TAX PLANNING USING PRIVATE CORPORATIONS

10/2/2017

Submission by the St. John's Board of Trade

Executive Summary

The St. John's Board of Trade believes the proposed changes will have significant negative impacts on Canadian businesses, the middle class and women:

- Higher taxes;
- Increased administrative burden on small & medium sized enterprises;
- Financial impact on family-run businesses; and
- Reversing gender parity gains.

We believe the impact of these changes are not yet fully understood by tax professionals, taxpayers or the Department of Finance, and that a significantly longer consultation period is required.

Recommendations:

1. Stop the Proposals until the impacts can be fully understood.
2. Extend the consultation period. The length of consultation should be commensurate with the degree of wholesale changes proposed. A 12 to 18month consultation period would be consistent with the significance of the changes being proposed, and would allow for meaningful consultation.
3. Establish a royal commission on taxation to undertake a comprehensive review of the taxing statues guided by the principles of simplification and modernization, with a goal of reducing compliance costs to enhances Canada's competitiveness.
4. Establish a standing committee with active representation from the SME community to support the commission by continuously monitoring changes and publicly reporting progress at least annually.
5. Consider proper grandfathering and phasing-in of changes in the taxation system of small businesses.
6. The Proposals must undergo a gender-based analysis.
7. The Proposals must recognize and reflect the importance of small business to the economic engine of the country.
8. The Proposals, particularly in the area of succession planning must take into consideration the real restrictions present in rural areas of the country.

Tax Planning Using Private Corporations

SUBMISSION BY THE ST. JOHN'S BOARD OF TRADE

We thank the Department of Finance (the "**Department**") for soliciting views on the 2018 Tax Planning Using Private Corporations proposals (the "**Proposals**") and the opportunity to provide recommendations. The St. John's Board of Trade is committed to helping business succeed. Accredited nationally with distinction, we are a non-partisan business advocacy organization that is the principal voice of business in the St. John's area. We believe a strong, vibrant private sector is critical for Newfoundland and Labrador's future.

We believe that to have a robust private sector, the Government of Canada ("**GoC**") must invest wisely in critical infrastructure, efficiently run its operations and keep taxes at rates that encourage investment and consumer spending.

We are very concerned about the impacts of the Proposals on our members and small business in Canada, many of whom represent the middle class. The GoC claims it values the contributions that small businesses and entrepreneurs make to the Canadian economy. Our members believe the tone, language in, and minimal consultation period on, the Proposals do not support that claim.

The Prime Minister, Minister of Finance and other leaders have stated that the Proposals are merely "closing loopholes" available to the wealthy. Rather than close loopholes, the Proposals constitute major tax reform which will impact all private business operating in NL, regardless of size and level of wealth. A 75-day consultation period is simply not sufficient to allow for in-depth analysis of the Proposals' impacts on small businesses and individuals who work in or own those businesses. We are unaware of any cogent argument for such a short consultation period. Any major tax reform must have a consultation period sufficient to allow Canadians to digest the impacts, to create an informed view and then to make their views known. Fairness and openness, and a willingness to listen, requires the consultation period be extended, allowing the GoC to form a committee of experienced individuals to fully understand the impacts, and provide advice to the Department. Even a change in the treatment of Cash Purchase Tickets in the farming industry had a consultation period of 124 days, yet major tax changes deserve only 75 days? The Minister has said that GoC has been looking and working on these changes for the past 18 – 24 months. Why are those affected not given ample time?

The Prime Minister, Minister of Finance, other leaders and the Department have compared employees to business owners throughout their communications on the Proposals. There are fundamental, incontrovertible differences between these types of taxpayers – differences which have traditionally been reflected in tax legislation. Quite simply, employees and business owners do not face the same circumstances. Assuming they do ignores fundamental differences and will result in unfair treatment of small business owners that will inhibit investment by the risk taking entrepreneurs that are the life blood of the Canadian economy.

Small business owners:

- risk their capital, and often that of their families;
- fund their own benefits (including maternity leave, vacation pay, health coverage and retirement);
- pay for business expansion;
- maintain reserves to keep the business operating in economic downturns;
- find financing; and, perhaps most importantly
- act as the key economic driver by creating jobs for others.

These significant differences between employees and business owners require an acknowledgement that their tax positions are not comparable. The Minister of Finance has stated that the proposed rules will "level the playing field" between business owners and employees. The reality is that the playing field **is** fundamentally different – how does identical tax treatment level the playing field?

The Prime Minister, Finance Minister and other leaders have repeatedly said that a person making $250,000 should not pay less tax than another making $50,000. Corporate tax is a minimum of 13.5% in NL (assuming no tax paid on sprinkled dividends). On $250,000 the minimum corporate tax paid will be $33,750. An individual earning $50,000 in employment income in NL will pay a little under $13,000. Research and statistics indicate the number of actual taxpayers in the government's example is miniscule, yet it is put forward as justification for the Proposals. The justification is defended by stating assumptions around "maximum RRSP and TFSA contributions" along with other assumptions that flow from a best-case scenario.

The Canadian tax system, particularly with respect to taxation of private corporations, is already quite complex, and in many cases, requires people to pay for the service of specialists simply to ensure compliance. For example, the recent changes to subsection 55(2) of the Income Tax Act ("**Act"**) have added a large degree of uncertainty and confusion to what was once a straightforward task of paying an intercorporate dividend. The ability of small business owners to comply with the Proposals 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 and to assess reasonableness. General compliance costs will increase for most small businesses, and it may be difficult for smaller, low-margin businesses to afford these increases. As examples:

- The income sprinkling sections include a reasonableness test that would require in depth analysis to determine the financial and labour compensation of related parties; and
- The anti-avoidance rules in contained in the Proposals are extremely broad and will create uncertainty for small businesses.

This increased level of complexity and uncertainty for small businesses will have a significant negative effect on growth in the NL economy.

We are concerned that the GoC has not considered the significant costs that the Canada Revenue Agency ("**CRA**") will incur to meet the compliance requirements discussed briefly above. How much of the stated $250 million revenue gain from the Proposals will be wasted on:

- Hiring more CRA auditors and other employees to audit, administer and enforce the Proposals;
- Litigation costs around the definition of "reasonableness" and its application to a myriad of situations; and
- Potential Charter arguments surrounding gender bias in the Proposals.

We believe that the Proposals will result in unfair treatment of intergenerational transfers, and provide an incentive for a small business owner to sell to a stranger rather than their daughters or sons.

Stated concisely, we believe the Proposals to be ill-advised, will decrease investment and employment, promote gender imbalance and cost more to the economy than the tax gains they will achieve. Shouldn't there be more time to think this through?

The rest of our submission will provide more technical detail on our position, and give specific examples of the harm these Proposals will cause. The examples we provide are not from textbooks, accounting journals or academic exercises. They are real life examples from our members – small and medium sized enterprises who will bear the brunt of the costs.

INCOME SPRINKLING – UNINTENDED CONSEQUENCES

> *"We will consider the gender impacts of the decisions we make," the Liberal platform promised. "Public policies affect women and men in different ways."*
> *Minister Morneau*

The Proposals introduce significant changes to the current income sprinkling rules which already contain provisions to prevent what is considered inappropriate income splitting between family members. The Proposals could have retroactive application – a result that is punitive since income earned and tax planning put into place under a different regime will suddenly be subject to different rules. The retrospective nature of the legislation runs counter to the concept of integration if the dividends are taxed as noted in the proposals. 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.

<u>Technical Concerns</u>

The Proposals give rise to a number of specific, technical concerns and unintended consequences in the income sprinkling area:

- The definition of split portion looks at relevant factors to consider when determining whether a particular amount exceeds what would have been paid to an arm's length party. One of the 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. 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. This appears to be an unintended consequence – it is counterintuitive that an amount paid by an individual as consideration for shares would be excluded from amounts they could tax effectively remove from the business.

- 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 are vague and will lead to uncertainty in interpretation. As an example, the reasonableness tests contained 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 is “substantial”? How are specialized skills be taken into account? They may be of significant value but not require regular continuous and substantial activity. A more specific test that reflects the value of a contribution would lead to less ambiguity.
- 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. These will serve to increase compliance costs on small business owners. the application of the Proposals with respect to intergenerational transfers will be challenging, particularly when it comes to measuring the relative contributions by the next generation. For example, one of the proposed new changes includes 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?

<u>Gender Neutrality Concerns</u>

The GoC has stated repeatedly that it is committed to gender neutrality. These Proposals will directly and negatively impact women. The consultation paper states that over 70% of small businesses are led by men. Since the proposals are aimed at related individuals who do not lead the business, such as the business-owner’s spouse and children, women and young Canadians make up the vast majority of the targeted population. Many families make sacrifices and decisions to support their family unit with one parent staying home to handle the domestic requirements so that the other spouse can commit the long hours required to establish and grow the business in the hope of financial independence. The income sprinkling proposals serve only to harshly punish these families and send the message that these choices are neither valued nor supported by the GoC.

The Government’s position flies in the face of family law principles, where matrimonial assets are shared equally regardless of which spouse accumulated the wealth. The principle is clear - a couple works together to build family wealth by each taking on certain responsibilities best suited to their skills and interests.

We find it ironic that when the Prime Minister was questioned about the appropriateness of using taxpayer's money to fund nannies to care for his children, the justification was that his role demanded his spouse attend events and accompany him at times, demonstrating his understanding of the demands of his role and the importance of the support of his spouse to ensure success. We agree. However, it seems that he does not share the same view of the importance of spouses who support small business owners. This is a double standard – and it is not acceptable.

Example 1 – Mr. & Mrs. Smith – Dividend Sprinkling

Mr. and Mrs. Smith operate a local bakery in St. John's. They originally incorporated the business a number of years ago and each contributed $50,000 for half of the common shares. Their seed capital allowed them to start the business. Mr. Smith performs the bakery operations while Mrs. Smith operates the retail side of the business. The business earns approximately $100,000 in taxable income each year so the corporate taxes are $13,500 at the combined small business rate of 13.5%. If they decide to each take a $43,250 dividend (remaining cash after corporate tax) their combined tax will be approximately $11,000 (ignoring all personal credits aside from the dividend tax credit). The combined $86,500 in family income puts them in the GoC's definition of middles class, and they should therefore not be affected by the proposal. In comparing the overall tax burden between the two shareholders versus employees, the same initial $100,000 would generate approximately $25k in tax if each spouse earned $50k in salary versus $24k if each took the dividends. Factoring in the ability to build RRSP room for the salaried employee, the amounts are comparable if even slightly tilted to the salaried employee

Mrs. Smith decides to leave the business and stay home to start a family. Mr. Smith has to now put in longer hours but the tradeoff is worth it to allow Mrs. Smith to stay with the couple's young children. the Proposals would have Mr. and Mrs. Smith both considered specified individuals, and would assess if either of them were receiving split income. This would depend on whether or not the dividends each receive are an excluded amount which is only possible if no portion of the dividend is a split portion. They would have to determine what a "reasonable" dividend would be with regards to functions performed, assets contributed, risks assumed by each and amounts previously paid to them.

All of this would involve an intensive analysis of the history of the business along with reviewing where the initial $50k seed money originated from for each person. For example, if Mrs. Smith borrowed her initial $50k from a family member, it would be ignored for the purpose of the reasonability test. Even after they put in the work to determine what was reasonable, they are left at CRA's discretion on whether or not they are correct in their interpretation. This issue will come up each year the company wants to pay a dividend to its shareholders.

In the worst-case scenario, if Mrs. Smith's entire dividend was considered a split portion, the total taxes increase from $24k to $41k. This creates unfairness and does not recognize the family contribution to the business by both spouses. It also creates confusion, uncertainty, complexity and compliance costs that previously did not exist.

<u>Succession/Sale of a Business</u>

Another unintended result of the proposal is in the expanded definition of specified individual and the impact it has on the transfer of small businesses from parents to children. The unintended results from the Proposals would rarely, if at all, occur under the existing legislation as a specified individual is defined to be a minor child. If would be very uncommon to see a minor child in the position of vendor. The following are a few common situations to illustrate these points.

Example 2

Mrs. Smith started an office supply wholesale business in St. John's several years ago, successfully grew the business and then decided to retire, leaving the business to her children to continue to operate. The value of the business had grown significantly over the years resulting in a significant amount of goodwill. Over the years Mrs. Smith was actively involved in the business and paid herself a salary reflective of her contributions. In the past few years, Mrs. Smith's health has been on the decline so she has stepped away from the operations of the business.

Mrs. Smith decided to implement an estate freeze several years ago, where she exchanged her common shares for high value preferred shares having a low paid-up capital (PUC). New common shares were then issued to a family trust. Her plan was to eventually have the family trust distribute the common shares to the children and then have the corporation redeem the preferred shares over time to fund her retirement. The redemption of the preferred shares would trigger a deemed dividend equal to the difference between the redemption proceeds and the PUC of the shares redeemed.

Under the Proposals, it is unclear how Mrs. Smith's contribution will be determined given her 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 her preferred shares is the result of her contribution, the legislation does not provide such clarity and comfort and leaves her open to a challenge from the CRA.

The above is a very common estate planning mechanism for small business owners. In his September 5th contribution to The Globe and Mail, Minister Morneau stated "for those business owners and professionals who have saved and planned for their retirement under the existing rules, I want to be clear: We have no intention of going back in time. Our intent is that changes will apply on a go-forward basis and neither existing savings, nor investment income from those savings, will be touched." While this comment appears to refer to the taxation of passive income in companies, the intent of the Minister to apply rules on a go-forward basis to prevent Canadian individuals from having their current retirement savings taxed at a much higher rate than anticipated is not met in this example. Mrs. Smith could be paying tax a much higher than anticipated when the planning was undertaken. In this manner, the proposed legislation could in fact "go back in time" to increase tax on many small business owners' retirement planning.

Example 3

Now assume that Mrs. Smith has determined that the children are either not capable of, or not interested in, operating the family business. She has no desire to sell the business to anyone outside the family as she wants to preserve her legacy. As a result, she has hired a senior management team 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 Mrs. Smith's own issues regarding the redemption of her preferred shares, under the proposed rules, her children would have no way to extract funds from the corporation in a tax effective manner as long as she is alive. The children cannot draw a salary as they are not providing services to the business. Any dividends paid on their common shares will be subject to TOSI. Essentially, the next generation cannot extract funds from the corporation without paying a punitive rate of tax.

Example 4

Now assume Mr. and Mrs. Smith started a dry-cleaning business in St. John's and the common shares were originally issued equally to each spouse. Mr. Smith has been active in the business since its inception while Mrs. Smith has been employed elsewhere. An estate freeze was implemented with the plan being to fund their retirement by redeeming the preferred shares over time.

Under Proposals, it any deemed dividend received by Mrs. Smith on the redemption of her preferred shares will 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 because she chose to invest in the family business instead of an arm's length corporation which seems to be an unintended consequence of the Proposals.

Example 5

This example uses the same facts as Example 4, except that Mr. and Mrs. Smith intend to sell their preferred shares to their children as part of an intergenerational transfer of the business. Mr. and Mrs. Smith intended to benefit from the use of their available capital gains exemptions.

Under the Proposals, Mrs. Smith would not be able to utilize her capital gains exemption. In addition, any gain realized by Mrs. Smith 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. the Proposals make both Mr. and Mrs. Smith specified individuals. Fortunately for Mr. Smith, 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. Smith's capital gain, on the other hand, would likely not be an excluded amount, and 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.

A sale of shares to an arm's length third party would not lead to the same result. In this case, the gain realized by Mr. Smith 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 capital gains exemption. Mrs. Smith's gain would still be considered split income but only the taxable portion of the gain will be subject to tax at the highest personal tax rate. The Proposals severely penalizes intergenerational transfers by significantly increasing the tax paid when compared to an arm's-length sale to a third-party.

The amount of this additional tax paid should not be underestimated, and is shown in the following example.

Example 6

Assume that Mr. and Mrs. Smith are equal shareholders in a successful private corporation they started many years ago. Mr. Smith has been active in the business while Mrs. Smith 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. Smith have $180,000 of taxable income, excluding any income realized on this transaction.

If they sell to their son, the Proposals will recharacterize Mrs. Smith's $2.5 million gain into an ineligible dividend subject to TOSI, resulting in a combined income tax liability of $1,649,301.

If they sell to the third party, Mr. Smith will include in his income 50% of the $2.5 million capital gain and shelter a portion of it with his capital gains exemption. Mrs. Smith, unfortunately, will still be subject to TOSI, but only on the taxable portion of her $2.5 million capital gain. In this case Mrs. Smith'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 would be $1,212,190.

In summary, if Mr. and Mrs. Smith sell to their son, they will have $3,710,699 after tax to fund their retirement. They will be left with $4,147,810 if they sell to the arm's length party. This results in a clear bias to sell to an outside party versus keeping the business in the family.

Example 7

This example highlights an anomaly in the proposed rules. Under the Proposals, 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. At first glance, this seems to make sense. However, this carve out can lead to presumably unintended results under certain circumstances.

Here, Mr. and Mrs. Smith are equal shareholders of a private corporation that carries on the family business. Mrs. Smith has been actively involved in the business while Mr. Smith 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. Smith. will each realize a capital gain of approximately $4 million.

Mr. Smith's capital gain would be split income under the Proposals while Mrs. Smith's capital gain will not. In the year of sale, Mr. Smith'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. Smith's taxable capital gain will be included in his income as an ineligible dividend and taxed at the top personal rate. However, if Mr. Smith 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. Smith were to withdraw $60,000 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 $1,744,400 to $1,026,000. Surely this cannot be the intent.

<u>Pipeline Planning</u>

Under the Proposals, double taxation can result when a specified individual dies and is deemed to dispose of shares of a small business. Currently, this element of double taxation could be eliminated by carrying out what is known as pipeline planning, which the Proposals will eliminate. In order to continue to avoid the application of double taxation under the Proposals, there must be a redemption of shares or a winding up of the underlying small business in order to trigger a deemed dividend and a capital loss in the estate that can be carried back by the estate to the terminal return to offset the capital gain triggered on death. In effect, this converts what would otherwise be a capital gain on death into a dividend which can avoid the double taxation.

Under the Proposals, this planning is no longer available if the deceased was a specified individual and the resulting capital gain realized on the fair market value deemed disposition on death is considered split income. The new result would be:

1. A deemed disposition of the shares of the small business at their fair market value at the time of death of the specified individual.
2. The estate of the specified individual would acquire the shares at their fair market value.
3. Since the specified individual and the estate would not be dealing with each other at arm's length, twice the taxable capital gain is recharacterized as an ineligible dividend and reported on the terminal return as such.
4. If the specified individual's estate attempts to trigger the deemed dividend and capital loss, it cannot elect to carry the capital loss back to the terminal return since no capital gain has been reported.

The result is a significant increase in the overall tax burden for the family, as the following example illustrates.

Example 8

Assume Mr. and Mrs. Smith each own 50% of the shares of a holding company that owns shares of a publicly traded company having a fair market value of $1 million. These shares have a nominal cost base and were transferred to the corporation by Mr. Smith. As this is the only asset of the company and there are no liabilities, Mr. and Mrs. Smith's shares of the holding company have a total fair market value of $1 million ($500,000 each). Assume that the tax cost of Mr. and Mrs. Smith's holding company shares is nominal. Mr. and Mrs. Smith pass away and leave these shares to their children. In the year of death, Mr. and Mrs. Smith earned $180,000 of taxable income from other sources. On death, Mr. and Mrs. Smith are deemed to have disposed of their holding company shares at their fair market value triggering a combined $1,000,000 capital gain, $500,000 of which is reported on each terminal return.

Prior to the Proposals, the pipeline strategy could be used to eliminate the potential for double tax and preserve the capital gains treatment on death. If used, Mr. and Mrs. Smith's estates would have a combined tax liability of $387,815. Under the Proposals, the pipeline strategy is not available and the redemption strategy no longer works for Mrs. Smith's estate because the capital gain on death is converted to an ineligible dividend subject to TOSI. Without a capital gain to carry back to, it makes no sense to trigger the capital loss on the winding up of the holding company to convert the capital gain into a dividend. Instead, Mr. Smith's executors would redeem his shares in the holding company, taking half of the public company shares as the redemption proceeds while Mrs. Smith's executor does nothing. Mrs. Smith's estate is faced with a $284,620 tax liability because the capital gain is recharacterized as an ineligible dividend. When combined with the tax paid by Mr. Smith's estate, the total tax paid on death jumps to $478,675. There is still another layer of tax to be paid when the holding company sells the remaining public company shares, realizes a $500,000 capital gain and distributes the after-tax proceeds to Mrs. Smith's estate. This will create an additional tax of $134,175.

The total overall tax ends up being $612,850 versus $387,815 under current legislation.

Second Generation Income

The Proposals introduce the concept of second generation income as split income which appears to cause some unintended results. Second generation income includes income subject to TOSI, the attribution rules or capital dividends paid to a specified individual who has not yet attained the age of 24. The following details our concerns with the proposed legislation:

1. A specified individual that uses "tainted capital" to fund their own small business will be subject to TOSI on dividends that otherwise would not have been subjected to TOSI. Under both the existing rules and 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.
2. 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. 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.
3. The addition of second generation income in the proposed legislation 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.

Additional Considerations – Start-Ups

In the Proposals, 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. There appears to be an issue with this when a specified individual contributes a nominal amount of seed money to fund a startup company. If the specified individual does not make any further capital contribution, is not active in the business and assumes no risk, any dividends received from the business will be a split portion subject to TOSI. This also applies to any gain realized on the disposition of the specified individual's shares.

This result will greatly discourage family members from investing in startups in NL. Many of the startups we see in NL were seeded specifically by family members. If those same family members invested in a public company or in a startup private company that was arm's length, they could participate in the growth of the company and dispose of their shares with effective tax treatment. The situation worsens when considering capital contributions of specified individuals under the age of 24. The Proposals differs when considering a reasonable rate of return on capital contributions by a specified individual who has not attained the age of 24 before the year versus a capital contribution by a specified individual who has attained the age of 24 before the year.

HOLDING PASSIVE INVESMENTS INSIDE A PRIVATE CORPORATION – UNINTENDED CONSEQUENCES

"We need middle class Canadians to have money in their pockets to save, invest, and grow the economy – to bring back fairness and to strengthen the heart of the Canadian economy."
Prime Minister Justin Trudeau

The Department has indicated that its overall goal is to ensure the tax system is fair and neutral, so that taxpayers are indifferent whether they earn income through a corporation or directly. In substance, they want to ensure that shareholders and employees end up with the same-after tax savings in their personal bank accounts regardless of the source of the capital.

Integration

One of the key features of the Canadian income tax system that helps ensure individuals are indifferent whether they earn income through a corporation or directly, is the concept of income integration: all types of income ultimately attract the same level of tax whether earned through a corporation or by an individual directly.

In broad terms, when functioning effectively, the corporate tax + dividend tax approximates the tax paid by the employee.

However, to the extent the corporation does not pay a dividend to the shareholder, the dividend tax is deferred. This deferral is intended to provide corporations with additional capital to invest in their businesses.

If a company has excess funds and invests in passive investments instead of its business, the Department is fearful of additional saving opportunities that accrue to a private company that are not available to an employee. Because private corporations start with greater after-tax earnings than employees, they can acquire a larger pool of passive investments if they so choose. In order to maintain the fairness and neutrality of the tax system, Finance would like to eliminate this opportunity.

However, in the Proposals the Department has not indicated that it has considered or given weight to the myriad of other factors that a business owner currently considers when choosing to retain passive assets in their active business. A non-exhaustive list would include:

- Operational risks;
- Business cycle concerns;

- Borrowing capacity;
- Meeting covenants on its existing debt;
- The owner's risk propensity;
- Stage of business life-cycle; and
- Longer term expansion plans.

There has been no acknowledgement that the business owner, in retaining the assets in their business, has assumed a higher level of risk than the "employee investor" – who only faces investment risk – in that the assets retained in the business are also subject to claims by creditors during a business downturn where all assets of the business may be exposed or completely depleted.

Has the Department, in its efforts to eliminate this "opportunity", considered fully the additional costs of compliance and enforcement, the fundamental paradigm shift facing business owners as they are encouraged to distribute passive capital from our small business engine, and the inherent increase in risk to the Canadian economy as businesses reduce their available capital? The one-dimensional approach in the Proposals leads us to think it has not.

The Proposal

The Department's proposed solutions to "resolve" this opportunity (the "Apportionment Method" or the "Elective Method") are cause for concern and, in the absence of draft legislation, leave more questions than answers.

Apportionment Method

One goal of sound tax policy is simplicity. The Proposal has an apportionment method that would add an additional level of bewildering complexity to the small business owners' already heavy compliance burden.

It would require a multi-dimensional tracking of after-tax income taxed at the small business rate and general corporate rate, and amounts contributed by shareholders in three separate pools. Annual passive investment income of the corporation would then be apportioned to these pools based on the corporation's opening balances in the pools. Dividends could be designated from these pools, it would appear at the discretion of the company:

- Non-eligible dividends (from small business rate pool)
- Eligible dividends (from general rate pool)
- Tax free dividends (from shareholder contributions pool)

We also understand this method would maintain the same tax rate on investment income (i.e. ~53.67%), but eliminate the Refundable Dividend Tax on Hand (RDTOH) mechanism when dividends are paid. As well, public company dividends would not automatically be eligible dividends and the non-taxable portion of capital gains may no longer form part of the Capital Dividend Account (CDA), but will be apportioned using this method.

We are left with many questions:

1. Assuming the rules will be applicable on a go-forward basis – will the current value of equity be considered a "shareholder contribution"?

If so, this would mean that current investments would be taxed as investment income, but after-tax income could be distributed tax free to shareholders. Effectively this would tax investment income at around ~53.67%. However, if the individual shareholder is not at highest tax bracket – there is a tax cost – even if paid out of the "shareholder contribution" pool. How does the Department propose to deal with this apparent inequity?

2. How will intercompany loans be treated?

3. How will loans from corporate shareholders be treated?

4. As business owners will have to consider TOSI on dividend planning, is the business able to allocate tax-free dividends from the shareholder contribution pool to non-active shareholders to avoid TOSI?

Default Treatment / Elective Method

As an alternative to the apportionment method, the Department has indicated it could introduce a method whereby private corporations would be subject to a default treatment, unless they elect otherwise.

The choice between the default tax treatment or the elective treatment would determine whether passive income would be treated as eligible or non-eligible dividends when distributed to shareholders, without the need for tracking.

We understand that under the default tax treatment, passive income earned in a CCPC would be subject to non-refundable taxes (at rates equivalent to the top personal tax bracket), and dividends distributed from such income would be treated as "non-eligible" dividends. This method lends itself to several troubling concerns and potential unintended consequences:

- While corporations taxed under this default tax treatment could earn income taxed at the general rate, it would implicitly be assumed that the passive investments and related income is funded using earnings taxed at the small business rate.
- It also assumes that shareholders' contributions are not used to fund passive investments.

Given the implicit presumption that passive income is funded with earnings taxed at the small business rate, the default tax treatment may not be suitable for corporations that only earn income taxed at the general rate (or if a significant portion of the income is taxed that way).

We understand that businesses that pay substantial tax at the general rate would be able to elect a tax treatment that would apply additional non-refundable taxes on passive income, and would treat dividends paid out from passive income as eligible for the higher dividend tax credit rate. However, this election would remove the corporation's access to the small business rate.

Presumably, corporations that are not otherwise eligible for the small business deduction would make the election. However, corporations eligible for the small business deduction would have to weigh the tax cost of foregoing the small business tax rate against their shareholders being able to pay less tax on dividends paid out of passive income.

As noted, above, under this method, the dividend tax rate will depend on the source of capital used to fund the passive investments, but provides no preferential treatment for passive income earned from shareholders' contributions (irrespective if election is made or not).

Taxation of Capital Gains

The Proposals, indicate that capital gains will continue to be taxed at a 50% inclusion rate. However, the non-taxable portion of capital gain will no longer be included in the capital dividend account ("**CDA**").

The Department is considering whether additions to the CDA should be preserved in certain limited situations – such as arm's length sale of a corporation (earning exclusively active income) owned by another corporation.

Yet, in a situation where a business owner, after years of using a building and land in an active business, decides to sell the assets at a gain there could be a very negative result. The Proposals will mean that the non-taxable portion of the gain would not be added to the CDA. Why should goodwill gains or capital gains on capital assets be treated any differently than shares of an Opco?

To illustrate some of the concerns that a business owner may have under the elective method in investing in passive assets that accumulate capital and will eventually realize a capital gain, as opposed to the Departments example that tracks only interest income, we have included an example (we have used current NL tax rates in the example).

Example 1:

In this example:

- Company A, owned by shareholder A, is a CCPC that earns $100,000 in pretax active income. For illustrative purposes, assume its small business rate of tax is13.5%, its investment income rate of tax is 53.7% and that it has an RDTOH rate of 30.7%%.
- Individual B also earns $100,000 and pays personal income tax of 51.3%.
- Non-eligible dividends are taxed at 43.62%
- Company A invests in a stock that accumulated value at 6% per year.
- The company chooses to hold the stock while it accumulates capital.

On the eventual realization of the capital gain under the new proposed default/elective method, there is potentially no availability of the CDA on the un-taxed half of the capital gain realized by Company A.

Under the default/elective method, Company A will have the same after-tax proceeds to reinvest in the stock. Under the current regime and the new proposed default/elective method Company A will have $86,500 to reinvest. The individual would have $48,700 to invest.

If Company A were to sell the stock after one year of capital appreciation, the effective tax rate based on the actual cash left in the individual's hands in similar under the proposed changes as it was under the current regime (current CCPC regime: 50.1%, Individual: 50.6%, Default/Elective: 51.6%).

However, if the company chooses to hold on to the shares for 20 years before eventually distributing to the shareholder, the loss of the ability to pay the non-taxed half of the capital gains out to the shareholder tax free from the CDA leaves a significant difference in the effective tax rate that the company pays. There would be an effective tax rate of 36.2% under the current CCPC rules, 38.0% for the individual investor, and 56.2% to the corporation under the default/elective method. It would eventually leave the shareholder in a significantly worse place overall as compared to the current rules.

Corporations Focused on Passive Investments

For investment holding companies, we understand that the Department envisions allowing those companies to make an election that would for the most part result in the status quo tax treatment that we have today.

One difference would be that all income generated by the private corporation, both active business income and investment income, would be taxed as passive income (and therefore taxed at a level that approximates the top personal income tax rate). We understand the existing refundable tax system would apply so that a shareholder ultimately pays the same level of tax as an employee when the income is paid out as a dividend.

The Department also suggests that dividends received by such a company may be subject to a refundable tax to the extent the dividend represents after-tax business income, being the difference between the top personal tax rate and corporate tax rate.

Lastly, while the Proposals do not specifically state that the non-taxable portion of capital gains could be distributed to shareholders tax-free in this situation, they do suggest that maintaining the current system could be envisioned. One would hope that this means the non-taxable portion of capital gains get added to the CDA. However, it is unclear.

Marginal Tax Rate of the Corporate Investor

The Department offers a "solution" to high income tax rates on passive income on page 51 of the Consultation Paper:

> "… a corporate owner that pays personal taxes at a level below the top marginal income tax bracket could have an incentive to withdraw corporate earnings not required for business reinvestments as they are earned, in order to invest in a personal savings account. This would maintain the ability to pay taxes on passive investment income at a lower rate" pg. 51

However, is this practical?

Let's assume Mr. X is a resident of NL and wishes to pursue Finance's suggestion. Mr. X is the sole shareholder of an active corporation that has excess cash flow while Mr. X personally has nil taxable income. The maximum amount of tax able to be saved by taxing the income on passive investments at lower graduated rates would be approximately ~$26,000.

Backing into the assumption that in order to have $202,800 of taxable income to take advantage of said graduated tax rates, Mr. X would have to have an asset base of approximately $4,056,000 assuming a 5% rate of return.

Double Hit

To illustrate the combined impact of the changes to both the income sprinkling rules and the taxation of passive investments, consider the following example.

Mrs. Jones and her husband owned a gas bar and convenience store in rural NL. Mr. Jones worked in the business his entire life until his untimely death in 2016. Mrs. Jones, while present in the business serving customers and even pumping gas, has never drawn a salary from the business for her efforts over the 25 years that she and her husband owned the business. They were equal shareholders in the business and had invested everything that they had to acquire the business 25 years ago and both signed banking agreements pledging their family home as security. Since her husband's death Mrs. Jones is intent on selling the business and is currently seeking a third-party buyer as her children are not interested in assuming the business. Mrs. Jones will sell her business to a third party so section 84.1 is not a concern in this example. One would expect based on the examples provided in our document that Mrs. Jones would not suffer any consequences of the proposed tax changes as she is not undertaking an intergenerational sale. However, Mrs. Jones will suffer tax consequences as a result of the proposed changes.

For purposes of illustrating the tax impact we will assume that Mrs. Jones will receive $ 800,000 on the sale of the business on either an asset or share sale.

Scenario 1 – Sale of Shares

If Mrs. Jones is successful in selling her shares of the business under the current tax rules, Mrs. Jones could avail of the onetime lifetime capital gains exemption of $ 835,000 available for Qualified Small Business Corporations. Mrs. Jones would be subject to an alternative minimum tax amount of approximately $46,000 and would then receive the net proceeds of $754,000 on which to live for the remaining years of her retirement.

Under the proposed tax changes, Mrs. Jones now must meet the arbitrary and undefined "reasonableness" test to avail of the lifetime capital gains exemption. As Mrs. Jones has not taken any direct remuneration from the business, and as the subjectivity of meeting this test is difficult at best, Mrs. Jones faces a potential taxation on the sale of her shares of $172,000.

The net additional tax to Mrs. Jones as a result of the proposed changes is $126,000. If Mr. Jones had not passed away, the taxation to the family would have remained at $ 46,000 as it would be anticipated that he would meet the exemption criteria as he had taken wages from the business over the past 25 years.

Scenario 2 – Sale of Assets

On a sale of assets, for simplicity, we assume the same $ 800,000 proceeds and that the tax basis of the assets sold results in a gain on sale of $500,000. Once again Mrs. Jones will be negatively impacted by the proposed changes.

Under the current taxation rules the company would pay corporate tax on the disposition of its assets in the amount of $ 135,000 (26.8%) and the remaining after-tax income in the business $665,000 would then be used to fund Mrs. Jones' retirement. As Mrs. Jones did not receive remuneration from the business, she has no available RRSP limit and as Mr. Jones is deceased the ability to use his unused RRSP room is lost. The funds remaining in the business will attract tax on its earnings at a rate of 53.67%. Mrs. Jones has no history of being paid a salary from the company and her original capital contribution, while representing 50% of the capital contributed, was nominal, so it is likely that she will be subject to the extended TOSI rules. As a result, she will pay personal income tax on any dividends she draws from the company at a rate of 43.6%. Under the new rules Mrs. Jones is unable to receive the accumulated CDA.

As is illustrated in the table below, under the new rules, the combined corporate and personal tax rate on the investment earnings is now 73.9%.

Total Taxes on Interest Income

This table shows the integrated taxes paid by various ownership structures using 2017 Newfoundland & Labrador Rates

	Public Corporation	CCPC			Individual
		Current	Liberal Plan: Eligible dividends	Liberal Plan: Other-than-eligible dividends	
Passive Income	100.00	100.00	100.00	100.00	100.00
(Corporate tax)	(30.00)	(53.67)	(53.67)	(53.67)	-
Refundable tax	-	30.67	-	-	-
Cash	70.00	77.00	46.33	46.33	100.00
(Personal tax)	(29.83)	(33.59)	(19.75)	(20.21)	(51.30)
Net Cash	40.17	43.41	26.59	26.12	48.70
Total taxes	**59.83**	**56.59**	**73.41**	**73.88**	**51.30**
(Tax deferral disadvantag	-	(23.67)	(23.67)	(23.67)	(21.30)

Oberservations:

1 - Public corporations continue to receive a tax deferral benefit of 23.67% over CCPCs and 21.3% 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 company to grow others. Will tax rates of 73.88% justify the investment?

If we assume that Mrs. Jones invests the corporate after-tax funds of $665,000 conservatively to earn 3% income, and we assume that she requires $40,000 annually after-tax cash to meet her expenditures, under the old rules, Mrs. Jones would have sufficient funds to do so until she reached approximately 85 years of age. Under the new rules, because of the additional tax liability at the corporate level and at the personal level, she will run out of money at age 75.

Many questions left unanswered

The Department has indicated that:

"It is the intent that the new rules would apply on a go-forward basis" pg. 51 (*"Once the new approach is determined … the Government will consider how to ensure that the new rules have limited impacts pm existing passive investments"* pg. 51). They have indicated that time will be provided before the new regime becomes effective subsequent to Finance's release of the detailed proposal of the new approach.

"It is envisioned that corporations with a mix of active and passive income could, for instance, choose to hold passive investments in a corporation that could elect into this tax regime" pg. 51

Overall, the Proposals leave us with many unanswered questions on how they plan to ensure limited impact on existing passive investments, for example:

- Grandfathering: will there be a new "V-day"?
- Is Finance expecting investment companies which make the passive election to be set up?

- How will income on those investments be taxed?
- How will unrealized accrued gains on those investments be taxed?
- How will distributions of the capital used to fund those investments be taxed?
- How will capital gains on capital assets used in an active business be taxed?
- How will goodwill be taxed when a business is sold?

CONVERTING INCOME INTO CAPITAL GAINS – UNINTENDED CONSEQUENCES

Section 84.1 The GoC suggests that converting a corporation's regular income into capital gains is a means by which owners of private corporations can gain "unfair tax advantages'. The current system of taxation of corporations is designed such that individuals should be neutral as to whether they earn income inside a corporation or personally as the combined corporate tax and personal tax on the removal of after-tax corporate earnings approximates the tax that would have been paid had the individual earned the income personally. This is known as the "theory of integration". The current tax rates however, provide an incentive for shareholders to extract corporate surplus in the form of capital gains which are taxed at a lower rate than salary or dividends. This practice is commonly referred to as "surplus stripping".

Currently section 84.1 applies where a Canadian-resident individual sells shares of a Canadian corporation to another non-arm's length Canadian corporation and the two corporations are connected immediately after the sale. It prevents an individual from extracting non-share consideration from a corporation to the extent it exceeds the "hard" adjusted cost base of the shares. Capital gains realized by the individual (or a person with whom the individual does not deal at arm's length) on which the lifetime capital gains exemption was claimed and pre-1972 surplus are deducted in determining the amount of hard adjusted cost base. If section 84.1 applies, the amount extracted will be treated as a dividend. Non-share consideration can be extracted through a series of related party transactions such that 84.1 does not apply as long as the individual does not claim the lifetime capital gains exemption on the first disposition.

Under the Proposals, the "hard" cost base of shares will also be reduced by any capital gains realized on previous dispositions of the share by the individual or any non-arm's length individual. This will result in double taxation as tax will be paid on the capital gain realized on the disposition of the shares as well on the deemed dividend on a subsequent non-arm's length transaction whereby the cost base of the shares is extracted.

Intergenerational Transfers

The proposed expansion of the anti-surplus stripping rules in section 84.1 is contrary to the principal tax policies of simplicity, equity and neutrality.

The proposed changes add complexity for taxpayers as it may be very difficult to determine the amount of the capital gain exemption claimed by non-arm's length parties in previous transactions. This will likely lead to increased professional fees and other compliance costs in tracing and reviewing prior transactions.

We see inequity in double taxation on an intergenerational transfer of shares by way of a disposition to a connected corporation but not on a sale to an arm's length party. In explanatory notes, the Department uses an example of shares that have been transferred multiple times in both arm's length and non-arm's length transactions. In that example, a total of $240,000 of gain on the disposition of share is subject to double taxation – once as a capital gain at 25.65% when the shares are first disposed of and again as a deemed dividend at 43.6% upon sale of the shares to a non-arm's length corporation for both share and non-share consideration. In order to avoid the double tax, a non-arm's length purchaser, such as a child, would have to purchase the shares using personal funds that have already been subject to personal tax (which is significantly higher than the corporate tax rates). If the shares are sold to an arm's length corporation, the shares can be purchased with after-tax corporate funds, without double tax. It will cost the next generation of a family business owner significantly more to purchase the shares using personal funds than it will cost an arm's length corporation. Both the Prime Minster and the Finance Minister have stated that the proposed changes to the tax stem will ensure that everyone pays their fair share of taxes. We have yet to be shown how this is a fair result.

For example, suppose Mary owns a flower shop worth $1M in St. John's and she now wishes to sell to her daughter, Julie. If Mary sells outright to Julie, Julie will have earn over $2.05M in personal income such that she has the $1M left after tax at a rate of 51.3% to pay Mary. Assuming an arm's length corporation is taxed at the high rate of 30%, it will need to earn only $1.43M, a difference of $620,000.

The policy of neutrality means that the tax system should be designed such that decisions should not be influenced by the tax system but instead should be based on the underlying merits of the transaction. Under both the current section 84.1 and the proposed changes, neutrality does not exist in intergenerational transfers of businesses. As has been previously stated, under the current rules, extracting non-share consideration that represents gains on which the lifetime capital gains exemption has been claimed by a non-arm's length party results in double tax and disadvantages intergenerational transfers. Double tax will result under the proposed amendments to section 84.1 to the extent any capital gains have been realized on any disposition by a non-arm's length party.

Under the current rules, and using the same example above, Julie could buy her Mother's shares using a promissory note. She could then transfer the shares and the note to a holding company and the corporate funds could be used to repay the note to Mary. As long as Mary does not utilize her capital gains exemption on the transfer, Julie will not realize a deemed dividend on the transfer of the note to the holding company. Mary would pay tax of $256,500. Had Mary sold her shares to a stranger and claimed her capital gains exemption, the tax would have been only $42,066, a difference of $214,000. This is a cost Mary might have been willing to bear to have her shares transition to her daughter.

Under the Proposals, on the sale to Julie, assuming no capital gains exemption is claimed, Mary would still pay tax of $256,500. The capital gain realized by Mary however would not create "hard" cost base and on the transfer to a holding company, Julie would be deemed to have received a dividend of $1M, on which tax of $436,000 would result.

The Department has acknowledged that section 84.1 has an "adverse impact on genuine business transfers involving family members". We agree. The Proposals will make such transfers prohibitive in many circumstances and will have a significant impact on the transfer of businesses to family members who for instance, may have had a career in the family business for many years.

The Income Tax Act already contains legislation designed to prevent the conferring of a benefit on a family member and we question whether any change was required. The proposals will disadvantage a family member, with no possible remedy as the legislation is currently drafted. This is a one-sided adjustment that will result in a windfall for the federal coffers.

Post-mortem Planning

The proposed rules also have a significant impact on traditional post-mortem planning. Without such planning, double tax will result as the deceased business owner will pay tax on the capital gain realized on the deemed disposition of the shares of his company on his death and the estate will pay tax on the dividend on the extraction of assets from the estate.

Currently there are two methods whereby the double tax can be eliminated:

- Utilize subsection 164(6) planning whereby the company is wound up and the capital loss on the shares on the windup is carried back to offset the capital gain realized on the deemed disposition of the taxpayer's shares at death. The result is that only tax paid using this planning would be the tax on the windup dividend which at the highest marginal tax rate in NL would be 43.6%.
- Undertake "pipeline" planning to extract the "hard" adjusted cost base resulting from the deemed disposition of the taxpayers shares on death. Utilizing this planning will eliminate the dividend on the wind-up of the company as the value would be extracted as non-share consideration on a transfer of the shares to a new corporation. The only tax payable if this type of planning is undertaken would be the tax on the deemed disposition on the taxpayer's death, being 25.65% in NL.

The proposed rules eliminate pipeline planning as the "hard" adjusted cost base of the shares is reduced by the capital gains realized on the taxpayer's death, whether or not the taxpayer has claimed a lifetime capital gains exemption.

Changes in the tax on split income rules also has perhaps unintended consequences to subsection 164(6) planning. To the extent that the gain realized on the death of a taxpayer would be subject to tax on split income as a dividend, no capital gain is realized on the deemed disposition of the deceased's shares, and therefore there is no capital gain to which to apply the loss carryback.

Example

Assume 10 years ago as part of an estate planning exercise, the value of Mary's shares in the company was frozen in fixed value preferred shares. At the same time, Julie subscribed for common shares of the company for a nominal amount. Mary wasn't quite ready to give up the flower shop business and has continued to work there on a daily basis. Assume that over the last 10 years Mary has earned $50,000 per year in active business income and $15,000 per year on her investment portfolio. As Julie has not invested any significant capital in the company, she does not work in the business, nor has she assumed any risk, Julie would be subject to the expanded TOSI rules. Assume Julie dies after holding her shares for those 10 years and her executors are not able to take advantage of subsection 164(6) planning. As there are no other assets in the Estate, the business must be sold to pay for the tax on the shares of the Company on Julie's death.

The total tax liability incurred by the Company on income earned over the 10-year period during which Julie held the shares, by Julie's Estate on her death and on the wind-up of the Company is shown in the following table.

		Current	Proposals
Flower Shop Inc. - Tax on income			
Active Business Income		500,000	500,000
Tax at SBD rates	13.50%	(67,500)	(67,500)
Net available for reinvestment		432,500	432,500
Investment income		150,000	150,000
Tax at investment income rates	53.67%	(80,505)	(80,505)
Net after tax investment Income		69,495	69,495
Total income earned		650,000	650,000
Total tax paid by Company		(148,005)	(148,005)
RDTOH Balance		46,005	0
Net assets in Company		548,000	501,995
Julia - Tax on Death			
Value of shares at death		548,000	501,995
Tax on death	25.65%	(140,562)	
	43.62%		(218,970)
Unrecovered RDTOH		(46,005)	0
Net value available to beneficiaries		361,433	283,025
Julia's Estate - Tax on Wind-up			
Value of shares on death		501,995	501,995
Tax on distribution from Company		0	
	43.62%		(218,970)
Net assets available to fund Julia's and Estate's taxes		501,995	283,025
Total income earned		650,000	650,000
Total tax paid by Company, Julia and Estate		(288,567)	(585,945)
Net after-tax cash available to heirs		361,433	64,055
Effective tax rate		**44.39%**	**90.15%**

After-tax Assets Available to Beneficiaries		Current	Proposals
Company	Operating income and investment income	650,000	650,000
	Total tax paid by Company	(148,005)	(148,005)
	Refundable tax	46,005	0
	Net assets in Company	548,000	501,995
Julia	Value of Company shares at death	548,000	501,995
	Tax paid	(140,562)	(218,970)
	Refundable tax (assume not recovered)	(46,005)	0
	Net value available to beneficiaries	361,433	283,025
After-tax Assets Available to Beneficiaries		**Current**	**Proposals**
Estate	Value of shares on death	501,995	501,995
	Tax on distribution from Company	0	(218,970)
	Net assets available to fund Julia's and Estate's taxes	501,995	283,025
Summary	Total income earned	650,000	650,000
	Total tax paid by Company, Julia and Estate	(288,567)	(585,945)
	Net after-tax cash available to heirs	361,433	64,055
	Effective tax rate	**44.39%**	**90.15%**

Double tax on the death of a shareholder is never a fair result.

Was it the intent of the Prime Minister the Minister of Finance and the Department that a 90.15% effective tax rate could be applicable in any circumstance, let alone on the death of a second-generation shareholder of a family business?

Retroactive Tax

The proposals result in retroactive tax without the ability to retroactively plan to avoid double taxation. There are existing Estates that have lost the ability to plan to use the provision in subsection 164(6) to avoid double tax on death because the Estate no longer qualify as to make the election that under the currents rules would have been able to undertake a pipeline to avoid double tax on the value of the shares held on the death of a shareholder. In addition, there are thousands of estate plans that have been undertaken to freeze the value of the founding shares such that any future value can accrue to the next generation of shareholders. Those shareholders will now be subject to double tax.

Recommendations

Double tax on intergenerational transfers of shares will have an impact on a taxpayer's decision to sell shares to a family member. The Department has indicated that it is "interested in the views and ideas of stakeholders regarding whether, and how, it would be possible to better accommodate genuine intergenerational business transfers while still protecting against possible abuses of such accommodation". We agree that genuine intergenerational transfers should be accommodated, however, 75 days is not sufficient time to allow for consultation and feedback as to how that can be accomplished.

With respect to post-mortem planning, again, more time is needed for consultation and we recommend that any changes be put on hold. We also recommend that existing estates be grandfathered into such changes as there may already be a plan in place to undertake a pipeline to remove adjusted cost base and in some of those cases it may be too late to undertake traditional 164(6) planning. Without this accommodation, double tax will result.

The timeline to file a subsection 164(6) election and the scope under which it can be made should be expanded to allow executors to undertake such planning. The current one-year deadline is inadequate and the proposed amendments to section 84.1 could have extreme tax consequences if the deadline is not met.

Section 246.1 We understand that in recent years the Department of Finance ("Finance") and the Canada Revenue Agency ("CRA") have become increasingly concerned with transactions that result in distributions to individuals being taxed as capital gains instead of taxable dividends. This is especially true as the gap between dividend and capital gains tax rates for individuals has grown. Finance has attempted to deal with this issue through certain targeted changes to the *Income Tax Act* ("Act") in the past, with Proposals being their most recent attempt to address their concerns.

At a high level, the Proposals introduce a new broad based anti-avoidance rule that would act to re-characterize certain amounts paid to shareholders to be taxable dividends, even though the current integrated system of taxation may otherwise allow for certain distributions to be made as tax-free capital dividends, loan repayments or as return of previously taxed capital.

The St. John's Board of Trade have significant concerns with the breadth of the Proposals as the legislation and related technical notes released by Finance provide little to no guidance with respect to their intended application. We are concerned that this broadly worded provision, alongside the ambiguity left in the technical notes, creates significant uncertainty for taxpayers and more importantly will have unintended consequences for Canadian small businesses that are engaging in ordinary course business transactions.

We have included below an example to demonstrate how the Proposals will distort the system of integration, which is a fundamental principle of the Canadian tax system, and may result in a significant increase in the tax burden to small business owners who engage in otherwise *bona fide* business transactions.

Example

Consider Ms. A, a Canadian resident that resides in Newfoundland & Labrador. Ms. A owns 100% of the shares of a holding company ("Holdco"), which has as its only asset 100% of the shares of an operating company ("Opco"). Ms. A is looking to sell the shares of Holdco or have Holdco sell the shares of Opco to an arm's length individual.

We have provided below an analysis of the after-tax proceeds available to Ms. A under three scenarios:

A. Ms. A sells the shares of Holdco for $100,000;
B. Holdco sells the shares of Opco for $100,000 and distributes the funds to Ms. A and the existing tax rules apply to the sale and related distribution; and
C. Holdco sells the shares of Opco for $100,000 and distributes the funds to Ms. A and the new proposals in section 246.1 of the Act apply to re-characterize all amounts distributed to Ms. A as a taxable dividend.

The tax rates used in this example are the combined Federal and Newfoundland & Labrador provincial income tax rates.

	(A)				
		Sale of Opco by Holdco, funds distributed to Ms. A			
		(B)		(C)	
	Sale of Holdco by Ms A	Existing rules apply		New proposals re-characterize capital dividend to taxable	
Sale of Shares	**Personal**	**Holdco**	**Personal**	**Holdco**	**Personal**
Proceeds of Disposition	100,000	100,000		100,000	
Adjusted Cost Base	1	1		1	
Capital Gain	**99,999**	**99,999**		**99,999**	
Tax Rate	25.65%	26.83%		26.83%	
Taxes - permanent	(25,650)	(11,500)		(11,500)	
Taxes - refundable	N/A	(15,333)		(15,333)	
After-tax cash available	**74,350**	**73,167**	-	**73,167**	-
DISTRIBUTION OF CORPORATE PROCEEDS	N/A				
Dividends paid - capital		(50,000)	50,000	0	0
Dividends paid - taxable		(37,567)	37,567	(88,499)	88,499
Dividend refund		14,401		15,333	
Return of capital		(1)	1	(1)	1
		(73,167)		(73,167)	
Personal tax on dividends (not eligible)			(16,387)		(38,603)
Personal tax on capital gain					
After-tax cash at personal level (proceeds fully distributed)	**74,350**	**0**	**71,181**	**0**	**49,897**
Effective tax rate	**25.65%**		**28.82%**		**50.10%**

Under example (A), where the shares of Holdco are sold directly by Ms. A, she has an effective tax rate on the realization of the capital gain of 25.65%. This should be viewed as the "base case" example as this would be the general rate of tax to any individual on a capital gain.

Under example (B), where Holdco sells the shares of Opco and then distributes the funds to Ms. A, Holdco is first required to pay corporate tax on the gain at an effective rate of 26.83%. Holdco can then distribute its after tax proceeds to Ms. A through a combination of capital and taxable dividends. Ms. A will then be required to pay personal tax on the taxable dividend received, which will result in an overall effective tax rate on this transaction to Ms. A is 28.82%. This rate is only slightly higher than example (A), where she instead sells the shares of Holdco directly.

We are told "fairness" is the objective the Proposals. As the example illustrates, the after-tax cash available by either an individual or a holding company under our current system of taxation is relatively the same if the after-tax proceeds were retained in the corporation (25.65% versus 26.83%) – this is consistent with the concept developed during the 1972 Tax Reform involving integration and ensuring that double taxation did not occur. This is fair.

Also, in comparing example (A) and (B) the overall effective tax rate is still approximately the same (25.65% versus 28.82%) if Holdco decides to distribute all the funds to Ms. A through taxable and capital dividends. Again, this is fair.

The current system of taxation results in roughly the same effective tax rate under multiple scenarios. This is not an accident, and is not as a result of Ms. A using "loopholes" or aggressive tax planning to reduce her tax burden. It is the system working as it was designed to avoid double taxation. Put simply, the system as currently designed is fair.

Given the ambiguity in the current proposals, it appears that moving forward new section 246.1 will result in a re-characterization of the capital dividend received by Ms. A to be a taxable dividend. As example (C) shows, this will significantly increase the overall effective tax rate on a fully distributed basis. In fact, the effective tax rate to Ms. A almost doubles from 25.65% in example (A) to 50.10% in example (C). Is this "fair"?

Taken a step further, if the Proposals are left to stand as is, and the additional proposals with respect to the taxation of passive income are also implemented (effectively eliminating the concept of a dividend refund), the effective tax rate will further increase from 50.10% to 58.08%.

While we understand that the Department may need to implement new rules to address certain types of transactions that they feel are "mischievous", the proposals as they are currently written are far too broad and ambiguous and effectively cripple the system of integration that has been a cornerstone of the Canadian tax system for almost 40 years. We strongly encourage the Department to re-draft both the legislative proposals and the related technical notes to more clearly explain the types of transactions they find offensive and to clearly allow *bona fide* business transactions to still benefit from our current system of integration.

RECOMMENDATIONS

We believe that the GoC, the Prime Minister, the Minister and the Department cannot have fully considered the significant harm the Proposals will cause to small businesses – the lifeblood of the Canadian economy. For a stated gain of $250 million (much of which will be offset by compliance and other costs), the GoC risks investment in our economy and job creation.

We recommend the following:

1. Stop the Proposals until the impacts can be fully understood.
2. Extend the consultation period. The length of consultation should be commensurate with the degree of wholesale changes proposed. A 12 to 18-month consultation period would be consistent with the significance of the changes being proposed, and would allow for meaningful consultation.
3. Establish a royal commission to undertake a comprehensive review of the taxing statues guided by the principles of simplification and modernization. As well as having the goal of reducing compliance cost to make Canada a competitive tax regime once again.
4. Establish a standing committee with active representation from the SME community to support the commission by continuously monitoring changes and publicly reporting progress at least annually.
5. Consideration should be given to the proper grandfathering and phasing-in of changes in the taxation system of small businesses.
6. The Proposals must undergo a gender-based analysis.
7. The Proposals must recognize and reflect the importance of small business to the economic engine of the country.
8. The Proposals, particularly in the area of succession planning must take into consideration the real restrictions present in rural areas of the country.

St. John's BOARD of TRADE

The principal voice of the business community