February 12, 2018

The Honourable Bill Morneau P.C., M.P.
Minister of Finance
Finance Canada
90 Elgin Street
Ottawa, ON
K1A 0G5

Dear Minister Morneau:

Re: Submission on the Draft Legislation released December 13, 2017.

We are writing on behalf of the Conference for Advanced Life Underwriting (CALU). CALU is a national professional membership association of established financial advisors (life insurance, wealth management and employee benefits), and accounting, legal, tax and actuarial professionals. For over 25 years CALU has engaged in advocacy and government relations activities on behalf of its members, and its sister organization, Advocis. Through these efforts, CALU represents the interests of more than 12,000 insurance and financial advisors. The members of our two organizations provide financial, tax and estate planning advice to millions of Canadians from all walks of life and across a broad economic spectrum, including shareholders of private corporations.

Further to the release by the Department of Finance ("Finance") of revised draft legislation relating to the tax on split income ("TOSI") rules (the "draft legislation")[1], we wish to outline our comments and questions.

We would also like to take this opportunity to thank you and Finance staff for responding to the many concerns that were expressed by CALU[2] and other stakeholders in relation to proposals set out in the consultation paper released on July 18, 2017.[3]

The withdrawal of the two proposals relating to restrictions on claiming the lifetime capital gains exemption and the expansion of the corporate surplus stripping rules have been universally welcomed by the small business community. As well, we are very encouraged by your announcement that Finance will undertake a review of the tax rules which currently act as an impediment to the transfer of family businesses. While we continue to have concerns with the TOSI rules, we want to acknowledge the positive changes reflected in the draft legislation in relation to the proposals in the consultation paper.

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[1] Department of Finance – Amendments to the Income Tax Act dated December 13, 2017. All references to section 120.4 relate to the draft legislation unless stated otherwise. All other references to sections are reference to the Income Tax Act (Canada) as currently enacted unless stated otherwise.
[2] CALU submission to the Finance Minister dated October 2, 1017, a copy of which is included with this letter for reference purposes. Herein referred to as the "CALU submission".
[3] Department of Finance – Consultation Paper on the Taxation of Private Corporations and related draft legislation dated July 18, 2017. Herein referred to as the "consultation paper".

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Specific Comments on the Draft Legislation

1. Complexity and Tax Uncertainty

While recognizing the efforts of Finance to simplify the TOSI rules, they continue to be very complex in their application. There are a number of exemptions that may apply in any given year, and which often depend on factual criteria that may change from year to year. As well, qualifying for an exemption may require validating events and transactions which occurred many years in the past to demonstrate that the TOSI rules should not apply.[4] This places a significant and ongoing compliance burden on small business owners.

Despite efforts to clarify and provide examples on the application of the "reasonable return"[5] test, as well as provide a "bright line test" for the excluded business exemption, the Canada Revenue Agency ("CRA") will have significant and broad discretion to determine if income received by a taxpayer will be subject to the TOSI rules.

The nature of certain businesses (for example, those in the high tech or research and development fields) can experience widely fluctuating annual revenue and profits, which may bear little relationship to capital contributions or the number of hours worked by any given shareholder. To use a "reasonable return" test in these situations will clearly invite CRA audits, assessments and appeals, as well as litigation in tax courts that are already backlogged and unable to keep up.

As noted in the CALU submission, the requirement to obtain professional tax advice, combined with increased audit and litigation activity, will significantly increase compliance costs for both small business owners and the federal government, to the detriment of all taxpayers.

We therefore continue to be of the view that the most appropriate way to deal with the government's concerns with income splitting, while addressing the various issues relating to the draft legislation, is to simply expand the scope of the current TOSI rules to apply to adult children and spouses who are under the age of 25 throughout the year.

Alternatively, for the reasons discussed below, we recommend that spouses age 25 or older be fully excluded from the application of the TOSI rules.

2. Application of the Rules to Spouses[6]

The various issues relating to spouses being subject to the TOSI rules were discussed in the CALU submission. Our concerns have been partially addressed though the addition of new exclusions contained in the definition of "excluded amount", several of which apply specifically to spouses (notably the deeming rule in paragraph 102.4(1.1)(c). However, as discussed in the prior section on "Complexity and Tax Uncertainty", the availability of these exclusions may require the determination of events that took place years and even decades before the

[4] For example, where a spouse or adult children have worked in the family business over the course of many years, or the specified individual's shares were received on the death of a parent or other family member and tracking of the former contributions are required.

[5] Defined in subsection 120.4(1) and applicable in determining whether an amount is an excluded amount as defined in paragraph (g)(ii) of that definition in subsection 120.4(1).

[6] A reference to spouse also includes a reference to common-law partners.

introduction of this legislation. As well, depending on the nature of the business (discussed below), there is the potential for very different tax results based on similar fact situations.

The CALU submission also commented on the fact that the TOSI rules will have a more significant impact on female shareholders, based on current business ownership demographics. The gender analysis released with the draft legislation, reproduced below, does not attempt to refute this assertion.

> Gender considerations previously communicated with respect to the proposed income sprinkling measures are not affected by these revised draft legislative proposals. Data show that men represent over 70 per cent of higher-income earners initiating income sprinkling strategies, and women represent about 68 per cent of recipients of sprinkled dividends (and 58 per cent of recipients of income derived from trusts and partnerships). While this income is of benefit for recipients, it also creates incentives that reduce female participation in the workforce. Increased participation of women in the workforce is a source of economic opportunity for individuals and is a major driver of overall economic growth.[7]

However, Finance appears to justify the potentially negative impact of the TOSI rules on women by suggesting that the payment of dividends or realization of capital gains is discouraging them from participating in the workplace, which is adversely impacting overall economic growth.

While we agree that tax rules should not discourage any Canadians from working, we don't necessarily agree with the view that income splitting in the business context has acted as a disincentive to women entering the workforce. In fact, Chart 1 (on page 4) indicates that female participation in the workforce continued to grow over the period from 2001-2014[8], while participation by men in the workforce over the same period remained stable. In addition, the gap between male and female employment participation rates in 2014 has declined to its lowest point since tracking started in 1950.[9] As such, there appears to be little statistical correlation between the ability to income split with spouses and female participation in the workforce.

On the other hand, it could be argued that the ownership of shares by spouses (as well as children) will encourage their greater involvement in the business as employees and part of management. Further, providing a source of income to spouses who choose to assume more of the family responsibilities not only recognizes their contribution, but also provides them with more financial independence, which in our view is an appropriate social policy goal. The application of a punitive rate of tax on such income will likely result in the loss of this source of income for those spouses.

For these reasons, we continue to recommend that spouses age 25 or older be fully excluded from the application of the TOSI rules.

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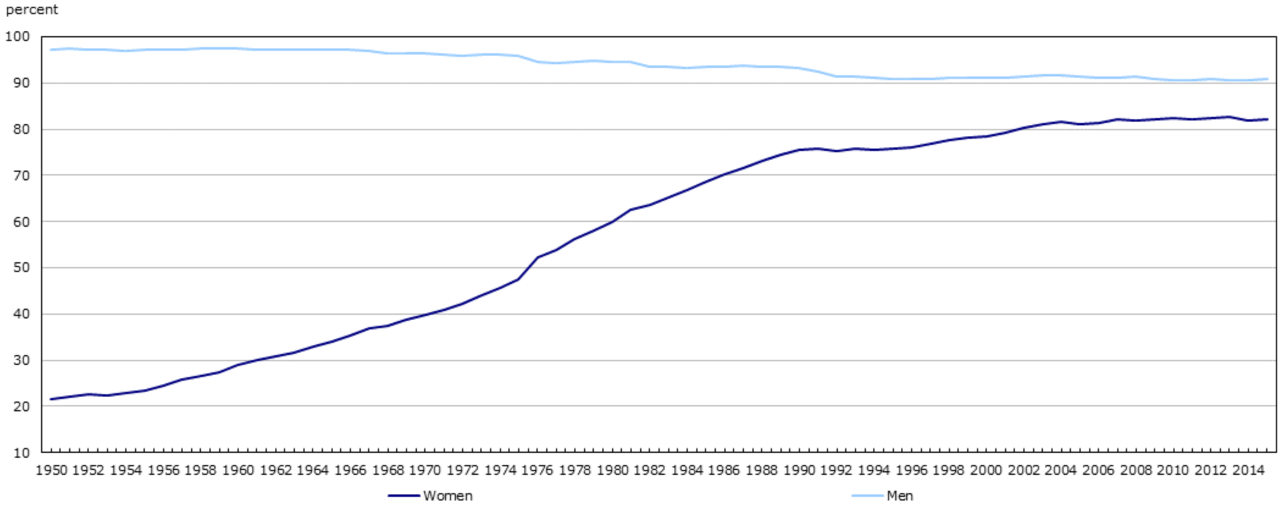
[7] Department of Finance – Backgrounder on Simplified Measures to Address Income Sprinkling" dated December 13, 2017.
[8] This is the period in which Finance noted a significant increase in the number of incorporated private businesses in Canada.
[9] Statistics Canada, Women in Canada: A Gender-Based Statistical Report (89-503-X) Seventh edition dated July 7, 2017.

Chart 1
Participation rates of people aged 25 to 54, Canada, 1950 to 2015



Note: Data covering the period of 1950 to 1965 exclude Newfoundland and Labrador.
Source: Statistics Canada, Labour Force Survey, CANSIM table 282-0002 and custom tabulations.

3. Excluded business definition

We have already commented on the level of discretion that will be provided to the CRA under the TOSI rules. This concern extends to determining if a person is “actively engaged on a regular, continuous and substantial basis in the activities of the business” (“actively engaged”), where such person does not meet the deeming rule under paragraph 120.4(1.1)(a) or any other exclusion from the TOSI rules.

For example, it is unclear how this test will be applied in those situations where the specified individual has several different business interests and therefore may not be involved in the day-to-day business operations of any one them. One could easily foresee a situation where the payment of a large dividend by any one company could be challenged by the CRA, on the basis that such dividends exceed a “reasonable return” in relation to other “source individuals” in respect of that business.

We are also concerned that the rule in subparagraph 120.4(1.1)(b)(ii), applicable to the split income of an individual who has attained 18 years of age in the year, and who acquired the relevant property as a consequence of the death of another person, only gives “credit” to the individual where the deceased was actively engaged in that business throughout five previous taxation years.

The following example demonstrates how this can result in unfairness.

> Jennifer (age 45) owns 5% of the shares of XCo, while her husband owns the remaining shares. Jennifer passes away, having been actively engaged in XCo for four prior taxation years. These shares are not qualified small business corporation shares. The shares are left to her son, David (age 25), who has been actively engaged in the business for two years. The business is sold two years later to a third party at a substantial gain from the inherited value. Because Jennifer had not been actively engaged in the business throughout five years prior to her death, David will not be deemed to have been actively engaged in the business for any period while Jennifer owned the shares. And since David was not been actively engaged in the business throughout any five previous years, the taxable capital gain resulting from the sale of his shares will be subject to the TOSI rules.

This can be contrasted to a situation where Jennifer, prior to her death, had been actively engaged in the business throughout five previous years, and her shares are transferred on death to her daughter, Mandy. Mandy is 18 years of age and currently attending university on a full-time basis. Again, we'll assume those shares are sold two years later at a substantial gain over the inherited value. In this situation Mandy would be deemed to have been actively engaged in the business throughout five previous years, and the taxable capital gain arising from the sale of the shares would not be subject to the TOSI rules.

We would therefore recommend that subparagraph 120.4(1.1)(b)(ii) be amended to deem *any* prior taxation year in which the deceased was actively engaged in the business to be a period of time in which a person, who acquired those shares as a consequence of death, was actively engaged in the business.

4. Exempt shares definition

The exemption from the TOSI rules for exempt shares will be helpful to many small business owners. However, there are several limitations on the availability of this exemption which we believe could result in unfair tax results amongst small business owners, as discussed below.

a) Share Ownership by Trusts

One of the requirements for shares to qualify as excluded shares is that the shares must be owned by the specified individual. However, it is often the case that, as part of an estate freeze, new common shares are issued to a discretionary inter vivos trust for the benefit of family members (which may include disabled or spendthrift individuals).[10] The shares may also be owned by an estate or testamentary trust for the benefit of family members.

There are valid non-tax reasons for establishing trust arrangements to own shares in a private corporation (whether as part of an estate freeze or otherwise), including facilitation of the governance and management of the business, dealing with incapacity issues and family law protection. The requirement for the shares to be owned directly by the specified individual will (in the absence of another exclusion) result in the application of the TOSI rules to income and capital gains designated by the trust to a specified individual. This will make trust arrangements less effective, which in turn impacts the ability of a business owner to properly structure his or her succession and estate plans.

As well, depending on the terms of the trust and other factors (such as the incapacity of a beneficiary), it may not be possible to distribute shares currently held in a trust to the beneficiaries in order to take advantage of this exemption.

We would therefore recommend that there be a special rule which would allow an inter vivos or testamentary trust to make an allocation of its share ownership to one or more specified individuals who are beneficiaries for purposes of the excluded shares definition.

Alternatively, we would recommend that there be a special share allocation rule where the trust is a life interest trust, a graduated rate estate or a qualified disability trust.

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[10] It should be noted that shares acquired as part of an estate freeze will for a period of time not qualify as excluded shares, due to the requirement that such shares represent 10% of the value of the corporation.

b) Provision of Services

The excluded shares exemption is not available where 90% or more of a corporation's income[11] is from the provision of services. The term "provision of services" is not defined for purposes of section 120.4, although this term is found in other sections of the Act.[12] As well, the term "services" is defined for the purpose of subparagraph 95(2)(b) to include the insurance of Canadian risks but excludes certain other business activities which presumably would otherwise be considered to be services.[13]

From an economic perspective, there is a relatively clear delineation between the provision of "goods" versus "services". It is understood that goods are physical objects whereas services describe the performance of work for others. Services often lack physical identity and cannot be distinguished from the service provider. Commonly cited examples of service businesses include banking, insurance, transportation and communications. There may also be some businesses which offer a mix of goods and services. On example is a restaurant business, where food is prepared for consumption (a good), and services are also provided (food and beverage service, valet parking, etc.).

Based on the use of the term "services" in the Act, as well as the more generally accepted use of this term, many businesses will be engaged in the provision of services. In fact, Statistics Canada data indicates that at the end of 2015 over 75% of small businesses were categorized as being in the service producing sector.[14] For these businesses to qualify under this exemption, they will need to demonstrate that 10% or more of their income in any given year arises from the provision of goods.[15] Also, looking at the types of businesses that are in the service producing sector (financial services, retail trade, healthcare, scientific, technology and technical services), it can be expected that most of these businesses will not qualify for the excluded shares exemption as they will not be able to satisfy the "10% test."

It is not clear to us what tax policy goal is being achieved by treating a business which earns 10% or more of its income from the sale of "goods" differently than a business which does not meet this test. For example, a building contractor and all incorporated sub-trades that work on a construction site may qualify for the excluded shares exemption. On the other hand, the shareholder of a technology consulting firm, with multiple offices and employing 20 full-time staff, is not provided similar access to this exemption. Such a delineation appears to run counter to the government's stated goal of encouraging the growth of innovative technology-based businesses in Canada.

We would therefore recommend that the exclusion for businesses engaged in the provision of services be eliminated or more narrowly defined to ensure it fairly targets only those types of businesses which Finance does not believe should have access to the excluded shares exemption.

(c) Use of Holding Companies

For shares to qualify as excluded shares, all or substantially all of the income of the corporation for the prior year cannot be derived from one or more related businesses in respect of the specified individual.[16] The

[11] Note that clarity should be provided as to whether this income test is based on revenues before or after expenses.
[12] For example, paragraph 20(1)(bb), section 68 and subsections 125(3.2) and (7).
[13] Subsection 95(3).
[14] Statistics Canada – Business Register, December 2015 (as reported in Statistics – Key Small Business Statistics – June 2016).
[15] This will in turn place a higher reporting and compliance burden on small businesses.
[16] Paragraph (c) of the definition of excluded shares in subsection 120.4(1).

Explanatory Notes released with the draft legislation indicate that the purpose of this limitation is "to prevent the circumvention of the TOSI rules by splitting a services business into services and non-services parts."

However, this limitation appears to have much broader application and could exclude shares owned by a specified individual in a holding company, where the operating company is a related business in respect of the specified individual (in particular where the holding company owns 100% of the operating company). This does not appear to be the intent of this carve out from the excluded shares exemption.

We would therefore recommend that this provision be amended to clarify that the excluded shares exemption is available for shares owned by a specified individual in a holding company, where the shares in the operating company would have been excluded shares had they been owned directly by that specified individual.

5. **Reasonable Return on Arm's Length Capital**

The term "arm's length capital" is relevant for purposes of subparagraph (f)(ii) of the definition of "excluded amount" in subsection 120.4(1). In effect, where the specified individual is between the ages of 18 and 24 in the year, the amount representing a reasonable return on the contribution of arm's length capital is excluded from the application of the TOSI rules.

The definition of arm's length capital excludes any amount that is borrowed by the specified individual under a loan or other indebtedness.[17] We understand the intent of this carve-out is to ensure that specified individuals contribute their own funds towards the acquisition of the property. However, **we are of the view that if the specified individual qualifies for a loan from a "restricted financial institution", without the direct or indirect support of a related person, then the loan or other indebtedness should qualify as "arm's length capital".**

Further, the Explanatory Notes indicate that contributions by way of salary would constitute arm's length capital. However, paragraph (c) of the definition of arm's length capital excludes amounts "transferred, directly or indirectly by any means whatever, to the specified individual from a person who was related to the specified individual". This appears to be drafted broadly enough to capture the payment of employment income from a related corporation.

We would therefore recommend the definition of arm's length capital include a specific exclusion for employment income (similar to the exclusion for bequests on death in paragraph (c) of the definition of arm's length capital).

6. **Spouses Living Separate and Apart**

An exception to the TOSI rules is provided where the specified individual has acquired property pursuant to a transfer described in subsection 160(4). Subsection 160(4) applies to property transfers between spouses under a court order or a written separation agreement, provided those parties are living separate and apart due to the breakdown of their relationship. However, this exception does not apply to property that has been acquired by the spouse prior to the breakdown of the marriage. We don't believe there should be a distinction between property acquired before marriage breakdown or as a consequence of marriage breakdown, given that subsection 160(4) creates a "bright line" test in determining when the TOSI rules should no longer apply. We would also note that the income attribution rules applicable to spouses[18] cease to apply under very similar

[17] Paragraph (b) of the definition of arm's length capital in subsection 120.4(1).
[18] Subsections 74.1(1), 74.4(2) and section 74.2.

circumstances, whether the property was lent or transferred prior to separation or as a consequence of separation.[19] Further, we believe this exemption should continue to apply to any property owned by a separated spouse that is substituted for the transferred property.

We would therefore recommend that in the event spouses continue to be subject to the TOSI rules, that the exclusion for spouses who are living separate and apart be expanded to include any income for the year, or taxable gains from the disposition of, any property (or property for which it is substituted) owned by a separated spouse, where the conditions in subsection 160(4) (other than the requirement that the property be transferred by the taxpayer to the spouse as a consequence of marriage breakdown) are met.

7. Taxpayer in Highest Marginal Tax Bracket

The July 18, 2017 draft legislation relating to the expanded TOSI rules provided an exception where a specified individual over 17 years of age was already subject to tax at the top marginal tax rate in the year.[20] This would permit the individual to continue to claim deductions as well as most applicable tax credits on such income. However, a similar provision does not exist in the draft legislation, thereby creating a tax penalty in situations where the arrangement results in no actual tax savings.

We recommend that an exception similar to the one contained in subparagraph 120.4(1.1) (e)(i) of the draft legislation released by Finance on July 18, 2017, which provides an exception from the TOSI rules where a specified individual is already subject to tax at the top marginal rate in the year, be included in the final legislation.

8. Pre-2018 Capital Gains

In the July 18, 2017 draft legislation relating to the expanded TOSI rules, individuals and trusts were provided with an election to realize an actual or deemed disposition of eligible property in order to both avoid the application of the TOSI rules for gains arising before 2018 and utilize the lifetime capital gains exemption. A similar election to trigger or realize gains is not provided in the draft legislation. Despite the introduction of additional exemptions that may result in the TOSI rules not applying to gains accruing before 2018, situations can still arise where such accrued gains will be subject to TOSI upon an actual disposition. This would appear to be inequitable, particularly since small business owners were given little time to plan for the application of the new rules.

We would therefore recommend that the TOSI rules not apply to capital gains realized by a specified individual on shares of a private corporation that have accrued prior to 2018. Alternatively, we recommend that the application of the TOSI rules to capital gains arising on the disposition of shares in a private corporation be deferred until 2019 to permit specified individuals to realize a capital gain in 2018 on the disposition of those shares without the application of the new TOSI rules.

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[19] Subsections 74.5(3) and (4).

[20] Subparagraph 120.4(1.1)(e)(i) of the draft legislation released by Finance on July 18, 2017,

9. Business Transition Rules

There are situations where an individual operates a business in a non-corporate form (for example, as a sole proprietor or in a partnership). Subsequently that business may be transferred into a private corporation. There are other circumstances where the business is sold or amalgamated with another business, with the individual becoming a specified individual in relation to that business. We believe contributions made by that individual to prior businesses should be recognized by the CRA in applying the "reasonable return" test to income or capital gains arising from the current business.

We would therefore recommend that rules be provided in the final legislation which would deem an individual's contributions to a former business, where such business continues to be operated by a successor business, as a contribution to the successor business for purposes of determining if an amount is a "reasonable return" in respect of that particular individual.

In Summary

In this submission, while we have outlined a number of concerns with the draft legislation, we have also provided our recommendations on how this legislation might be modified to meet the government's policy objectives while also reflecting the needs and interests of small business owners. We are of the view that some issues are so significant that further engagement with the small business sector and the tax community is warranted before proceeding with final legislation.

CALU is committed to ongoing dialogue with Department of Finance and the Minister's office to ensure that that the tax system is fair and equitable to all taxpayers including the shareholders of private corporations.

Yours truly,

G Chevalier G Legault

Gilles Chevalier
Chair of the Board

Guy Legault
President

cc. Elliot Hughes, Deputy Director, Tax Policy, Office of the Minister of Finance
Richard Maksymetz, Chief of Staff, Office of the Minister of Finance
Andrew Marsland, Senior Assistant Deputy Minister, Tax Policy Branch, Finance Canada
Justin To, Policy & Budget Director, Office of the Minister of Finance