

October 2, 2017

Paul Rochon
Deputy Minister
Department of Finance Canada
90 Elgin Street
Ottawa, ON K1A 0G5

Dear Mr. Rochon:

Re: Federal Consultation: Tax Planning Using Private Corporations

The enclosed submission sets out the views and recommendations of Chartered Professional Accountants of Canada (CPA Canada) in response to the Government of Canada's consultations on tax planning using private corporations.

CPA Canada is one of the largest and most respected national accounting organizations in the world, representing more than 210,000 Canadian chartered professional accountants (CPAs) at home and abroad. CPAs work in every sector of the economy. They are the business and accounting leaders that Canadian taxpayers count on to represent their interests with integrity and competence, and to help them comply with Canada's complex tax laws. CPA Canada also works collaboratively with the Government of Canada, including the Canada Revenue Agency and Finance Canada, with a view to improving the tax system for all Canadians.

In this submission, we present our serious concerns with the consultation process. When any new tax law is proposed, there should be a detailed, constructive, two-way consultation with all parties affected. In this case, the short consultation period, its summertime launch and the release of draft implementing legislation lead CPA Canada to believe such consultation has not occurred.

In CPA Canada's view, the July 18 proposals are contrary to the public interest due to the unintended consequences they would produce for small business owners and for all classes of Canadians. This package of proposals is so complex and so broadly targeted that it would be unworkable. Other, similarly complex, broadly applicable changes affecting small businesses were recently enacted. When you consider those changes in combination with the current proposals, significant risk is created to the integrity of the tax system, to the financial prospects and competitiveness of Canadian private businesses, and to the Canadian economy overall.

This submission advances many suggestions on how to improve the simplicity, certainty, efficiency and effectiveness of the proposals, as released on July 18, 2017, focusing primarily on tax policy matters. Submissions of the Joint Committee on Taxation of the Canadian Bar Association and CPA



Canada, which run well over 100 pages in total, raise a high number of technical concerns. These submissions highlight significant flaws in the proposals and, in some cases, put forward constructive suggestions to resolve these concerns.

In the almost half-century since Canada's last major tax reform initiative, the tax laws have seen layer upon layer of complex tax changes made without consideration of the impact on the tax system as a whole or on the public interest. As CPA Canada has expressed in numerous representations to government, a comprehensive tax review is long overdue. This review is urgently needed to ensure Canada's tax system is sustainable and competitive for the 21st century.

We therefore believe the government should consider setting aside these proposals pending a comprehensive review of the income tax system.

We would welcome the opportunity to discuss this issue and the comments throughout this submission with you further.

Yours truly,

Original signed by

Joy Thomas, MBA, FCPA, FCMA, C. Dir.
President and CEO
CPA Canada

c.c.: Ted Cook, Tax Policy Branch, Finance Canada
Brian Ernewein, General Director, Tax Policy Branch, Finance Canada
Andrew Marsland, Senior Assistant Deputy Minister, Tax Policy Branch, Finance Canada



CONSULTATION: TAX PLANNING USING PRIVATE CORPORATIONS

CPA CANADA'S RESPONSE TO THE DEPARTMENT OF FINANCE CANADA

EXECUTIVE SUMMARY

Chartered Professional Accountants of Canada (CPA Canada) welcomes the opportunity to comment on the government's consultation document *Tax Planning Using Private Corporations*¹ and draft legislation released on July 18, 2017 ("the July 18 proposals").

CPA Canada believes Canada's tax system should support sustainable economic growth in the public interest, reinforce our country's competitive position in the global economy and provide incentives for business owners to take risks and invest in our economy. CPA Canada fully supports the goal of an efficient and effective tax system that ensures abuses to the system are reduced or eliminated. CPA Canada also recognizes the Government of Canada's responsibility and right to make changes as it considers appropriate.

The numerous technical concerns and inappropriately targeted tax consequences of these proposals have been discussed by many other stakeholders in detail, including in the submission of the Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada ("Joint Committee"). In these pages, CPA Canada focuses on the tax policy aspects of the proposals.

Based on our initial analysis of the July 18 proposals and consultations with members and other stakeholders, CPA Canada believes the proposals would have far-reaching impacts that extend beyond Canada's top income-earners, and would adversely affect many middle-class taxpayers. If implemented, the proposals would create complexity and raise the cost of doing business in Canada, creating barriers to business investment and job creation, and diminishing competitiveness.

¹ Department of Finance Canada, *Tax Planning Using Private Corporations*, July 18, 2017.



Further, a 75-day consultation period does not provide enough time to properly evaluate the broad tax policy changes set out in the consultation paper. CPA Canada believes additional time is needed – for the issues to be considered and assessed and for the relevant economic data to be gathered and analyzed – so that all of the potential impacts on Canadian individuals and businesses can be identified and estimated. CPA Canada previously expressed the need for the government to consider extending the current consultation beyond October 2, 2017 in a letter to Finance Canada dated August 17, 2017 (see Appendix 1).

Extending the consultation would permit a more in-depth review of whether and to what extent the proposals adhere to the principles of a sound tax system. Under these principles, any changes to tax policy should be designed to achieve an equitable, efficient and effective tax system that ensures abuses to the system are reduced or eliminated while avoiding undue complexity. Tax system changes should also promote and support economic growth and competitiveness in Canada.

Tax, financial and economics experts and other stakeholders have observed that, in contrast to these principles, the proposals would add even more complexity and uncertainty to Canada's tax legislation than already exists. On top of the extra tax costs for affected taxpayers, the added complexity would raise the costs of compliance for all private corporation owners, given the time and effort required of tax advisers to determine their clients' obligations under the new rules.

Small business owners, their advisers and Canada Revenue Agency auditors are already challenged to deal with other recent and highly complex changes (e.g., to subsection 55(2), the small business deduction and the principal residence exemption). The July 18 proposals would magnify these challenges significantly, raising serious concerns over taxpayers' ability and willingness to comply with the tax system and whether the system is becoming unworkable.

Instead of layering on additional tax complexity by changing the tax system on a piecemeal basis with proposals like these, such changes need to be considered in the broader context of Canada's tax system overall.

"The last major overhaul was the result of a consultation process that took many years, being the Carter Commission (started in 1962 with a White Paper released in 1969). I caution our government against adopting the July 18th proposals without real and meaningful studies and a thorough consultation process."

– Comment from a CPA in New Brunswick



It has been more than 50 years since the last major tax system review. CPA Canada and many other national organizations, leading think tanks, economists and academics agree that a comprehensive review to improve the tax system’s simplicity, efficiency, fairness and competitiveness is long overdue. In addition, for the last four years and through its pre-budget consultation process, the House of Commons Standing Committee on Finance has recommended that the federal government should simplify the *Income Tax Act* and launch a national consultation process to accomplish this important task.

In addition to concerns with the proposals themselves, CPA Canada believes that the manner in which they have been presented is contrary to the public interest and the Canadian ideal of good business. CPA Canada believes the government should be more transparent with Canadians.

In its consultation paper, for example, the government suggests it is “...taking steps to address tax planning strategies and close loopholes that are only available to some—often the very wealthy or the highest income earners—at the expense of others.”² We have concerns with the suggestion that some Canadian taxpayers have been inappropriately taking advantage of these tax provisions. Characterizing the use of legally sanctioned tax planning by compliant taxpayers as making use of “loopholes” is inaccurate and unfair.

Rather, CPA Canada believes the government should acknowledge and explain the material shift in tax policy regarding the taxation of private corporations that these proposals actually represent.

Summary of recommendations

CPA Canada believes that the public interest would be best served by setting aside these proposals pending a more comprehensive tax system review. The goal of this review should be to ensure Canada has an efficient and effective tax system that supports sustainable growth and the competitiveness of Canadian businesses, now and in the future.

Below are CPA Canada’s recommendations in response to Finance Canada’s specific requests for responses on the July 18 proposals. These recommendations are discussed in more detail in the body of this paper.

² Ibid., at p. 3.



Even though Finance Canada has released draft legislation to implement some of these proposals, we have assumed that Finance is interested in hearing the views of Canadians on all of the proposals discussed in the consultation paper.

In addition to the recommendations below, CPA Canada supports the technical recommendations of the Joint Committee in its submissions on the July 18 proposals.

Income sprinkling

RECOMMENDATION: CPA Canada recommends the government provide data and analysis regarding the use of income sprinkling through private corporations to ensure the issues are well understood by stakeholders and the best solutions can be developed.

RECOMMENDATION: CPA Canada recommends that, in order to reduce subjectivity and improve certainty, the federal government should consider:

- abandoning the highly subjective “reasonability” test for compensation paid to family members
- consulting further with stakeholders to determine whether a simpler method could be employed to meet the government’s objectives, such as extending the tax on split income (TOSI) to children up to age 24 and not applying the rules to older family members
- if the reasonability test is maintained:
 - providing greater certainty through de minimis exceptions for smaller split income amounts that would exempt taxpayers below certain income levels or other thresholds and thereby reduce complexity and the potential for disagreements resulting from honest differences of opinion
 - provide clear and detailed administrative guidance when the proposals take effect (or earlier) so taxpayers can know with certainty and minimal cost whether they comply with the rules
- review and consult with Canadians on the appropriate taxing unit to achieve consistency in tax treatment of spouses throughout the *Income Tax Act*, including review of whether spouses should be considered a taxing unit, irrespective of whether they are in business or employment
- following that review, consider whether spouses should be exempted from the proposed TOSI rules.



Converting income into capital gains

RECOMMENDATION: CPA Canada recommends that the federal government:

- ensure neutrality and simplicity by reviewing the proposals that aim to prevent the inappropriate conversion of income to capital gains to ensure they would not lead to unexpected, uncertain, inappropriate and onerous tax results (e.g., double taxation on death)
- ensure procedural fairness by considering appropriate transitional periods and grandfathering rules to ensure the rules do not apply retroactively or retrospectively.

RECOMMENDATION: CPA Canada welcomes the government’s intention to engage in separate consultations on the issue of intergenerational transfers and recommends the review be conducted with a view to providing exceptions to ensure tax neutrality for transfers of family businesses to family member versus third parties.

RECOMMENDATION: CPA Canada recommends the government undertake a specific review of the tax issues arising on the death of a shareholder to ensure the taxation is fair and there is a simple and clear path to avoid double taxation.

Holding passive investments inside a private corporation

RECOMMENDATION: CPA Canada recommends that the federal government take steps to minimize complexity as follows:

- If the proposals on income sprinkling and the conversion of income into capital gains are adopted, conduct a more detailed review on whether the passive income proposals are in fact needed when the cost and complications created by those proposals are considered.
- If passive income rules are deemed necessary:
 - undertake further study and analysis to define “small business” for purposes of the passive investment rule (e.g., annual business income under \$150,000) and promote simplicity by including a de minimis rule to exclude small businesses from the application of any new rules in this area
 - promote certainty by establishing a safe harbour for companies that maintain a reasonable portion of their assets in passive investments relative to active business assets that are incidental to or necessary for the business, for example, by using a



variation of the current definition of a small business corporation (e.g., a straightforward 80 per cent test)

- promote procedural fairness by providing a reasonable transitional period (e.g., two years) and comprehensive transitional rules for individuals and their companies to plan for the change in this tax regime.

Conclusion

RECOMMENDATION: Instead of layering on ever more complex tax rules, CPA Canada recommends a comprehensive review of the tax system. CPA Canada has recommended such a review for many years, including in our annual pre-budget submissions to the Government of Canada. We are supported in this view by many other national organizations, leading think tanks, economists, academics and the House of Commons Standing Committee on Finance.



INTRODUCTION

This submission sets forth CPA Canada's views and suggestions on how the Department of Finance Canada could alleviate the adverse impact of and improve the July 18 proposals on income sprinkling, conversion of a private corporation's regular income into capital gains, and passive investment income.

CPA Canada is one of the largest and most respected national accounting organizations in the world, representing more than 210,000 Canadian chartered professional accountants (CPAs) at home and abroad. CPAs work in every sector of the economy, and are the business and accounting leaders that Canadian taxpayers count on to represent their interests with integrity and competence, and to help them comply with Canada's complex tax laws. CPA Canada also works collaboratively with the Government of Canada, including the Canada Revenue Agency and Finance Canada, with a view to improving the tax system for all Canadians.

Collectively, CPA Canada and the profession enable, champion and safeguard the Canadian ideal of good business, which values inclusion, sustainable growth and social development in cultivating a healthy and thriving economy.

For purposes of the current consultation, this submission begins with a review of some key principles of good tax policy design, followed by more detailed discussion of CPA Canada's overarching concerns outlined in the executive summary. This submission then presents analysis and recommendations on the three main areas covered by the June 18 proposals.

The views in this submission were developed in consultation with members of CPA Canada's tax committees who provide tax services as general practitioners or tax specialists to private Canadian businesses of all sizes and their owners. The submission also reflects feedback received from CPAs members across Canada, generally through CPA Canada's website, who have raised concerns about the effects of the changes. Some of their comments are reproduced herein. Our analysis is also informed by concerns and potential solutions identified through CPA Canada's participation in forums with legal and tax professionals, estate and trust practitioners, and other stakeholders. The views expressed in this submission, however, are those of CPA Canada.

PRINCIPLES OF A SOUND TAX SYSTEM

CPA Canada supports the goal of an equitable, efficient and effective tax system that ensures abuses to the system are reduced or eliminated. CPA Canada asserts that any changes to tax policy should be designed to achieve these ends while avoiding undue complexity, and also to promote and support economic growth and competitiveness in Canada. Thus, CPA Canada believes the July

18 consultation paper and accompanying draft legislation should be evaluated with due consideration to the key principles of:

- fairness and equity
- simplicity
- competitiveness
- efficiency
- neutrality
- certainty
- appropriate targeting
- transparency and consultation

These principles, as described below, are drawn in part from sets of tax policy design principles espoused by the Institute of Chartered Accountants in England & Wales³ and the American Institute of Certified Public Accountants.⁴

Fairness and equity – A tax system demonstrates fairness and equity when “taxpayers have a voice in the tax system, are given due process, are treated with respect by tax administrators” and “no group of taxpayers is favoured to the detriment of another without good cause.”⁵ When changing well-established tax law and especially when changing tax policy, the government should allow for an appropriate transitional period to give taxpayers sufficient time to adjust to the new conditions under which they must plan their tax affairs. New tax law should also employ appropriate grandfathering provisions to ensure policy changes or changes in well-established law are not retroactive or retrospective.

Simplicity – New taxation rules should be as simple as possible to administer so taxpayers can understand the consequences of their actions. Although the underlying tax issues may be complex, taxpayers need to understand tax rules and be able to comply with them correctly and cost-efficiently. Canada’s *Taxpayer Bill of Rights* states that taxpayers “have the right to have the costs

³ Institute of Chartered Accountants in England & Wales, *Towards a better tax system* (not dated).

⁴ American Institute of Certified Public Accountants, *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*, 2001.

⁵ American Institute of Certified Public Accountants, *Guiding Principles for Tax Equity and Fairness*, 2007.



of compliance taken into account when administering tax legislation.”⁶ Tax complexity can significantly increase taxpayers’ compliance costs.

Competitiveness – Proposed new taxation rules must consider the need to keep businesses competitive in a global economy featuring vibrant international tax competition and global mobility of investment. Tax requirements should not impede the operations or productivity of taxpaying businesses.

Efficiency – Proposed tax changes should not potentially increase the tax and administrative costs of running a business, which can impede entrepreneurial drive. Making piecemeal changes to longstanding legitimate tax structures that are used by a wide array of businesses of all sizes and income levels may lead to unintended outcomes and uncertainty until corrections are made.

Neutrality – The effect of the tax law on a taxpayer’s decisions as to whether to engage in a transaction or structure or how to execute an arrangement should be minimized.

Certainty – Taxpayers should, with a reasonable degree of certainty, be able to assess the tax impact and consequences of new legislation on their financial transactions in a way that would enable them to plan their financial affairs.

Appropriate targeting – New tax rules should be clearly and specifically targeted, with the reasons for imposing the rules clearly understood by the taxpayers and tax advisers who are affected by the changes. Guidance should include detailed examples of the types of taxpayers and transactions that new tax rules are designed to affect.

Transparency and consultation – Comprehensive consultation with all parties affected by proposed tax legislation is necessary, especially when broader changes in tax policy are contemplated. Enough time for a detailed evaluation process should be allotted. The consultation should be transparent to allow stakeholders to understand how and when the proposed tax would affect them, and to provide feedback about the impact. Further, the government should be open and willing to share its data and rationale for tax policy changes. The government should also be open and willing to consider the perspectives of affected parties to help determine the most effective manner to implement desired tax policy changes.

⁶ Canada Revenue Agency, Taxpayer Bill of Rights, at Item 10.



THE JULY 18 PROPOSALS – OVERARCHING CONCERNS

Appropriate targeting of incentives

With the July 18 proposals, the government is proposing to change tax laws that are clear and unambiguous and, in many cases, have been in force for over 40 years. CPA Canada believes the tax incentives available through the current rules have provided Canadian entrepreneurs and businesses with a competitive advantage.

Many small business owners have arranged their financial affairs based in part on these longstanding tax laws and continue to count on them in their business planning. The federal government has long known about and allowed this planning. Further, many of the taxpayers benefiting from these rules would not be considered wealthy but would instead fall within what most would consider as the middle class.⁷

In fact, contrary to the principle of tax neutrality, the proposals could have the most severe impact on private business owners at the lowest income levels. For example, if a corporation earns \$150,000 of income after tax at the small business rate and pays that income to family members as dividends, the application of the TOSI rules would result in tax at the top personal tax rate on some of the dividends paid, no matter who is taxed on the dividends. So, even if none of the family members are top-rate taxpayers, they would still pay the top rate on such dividends.⁸

If the government has concluded that the tax advantages for private corporations are no longer properly targeted, CPA Canada suggests the federal government should provide data to support this conclusion. Further, before eliminating any incentives that businesses currently depend on, the government should consider whether additional measures are needed to encourage and support business creation and growth for a stronger economy that benefits all Canadians.

⁷ Data from Wolfson, Veall, Brooks and Murphy (2016) (supra, note 13) show that CCPC ownership is prevalent across the entire income spectrum. Among the 90 per cent of Canadians who have after-tax incomes of less than \$70,000, roughly 5 per cent on average hold ownership in a CCPC. This percentage may be small, but 5 per cent of 90 per cent of all Canadians still represents an estimated 1 million to 2 million Canadians who are lower and middle-income and own CCPCs.

⁸ An ineligible dividend would give rise to taxable income of \$175,500. If the family has no other sources of income, no one could be top-rate as the top tax bracket begins at an income level of \$200,000. The TOSI rules could therefore result in an inappropriate amount of tax for a middle-class family.



Due process for introducing tax policy changes

The government has repeatedly characterized some of the July 18 proposals as the closing of “loopholes.” CPA Canada respectfully submits that the rules Finance Canada seeks to change do not meet commonly accepted definitions of the term.

A “loophole” is defined by Merriam-Webster as “an ambiguity or omission in the text through which the intent of a statute, contract, or obligation may be evaded.”⁹ Similarly, Cambridge defines loophole as “a small mistake in an agreement or law that gives someone the chance to avoid having to do something.”¹⁰

Rather than loopholes, the tax policy features that the government proposes to change produce the results they were designed to achieve when they were enacted. Over time, these laws may have come to be used in ways that the current government considers inappropriate. If the government intends to change existing tax law to better reflect a contemporary viewpoint, CPA Canada believes that reason should be clearly stated.

Examples in Appendix 3 demonstrate why two of the key changes – the proposed expansion of the tax on split income and the broadening of the rules in section 84.1 of the *Income Tax Act* – are clearly changes in tax policy. This distinction is important for two reasons.

First, we have received many comments from CPA Canada members who have provided advice to clients that was legally effective and based on tax law that has existed for some time. These members believe that the government’s implication that providing this advice is the same as recommending the use of loophole sends the message that members were engaged in inappropriate activities. We believe that this approach has been unhelpful and acted as a barrier to an effective tax consultation process.

Second, as tax policy changes, the proposals should not be subject to immediate implementation without an appropriate phase-in period, as is often the case when the government closes perceived loopholes in the tax law. For example, certain of the July 18 proposals would be effective January 1, 2018, even though a corporation’s current taxation year may already straddle that phase-in date.

⁹ <https://www.merriam-webster.com/dictionary/loophole>

¹⁰ <http://dictionary.cambridge.org/dictionary/english/loophole>



New tax policy should be introduced through a due process adhering to principles of procedural fairness, transparency and consultation. This includes open analysis and discussion with businesses, the tax community and other stakeholders, together with an appropriate implementation timetable and transitional rules that would give affected taxpayers a reasonable amount of time to bring their affairs in line with the new policy.

Avoiding additional complexity

CPA Canada submits that the July 18 proposals would adversely affect the efficiency and effectiveness of the Canadian income tax system by adding even more complexity and uncertainty than already exists. This could lead to unintended consequences that are counter to the public interest. The submissions on these proposals by the Joint Committee include numerous examples of these adverse effects within its 100+ pages of expert technical analysis.

Among other issues, there are concerns that the proposals are too broadly targeted and would adversely affect middle class taxpayers and small business entrepreneurs – the very groups the government has said it most wants to support. **It is important to emphasize that even if members of these groups are not affected by an increase in their own taxes, they would most certainly be affected by a significant increase in the cost of compliance.**

The heavy compliance burden would increase the risk of inadvertent non-compliance due to errors as small business owners and other taxpayers try to comply with new rules they do not fully understand. The additional complexity and high compliance burden could also increase wilful non-compliance and participation in the underground economy, and lead taxpayers to seek aggressive tax planning alternatives.

Increased complexity could also be costly for taxpayers in terms of the additional expense and time they need to spend to comply with the new rules. Costs would increase even for those business owners whose taxes are ultimately unaffected since they would still need to spend the time and bear the expense of determining their status under the rules.

“[The current proposals] will create a lot of uncertainty in the tax planning and compliance work for small business owners and their advisers. Accordingly, it will lead to time, energy and resources being used in planning and defending tax matters instead of growing their businesses and creating jobs for the middle class.”

– Comment from CPA in Alberta



CPA Canada is also concerned that the complexity associated with these proposed new rules would adversely affect the public interest by putting professional tax practitioners at greater risk of making errors and by increasing the cost of compliance for taxpayers who seek the services of tax preparers. This could also raise the liability and reputational risk for tax practitioners and discourage them from providing tax services.

Further, many small businesses who have straightforward or limited tax service needs now benefit from tax services provided by CPAs who are general practitioners. If the complexity and risk causes some general practitioners to stop providing tax services, their small business clients would be compelled to bear the added expense of consulting with tax specialists.

Finally, additional complexity could also adversely affect the federal government, by adding costs to administering the tax system, including potentially increased litigation costs for settling disputes.

THE JULY 18 PROPOSALS: ANALYSIS AND RECOMMENDATIONS

In this section, we set out CPA Canada's views on the proposals addressing income sprinkling and conversion of income to capital gains, and then discuss the proposals on passive investment income. We follow this order, rather than the order used in the July 18 consultation paper, for two reasons:

1. CPA Canada believes the first two items are more advanced, given that draft legislation has already been prepared, while the taxation of passive investment income appears to be more open to discussion in the absence of draft legislation.
2. CPA Canada believes that no action is needed to address the taxation of passive income, especially if one balances complexity with the need for fairness. In addition, many substantive concerns would be addressed if the government were to satisfactorily address the concerns raised regarding income splitting and conversion of income to capital gains.

Income Sprinkling

Finance Canada's consultation paper states that "income sprinkling is providing unintended benefits to higher-income individuals, principally through the use of private corporations. This is



unfair and inconsistent with a tax system that works for all. Adjustments to the tax rules are required to address those concerns.”¹¹

Among the many issues raised by the Joint Committee in its submission, CPA Canada highlights two key concerns:

- 1) As proposed, the rules are based on the notion of what is “reasonable” compensation for family members, which is highly subjective and would create significant uncertainty as to what is “reasonable” in this context. There is the risk of serious disputes occurring between taxpayers and CRA, which could lead to significant cost to both taxpayers and the government. Currently, there is insufficient publicly available data to accurately determine the impact of the proposals.
- 2) CPA Canada believes that as part of this consultation, it is incumbent on the government to consider whether the appropriate taxing unit should include both spouses, rather than the individual taxpayer, as is the case in other countries.

Lack of available data for evidence-based decision making

CPA Canada supports the federal government’s public policy objective of designing a tax system that is fair and equitable, while ensuring that the system is competitive and supports growth. Given the limited availability of public data on these issues and in keeping with the government’s stated commitment to greater transparency, we ask the government to help the public understand the scope of these changes.

For example, the government’s consultation document states that the income sprinkling proposals would raise an estimated \$250 million in additional revenue. This figure likely results from quantitative analysis conducted that would also likely contain some distributional perspective. Providing the details of such an analysis or data on the number of affected businesses, including detail on the revenue/income distribution of those businesses, would facilitate a greater understanding of the extent to which business owners would be affected by these changes and would improve the government’s consultation process.

¹¹ Supra note 1, at page 23.

As noted in a media report, “There is no detailed research revealing how many people are incorporating as a small business primarily as a tax-avoidance strategy.”¹² The report quotes University of Ottawa researcher Michael Wolfson: “I think it’s really a shame that [the government doesn’t] seem to have the numbers readily at hand. If public policy is to be done on an evidence-based manner, then a substantial investment needs to be made ... on making sure you have the information in order to understand and monitor what’s going on with these programs.”

In the absence of such data in the public domain, CPA Canada believes the proposed changes would affect a far wider spectrum of businesses well beyond those in the higher-income brackets. Data from Wolfson, Veall, Brooks and Murphy (2016)¹³ show that CCPC ownership is prevalent across the entire income spectrum, suggesting that possibly as many lower and middle-income business owners could be affected by these changes as higher-income business owners.¹⁴

Feedback from CPA Canada’s members also indicates that business owners across the spectrum of income levels have in fact made use of tax planning that involves income sprinkling.

The important question is the degree to which lower- and middle-income CCPC owners use these tax planning tools. If even a small proportion do leverage these tools, then likely as many lower and middle income business owners would be affected as higher-income business owners.

¹² Alexandra Posadzki, Eric Atkins and David Parkinson, “Small business, big trouble”, *The Globe and Mail*, September 15, 2017.

¹³ Michael Wolfson, Mike Veall, Neil Brooks, and Brian Murphy, “Piercing the Veil: Private Corporations and the Income of the Affluent,” *Canadian Tax Journal* (2016) 64:1.

¹⁴ In absolute terms, the number of individuals in these income brackets would far exceed those in the highest income brackets. By our rough estimation based on Wolfson et al. (2016), over 1.3 million individuals reported CCPC income in the bottom 90 per cent of income-earners in Canada (namely, 90 per cent of those who have an upper after-tax income threshold of \$68,800 based on T1 statistics). In comparison, the top 10 per cent of Canadian income-earners who hold shares in at least one CCPC account for just over 500,000 Canadians. In other words, among Canadians who report CCPC income, there are potentially 2.6 times as many users of these tax planning tools in lower or middle-income cohorts relative to top-income earners in Canada. The important question then is the degree to which lower- and middle-income CCPC owners use these tax planning tools. The data above provides no insight into this issue since no publicly available data on income sprinkling is available by income cohort. However, if even a small proportion do indeed leverage these tools, then likely as many lower- and middle-income business owners would be affected as higher-income business owners.



CPA Canada shares the concerns raised by many business groups that these changes would be just as detrimental to lower- and middle-income entrepreneurs as any other income group. If so, the government should consider whether other, more targeted programs are needed to encourage entrepreneurship.

Finally, the proposal's use of "reasonability" as a test to determine application of the rules to dividends paid to family members is unduly subjective, adding undue complexity and opening occasion for disputes. Following the principle of simplicity, CPA Canada believes that a more straightforward solution could be found to meet the government's objectives. For example, several experts have suggested that the proposed tax on split income rules could apply simply based on a revised age of the dividend recipient. Such a system would be much easier to apply as the proposed reasonability tests would not be needed.

Income sprinkling – recommendations

RECOMMENDATION: CPA Canada recommends the government provide data and analysis regarding the use of income sprinkling through private corporations to ensure the issues are well understood by stakeholders and the best solutions can be developed.

RECOMMENDATION: CPA Canada recommends that, in order to reduce subjectivity and improve certainty, the federal government should consider:

- abandoning the highly subjective "reasonability" test for compensation paid to family members
- consulting further with stakeholders to determine whether a simpler method could be employed to meet the government's objectives, such as extending the tax on split income to children up to age 24 and not applying the rules to older family members
- if the reasonability test is maintained:
 - providing greater certainty through de minimis exceptions for smaller split income amounts that would exempt taxpayers below certain income levels or other thresholds and thereby reduce complexity and the potential for disagreements resulting from honest differences of opinion
 - provide clear and detailed administrative guidance when the proposals take effect (or earlier) so taxpayers can know with certainty and minimal cost whether they comply with the rules.



The taxing unit: individual or family?

As part of this consultation, CPA Canada believes the government should consider the appropriate taxing unit. The *Income Tax Act* is inconsistent in its treatment of the individual versus the family, and spouses in particular. The Act considers a couple as the taxing unit for most income-tested benefits, pension income-splitting and spousal Registered Retirement Savings Plans. Pension income-splitting recognizes, for example, the financial difficulties of those on a fixed income and explicitly sanctions lowering the effective tax rates of these couples.

Family law generally recognizes both spouses as making equal contributions in the marriage, and there are strong arguments that tax rules should mirror this implied sharing of property and therefore income.

“Just because a spouse may not be at the office every day doesn’t mean he or she isn’t very involved in the affairs of the company and acting as a sounding board and providing valuable perspective and advice to the active spouse.”

*– Comment from CPA Canada member
in British Columbia*

In analyzing the appropriate unit of taxation, consideration should be given to whether taxing the family unit would act to discourage the spouses of business owners from participating in the family business or broader workforce. It is worth recognizing that starting a business is often a decision and commitment made by a family rather than an individual. And, as mentioned, family law generally recognizes both spouses as making equal contributions in the marriage.

The taxing unit – recommendation

RECOMMENDATION: As part of a comprehensive tax reform initiative, CPA Canada recommends the government:

- review and consult with Canadians on the appropriate taxing unit to achieve consistency in tax treatment of spouses throughout the *Income Tax Act*, including review of whether spouses should be considered a taxing unit, irrespective of whether they are in business or employment
- following that review, consider whether spouses should be exempted from the proposed TOSI rules.



Converting income into capital gains

In its July 18 consultation paper, Finance Canada notes that converting a private corporation's regular income into capital gains can provide an unfair opportunity for taxpayers to reduce taxes.

CPA Canada is concerned that the changes proposed in this area need to be carefully reviewed to ensure that they are properly targeted. Based on consultation with CPA Canada members and other stakeholders, we understand that in some cases the tax that would result from these changes would be substantially above the current highest rate of taxes. This is inappropriate.

CPA Canada believes enacting these proposals would be tantamount to imposing a potentially large tax increase. It would also undermine retirement and succession planning for small business owners in ways that would be retrospective, retroactive and punitive, and would harm Canadian competitiveness overall.

RECOMMENDATION: CPA Canada recommends that the federal government:

- **ensure neutrality and simplicity by reviewing the proposals that aim to prevent the inappropriate conversion of income to capital gains to ensure they would not lead to unexpected, uncertain, inappropriate and onerous tax results**
- **ensure procedural fairness by considering appropriate transitional periods and grandfathering rules to ensure the rules do not apply retroactively or retrospectively**

Intergenerational business transfers

CPA Canada is concerned that Finance Canada's proposed changes could adversely affect legitimate intergenerational transfers of businesses because of the substantially increased cost of a transfer to a family member versus an independent third party. To preserve neutrality, tax should not be a deciding factor when a vendor is considering who to sell to.

We are particularly concerned that the proposals do not adequately address the complex issues that are involved in post-mortem taxation, as shown in the example in Appendix 4. The example illustrates how the proposals would breach the concept of tax neutrality and fairness by potentially creating double taxation. The tax issues arising on the death of a shareholder require detailed review. Simply passing away as a shareholder of a private corporation should not create a need for complex tax planning.



CPA Canada also believes that the government needs to conduct a full consultation to determine how it can distinguish between legitimate intergenerational transfers and those done for primarily for tax planning purposes.

Intergenerational business transfers – recommendation

RECOMMENDATION: CPA Canada welcomes the government’s intention to engage in separate consultations on the issue of intergenerational transfers and recommends the review be conducted with a view to providing exceptions to ensure tax neutrality for transfers of family businesses to family member versus third parties.

RECOMMENDATION: CPA Canada recommends the government undertake a specific review of the tax issues arising on the death of a shareholder to ensure the taxation is fair and there is a simple and clear path to avoid double taxation.

In considering possible changes in this area, we believe that the government has examples already to work from, such as recently introduced legislation in Quebec and suggestions made by the Conference for Advanced Life Underwriting (CALU). CPA Canada would welcome the opportunity to work with the government and other stakeholders to help develop legislation that balances the need to provide tax neutrality when an owner considers the sale of the business with the interest of protecting the Canadian tax base.

Holding passive investments inside a private corporation

Are the passive income changes needed?

In the July 18 proposals, Finance Canada notes that “some individuals gain an unfair benefit by retaining passive investments in a corporation, taking advantage of the fact that corporate income tax rates are much lower than personal tax rates for higher-income individuals.”¹⁵

The consultation paper follows this statement with an example using theoretical tax rates that assumes a corporation earns \$100,000 of business income eligible for the small business deduction and the after-tax amount is invested for 10 years, generating interest at a rate of 3 per cent annually. After 10 years, the retained earnings of the corporation are paid out as a dividend.

¹⁵ Department of Finance, “Summary Overview: Consultations on Tax Planning Using Private Corporations,” at http://www.fin.gc.ca/n17/data/17-066_1-eng.asp.



This result is compared to the result where an individual earns the business income personally, reinvests the after-tax income and realizes the same rate of return.

Before dealing with issues involving passive income in a corporation more generally, we have concerns about the calculations used in the July 18 consultation paper to justify new tax rules. In particular, CPA Canada submits that any analysis on tax rate effects must use actual tax rates. Since this analysis was not provided, we have recalculated the amounts under the same scenarios using actual tax rates for each province. In addition, we performed the same calculations on the assumption that the \$100,000 of business income was taxed at the general rate. These calculations are reproduced in Appendix 5.

Based on these calculations, we have the following observations:

- Where income is taxed at the general tax rate, there is nothing to suggest that using a corporation provides a tax benefit if it is assumed that the final dividend would be paid to an individual with income taxed at the top rate without the benefit of income sprinkling and capital gains planning. The use of a corporation produces a cost in many provinces, and this cost is significant in some cases.
- Even though there is a benefit associated with reinvesting the tax savings from the small business deduction in a corporation, the benefit in all provinces (except Saskatchewan) is lower than the hypothetical benefit in Finance Canada's calculations. The average provincial benefit was approximately \$4,200 while Finance Canada calculates the benefit to be approximately \$5,700. CPA Canada questions whether accumulating a 4.2 per cent benefit over 10 years is significant.

Differences vary depending on the rate of return and the type of the passive income.

Why the actual benefits calculated differ so significantly from Finance Canada's numbers and provincially is important to understand. CPA Canada submits that another flaw in Finance Canada's analysis is the assumption that investment income and general rate business income are integrated. In fact, in some provinces, both types of income are under-integrated. Therefore, where a corporation earns passive income, no benefit arises until the accumulated after-tax income from reinvesting the tax deferral overcomes the inherent under-integrated cost.

Finally, CPA Canada believes that Finance Canada should conduct a detailed review of how other countries treat passive income for tax purposes. For example, a study of 16 countries published in

*Tax Notes International*¹⁶ indicates that taxes to encourage corporate distributions are not common and only apply in limited circumstances. The use of an untried tax system could produce unintended results, and Finance Canada's proposals could disadvantage Canadian businesses, contrary to the principles of equity and competitiveness.

Overall, CPA Canada does not believe Finance Canada has made the case that there is a material problem associated with the current tax treatment of corporations earning passive income on the reinvestment of a tax deferral on business income, especially where the original business income was not eligible for the small business deduction.

How many corporations are affected?

As mentioned earlier, Finance Canada seems to imply that the new rules would only create issues for "some individuals" making use of private corporations. However, it appears the proposals would affect many more taxpayers.

According to Innovation, Science and Economic Development Canada, as of December 2015, there were 1.14 million small businesses in Canada (defined as having between one and 99 paid employees), representing 97.9 per cent of all employer businesses in Canada.¹⁷ That figure includes small business owners who structure their business through an incorporated entity, many of whom would not be considered wealthy.¹⁸

Thus, this tax proposal would affect a wide variety of private business owners, not just wealthy Canadians. This would impose a significant compliance responsibility on any person or corporation carrying on business in a private corporation, and lower-income business owners could experience the harshest impact.

Finance Canada seems to take the position that the current rules give taxpayers who are entrepreneurs an advantage over taxpayers who are employees and do not have a private corporation available for tax planning purposes. Thus, Finance Canada is considering approaches

¹⁶ Nathan Boidman and Michael Kandev, Volume 87, Number 10 – September 4, 2017 issue, as cited by Brian Bloom, Davies Ward Phillips & Vineberg LLP, in a memorandum dated September 5, 2017.

¹⁷ [https://www.ic.gc.ca/eic/site/061.nsf/vwapj/KSBS-PSRPE_June-Juin_2016_eng.pdf/\\$FILE/KSBS-PSRPE_June-Juin_2016_eng.pdf](https://www.ic.gc.ca/eic/site/061.nsf/vwapj/KSBS-PSRPE_June-Juin_2016_eng.pdf/$FILE/KSBS-PSRPE_June-Juin_2016_eng.pdf), at pages v and vi.

¹⁸ See note 14.



that would treat tax savings held in corporations as equivalent to savings held directly by individuals.

As discussed previously, we do not believe that Finance Canada has established this assertion. If it is true, CPA Canada does not agree that this necessarily creates a problem. Further, simply comparing employees and business owners primarily on the basis of tax rates is superficial.

In comparing employees and business owners, a key difference is that most entrepreneurs do not benefit from employer-sponsored pension plans and the related tax benefits. Although it is technically possible for incorporated owner-managers to use Registered Retirement Pension Plans (RRSP) or Registered Pension Plans, many small business owners who structure their business through an incorporated entity rely on the CCPC to fund a key portion of their retirement savings. There are many reasons for this, but a key consideration is flexibility.

If an owner-manager accumulates savings in an RRSP, for example, this creates a significant barrier if the owner-manager later wants to use those savings in the business. Current rules prevent RRSPs from holding an investment in the business. Also, if funds are withdrawn from the RRSP, tax would be payable, reducing the funds available and effectively eliminating future RRSP contribution room.

Holding funds in the corporation is far more flexible. Funds can be used in the business as needed and reinvested in passive assets when they are not. Retained earnings and passive assets also allow businesses to leverage these assets for third-party bank debt more easily than active business assets, which may not be liquid. A build-up of passive investments can allow the owner to take bigger risks, or to exit the business and join a start-up company for reduced compensation so the start-up can benefit from the experience and expertise of the entrepreneur during years when it has little or no income.

Further, entrepreneurs often incorporate their business for a variety of reasons that have nothing to do with taxes. For example, many people decide to incorporate to secure legal liability protection or satisfy requirements of investors or lenders.

“Business owners are not in it for the tax shelters! These are people who are working for equity and not much else. Quite often there is very little at the end of the year for the entrepreneur to “draw a wage”. Cash flow is sacrificed in order to build a business, debt is incurred to acquire equipment, lives are stretched and hours are long.”

– Comment from CPA in Saskatchewan

Finance Canada's consultation paper states that "corporate income is taxed at lower rates than personal income, giving businesses more money to invest in order to grow their businesses, find more customers and hire more people."¹⁹ However, the proposed changes create a distortion between capital assets and financial assets and assume the latter hold no economic value. Money held in passive investments can still serve to promote business investment and job creation; the distinction is that passive investments facilitate other businesses in the economy to do so.

Having the option of holding retained earnings in passive investments also allows business owners to deal with economic fluctuations and uncertainty by providing funds when the business is not as profitable and by facilitating planning for future investment.

The proposed changes – which would impose a deferred taxation approach – could diminish the incentive to hold passive investments and accept investment risk, encouraging owners to hold shorter-term assets that provide little financial benefit to the broader economy. As demonstrated in Appendix 4, the effective tax rate that could apply on passive income earned would be extremely high under the proposed changes.

If the changes are implemented as proposed, CPA Canada believes that a wide range of new rules would be needed to maintain both fairness and integrity.²⁰ In addition to the economic cost, we believe that a new system would create significant compliance costs, create uncertainty and lead to a less favourable business environment that would impede Canadian entrepreneurship and competitiveness.

The government also needs to provide a reasonable transition period for individuals and their companies to plan for the change in this tax regime. Unlike employees who receive a regular paycheque, the earnings of self-employed entrepreneurs tend to fluctuate, with periods of high earnings followed by periods where little or no income is earned. Accumulating cash through private corporations provides practical protection to help entrepreneurs build a much-needed reserve to manage the uncertainties of their income flows. This transition could be more complex than expected. For example, how would accrued capital gains on passive investments be treated once the rules are effective?

¹⁹ Supra note 1, at p. 32.

²⁰ See material from the presentation by Bruce Ball, Jeffrey Trossman and Alexandre Laurin at the Canadian Tax Foundation Tax Policy Conference on September 25, 2017. The presentation outlines a number of complex rules that may be needed. See the submission made by the Joint Committee.



Passive investments – recommendations

In short, CPA Canada does not believe that Finance has made a compelling case for the need to introduce such complex rules. We are concerned that such proposals would create significant complexity that is disproportional to the additional revenue that would be raised.

In addition, CPA Canada believes this aspect of the July 18 proposals would likely be unnecessary if the preceding proposals on income splitting and conversion of business income to capital gains are appropriately implemented. In the absence of these tax planning options, it seems likely that much of the passive income retained in corporations would be ultimately paid to their owners and taxed as dividend income. If the other July 18 proposals proceed, CPA Canada does not believe that the amounts of retained passive income involved would warrant the complexity and compliance burden associated with the July 18 proposals in this area.

RECOMMENDATION: CPA Canada recommends that the federal government take steps to minimize complexity as follows:

- **If the proposals on income sprinkling and the conversion of income into capital gains are finalized, conduct a more detailed review on whether the passive income proposals are needed when the cost and complications created by those proposals are considered.**
- **If passive income rules are deemed necessary:**
 - **undertake further study and analysis to define “small business” for purposes of the passive investment rule (e.g., annual business income under \$150,000) and promote simplicity by including a de minimis rule to exclude small businesses from the application of any new rules in this area**
 - **promote certainty by establishing a safe harbour for companies that maintain a reasonable portion of their assets in passive investments relative to active business assets that are incidental to or necessary for the business, for example, by using a variation of the current definition of a small business corporation (e.g., a straightforward 80 per cent test)**
 - **promote procedural fairness by providing a reasonable transitional period (e.g., two years) and comprehensive transitional rules for individuals and their companies to plan for the change in this tax regime.**



CONCLUSION

CPA Canada is concerned that the July 18 proposals would complicate an already complex *Income Tax Act* and lead to significant unintended consequences. Further, it appears that that ordinary, middle-class taxpayers, including the entrepreneurs who are running the small businesses that largely drive the Canadian economy, might be economically harmed the most.

“The changes that have been announced are not tweaks but represent full tax reform. Taxation is comprised of highly complex principles that take time, thoughtful consideration and communication to develop - none of which have been reasonably provided to the Canadian public, thus far.”

– Comment from CPA in Newfoundland and Labrador

When any new tax law is proposed, there should be a detailed, constructive, two-way consultation with all parties affected. In this case, the short consultation period, its summertime launch and the release of draft implementing legislation lead CPA Canada to believe such consultation has not occurred.

The government should provide statistical data to help stakeholders understand the scope, rationale and possible implications of the change on taxpayers of all income levels. The government should also allow enough time for stakeholders to evaluate the proposals and provide detailed input on how the proposals will affect them. Finally, if more time were allowed to study the proposals, it is possible that additional economic data may emerge that would help guide the decision making process.

CPA Canada further submits that the July 18 proposals represent the sort of piecemeal changes that have been accumulating over time to the detriment of the efficiency and effectiveness of the Canadian income tax system.

Conclusion – recommendation

RECOMMENDATION: Instead of layering on ever more complex tax rules, CPA Canada recommends a comprehensive review of the tax system. CPA Canada has recommended such a review for many years, including in our annual pre-budget submissions to the Government of Canada. We are supported in this view by many other national organizations, leading think tanks, economists, academics and the House of Commons Standing Committee on Finance.

CPA Canada would be pleased to discuss these recommendations further with Finance Canada officials. CPA Canada and its members would also welcome the opportunity to assist Finance



Canada in refining the current proposals and in undertaking the more comprehensive tax reform that is required and long overdue.



APPENDIX 1

LETTER TO DEPARTMENT OF FINANCE CANADA, AUGUST 17, 2017

August 17, 2017

Mr. Paul Rochon
Deputy Minister
Finance Canada
90 Elgin St
Ottawa, ON K1A 0G5

Via email: paul.rochon@fin.gc.ca

Dear Mr. Rochon,

Re: Request for an extension to the consultation period beyond Oct. 2, 2017

Finance Canada's consultation on Tax Planning Using Private Corporations

Chartered Professional Accountants of Canada (CPA Canada) respectfully requests that the Department of Finance Canada consider extending the 75-day consultation period provided for the Tax Planning Using Private Corporations proposals issued on July 18, 2017.

We believe that the 75-day period for comments, with a closing date of October 2, 2017, is unreasonably brief and insufficient for CPA Canada's submission to thoroughly address all of the complexities associated with the proposed changes affecting income sprinkling, passive investment income and capital gains, as outlined in the Department's consultation paper.

CPA Canada represents the Canadian CPA profession, with more than 210,000 professional accountants working in all sectors of the economy across the country and around the world. Our members include tax intermediaries who taxpayers count on to represent their interests with integrity and competence and to help them comply with Canada's complex tax laws.

CPA Canada is engaging in consultations with our membership and other stakeholders, including small businesses across the country, many of whom have indicated to us that the implications of the proposals are far reaching and could have unintended consequences. The timing of the consultation period, spanning the summer months, has frustrated the ability to assemble and engage stakeholders. The



brevity of the period does not leave enough time for a substantive consideration of the proposals' transitional provisions.

Our experience with other recent complex legislative change, such as to the rules restricting access to the small business deduction and to section 55(2) of the *Income Tax Act*, shows that early and extensive consultation is a key to balancing fairness and complexity. Broad consultation can help ensure that legislation meets its objectives without unexpected and burdensome effects.

By extending this 75-day consultation period, the Department can help ensure all of the issues raised can be thoroughly researched and analyzed and the potential impacts on Canadian businesses and individuals can be properly identified and estimated. CPA Canada is not alone among stakeholders in urging the government to allow a more reasonable consultation period.

We would welcome the opportunity to discuss this issue with you further.

Yours truly,

Original signed by

Joy Thomas, MBA, FCPA, FCMA, C.Dir.
President & CEO

c.c. Mr. Andrew Marsland
Senior Assistant Deputy Minister, Finance Canada

Mr. Brian Ernewein
General Director, Finance Canada

Mr. Gabe Hayos
Vice-President, Taxation, CPA Canada

Mr. Bruce Ball
Incoming Vice-President, Taxation, CPA Canada

APPENDIX 2

EXAMPLE: TOTAL TAXES ON INTEREST INCOME

This table shows the integrated taxes paid by various ownership structures based on 2017 Ontario tax rates.

| | Public Corporation | CCPC | | | Individual |
|------------------------------------|--------------------|--------------|------------------------------------|--|--------------|
| | | Current | As proposed: Eligible dividends | As proposed: Other-than-eligible dividends | |
| Interest income | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 |
| (Corporate tax) | (26.50) | (50.17) | (50.17) | (50.17) | - |
| Refundable tax | - | 30.67 | - | - | - |
| Cash | 73.50 | 80.50 | 49.83 | 49.83 | 100.00 |
| (Personal tax) | (28.91) | (36.47) | (19.60) | (22.57) | (53.53) |
| Net Cash | 44.59 | 44.03 | 30.23 | 27.26 | 46.47 |
| Total taxes | 55.41 | 55.97 | 69.77 | 72.74 | 53.53 |
| <i>(Tax deferral disadvantage)</i> | - | (23.67) | (23.67) | (23.67) | (27.03) |

Observations:

- 1 - Public corporations continue to receive a tax deferral benefit of 23.67% over CCPCs and 27.03% over individuals.
- 2 - A CCPC already pays more total tax than individuals and public corporations. For "fairness", this will be increased another 30%.
- 3 - Canadian entrepreneurs often use profits from one company to grow others. Will tax rates of 72.74% justify the investment?

APPENDIX 3:

CLEAR CHANGES IN TAX POLICY: ANALYSIS OF TWO PROPOSALS

The examples below demonstrate why two of the July 18 proposals – the proposed expansion of the tax on split income and the broadening of the rules in section 84.1 of the *Income Tax Act* – should be considered and implemented as changes in tax policy, not loophole closing. As tax policy changes, they should be implemented following a transparent process of broad consultation, with appropriate transitional relief and grandfathering.

“I agree with the comments of others who find the use of language ‘closing tax loopholes’ etc. as problematic. It is unhelpful language. It makes it sound like the tax community and their private company clients were engaged in ‘inappropriate’ tax planning. This is clearly not the case.”

– Comment from a CPA in Ontario

Example 1: Extending the tax on split income rules to adult family members

When the TOSI was introduced in the 1999 federal budget by the government of the day for application in 2000 and later tax years, the government stated that “the scope of this new measure is narrow; it targets those structures that are primarily put in place to facilitate income splitting with minors.”²¹

At the time, the government was fully aware that similar planning was being used for family members aged 18 and older, including for spouses in particular as this has been dealt with in previous tax cases.²² However, a clear policy decision was made to specify that income sprinkling with minors was unacceptable and that a legislative change was needed to address that. That change specifically excluded income sprinkling with older family members.

By proposing to extend the TOSI to adult children 17 years after the original proposals were enacted, the current government is clearly changing tax policy. CPA Canada respectfully suggests that the income sprinkling proposals should be presented as such, rather than stating that some

²¹ Department of Finance Canada, 1999 Federal Budget Plan, Tax Measures: Supplementary Information.

²² See *Melville Neuman v. Her Majesty the Queen*, 98 DTC 6297 and *Her Majesty the Queen v. Jim A. McClurg*, 91 DTC 5001.



Canadian taxpayers have been inappropriately taking advantage of tax policy reflected in law currently on the books.

Example 2: Expanding section 84.1 to deny the cost base for fully taxable gains

In 1985, the federal government replaced the rules in section 84.1 of the *Income Tax Act* with a requirement to reduce paid-up capital or immediately recognize a dividend on certain non-arm's length share transfers to a corporation. Since it was now possible to receive proceeds of disposition from a non-taxable capital gain, the government recognized the need for "an anti-avoidance rule designed to prevent the removal of taxable corporate surplus as a tax-free return of capital through a non-arm's length transfer of shares by an individual resident in Canada to a corporation."²³ This rule also covers the tax-free treatment afforded under the so-called Valuation Day rules.

The July 18 proposals would expand the rules in section 84.1 to apply to situations where corporate surplus is realized as a taxable capital gain. This is clearly well beyond the original policy intent: section 84.1 was designed solely to deal with non-taxable gains.

As is typical for tax changes designed to close loopholes, the proposed change to section 84.1 would apply with only limited grandfathering. In particular, where shares have cost base related to gains of non-arm's-length persons that were already taxed before July 18, 2017, the transfer of the shares to a private corporation would generate a taxable dividend or a paid-up capital reduction. This treatment would apply to (among others) situations where the gain was previously triggered and taxed due to the death of a shareholder and the beneficiary who now owns the shares plans to sell them or enter into so-called "pipeline planning" to avoid double taxation.

This result is inequitable and breaches the principle of procedural fairness.

²³ Department of Finance, Technical Notes to Section 84.1, May 1991.



APPENDIX 4:

EXAMPLE: IMPACT OF SURPLUS STRIPPING PROPOSALS ON POST-MORTEM PLANNING

John inherited shares of an operating company (“Opco”) when his father David passed away in January 2016. At the time of David’s death, the shares of Opco had a nominal adjusted cost base and paid-up capital. After David’s death, John was advised that the most efficient way to avoid double taxation on the shares of Opco was to either sell the shares to a third party or enter into so-called “pipeline planning,” which is sanctioned by the CRA in certain conditions. This planning would allow the cost of the Opco shares to be converted into debt or paid-up capital, allowing John to realize the value of Opco (up to its value on David’s death) as a tax-free repayment. The Canada Revenue Agency allowed this planning because the gain had previously been taxed on David’s final tax return.

The July 18 proposals offer no grandfathering to someone in John’s position. If he were unable to sell Opco, double tax would likely arise. If we assume that John liquidates Opco for proceeds equal to the value of the shares at the time of David’s death, John would realize a deemed dividend and a capital loss equal to that value. Assuming that John will not utilize the capital loss and John and David are taxable at Ontario’s top rates, the combined tax rate that would apply on the value of Opco could be as high as 72 per cent – which is clearly unacceptable.²⁴

This example also highlights a further concern. If the pipeline approach is no longer available to eliminate double taxation, we believe that the operation of subsection 164(6) of the *Income Tax Act* is too restrictive. First, any loss generated by an estate needs to be generated during the estate’s first taxation year to be eligible to be applied on the final tax return of a deceased individual. It would also be necessary to create a disposition giving rise to a loss.

²⁴ In 2016, the top Ontario marginal tax rate on a capital gain was 26.76 per cent. The current top tax rate on an ineligible dividend is 45.3 per cent.



APPENDIX 5

ARE THE PASSIVE INCOME CHANGES NEEDED?

Finance Canada’s July 18, 2017 consultation paper includes an example using theoretical tax rates that assumes a corporation earns \$100,000 of business income eligible for the small business deduction and the after-tax amount is invested for 10 years, generating interest at a rate of 3 per cent annually. After 10 years, the retained earnings of the corporation are paid out as a dividend. This result is compared to the result where an individual earns the business income personally, reinvests the after-tax income and realizes the same rate of return.

CPA Canada submits that any analysis on tax rate effects must use actual tax rates. Since this analysis was not provided, we have recalculated the amounts under the same scenarios using actual tax rates for each province. In addition, we performed the same calculations on the assumption that the \$100,000 of business income was taxed at the general rate.

| 10-year return on income using actual versus theoretical tax rates: General rate business income | | | |
|---|--------------------------|--------------------------------|----------------------------|
| Province | Income earned personally | Income retained in corporation | Advantage/ Disadvantage |
| British Columbia | \$61,110 | \$62,015 | \$905 |
| Alberta | 60,706 | 60,755 | 49 |
| Saskatchewan | 61,043 | 62,536 | 1,493 |
| Manitoba | 57,495 | 55,506 | -1,989 |
| Ontario | 53,370 | 54,885 | 1,515 |
| Quebec | 53,658 | 54,575 | 917 |
| New Brunswick | 53,671 | 56,858 | 3,187 |
| Nova Scotia | 52,757 | 49,344 | -3,413 |
| Prince Edward Island | 56,209 | 55,069 | -1,140 |
| Newfoundland and Labrador | 56,302 | 49,902 | -6,400 |
| Finance Canada’s assumed rates | 57,535 | 60,457 | 2,922 |



| 10-year return on income using actual versus theoretical tax rates: Small business income | | | |
|--|------------|-------------|----------------------------|
| Province | Personally | Corporation | Advantage/ Disadvantage |
| British Columbia | \$61,110 | \$65,113 | \$4,003 |
| Alberta | 60,706 | 64,555 | 3,849 |
| Saskatchewan | 61,043 | 66,485 | 5,442 |
| Manitoba | 57,495 | 61,025 | 3,530 |
| Ontario | 53,370 | 58,510 | 5,140 |
| Quebec | 53,658 | 57,549 | 3,891 |
| New Brunswick | 53,671 | 58,095 | 4,424 |
| Nova Scotia | 52,757 | 56,993 | 4,236 |
| Prince Edward Island | 56,209 | 59,279 | 3,070 |
| Newfoundland and Labrador | 56,302 | 60,766 | 4,464 |
| Assumed rates used by Finance Canada | 57,535 | 63,207 | 5,672 |