planning due to the proposed amendment to section 84.1 (discussed below), results in double taxation where there has been a fair market value deemed disposition of shares of a private corporation owned by a specified individual on death. The unfair results of the compounding effect of these proposals are discussed below in the capital gains section of this letter.

Additional considerations

One of the relevant factors to be considered when determining whether an amount is a split portion is the capital contribution made by the specified individual. This concept appears flawed where a specified individual has contributed a nominal amount as seed capital to a startup business. Assuming the adult specified individual does not make any further capital contribution, is not active in the business and does not assume any risk, the entire amount of any dividend received (as well as any gain realized on the disposition of the shares) will be the split portion subject to TOSI. It does not matter that the capital contribution was made at a time when the business had no value. All that has happened is that the business has been successful and grown in value and the nominal investment

made by the specified individual has paid off. This does not appear to be different than a speculative investment made in a public company or an arm's length private company.

The anti-avoidance provision is unnecessarily broad and, as a result, catches many unintended transactions. In particular, the purpose test is easily satisfied creating a great deal of uncertainty when planning for these provisions. Specifically, paragraph 120.4(1.1)(d) states that "...if it can reasonably be considered that one of the reasons that any person or partnership acquires or holds a property is to avoid additional tax under subsection (2)...for, or in respect of, the individual for the year or any earlier taxation year of the individual...". In fact, the provision is so broad that it effectively renders other attribution rules such as subparagraph 74.5(2) redundant. Given that a number of attribution rules are already in place and the Act also contains the general anti-avoidance rule, the scope of this anti-avoidance provision should be much narrower and focused on specifically offensive transactions with respect to TOSI.

The provisions dealing with the reasonable rate of return on capital contributions by a specified individual differ depending on the age of the individual. It is difficult to understand the rationale behind setting a different hurdle rate (particularly when the prevailing prescribed rate is only 1%). It is not clear why a capital contribution by a specified individual who has not attained the age of 24 before the year is any different than a capital contribution by a specified individual who has attained the age of 24 before the year.

Clause 120.4(1.1)(e)(ii)(C) appears to be a relieving provision allowing an individual to step into the shoes of the deceased with respect to contributions made and risks assumed on inherited property. This effectively allows an individual's excluded amount to be passed on to others. Unfortunately, there is no similar relieving provision when the connected individual becomes incapacitated. We recommend that a similar provision be added to address the incapacity of a connected individual.

Recommendations

- The proposed TOSI changes should be revised to extend the current rules to include only family members aged 18 to 24. In general, most of the unintended results noted above stem from the elimination of the age ceiling in the definition of a specified individual. If the current split income rules were extended to family members aged 18 to 24, but not to other adult family members, the majority of the problematic issues noted above would not exist. In particular we think that spouses should be exempted from these provisions. From a policy perspective this would be consistent with the rules applicable to retired Canadians and seniors. Current policy allows for pension income splitting between spouses/common-law partners, which includes the splitting of RRSP and RRIF receipts annually.
- Consideration should be given to the appropriate taxing unit - individual, joint spouses/common law partners or household. Various options exist, including the current system employed in the United States. Many of the issues that the proposed legislation aims to address would be eliminated by such a filing regime. This approach would also reduce complexity of tax compliance and uncertainty for entrepreneurial families, rather than increase it.
- If the proposed rules are implemented, transitional issues should be introduced in order to avoid punitive consequences upon succession/sale of a business/death of business founders who have put plans into place in good faith reliance on the current regime. Consistent with the recommendation relating to passive income, pre-2018 and post-2017 pools should be created in order to ensure that the new rules have little or no impact on after-tax corporate earnings accumulated under a much different tax regime. In other words, the existing TOSI rules would

continue to apply to the pre-2018 pool while the new TOSI rules as amended would apply to corporate earnings post-2017.

3. HOLDING PASSIVE INVESTMENTS INSIDE A PRIVATE CORPORATION

The Government has put forward proposals in an attempt to equate the after tax return of corporate invested earnings to individual invested earnings. The proposals are aimed at achieving the policy objectives of neutrality and fairness, while attempting to limit the complexity associated with these proposals. The Government has indicated that these objectives will be met by eliminating the perceived tax advantages available to shareholders who earn passive income in a corporation on excess funds that are not required to grow their business.

We recognize the Government's concern that individuals who earn passive income through a corporation have access to a greater amount of capital due to lower corporate rates compared to personal rates. However, we challenge the concept of "fair" in this simplistic comparison, in which none of the benefits available to employed individuals have been considered. We have also identified inherent flaws in each of the approaches put forward, and several areas that require further clarity and consideration. We have provided recommendations as to how some of these issues can be addressed.

Proposed approaches

We have analyzed and provide comments below on the two alternatives put forward under the deferred taxation approach: A) the apportionment method and B) the elective method. We have not commented on the 1972 approach, given that the Government is not considering the implementation of this approach at this time.

It should be noted, however, that the 1972 approach was designed to impose a refundable tax which would be refunded when preferentially taxed business income used to fund a passive investment was redeployed in business activities. Despite the complexity, corporations that were able to reinvest in their businesses were able to recoup the upfront taxes paid on ineligible investments. Conversely, the two approaches discussed below do not directly recognize reinvestment in business activities by corporate owners. Corporate surpluses may be required by businesses in times of economic downturn or future expansion and the two methods contemplated should consider these business issues.

Deferred taxation

The Government has proposed to replace the current regime of refundable taxes with an approach that would remove the refundability of passive investment taxes where earnings used to fund the passive investments were taxed at lower corporate tax rates. The new approach also proposes to eliminate the addition to a CDA for the non-taxable portion of capital gains. The Government has provided illustrative examples of how these proposals eliminate the tax benefits of the current system.²

A) Apportionment method

This approach tracks the source of funds and apportions passive income earned each year to three pools - shareholder contributions, income taxed at the small business rate and income taxed at the general rate.

² See Department of Finance Canada, "Tax Planning Using Private Corporations" (consultation paper), Tables 7 and 8 on pages 44 and 46.

Although this method achieves consistency in the after-tax return of an individual taxed at the top personal tax rate and a corporate taxpayer earning income at the general or small business rate, the Government has underestimated the level of complexity associated with implementing this method.

Complexity of method

Although draft legislation is yet to be released, based on the information provided by the Government, the proposed approach would create a high level of complexity for CCPCs. The complexities include the following:

- Taxpayers would be required to track three separate pools of earnings for each entity within their structure which could include multiple tiers, various ownership percentages, etc.
- Clarification would be needed as to whether the shareholder contribution pool would be tracked by each shareholder or by share classes for each corporation.
- Structures could include entities where elections may be necessary (passive investment entities), resulting in the need to track the application of both the current system (i.e., the refundable regime) and the proposed non-refundable system.
- Shareholder contributions could be difficult to track in situations where there has been a change of ownership or an acquisition from an arm's length party. This could be an issue, depending on what transitional rules would be applied.
- The impact of transitional measures including the implication of current refundable dividend tax on hand (RDTOH) balances, CDA balances and General Rate Income Pool (GRIP) implications would require consideration.
- It would be necessary to monitor intercorporate dividend distributions to track the source of income of the payor of the dividend. The calculation of the various pools would need to take into account any dividends received based on the pool of the payor corporation.

The ability to comply with the proposed rules will also depend on the availability of resources to track the different pools. Given the added complexity of these new rules, the general compliance costs will increase for most taxpayers, and it may be difficult for smaller, low-margin private businesses to afford these increases. Although professional advisors stand to benefit from the additional administrative and compliance burden, the impact to private businesses could be significant. It would not be unreasonable to assume that compliance costs could triple as a result of the proposals that have been put forward. Consideration should be given to reviewing the size of corporate taxpayers that should be subject to the proposed rules.

Transitional issues

Although the Government has indicated its intent to apply the proposed rules on a go-forward basis, various transitional and grandfathering implications must be considered. First, the stated plan is to limit the impact of the amendments on existing passive investments; however, there is no indication as to whether this includes the future income earned on these passive investments, or only capital appreciation. If capital appreciation of current portfolio investments will be subject to the proposed rules after the date on which they come into effect, then certain methods would be required to be adopted to determine the value of these investments on the date that the rules are introduced. Following a "valuation day" approach similar to the rules adopted in 1972 may be too complex, and alternative methods should be considered.

Transitional rules must also address the consequences of the proposed changes on current balances of CDA, GRIP, and RDTOH. Given the Government's intention to apply the rules on a go-forward basis, the existing CDA, RDTOH, and GRIP balances realized up to the date on which the new rules come into effect should be retained.

Reinvestment of passive income

The Government has not explicitly stated that the shareholder contributions pool would also include reinvested passive income. Since this income would already have been taxed at rates comparable to high personal taxation rates, any passive income earned from reinvested shareholder contributions should be included in the shareholder contributions pool and should be distributable as tax-free capital dividends. Alternatively, as the Government has also noted in the consultation paper, these balances could be paid out by maintaining the current dividend refund regime.³

Shareholder and other loans

The Government has not provided a definition of what would be considered "amounts contributed by shareholders from their after-tax income". Although this certainly includes equity investments, no reference is made as to whether it would also include loans from an individual shareholder to their corporation. Given that these funds would be contributed using personal after-tax income, any passive income earned from these amounts should be included in the "shareholder contributions" pool and be distributed tax-free.

Further, the three pools outlined in the apportionment method do not anticipate all potential sources of funds which can be used to invest in passive assets (i.e. loans from related or unrelated parties).

For example:

- Passive income earned from funds loaned by related individuals to the respective shareholders should be attributed to the shareholder contributions pool.
- Passive income earned from funds loaned by related corporations would presumably need to be sourced to determine the rate of tax applicable to the lender corporation. This would create an additional level of complexity in regards to tracking the source of capital relating to loans between related parties.
- Passive income earned from funds loaned by unrelated individuals/corporations would presumably be apportioned irrespective of the source of capital by the unrelated lender.

B) Elective method

As an alternative to the apportionment method, the Government is proposing to introduce a method whereby corporations would be subject to a default tax treatment unless they elect otherwise. The choice between the default tax treatment and the elective treatment would determine whether passive income would be treated as eligible or non-eligible dividends when distributed to shareholders as dividends without the need for tracking.

Default treatment

Although more simplistic in nature, the default method results in a lower after-tax return compared to an individual in the top personal marginal tax rate based on the inherent assumptions as disclosed in Table 10 of the consultation paper.⁴ This would seem counterintuitive to the Government's objective of achieving tax rate equality between a corporate taxpayer using active income to fund passive investments and an individual taxpayer earning the same funds personally, being taxed at the top marginal rate and investing the after tax funds in a registered or other investment.

In addition, the default method would treat income subject to the general corporate tax rate as an ineligible dividend, since it is assumed that all income is subject to the small business rate. As such,

³ See footnote 18 on page 47 of the consultation paper.

⁴ Page 50 of the consultation paper.

the merits of the default method seem contrary to the Government's objective to equalize individual and corporate taxpayers earning passive income, where the corporation is earning general rate income.

Elective treatment

The proposals compensate for this shortfall by allowing corporations to choose the elective method for entities that earn income subject to the general rate and be eligible for the higher dividend tax credit. However, this method would not permit such corporations who earn a combination of small business and general rate income to have access to the small business deduction.

It appears, but it is not entirely clear, that under the elective treatment any dividends paid by corporations would be eligible dividends, regardless of source. This should be confirmed by the Government.

Under both the default and elective treatments, the Government has not considered recognition for shareholder contributions that would presumably have already been taxed at high personal rates. Unlike the apportionment method that recognizes PUC contributions, the elective method can result in very high and punitive effective tax rates on passive income earned through a corporation funded by shareholder contributions.

Due to all of these factors, it is unclear which taxpayers would choose the elective method.

Technical and practical concerns

There are a number of common technical and practical concerns that would apply to either the apportionment method or the elective method. Some issues are identified below.

Determination of excess earnings (i.e., earnings not used in an active business)

As part of the objectives previously mentioned, the Government has indicated that it is targeting private corporations that "earn income beyond what is needed to re-invest and grow the business"⁵. However, there is no indication of how this threshold will be established. There are numerous circumstances that may require corporations to have access to investments in their businesses, such as having security against unforeseen costs and economic downturns, future capital expansions, and various other reasons. If these rules were to be applied to all passive income earned in a corporation, the Government may be penalizing corporations that are accumulating cash for legitimate business reasons rather than for personal advantage. In addition, many private corporations require a minimum level of liquidity, i.e., cash and short-term investments, as part of their banking covenants. The proposed rules do not contemplate the significance of these commercial issues.

Corporations focused on passive investments

The Government has proposed an additional election for corporations focused on passive investments, under which the current regime of refundable taxes could be maintained. Further clarity is required as to the conditions to be met in order to make this election and the related timing considerations. Presumably, a corporation that focuses on passive investments would require "all or substantially all" of its income to be passive income although some minimal level of active income should be acceptable. In addition, further clarity is required to confirm that preexisting CDA and RDTOH balances would be preserved if corporations make this election.

⁵ Page 32 of the consultation paper.

Further clarification is also required as to whether certain recharacterization rules currently permitted under the Act would continue to be applicable. For example, where a corporation focused on passive investments lends funds to a corporation engaged in an active business, any interest income, which would otherwise be passive, is recharacterized under subsection 129(6) of the Act to be active income as long as the two corporations are associated and the interest expense is deducted against income from an active business carried on by it in Canada.⁶ There are no comments provided on whether this rule would still apply to corporations that make this election, since all income generated would be taxed as passive income if corporations elect to use this method. Further consideration should be given for a carve-out rule to respect the mechanics of subsection 129(6) of the Act. Further clarification would also be required regarding whether the election for corporations focused on passive investments could be rescinded in situations where there is a change in the type of income earned by the corporation.

Part IV tax

There are no comments provided by the Government regarding whether Part IV tax would still apply to dividends received by CCPCs from both connected and non-connected corporations. Based on the proposed rules, it may be the Government's intent that Part IV tax would no longer be applicable to CCPCs, since there will be no dividend refund, other than for corporations focused on passive investments. On the other hand, if Part IV tax will still be applicable, an additional non-refundable tax should not apply to these dividends, as this would result in double taxation.

GRIP

Given that the proposed approaches for paying out eligible versus non-eligible dividends is to examine the rate of tax applicable to the funds used to earn the related passive income, amendments would be required to the definition of GRIP to take these changes into account. Under the current rules, GRIP is calculated based on after-tax earnings subject to the general corporate rate, out of which eligible dividends can be paid. Under the apportionment method, the current definition of GRIP would still apply for taxable income subject to the general rate; however, it would also include passive income earned which is apportioned to this pool. Under the elective method, GRIP would require a definition that reflects whether the corporation falls under the default or elective treatment. The definition of GRIP would thus require modification based on the approach that is adopted.

Preservation of the CDA

The Government has indicated that it will consider preserving additions to the CDA in certain situations, including, for example, "a capital gain realized on the arm's length sale of a corporation controlled by another corporation, where the corporation being sold is exclusively engaged in an activity earning active income".⁷ We believe that additions to the CDA should also be preserved for capital gains arising from the sale of active business assets by a corporation. The rationale for this is that these capital assets are used to earn active business income and it is our understanding that the Government is in support of corporations that re-invest in their business to generate active income. As such, these capital gains should not be subject to the proposed rules.

Consideration should also be given to whether the intention to eliminate CDA would be applicable to the donation of public securities. Under the current rules, the full amount of capital gains realized on public securities that were donated to a registered charity by a corporation are added to the CDA, pursuant to subparagraph 89(1)(a)(i) of the Act under the definition of "capital dividend account". If

⁶ Subsection 129(6) of the Act.

⁷ Page 51 of the consultation paper.

this will no longer be the case under the proposed changes, taxpayers may lose the incentive to use this method of charitable giving. Although obtaining tax advantages may not be the primary motivating factor for charitable giving, the Government had clearly established an incentive for corporate charitable giving. As such, a carve-out rule to maintain the CDA created on the donation of public securities should be considered to preserve the Government's original intention.

Change in use of assets

The effect of the proposed rules on the change in the use of certain assets from income-producing property to capital property, and vice versa, should be reviewed. For example, it is not uncommon for real estate companies to convert passive rental investments into income-producing residential developments. Clarity would be required as to the impact of the deemed disposition at the change in use date, and the related implications to the CDA. We would recommend that it be clearly stated that if a change in use from capital property to income-producing property occurs after the proposed rules are put into place, the CDA should be preserved up to the change in use date.

Application to other private corporations

The Government has not definitively indicated its intention to apply the proposed changes to all private corporations, rather than just CCPCs. Since non-CCPCs do not currently pay the high rate corporate tax on passive income (other than Part IV tax on dividends), non-CCPCs would be subject to higher corporate tax rates under the proposals. This would potentially reduce the incentive for non-residents or non-CCPCs to invest in Canada, thereby leaving Canada at a competitive disadvantage compared to other jurisdictions. As well, non-resident individual shareholders do not appear to be targeted in the proposals, as they are generally subject to different tax rules and rates.

Recommendations

- **Do not proceed** - Due to their complexity and ambiguity, as well as the uncertainty that would ensure from their enactment, we recommend that the passive investment rules be abandoned.
- **De minimis test** - Given that the scope of the proposed changes is very broad and the rules will affect a large number of taxpayers, consideration should be given to mitigating the increased burden on certain taxpayers. For example, a de minimis test could be implemented for corporations that earn some passive income under a certain threshold on a yearly basis or below a cumulative threshold of passive income over a certain number of years. The intention would be that the Government's focus would be on corporations that earn significant passive income and are more likely to have excess cash beyond what is needed in their business. Comments made by the Honourable Prime Minister Justin Trudeau seem to support this recommendation: "The private corporation route only really benefits people making more than hundreds (of) thousands of dollars."⁸
- **Rolling start rule** - Corporations that earn passive income from corporate earnings taxed at the lower rate should be given a period of time to reinvest such income in their active business. For example, if passive income earned is reinvested in the business within a period of time (e.g., a number of years), then such income should be exempt from the proposals (i.e., interim passive income would continue to fall under the current regime of refundable taxes). If this approach is implemented, the issue of retroactive application in cases where income is not reinvested in the required period of time would require consideration. The benefit of the rolling start rule would be that it would consider legitimate commercial issues that typically arise in

⁸ <http://nationalpost.com/news/politics/scheer-calls-tax-proposal-crippling-but-trudeau-insists-it-wont-affect-those-making-less-than-150000>

private businesses – such as the need for funds to undertake future expansion, or negate the effects of future economic downturns.

- Application to other private corporations - In order to maintain adequate incentive for non-residents and non-CCPCs to invest in Canada, thereby ensuring that Canada remains competitive, the proposed rules should not apply to non-CCPCs.
- Transition - We would like to reemphasize that introducing the proposals would have a significant impact on a broad number of taxpayers. The legislation would be changing in a substantive way, with severe modifications to RDTOH, CDA and GRIP. In addition, these changes are proposed to come into effect at a time that coincides with several other changes affecting private corporations, such as the limitations on accessing the small business deduction, the revised capital gains stripping provisions under subsection 55(2), and the new cumulative eligible capital regime to name a few. As such, we strongly urge the Government to introduce any new measures in a manner that gives taxpayers an opportunity to gradually transition into the new regime. This approach will ensure business stability.

4. CAPITAL GAINS

Proposed amendments to section 84.1 of the Act

Surplus stripping

The stated purpose of the amendment to section 84.1 is to "... prevent individual taxpayers from using non-arm's length transactions that 'step-up' the cost base of shares of a corporation ..." ⁹ to extract the surplus at the capital gains tax rate rather than at the taxable dividend tax rate.

This objective is proposed to be achieved by extending the current rules which create an artificially low adjusted cost base (ACB) if an amount was claimed under the LCGE or pre-1972 surplus, to cases where the ACB is increased in a taxable non-arm's length transaction.

Essentially, section 84.1 provides that where an individual disposes of shares of a corporation to another corporation with which the individual does not deal at arm's length and the two corporations are connected after the transaction, any non-share consideration received on sale that exceeds its ACB is deemed to be a taxable dividend. In addition, the PUC of any share consideration is reduced to the higher of the PUC of the acquired shares and the vendor's ACB, thereby creating a potential taxable dividend and double taxation on the subsequent redemption of the shares.

The proposed amendment applies to dispositions made on or after July 18, 2017; however, dispositions before that date must be considered in the calculation of the ACB as well. As such, the proposal can have a retrospective application.

Under current rules, when two related individuals trade the shares of a family owned business, the seller is taxed on the gain, if any, regardless of the consideration received.¹⁰ The purchaser must pay consideration, if any, with what remains of its income already taxed at a rate of up to 53% (for an Ontario resident).

Under the proposed amendment, if the purchaser recovers his or her initial investment via a dividend taxable at 39% (on an eligible dividend) or 45% (on a non-eligible dividend), then the Government

⁹ Page 60 of the consultation paper.

¹⁰ Section 69.

could receive up to 72% in total taxes.¹¹ Similar transactions undertaken by the same individuals on the public market would only be taxable at 27%, leading to a grossly unfair result for private business owners. Similar problems are evident in post-mortem situations, as discussed below.

The proposed amendment appears to cover a much broader range of transactions than those contemplated in the consultation paper.

Recommendations for surplus stripping proposals

- We recommend that a more targeted approach would be to leave subparagraph 84.1(2)(a.1) and subparagraph 84.1(2)(a.1)(ii) as they currently read and add a specific anti-avoidance rule with a purpose test that aims to prevent the surplus stripping transactions that the government is targeting. The mechanism of this specific rule could then remain the same, and extend the application of subparagraph 84.1(2)(a.1)(ii) ITA to "artificial" surplus stripping transactions only if the purpose test is met, thus avoiding penalizing legitimate transactions between related persons.
- The potential impact of subsection 120.4(4) (if that provision is not corrected, as discussed above in Example 5) must be addressed to allow for an ACB adjustment to the non-arm's length transferee.
- In order to comply with the proposed rule, it will be necessary for a purchaser to have historical knowledge of the gains realized by all related transferors as well as the origin of his or her shareholdings. This could be an onerous and almost impossible burden in many cases. We recommend that the proposed amendment should not apply in a manner that incorporates transactions prior to July 18, 2017.

Intergenerational and other transfers between family members

Numerous studies and analyses that have been published as well as representations made to the Ministry of Finance, demonstrating the clear inequity that will exist under these proposals, between the transfer of shares of companies within the family as compared to the sale of shares to unrelated persons.¹²

For example, typically, a purchaser will use a company to purchase the shares of a business followed by an amalgamation to match the cost of borrowing to the income generated by the business. A sale of shares to a third party not only allows the vendor to realize a capital gain and benefit from the LCGE, but also enables the purchaser to finance the purchase and reduce the cost of financing in a corporate environment. By contrast, a related purchaser will not be able to use a company to acquire the shares as this would result in a taxable dividend versus a capital gain to the vendor and restrict access to using the capital gains exemption. As a result, the financing would be at a personal level and the funds required to repay the loan would be taxable to the individual at the personal level and would increase the amount of cash required by the purchaser to pay for the purchase. This is clearly not equitable or fair to the purchaser.

The impact of the difference in tax treatment is significant. The increase in tax in the hands of the seller to a non-arm's length corporation, applicable to a non-eligible capital gain versus a dividend, is

¹¹ 27% on the seller's capital gain and 45% on the non-eligible dividend received by the buyer.

¹² See, for example, Suzanne Landry, *Transmission d'entreprises familiales : que faire devant l'iniquité fiscale?*, Congrès de l'APFF (2011), and infra footnote 14.

approximately 67% more¹³, since the deemed dividend can only be a non-eligible one. Otherwise, if the gain were eligible for the LCGE in the hands of the individual vendor, the amount of before-tax active business income of the target corporation required to provide the related individual purchaser with the after-tax financial resources to pay the purchase price, could be 30% higher.¹⁴

Several suggestions to exempt legitimate family transactions from these provisions have been made in the past. Quebec tax legislation has been amended to try to achieve this, at least in part. The consultation paper refers to what would be "... the hallmarks that ensure a genuine transfer of a business to a new owner..."¹⁵. It also refers to the US legislation: "... long-standing rules meant to distinguish cases where a parent 'terminates' his or her interest in a corporation on the sale of shares to a family member including a corporation controlled by family members".¹⁶

The consultation paper notes that "[t]he American approach arguably accommodates genuine intergenerational transfers..."¹⁷ and that the fundamental characteristics of a genuine transfer referred to above provide an interesting starting point for an objective definition of possible transfers eligible for relief from these rules. However, we believe that it places a framework that appears to be too rigid and could force an abrupt departure of the parent who wishes to transfer the business within his/her family. For example, the effect of "putting an end to one's interest in a company" can have important consequences not only in succession support but also with the company's clients, suppliers and financial stakeholders.

Recommendations regarding intergenerational transfers

- In our Canadian context, where hundreds of thousands of family businesses will change hands in the near future, it is essential that exemption from section 84.1 be provided for legitimate family transfers. As previously noted, an inequitably high cost of intergenerational and other family transfers over arm's length sales will favour consolidation and arm's length sales and will erode the domestic base of strong entrepreneurship.
- In the alternative, more thorough consultation, taking into account the diversity of situations in the process of transferring family-owned businesses is needed. The outcome of such in-depth consultation must be fairness of results when comparing sales of businesses between family members with third party transactions and achieving a simpler approach while continuing to protect against potential abuses.

Proposed section 246.1 of the Act

Proposed new section 246.1 is one of the measures aimed at preventing the conversion of income into capital gains and specifically targets "surplus stripping"...

We are concerned that proposed section 246.1 goes far beyond the stated purpose of preventing so-called situations of "surplus stripping", which generally involve the extraction of corporate income at a reduced rate of personal income tax, by accessing capital gains rates instead of higher taxable dividend rates. Based on the proposed broad wording of section 246.1, it appears to apply to many situations which seem outside the classic "surplus stripping" that section 246.1 seeks to target.

¹³ 39% or 45% rate instead of 27%.

¹⁴ See See Chambre de commerce et d'industrie de Shawinigan, *Problématique fiscale reliée au transfert d'entreprises familiales*, February 7, 2017.

¹⁵ Page 58 of the consultation paper.

¹⁶ Page 59 of the consultation paper; by referring to the sections 302 and 318 of the U.S. federal tax legislation.

¹⁷ Ibid.

As currently drafted and based on the limited explanation provided, it seems that any payment of a capital dividend or return of capital by a private corporation to an individual shareholder not dealing at arm's length with the corporation could be subject to section 246.1, irrespective of the nature of the transaction that caused the CDA to become accessible.

We are also very concerned that the proposed legislation is applicable to distributions occurring on or after July 18, 2017 (Announcement Date). This could lead to a very punitive tax result for taxpayers that implemented legitimate transactions before the Announcement Date and amounts to retrospective legislation. We believe that the introduction of retrospective legislation results in a less predictable environment for Canadian business, and may influence future decision-making.

Proposed legislation – technical concerns

We would like to point out some technical concerns with the legislative language. Paragraph 246.1(2)(c) provides triggering events that must occur in the series of transactions that includes the receipt of an amount by the individual. These events are:

- (i) A disposition of property; or
- (ii) An increase or reduction of PUC of shares of a corporation.

We understand that paragraph (c) aims to catch the transaction or event that would result in a capital gain for the private corporation and, thus, in an increase of CDA becoming available for payment to an individual shareholder.

Under the proposed wording of subparagraph 246.1(2)(c)(i), any disposition of property may qualify (as long as it is in the same series of transactions that includes the receipt of the amount by the individual), whether or not the disposition of property is made to an arm's length person. In addition, as any distribution of cash to an individual constitutes a disposition of property, subparagraph (c)(ii) seems to be meaningless, as the payment of a capital dividend would automatically require a disposition of property (either immediately or as part of a series where the initial capital dividend is funded by issuing a promissory note that is later paid in cash). There is also no specification as to the entity making the disposition, which may be any person, not only a non-arm's length person.

The second triggering event under paragraph 246.1(2)(c) is an increase or reduction of the PUC of shares of a corporation. It is not clear what the purpose of this subparagraph 246.1(2)(c)(ii) requirement is, and no example is provided in the explanatory notes. We understand that it could cover a situation where an increase in PUC of the shares held by a corporate shareholder would be subject to subsection 55(2) and could thus create a capital gain for the corporate shareholder. It could also cover a situation where a PUC reduction is made on shares held by a corporate shareholder for an amount exceeding the adjusted cost basis (ACB) of such shares, resulting in a capital gain for the shareholder under subsection 40(3).

The last requirement for the application of section 246.1 is provided under paragraph 246.1(2)(d): whether "it can reasonably be considered that one of the purposes of the transactions, event 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 is avoided" (emphasis added). This is the key criterion to determine whether

section 246.1 applies to an amount; unfortunately, the wording used creates uncertainty and confusion for taxpayers:

First, the threshold for the purpose test is very low, being a “one of the purposes” test (as opposed to, for example, a “one of the main purposes” test). We note that the use of the word “reasonably” brings an additional level of subjectivity in determining the application of the purpose test.

Another area of uncertainty in paragraph 246.1(2)(d) arises from the use of the expression “significant reduction or disappearance of assets”. Neither the word “significant” nor the phrase “reduction or disappearance of assets” is defined in the Act. It is unclear what a “significant reduction or disappearance of assets of a private corporation” may mean. Based on the general meaning of the words “reduction” and “disappearance” as defined in dictionaries, it seems that any disposition of assets would fall under the meaning of such words, including a disposition of cash by the corporation in favour of its individual shareholder in payment of a capital dividend or return of PUC. As to the word “significant”, in the context of the application of subsection 55(2), the phrase “significant increase” has been interpreted very broadly, to include increases in terms of percentage or value as low as 1%. It is likely that the phrase “significant reduction” could be interpreted in a similar fashion.

Proposed legislation –general policy concerns

The explanatory notes address the reason for the introduction of section 246.1 and cover, inter alia, an example of surplus stripping, the meaning of the avoidance tax purpose test and the meaning of “significant reduction or disappearance of assets”.

New section 246.1 of the Act is an anti-avoidance provision intended to prevent the distribution of corporate surplus (in general, unrealized corporate value less liabilities) to an individual shareholder resident in Canada, which would otherwise be distributed as a taxable dividend, on a tax-reduced or tax-free basis in a non-arm’s length context (this is an example of what is generally called “surplus stripping”)

The example of what is called surplus stripping is ambiguous. In fact, per that example it would not be possible to distribute unrealized corporate value to an individual shareholder (as such a distribution would trigger a disposition). In order to distribute property to an individual at a lower tax rate, that accrued value would have to be realized in order to generate advantageous tax accounts such as CDA and RDTOH.

In addition, the distribution of realized corporate value arising from a disposition of a capital property to a non-related person should not be caught by an anti-surplus stripping rule. Indeed, in such a case the amount of taxes paid would always correspond to approximately 25% of the gain realized (which is approximately the tax rate payable by an individual on a capital gain) regardless how the proceeds of that gain are distributed.¹⁸ This assumes that the concept of integration remains foundational to Canadian tax policy.

A typical example of surplus stripping would rather be the distribution by a corporation of income derived from an active business (distribution of business income) by triggering an “internal” capital gain in order to benefit from the advantageous tax accounts (CDA and

¹⁸ See the examples in the Appendix 1 to this letter.

RDTOH) arising from such transaction. In this typical example, the taxes payable as a result of this transaction would decrease from approximately 40% to 25%.

The interpretation of what is considered avoidance of tax in the explanatory notes is problematic as well. Based on this interpretation, as a taxable dividend would always be subject to an amount of tax higher than a tax-free capital dividend, any payment of a capital dividend (or tax-free return of PUC) could be considered tax avoidance.

In order for the avoidance tax test to be meaningful, the tax-free dividend (or tax-free return of capital) should be compared to a potential taxable distribution of business income. Unfortunately, the explanatory notes do not refer to a potential distribution of business income. Accordingly, any tax-free distribution could be caught. If this is intended, inclusion of the reference to tax being avoided may be redundant, as virtually any distribution of PUC or payment of a capital dividend results in tax at a rate that is less than a taxable dividend.

Another general concern relates to the concept of reduction or disappearance of assets. The explanatory notes state:

A "significant reduction or disappearance of assets" of a corporation may result from several amounts received or receivable by the individual as part of a series of transactions, in which case each amount would be recharacterized as a taxable dividend. The assets that could be reduced or disappear include assets acquired directly or indirectly in the series (e.g., cash received under a loan).

As a distribution to an individual shareholder could, by itself, be considered a "reduction or disappearance of assets", that concept appears to be meaningless.

Finally, uncertainty exists where separate and unrelated transactions are undertaken within the same corporation or by two subsidiary corporations of the same parent corporation. If one such transaction is viewed as acceptable (the "good" transaction) and one transaction is viewed as offside (the "bad" transaction), it is unclear as to which of the CDA balances would be distributed first to the shareholder. The determination of whether the distributions are administered on a first-in, first-out, a last-in, first-out, or some other basis such as a weighted average, creates undue complexity and unpredictability in the system.

Examples of overly broad application of section 246.1

We understand that, as currently drafted, proposed section 246.1 could apply to almost every capital dividend or PUC reduction paid by a private corporation on the shares held by an individual shareholder not dealing at arm's length with the corporation. The examples described below, which are not typically considered to be surplus stripping, illustrate the overly broad and inappropriate scope of application of section 246.1.

Example 1: Sale of all business assets to a third party purchaser

Facts:

- A private corporation controlled by an individual shareholder resident in Canada sells all of its business assets to an arm's length purchaser in consideration for cash (the sale).
- A significant capital gain is realized by the corporation on the sale, thereby increasing its CDA and its RDTOH.

- A few months later, a capital dividend equal to the CDA is paid in cash by the corporation to the individual shareholder.

Application of section 246.1 to the facts:

- The sale and the disposition of cash in favour of the individual shareholder in payment of the capital dividend are dispositions of property under subparagraph 246.1(2)(c)(i).
- The sale and the payment of the capital dividend in cash are significant disappearances of assets of the payer corporation.
- It can reasonably be considered that one of the purposes of the sale was to distribute a portion of the resulting CDA and thus avoid tax for the individual shareholder as no taxes are payable on the dividend, which is less than taxes that would have been payable had the individual shareholder received a taxable dividend.
- Furthermore, it can reasonably be considered that one of the purposes of the payment of the capital dividend was to avoid tax for the individual shareholder as no taxes are payable on the dividend, which is less than taxes that would have been payable had a taxable dividend been received.

Additional comments:

We understand that under this example, even if a taxable dividend had been paid first by the corporation and the remaining cash of the corporation was equal to the CDA distributed afterwards, section 246.1 could still have applied to such capital dividend. In fact, the corporation still had the choice not to make the subsection 83(2) election in respect of the dividend, in which case taxes payable by the individual shareholder would have been higher. Accordingly, the election under subsection 83(2) could be considered a transaction or event made in order to reduce the tax otherwise payable by the individual shareholder in consequence of a distribution of property by the corporation.

Example 2: Return of capital contributed by an individual shareholder

Facts:

- An individual shareholder resident in Canada makes a capital contribution in cash to a private corporation controlled by him.
- The corporation earns business income.
- A few years later, the corporation makes a reduction of PUC on the shares held by its controlling shareholder, payable in cash.

Application of section 246.1 to the facts:

- The reduction of PUC falls under subparagraph 246.1(2)(c)(ii) and under subparagraph 246.1(2)(c)(i) as there is a disposition of cash.
- The payment of such reduction in cash is a significant disappearance of assets of the payer corporation (the distribution of cash) and results in tax avoidance for the individual shareholder as no taxes are payable on the return of capital, which is less than taxes that would have been payable had he received a taxable dividend.

Punitive impact of subsections 246.1(1) and (3)

As discussed above, once the conditions of subsection 246.1(2) are met, two consequences arise:

- (i) The amount received by the individual shareholder is recharacterized as a taxable dividend per subsection 246.1(1); and
- (ii) The CDA is reduced by the amount of any capital dividend recharacterized as a taxable dividend per subsection 246.1(3).

We are concerned that where an amount is recharacterized under subsection 246.1(1), there is no corresponding deeming that the private corporation has paid a taxable dividend on shares of its capital stock. Accordingly, we understand that no dividend refund could be obtained by the corporation under subsection 129(1) and that no designation under subsection 89(14) could be made by the corporation in respect of the dividend to be considered as an "eligible dividend" as defined in subsection 89(1).

We are also concerned that the reduction of the CDA under subsection 246.1(3) is permanent, without any possibility of future CDA increase depending on transactions or events occurring after the payment of the amount to the individual shareholder (e.g., a sale of assets to a third party purchaser). This permanent reduction is too punitive and creates double taxation.

Another important issue of concern with respect to proposed section 246.1 is its application date. The section is applicable in respect of amounts received or that become receivable on or after the Announcement Date. This means that the new rules may adversely change the tax consequences foreseen by taxpayers and arising from transactions that occurred months or years before the Announcement Date, if the CDA was not yet paid out to the individual shareholder. This result is extremely unfair for taxpayers having undertaken legitimate tax planning consistent with the legislation and case law in force before the Announcement Date.

Consider the following example: In January 2017, a private corporation controlled by an individual shareholder sold all of its business assets to a third party purchaser. The sale resulted in (i) income taxes payable by the corporation on the capital gain realized (at a rate of approximately 25%); and (ii) a significant increase of the CDA (equal to 50% of the capital gain realized). The corporation chose not to pay out (or to distribute only a portion of) the CDA to its individual shareholder for various reasons. We understand that as currently drafted, proposed section 246.1 could apply to a distribution of this CDA after the Announcement Date, even if the event triggering the CDA increase occurred months before the Announcement Date, in January 2017.

This result is unfair to taxpayers, as it could dramatically increase the overall taxes payable in respect of the sale transaction. There could be a substantial difference in the taxes payable by two taxpayers having undertaken the same transaction, only because one would have distributed the CDA before the Announcement Date. This is inequitable from a tax policy perspective.

Finally, we are concerned that the recharacterization of a tax-free receipt as a taxable dividend could be applied twice to the same transaction. For example, if a corporation pays a capital dividend by way of issuing a promissory note, the promissory note would be "received" by the individual. When payments are subsequently made on the promissory note, those additional payments may be viewed as amounts "received" by the individual. In particular, the explanatory notes reference the provision applying in situations where assets are reduced or disappear through cash received under a loan.

Recommendations

- Narrow the breadth of application - We are concerned that proposed section 246.1 goes too far in that it could apply to a broad range of situations in a manner that is

unintended, inequitable and overly punitive. Accordingly, we believe that proposed section 246.1 should not be enacted as currently drafted.

As a typical example of surplus stripping involves the triggering of an "internal" capital gain in order to make a distribution of business income, the proposed legislation should only be applicable to that situation. Accordingly, the distribution of proceeds from a transaction with a non-related person should not be caught by the new rules. A carve-out should be provided in the new legislation when, as part of the series of transactions or events that includes the distribution, a disposition of property to a non-related person is made, or the direct or indirect interest of the individual shareholder in a corporation is reduced in favour of a non-related person.

- Suspend rather than deny CDA - The CDA increase arising from an "internal" capital gain should be suspended (instead of being permanently lost) until the capital property or a property deriving its value from that property is disposed of, directly or indirectly, to a non-related person.
- Remove retrospectivity - Transitional rules should be introduced in order to protect the tax consequences that were anticipated by taxpayers at the time that they undertook a transaction. For example, new section 246.1 could apply only in respect of CDA increases arising from transactions occurring after the Announcement Date (taking into account that the amounts required by subparagraph 13(38)(d)(iii) to be included in computing a corporation's income in respect of a business only increase the CDA at the end of the year pursuant to paragraph (c.2) of the definition of CDA in subsection 89(1)).
- Adjust the draft legislation - We recommend the following changes to the wording of the legislation:
 - Paragraph 246.1(2)(c) should be modified to read "as part of the transaction, event or series, where the transaction, event or series began on or after July 18, 2017, there is...".
 - This change is intended to eliminate the retrospective application of the provision and would be an important and helpful confirmation for the business community of the Government's assertion that the proposals are not intended to apply retroactively.
 - Paragraph 246.1(2)(d) should be modified to read "it can reasonably be considered that a primary purpose of the transaction...".
 - This change is intended to emphasize that there must be a clear tax motivation in order for the transaction to be caught, rather than the provision being applicable to ordinary course business transactions where an ancillary impact might be, for example, an addition to the CDA.

Death of a taxpayer

The death of a taxpayer can result in adverse tax consequences to taxpayers without proper planning. A number of provisions apply on death. The intent of these provisions generally is to tax any inherent capital gains on assets held at death, tax previously deferred income (e.g., RRSPs) and allow for the step up in basis of the assets held at death. However, it has long been acknowledged that for owners of private corporations, the rules do not always work well to avoid double or triple taxation. As a result, the executors of an estate of the owner of a private company must enter into complex and costly transactions to obtain a fair result.

Whether intended or not, the proposed legislation has effectively shut down commonly used post-mortem tax strategies. Below we examine a number of common post-mortem planning scenarios that are affected by the proposed legislation.

Scenario 1 –transfer of business to the next generation

John is married to Johanna. They have two children, Mary and Bob, who are above the age of 24 years. John and Johanna are equal owners of their family corporation, JohnCo. John and Mary are the principal individuals who run the business and Johanna has never been involved in the business. On January 2, 2018, both spouses pass away. The only assets owned at the time of their death are the shares of JohnCo that are evenly distributed to Mary and Bob according to the decedents' wills.

Current rules

Under the existing legislation, the transfer of the family business to Mary and Bob enables both parents to claim their LCGE to shelter the capital gains arising from the deemed disposition of the shares of JohnCo upon death. Subsequently, their children will be able to extract corporate surpluses in the form of dividends, and eventually utilize the LCGE on their subsequent sale of the shares. The current legislation enables the children to benefit from the value of the business created throughout their parents' lifetime.

Proposed rules

As currently drafted, the proposed legislation would still allow John to claim the LCGE to shelter the capital gain created on the deemed disposition of the shares of JohnCo. This is because he has been actively involved in the business and made significant labour contributions to the company in his lifetime.

However, since Johanna has never participated in the company's activities, she did not contribute significant assets to JohnCo and has not assumed any risks relating to the business. Therefore, her capital gain on death would be recharacterized as a taxable non-eligible dividend, thus eliminating the possibility to claim the LCGE.

Fortunately for Johanna, her estate may be able to file an election to claim the LCGE on the shares of JohnCo in 2018.¹⁹ However, this option is unavailable for future deaths and for value that accrues in subsequent years, since the transitional rules are only applicable to the 2018 taxation year.

Overall, after 2018, the income tax liability that would be created upon death is higher than it currently is under the existing legislation. Although Johanna did not directly contribute to the company, she has likely supported her husband in his endeavours, helped him in his decision-making and took care of the family while the business's activities were consuming a significant amount of John's time. This indirect support does not appear to have been considered when determining an individual's split income under the proposed rules. The proposed rules increase the tax on death by deeming the value to be treated as a non-qualified dividend. However, the PUC of the shares owned on death and transferred to the children does not change so that when retained earnings are paid out of the corporation to the children, the same amount will be taxable again as a dividend. Double taxation results.

The proposed legislation deems shares received upon the death of John and Johanna to retain their characteristics with respect to the contributions made to the business by them.²⁰ Therefore, the owner of John's shares would be considered to have made significant contributions to JohnCo and the owner of Johanna's shares would be considered not to have made any contribution to the business.

Consequently, any income received on 50% of the shares received by each child (i.e., Johanna's shares) would be subject to TOSI (discussed above) and the LCGE could not be claimed. As well, the distribution of value attributable to Johanna's shares to Mary and Bob which was taxed at the time of

¹⁹ As indicated in proposed subsection 110.6(18).

²⁰ As indicated in the proposed clause 120.4(1.1)(e)(ii)(C).

Johanna's death will be taxed again in the hands of Mary and Bob at the highest rate of tax regardless of their personal marginal tax rate.

Observations and suggestions

The proposed rules under income sprinkling are intended to limit the tax benefits received by business owners who are able to split income with their family members during their lifetime. However, these rules continue to apply even after death, not allowing the genuine intergenerational transfer and creating ongoing complexity for family members who inherit affected shares.

If the proposed legislation is enacted as proposed, a transfer of business from one generation to the next may face undesirable results unless all children are actively involved in the business, which is not always in the best interest of the business or the family.

As indicated in the consultation paper, the Government is not aiming to stop Canadians from passing their family businesses to the next generation. In order to encourage the transfers of businesses to the next generation, the Government may consider removing the application of TOSI to the spouse's income while maintaining the application of the amended TOSI rules to the children's income, to the extent that the children are not providing significant contributions to the business. This would allow individuals to effectively transfer the business to their children without adverse tax consequences. This approach would resemble an arm's length sale with respect to the intergeneration transfer that works in the United States, as noted in the consultation paper.

Scenario 2 – pipeline transaction

Louise was married to Mark and they had a daughter, Angela. Louise owned 100% of the issued and outstanding shares of LouiseCo. Louise was the only family member involved in LouiseCo's operations. On July 19, 2017 Louise passed away. Louise's estate implemented a post-mortem pipeline transaction that consists of incorporating a new corporation (NewCo) and transferring the shares of LouiseCo in exchange for a promissory note equal to the fair market value of the shares on death. NewCo and LouiseCo will be amalgamated and the corporation will redeem the shares held by the estate.

Current rules

The Act enables taxpayers to perform post-mortem tax planning transactions in order to avoid double taxation caused by the deemed disposition on death. The value of the corporation on the date of death would be solely taxed in the deceased's hands, and the beneficiaries of Louise's estate would be able to extract the fair market value of the shares on a tax-free basis (through shares with a high ACB or a promissory note). The Act currently contains certain anti-avoidance rules, such as section 84.1 and subsection 84(2), that are designed to ensure that such transactions are within the spirit of the Act.

Performing a post-mortem pipeline transaction provides the estate and its executors sufficient time to properly arrange the affairs of the deceased without encountering adverse tax consequences.

Proposed rules

As presently drafted, the legislation would render this post-mortem pipeline transaction ineffective, due to the amendments to section 84.1 effective as of July 18, 2017. In fact, the ACB of the acquired shares would be reduced by any capital gain realized by a non-arm's length party in any previous transactions, irrespective of the use of the LCGE.

In the absence of the pipeline strategy, double or even triple taxation could arise on the fair market value of LouiseCo. First of all, income tax would be payable on Louise's terminal return as a capital gain. Secondly, the corporation may be subject to income tax on the liquidation of its assets. Lastly, an income tax liability would be created on the deemed dividend arising when LouiseCo is wound-up.

On the other hand, if Louis personally held the assets (whether active assets or an investment portfolio), income tax would simply be payable on the capital gain in her terminal return. This creates

a clear inequity, and is grossly punitive to the estates of individuals who own shares in private companies.

Scenario 3 – subsection 164(6) loss-carryback

Pamela had a 30 year old son, David. Pamela passed away on August 31, 2017. On death, her only assets were the shares of OpCo, which she and David owned together, each with 50%. Pamela had never been involved in the activities of OpCo; David or his late father had always taken care of the operations. David had inherited his father's shares when his father died. Immediately after her death, the corporation redeemed all of the shares held by Pamela's estate, resulting in a deemed dividend.²¹ The capital loss created by the deemed dividend was carried back to Pamela's terminal return.

Current rules

The existing provisions of the Act enable taxpayers to carry back a loss from the estate's first taxation year to the deceased's terminal return.²² This post-mortem strategy increases the effective tax rate of the individual from the capital gains rate to the dividend rate, but it ensures that double or triple taxation on death is eliminated. This tax planning strategy essentially enables the deceased taxpayer to obtain the same tax results as all other taxpayers who redeem shares of corporations.²³

Certain provisions already in the Act, such as the stop-loss rules, ensure that such post-mortem transactions are within the spirit of the Act.

Proposed rules

As currently drafted, Pamela's capital gain on death would be recharacterized as an ineligible dividend on her terminal return since she did not make significant labour, capital or risk contributions to the business.²⁴ In this context, the deeming rule limits the corporation from utilizing its earned tax attributes, such as the CDA, GRIP and RDTOH. Additionally, the losses arising from the redemption of shares held by the estate cannot be utilized because there is no capital gain on death to offset.

Observations and suggestions

The proposed amendments to TOSI are intended to ensure that only reasonable compensation is paid to family members, effectively imposing a reasonableness test to the amounts paid. It is the Minister's intentions to ensure no tax advantage is obtained by business owners and their families, as a result of their shareholdings.

As noted above, these proposed rules around income splitting continues to apply after death, resulting in adverse tax consequences to both the deceased's estate and the beneficiaries.

Scenario 4 – Growing a family business

Daniel is a sole shareholder of DanCo and has one son, Greg. Greg is currently working with his father in the business and would like to take over his father's business upon his passing. Daniel passes away on January 2, 2018 and leaves the shares of DanCo to Greg. As suggested by his tax advisor, Greg transfers the shares of DanCo to a holding company on a tax-deferred basis. The shares held by Daniel do not qualify for the LCGE at the time of death.

Current rules

Under the current legislation, the transfer of the family business to Greg enables Greg to have an increase in the ACB of the shares he received and he is able to transfer them to a holding company and withdraw funds tax-free since Daniel has paid tax on the accrued gain up to the date of his death.

²¹ Pursuant to subsection 84(3).

²² Pursuant to subsection 164(6).

²³ Pursuant to paragraph 111(1)(b).

²⁴ As indicated in proposed subsection 120.4(4).

Proposed rules

As currently drafted, the proposed amendments to section 84.1 would reduce the ACB of the shares of DanCo held by Greg's holding company to be the ACB of the shares of Danco held by Dan initially. If Greg continues to grow his father's business for twenty years and subsequently decides to sell the company to a third party, assuming that the shares still do not qualify for the LCGE, he would not be able to benefit from the increased tax base created on his father's death. Consequently, the value of DanCo at the time of Dan's death would be taxed again.

Observations and suggestions

In the consultation paper, the Government indicated that intergenerational transfers of businesses should be treated similarly to third-party sales. If Greg were an arm's length party, he would be able to plan to extract pre-acquisition surpluses tax-free. Greg is not able to benefit from those rules. Therefore, we recommend that the wording of the proposed legislation be redrafted to remove the inequity and create a similar tax result to that of a third party transaction.

Scenario 5 – "asset drop"

Thomas was the sole shareholder of TomCo. He was single and did not have any children. Thomas passed away on September 1, 2017. As indicated in his will, the shares of TomCo (which were his only assets) will be distributed evenly between his adult siblings. It is the intention of the executor to sell the assets of the company during the next few years and distribute the resulting cash to the siblings. Due to the nature of the assets of TomCo, it will not be possible to sell all of the assets within one year of Thomas' death. In order to eliminate double taxation as a result of death and because it will not be possible to liquidate the corporation within the estate's first taxation year, the executor transferred all of TomCo's assets to a newly formed subsidiary (SubCo) at fair market value, thus creating a capital gain and increasing the CDA balance. TomCo subsequently reorganized the shares of TomCo and redeemed shares owned by the estate for a note, carrying back the loss created on the redemption.

Current rules

The current provisions of the Act enable corporations to internally sell their assets, simultaneously creating taxable capital gains and an addition to the CDA balance. The CDA can then be used to pay dividends to shareholders on a tax-free basis. As well, the current provisions allow corporations whose assets cannot be liquidated within one year to create a taxable distribution and a redemption of the shares instead of a gain, thereby avoiding the double taxation that would otherwise result.

Proposed rules

Under the proposed legislation, this particular post-mortem planning would be disallowed. Capital dividends to an individual shareholder would be prohibited in situations where the CDA balance was created on a non-arm's length basis.²⁵ While we understand that the intention of the Government is to prevent owners of private corporations from converting what would otherwise be a taxable dividend into a non-taxable dividend, applying these rules to post-mortem situations can result in double taxation.

Observations and suggestions

This particular post-mortem strategy is commonly used by estates that cannot be wound up within the estate's first taxation year. It is not uncommon for the winding up of an estate to extend beyond one year. Some estates are delayed in winding-up because of legal proceedings and/or family and business issues that have to be dealt with prior to the wind-up.

Recommendations

- Most post-mortem planning techniques to avoid double taxation will no longer be available if the legislation goes ahead without change. Some options to prevent this unfair result include:

²⁵ As indicated in the drafted section 246.1.

- The one-year timeline to use the loss carryback of subsection 164(6) could be extended. Consideration should be given to extending the deadline to at least three years, which is the normal carryback period currently provided by paragraph 111(1)(b).
- The proposed legislation should be adjusted to contemplate and accommodate the death of taxpayers who hold private company shares in order to eliminate unintended double taxation.
- If the rules are not to be adjusted to prevent the double taxation discussed above, transitional rules and grandfathering provisions should be considered for the estates of taxpayers who passed away before July 18, 2017 and are in the process of winding up, and who would normally have one year to implement the pipeline transactions started before the proposal date.

CONCLUSION

In closing, it is our position that these proposals should be seen as significant tax reform and not merely the closing of “loopholes”. Considering the broad sweeping impact of the proposals, and having regard to the numerous technical, policy and equity concerns identified above, we believe that the Government and the business community would be well served by the establishment of an advisory committee with broad representation to address private company tax reform with the objective of informing the Government’s view on how best to improve the overall tax regime. Ample time should be given to develop recommendations, assess their consequences and focus not only on closing so-called loopholes, but also on encouraging business entrepreneurship, growth and competitiveness for Canada. We do not believe that rushing the process with only a 75-day consultation period, instead of a full tax advisory process, serves taxpayers or the government well. We submit that these proposals should be reconsidered, as they are fraught with complexity, technical errors, unintended consequences, and taxpayer inequity. In particular, we advise a rigorous review and revision of the most troubling areas as outlined in our submission, the most urgent of these recommendations being to:

- Abandon the passive income proposals for all the reasons that similar proposals were abandoned in 1972. These proposals do not achieve the stated objectives of fairness and simplification. This would also contribute to solving the potential double and triple tax situations arising on death.
- Exempt spouses from the income sprinkling provisions. This would eliminate a large portion of the inequitable and complex situations created by this section of the proposals, including those noted regarding the death of a taxpayer.
- Revise the proposed rules associated with intergenerational transfers (section 84.1) to allow for equal treatment between intergenerational or other related party transactions and arm’s length transfers.
- Eliminate the retrospective aspects of the proposed legislation, in particular as they relate to changes in the CDA regime and historical arm’s length transaction tracking (sections 246.1 and 84.1).
- Eliminate the inherent and punitive double tax aspects of the proposals as they relate to the death of a taxpayer who owns CCPC shares, in particular, by extending the loss carryback provisions of 164(6) and creating transitional or grandfathering opportunities for estates currently in progress,

A full summary of the recommendations included in our submission is provided in Appendix 2 to this letter.

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October 2, 2017
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We hope that our specific comments and recommendations are helpful in your consideration of these proposals. We would be pleased to meet with you or other officials to discuss our submission. Deloitte is committed to making a significant contribution to help shape Canada's tax policy and its application to the future of our country.

Yours very truly,

A handwritten signature in blue ink, appearing to read "Deloitte" followed by a stylized signature.

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APPENDIX 1
Integration rules in a private corporation holding structure

The table below illustrates that the overall taxes paid in various distribution scenarios following a sale of assets to a third party purchaser are similar at any time following the sale, regardless of the order of distribution of the proceeds in the form of capital dividends and taxable dividends.

Example : sale of all business assets for \$100M (assuming no cost). We have used the combined tax rates applicable in the province of Québec.

	1	2	3	4	5
	Sale by an individual	Sale by Opco, no distribution	Sale by Opco and distribution of the CDA	Sale by Opco and distribution of a taxable dividend	Sale by Opco and distribution of all after- tax proceeds
	(\$M)	(\$M)	(\$M)	(\$M)	(\$M)
Capital gain	100.0	100.0	100.0	100.0	100.0
Income taxes	(26.7)	(25.2)	(25.2)	(25.2)	(25.2)
Net after-tax cash	73.3	74.8	74.8	74.8	74.8
Capital dividend	-	-	50.0	-	50.0
Taxable dividend	-	-	-	40.1	40.1
Personal income taxes	-	-	-	(17.6)	(17.6)
Dividend refund	-	-	-	15.3	15.3
Aggregate taxes paid	26.7	25.2	25.2	27.5	27.5

This table illustrates that in any event in the case of a sale to a third party purchaser, the aggregate corporate and personal income taxes payable are similar, primarily because of the dividend refund available to a private corporation on the payment of a taxable dividend. Accordingly, there is no need for the application of section 246.1 to capital dividends paid in this context; corporate and personal income taxes are already integrated under the current rules.

APPENDIX 2

SUMMARY OF KEY RECOMMENDATIONS

Overall recommendations

- The Government should treat this as private company tax reform and use this occasion as an opportunity to form an advisory group with broad representation to develop recommendations that take into account the anticipated impact on the broader economy.

Income sprinkling

- The proposed TOSI changes should include only family members aged 18 to 24 and not spouses.
- Consideration should be given to the appropriate taxing unit - individual, joint spouses/common law partners or household.
- Transitional issues should be introduced in order to avoid punitive consequences upon succession or sale of a business or the death of business founders who have put plans into place in good faith reliance on the current regime. We recommend that the existing TOSI rules continue to apply to the pre-2018 pool and the amended TOSI rules apply to corporate earnings post-2017.

Holding passive investments inside a private corporation

- The incorporation of a de minimis test into the rules in order to target the changes more efficiently should be considered. The proposals would thus apply only to corporations that earn significant passive income and are more likely to hold resources beyond what is needed in their business operations.
- A rolling start rule, which would allow a reasonable time period for reinvestment of passive income earned into the business operations, should be introduced. This will more objectively reflect the commercial reality of business cycles.
- In order to ensure that Canada remains attractive to foreign investors, the proposals should only apply to CCPCs and not to other private corporations.
- Reasonable transitional measures should be put in place to ensure that the severity of the changes can be absorbed by businesses in a manner that does not have the unintended effect of business instability.

Capital gains

- Legitimate intergenerational and other family transfers of businesses must not be penalized.
- A narrower, more targeted approach should be implemented to prevent unacceptable surplus stripping transactions. A clear purpose test would avoid penalizing legitimate transactions between related persons.
- A CDA increase arising from an "internal" capital gain should be suspended (instead of being permanently lost) until the capital property or a property deriving its value from that property is disposed of to a non-related person.
- The distribution of proceeds from a transaction with a non-related person should not be caught by the new rules. A carve out should be provided in the new legislation.
- In order to ensure that the need for historical knowledge of the gains realized by all related transferors as well as the origins of shareholdings is reasonable, the proposed amendment to

sections 84.1 and 246.1 should not apply in a manner that incorporates transactions prior to July 18, 2017.

- The proposed legislation should be adjusted to contemplate and accommodate the death of taxpayers who hold private company shares in order to eliminate double taxation.
- The one-year timeline to use the loss carryback of subsection 164(6) should be extended. Consideration should be given to extending the deadline to at least three years, which is the normal carryback period currently provided by paragraph 111(1)(b).
- Transitional rules and grandfathering provisions should be considered for the estates of taxpayers who passed away before July 18, 2017 and are in the process of winding up, and who would normally have one year to implement the pipeline transactions started before the proposal date.