October 2, 2017

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

Dear Minister Morneau:

Re: Submission on the Department of Finance Consultation Paper released July 18, 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. 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 Department of Finance ("Finance") consultation paper released on July 18, 2017 and accompanying draft legislation, we wish to provide our comments on the specific proposals outlined in that paper (the "Finance proposals"). We will initially provide some context as to why our members and the business community in general are reacting so negatively to these proposals. We will then discuss the proposals in more detail, outline specific concerns of our members and their small business clients, and provide recommendations on how the government might move forward in addressing these specific issues. It is important to add that while our members have concerns with other elements of the proposals set out in the consultation paper, given the limited timeframe available to us, we have chosen to only comment on the most important ones.

i. General Comments on the Consultation Process

a) The Consultation Process

The Finance proposals significantly undermine the theory of integration, which has underpinned the taxation of private corporations and their shareholder since 1972. These principals were developed over a four-year period by the Carter Commission, and then subject to further analysis and debate

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before moving to the legislative stage. Given the time, thought and effort that was taken to initially develop this framework, and the complexity of the issues, we don't believe it is appropriate to release proposals in the middle of the summer with a very short consultation period of only 75 days.

As well, the current consultation process provides little or no opportunity to discuss the underlying tax principles. Instead, the consultation paper attempts to limit feedback by asking questions relating to how best to implement the underlying changes in tax policy. We believe there are many policy issues that need to be transparently addressed before the Finance proposals move forward. For example:

- Why is passive investment income in a private corporation considered to be "bad", but the same does not appear to hold true for passive income earned in public and non-resident controlled private corporations? What are the financial and economic implications of this different treatment?
- Why is income sprinkling within the private corporation context considered to be "bad", whereas the splitting of Canada Pension Plan and registered pension plan (RPP) benefits is not being reviewed? More importantly, why is pension splitting permitted for members of registered pension plans under the age of 65, whereas similar tax treatment is not available to registered retirement savings plan (RRSP) holders who have annuitized their benefits prior to age 65?
- Why is passive investment income earned within a private corporation "bad", whereas contributions to RRSPs are encouraged?
- Why are members of RPPs entitled to generate significantly higher pension benefits than those saving for retirement through RRSPs?
- Why is the "tax on split income" regime used to deal with dividend sprinkling with adult shareholders, rather than extending the income attribution rules in the Income Tax Act (Canada) (the "Act")?
- Would it be better to put additional limits on the ability of businesses to access the small business deduction, and use the tax savings to fund a general reduction in personal marginal tax rates?
- What impact will the new income sprinkling and surplus stripping rules have on the successful transfer of owner-operated businesses to the next generation of owners?

We agree with views expressed by many commentators that the comparison in the consultation paper contrasting the tax positions of shareholders in private corporations and salaried employees was not appropriate. Such comparisons fail to consider the additional risks and costs associated with running a business vs. the availability of employer-paid benefits, statutory protections available to employees (severance, maternity leave, short- and long-term disability), and employer-sponsored pension plans, to name a few.

We also find the discussion of some of the business data in the consultation paper to be somewhat misleading. For example, much is made of the growth of incorporated businesses from 2001 to 2014, with the inference that individuals are incorporating primarily to take advantage of favourable tax rules. However, the actual growth rate for incorporated businesses over that period of time was approximately 3% – which does not appear to be inordinate. During that same time period, the incorporation of some professional practices (with the related income-splitting opportunities) was expressly encouraged by provinces, with the tacit approval of the federal government. As well, in the past decade many self-employed individuals have been required to incorporate in order to provide their services to larger companies and government entities.[1]

It was also noted that passive investment income of private corporations has grown to $26.7 billion. However, this represents on average only $15,000 of passive investment income when spread over 1.8 million companies. We also question recent estimates that only 50,000 private corporations are affected by the income-sprinkling rules. Based on input from the accounting community, we believe the number of affected corporations will be significantly higher than this number. In any event, none of these statistics on their own appear to justify the need for the government to take either quick or drastic measures.

And finally, describing many of these planning activities as "tax loopholes", leaving the impression these planning arrangements fall in the same category as international tax evasion, is disrespectful to small business owners. The vast majority of these individuals are paying their fair share of taxes, and the impugned planning is based on established tax rules, confirmed by Canada Revenue Agency (CRA) tax rulings/interpretations, and tax court decisions.

b) Multi-Layered and Punitive Tax Results

A number of tax and accounting professionals have already documented situations where the net impact of these proposals, in combination with other anti-avoidance rules contained in the Act, can result in an overall corporate/shareholder tax burden on capital gains and dividend income far in excess of 50%. We believe this is particularly problematic where the rules are triggered on the death of the shareholder, and will be discussed in more detail below.

In addition, the government's focus on shutting down "loopholes" by imposing the highest marginal rate on split income will catch many "middle-class" business owners in the tax net, resulting in a higher tax burden than would otherwise be the case if the split income was attributed to that person.

While not wanting to enter into a debate on whether the income sprinkling and surplus stripping proposals are retroactive in nature, we are very concerned when new tax provisions are introduced which dramatically impact the tax results of current planning arrangements, without providing appropriate grandfathering or transitional relief. With both the income sprinkling and surplus stripping rules there are circumstances where the punitive impact of those rules on arrangements in place before July 18, 2017 cannot be avoided. In other cases, the costs to restructure corporate shareholdings and/or obtain corporate valuations will result in fees and expenses in the tens of thousands of dollars for every affected business owner. It has been estimated that these costs could collectively be in the billions of

[1] For example, a number of individuals who lost their jobs in the oil and gas industry in western Canada decided to become independent contractors. However, to gain contracts within the oil sector, they were required to become incorporated and demonstrate they had liability insurance. A requirement for contractors to be incorporated is also a common practice in the high tech and other "new age" industries.

dollars.[2] This is truly dead money that could be better spent by businesses owners in expanding their operations, investing in research and development, and hiring new staff.

Irrespective of whether these proposals proceed, **CALU would recommend that Finance develop more consistent and transparent criteria for determining the application of new tax rules to existing arrangements, and that such guidelines be published to external stakeholder groups.**

c) Economic and Social Impact

While we applaud the government's desire to support the growth of the middle class, we don't believe this need be done at the cost of other Canadians. The goal should be to enable all Canadians to be as successful as possible, rather than attack those that are already successful. It is a proven fact that all boats do rise with the tide, provided they are not weighed down by external forces.

Indeed, the small business sector in Canada has been one of the great economic success stories over the past decade. This sector is by far the largest employer in the private sector, and has created 85% of the new jobs between 2005 and 2015.[3] The government should not, without extensive economic analysis, introduce tax measures that could hinder the growth of this extremely important business sector.

There is growing concern that these proposals will result in an exodus of high-tech entrepreneurs, as well as a loss of health care professionals in Canada. And based on the input we are receiving from our members, we believe this is just the tip of the iceberg, with the impact being felt throughout the small business community. In turn, this will adversely impact new job creation, innovation, risk taking, philanthropy and overall economic activity in Canada.

We therefore recommend that the government defer on implementing any of the proposals until it has undertaken a more detailed economic review of their impact on the small business community.

d) Tax Uncertainty[4]

The complexity of these proposals and the accompanying legislation is overwhelming, with even the most experienced tax professionals struggling to understand their impact on different planning

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[2] This number is based on projected fees in the range of $10,000-20,000 for a tax review, corporate share restructuring and share valuations, and assuming at least 50,000 affected businesses. There would be additional annual accounting and other fees to ensure ongoing compliance.

[3] Statistics Canada – Key Small Business Statistics June 2016.

[4] "The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person. Where it is otherwise, every person subject to the tax is put more or less in the power of the tax-gathered, who can either aggravate the tax upon any obnoxious contributor, or extort, by the terror of such aggravation, some present or perquisite to himself. The uncertainty of taxation encourages the insolence and favours the corruption of an order of men who are naturally unpopular, even where they are neither insolent nor corrupt. The certainty of what each individual ought to pay is, in taxation, a matter of so great importance that a very considerable degree of inequality, it appears, I believe, from the experience of all nations, is not near so great an evil as a very small degree of uncertainty." Source: Adam Smith, *The Wealth of Nations*, 1776.

scenarios. This creates an environment for inadvertent non-compliance and an unfair trap for less sophisticated business owners and advisors.

The income sprinkling and surplus stripping proposals also require tracking of events and transactions going back many years to determine the tax consequences associated with current transactions – again creating a situation where taxpayers unwittingly don't comply with the legislation.

In our view, the CRA is being given overly broad discretion in the application of the rules through the introduction of a "reasonableness test" in relation to the payment of dividends, continued expansion of anti-avoidance rules governing non-arm's length transactions and using "one of the purposes" test in proposed section 246.1.

In summary, the ongoing need for 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.

ii. Discussion of the Three Proposals

By way of background it is not our intent to review each proposal and legislative section in detail. Instead, we wish to comment on specific concerns raised by our members and provide some input on how those concerns might be addressed.

a) Income Sprinkling Rules

Income Sprinkling with Spouses/Partners

We recommend that the proposed income sprinkling rules not apply to spouses or common-law partners.[5] There are several reasons in support of this position. First, in many small businesses, one spouse will effectively run the business with his or her partner providing much needed support in the business and at home. Often there is no remuneration provided for these services. As such, it is very difficult to both document and measure such contributions using a "reasonableness test", particularly where the couple has operated the business over many years. This places a significant compliance obligation on the spouses as they may have to track activities that took place 20, 30 or even 40 years ago, to prove their contributions of labour, capital and assumption of risk in relation to the business.

As well, one spouse may have to temporarily exit the business due to illness, child care or parental obligations. There is a real concern that dividends paid while a spouse is not actively at work will not be considered "reasonable", even though this permits the other partner to be fully focused on the business operations.

It is also very true that the success or failure of the business will have a dramatic impact on the family fortunes, as personal assets such as the family home may be required to secure financing for the

[5] Similarly, the limitations on the lifetime capital gains exemption should not apply to spouses or common-law partners.

business. Such contributions during the start-up phase of a business could easily be overlooked or under-valued when applying the reasonableness test.

One might ask how the contributions of a “business spouse” is any different from the role played by an “employee spouse”, who may also help advance the career of his or her spouse. We believe there are subtle but important differences. For example, even the most devoted spouse would not be expected to go to their employed partner’s place of work to fill in for another sick employee. Nor would the spouse be required to co-sign a loan or agree to mortgage the family home to ensure a partner retains his or her employment. Clearly, the spouse of a business owner is more fully invested, emotionally and financially, in the success of the business.

We also believe the application of the income sprinkling rules to spouses will have a more significant impact on female shareholders, based on current business owner demographics. This could result in the female spouse not acquiring shares in the business for fear of the application of the “tax on split income” (TOSI) rules, or alternatively being taxed on dividend income at a higher rate than their spouse (see discussion below). A further impact is that the affected spouse could lose access to part or all of the lifetime capital gains exemption, significantly diminishing what is retained after-tax on the sale of shares in relation to their spouse. Consider the following example:

> *Example 1:*
> Bill and Janice started up a retail business in 2008 using funds borrowed from Bill’s parents. In 2010 the business was incorporated with Bill and Janice each owning 50% of the shares. Initially the business was only moderately successful, with Bill and Janice taking home $60,000 each in salary and dividends. Janice became pregnant in early 2014 and decided to stay home with the baby instead of paying for expensive day-care. On the advice of their accountant it is agreed that Janice would no longer receive a salary, and instead she and Bill would each receive $30,000 in dividends from the business while she was on is on maternity leave. Bill and Janice had a second baby in 2017 and she continued to stay at home.
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> It is now 2018 and their accountant advises Bill and Janice that because Janice is not working in the business and has not contributed capital to the business, the TOSI rules would apply to tax the dividends paid to Janice at the top marginal rate (rather than at Bill’s lower marginal rate). As well, Janice could lose access to income-tested benefits. They are forced to increase Bill’s salary to compensate for the loss of her dividend income, and Janice must rely on Bill for household and personal spending money.
>
> Bill and Janice separate three years later, and under the separation agreement it is agreed that Janice will sell her shares to an arm’s-length employee that recently joined the company for $400,000. She was anticipating that she could claim the lifetime capital gains exemption to fully shelter the gain on the sale, which would be used to purchase a new home. However, since the capital gain arising from this sale would be included in her income under the TOSI rules, this also eliminates her ability to claim the capital gains exemption. This results in a capital gains tax liability of approximately $100,000 on the sale of the shares and leaves her with significantly less funds to purchase a new home.

We are having difficulty accepting that this is the correct tax policy or result.

Income Splitting with Adult Children

There are two main regimes in the Act for combatting income splitting among family members. The first is set out in sections 74.1-74.5 of the Act, and generally has the effect of including "attributed income" in the income of the transferor. The second regime, the so-called TOSI rules, taxes "split income" to the recipient of that income at the top marginal tax rate. As already discussed, it is proposed that the TOSI regime be applied to certain business-related income received by non-arm's-length adult shareholders, with special rules applying to shareholders between the ages of 18 and 24.

The TOSI rules would effectively apply an additional tax penalty where the person attempting to sprinkle dividends (and other income) would not otherwise be in the highest tax bracket. This is due to the split income being taxed at a higher rate than would have been the case had the income been earned directly. Thus, the rules not only remove the incentive to income split with family members, but create a significant disincentive for those owners who are not in the top marginal tax rate. In other words, by applying the TOSI rules (rather than the income attribution rules) to adult children, a "middle-class" business owner is discouraged from including children in the ownership of the business operations. This is particularly problematic for farming operations and similar businesses where there is a desire to include children in the business and eventually pass the business on to the next generation.

Given that the attribution rules would have the desired effect of discouraging income splitting by business owners in the top marginal tax rate, while not penalizing owners in lower marginal tax brackets, **we recommend the government consider using the existing attribution rules with modifications for adult children, rather than the proposed TOSI rules, in combination with an appropriate reasonableness test**.

We also recommend that, similar to the existing income attribution rules, there be no attribution of income earned on split income for adult children aged 18 to 24.

We would also like to comment on the reasonableness test in relation to capital contributions by specified individuals between the ages of 18 and 24. These rules provide that any dividend paid in excess of the prescribed rate under the attribution rules (currently 1%) is deemed to be unreasonable. Further, there is an anti-avoidance rule which provides that if a specified individual's capital contribution arose from split income or from a loan or guarantee by a related individual, the capital contribution is ignored for purposes of the reasonableness test. Given the scope of these anti-avoidance rules, and the fact that it is possible for specified individuals between the ages of 18 and 24 to have independent sources of capital (i.e., inheritances, employment earnings) it is not clear why the rules further restrict the rate of return they will qualify as being "reasonable".

We would therefore recommend that the rule be modified so that the reasonableness test in relation to capital contributions for specified individuals between the ages of 18 and 24 be the same as that applicable to specified individuals over the age of 24.

Definition of Connected Individuals/Specified Individuals

Under the proposals a connected individual can also be a specified individual depending on that person's relationship with other shareholders. This would allow the CRA, for example, to apply the TOSI rules to dividends paid to a controlling shareholder who is also a specified shareholder (and who is not otherwise taxed at the top marginal tax bracket) on the basis that such dividends are not reasonable. This would not only result in those dividends being taxed at the top marginal rate, but also the disallowance of the lifetime capital gains exemption on the sale of those shares. In effect, the CRA has been given the ability to challenge the payment of any dividend under the reasonableness test in most family-owned businesses. We don't believe this is an appropriate result as demonstrated by the following example:

> *Example 2:*
> Jim and Rita, age 65 and 63 respectively, operate an incorporated farming business in Saskatchewan that was established about 30 years ago. They take out a modest salary and retain any excess profits in the business to smooth out the impact of bad crop years and other adverse business contingencies.
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> Their daughter, Sara, graduated from university five years ago and now works in Regina. Luke, their son, has followed in his parent's footsteps and helps manage the farm, also earning a fairly modest income. Jim and Rita are planning to retire by the end of the year, with Luke assuming ownership of the company. However, given Luke's financial situation and the risks associated with the farming operation, Luke has been unable to obtain financing to purchase their shares. Instead, with the advice of their accountant and lawyer, they have implemented an estate freeze.
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> Under this arrangement, Jim and Rita both received fixed value preference shares with a redemption value equal to the current fair market value of the business (approximately $750,000). Under their estate plan these shares will be distributed on their death to Sara, with the expectation that Sara's shares would be redeemed over time.
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> The preference shares carry a dividend rate of 4% which, combined with their government benefits and RRSPs, should provide them with total after-tax income in the range of $60,000. They have now been advised that under new proposals, starting in 2018, the dividends on their shares may be taxed at the top marginal rate of approximately 42% rather than their current tax rate of 22%. This is because they are no longer working in the farm operation and their initial capital contribution to the business was nominal. This will reduce their after-tax income by approximately $6,000, which represents an overall reduction of 10%. They would have never completed the estate freeze if they had fully understood the impact this would have on their retirement income.

We recommend that the definitions of connected and/or specified individuals be modified to avoid this type of result.

Application of Subsection 120.4(4) on Death

Existing subsection 120.4(4) generally provides that a capital gain realized by a specified individual from the disposition of private company shares to a non-arm's-length person is subject to the TOSI rules. This rule deems twice the amount of the taxable capital gain to be a taxable dividend. With the extension of the TOSI rules to adults, it would appear this rule could cause a capital gain arising on death, by virtue of subsection 70(5), to be converted into a taxable dividend. This is turn would restrict the availability of the lifetime capital gains exemption (LCGE) as well as the carry-back of capital losses from the deceased's estate under subsection 164(6). The net result is combined taxes on the "same" gain in the range of 70%.[6]

Given this does not appear to be the appropriate tax result, **we recommend that subsection 120.4(4) be amended such that it does apply where the capital gain arises under subsection 70(5) of the Act.**

Lifetime Capital Gains Exemption – Transitional Rules

New rules will restrict a specified individual's access to the lifetime capital gains exemption on the disposition of shares in certain situations. Transitional rules will allow the crystallization of gains in 2018 and the use of the individuals LCGE to shelter such gains. The electing party will be deemed to have reacquired the property at an amount equal to the lesser of the designated amount and the fair market value of the property. However, the acquisition cost will be ground down to the extent the designated amount exceeds 110% of the fair market value of the shares.[7]

For example, assume Andrea has $800,000 of LCGE and obtains two independent valuations indicating the value of the shares is in the range of $600,000 to $700,000. She settles on a valuation of $650,000, and this is the designated amount. The CRA prepares their own valuation and determines the fair market value of the shares to be $550,000. The acquisition amount will be the lesser of $650,000 and $550,000 minus the grind of $45,000 - ($650,000 x $550,000*1.1), being $505,000. Thus, the new cost of those shares will be at least $45,000 lower than the lowest of three fair market valuations.

It is unclear why Andrea would be penalized through a reduction in the cost base of the shares when she acted reasonably in terms of determining the designated amount. **We would recommend that the acquisition cost be determined as the lesser of the designated amount and the fair market of those shares without a potential grind.**

b) Passive Investment Rules

We are aware that Finance has already received many thoughtful and detailed responses relating to the proposals governing the taxation of passive investment income within a private corporation. While not intending to go into detail on the various concerns that have already been expressed, we want to emphasize the following points:

- There are a number of valid non-tax reasons for accumulating funds within a private corporation – to help secure bank financing; fund future business expansion; create a sinking fund to cover pregnancy leave or illness; and to supplement retirement funding. The fact that the business owner invests these funds rather than immediately deploying them in the business should not

[6] The additional layer of tax would arise from a deemed dividend to the estate arising from the redemption of the shares.
[7] Proposed subparagraph 110(18.1)(a)(ii) of the Act.

result in a penalty tax being applied when those funds are ultimately distributed to shareholders.

- While acknowledged in the consultation paper, we don't believe the government fully appreciates the administrative burden, costs and complexity that will be imposed on small business owners to comply with these proposals. For example, the pooling system under the apportionment method would be extremely difficult and time consuming to manage, and may be complicated by the fact that an additional pool would likely be required to track income arising from the disposition of property used in the active business (for example, a building used for business operations).
- For taxpayers who are not in the top marginal tax bracket, the existing refundable tax system already imposes an additional tax burden on income retained in the corporation that effectively negates the tax benefits of retaining income in the corporation for investment purposes.
- While it is understood that the government does not intend that these proposals apply to passive investments currently held in private corporations, we believe the complexity of administering any grandfathering rules would be daunting. For example, the rules would need to deal with co-mingling and tracing of funds arising from passive investments acquired before and after the effective date. It can be expected that any grandfathering regime will impose significant tracking and monitoring costs on small business owners.
- It has been suggested that rather than retaining income in their corporation, small business owners could withdraw excess income as salary, and then shelter a portion of this income through contributions to an RRSP. However, by doing so the business owner loses access to those funds for business purposes. This is due to the fact that business owners cannot use the RRSP as security for borrowing without negative tax results, the later withdrawal of those funds for business purposes could result in significant tax and other costs, as well as the loss of RRSP contribution room.
- The government has recently indicated these proposals will unlock funds held in private corporations for business purposes. If this is the overriding concern of the government, we question why similar rules are not being put forward for public companies and private companies controlled by non-residents, which also benefit from the lower general corporate tax rate, and presumably have hundreds of billions of dollars in cash reserves.

We are of the view that the proposals relating to passive investment income will have a wide-ranging and significant impact on the financial position of private corporations and their owners. **We would therefore restate our recommendation that the government should conduct a complete economic impact analysis before proceeding with any changes in this area.**

The debate on the passive investment rules has also served to highlight the current inequities in the Canadian retirement system. Most business owners (as well as many other Canadians) rely on RRSPs or defined contribution pension plans (DC plans) to accumulate tax-deferred retirement savings. However, there is a major segment of employees[8] that participate in defined benefit pension plans (DB plans).

[8] In 2014, approximately 4.4 million Canadians were members of DB plans – representing approximately 70% of all participants in registered pension plans. Statistics Canada – Pension Plans in Canada – 2015.

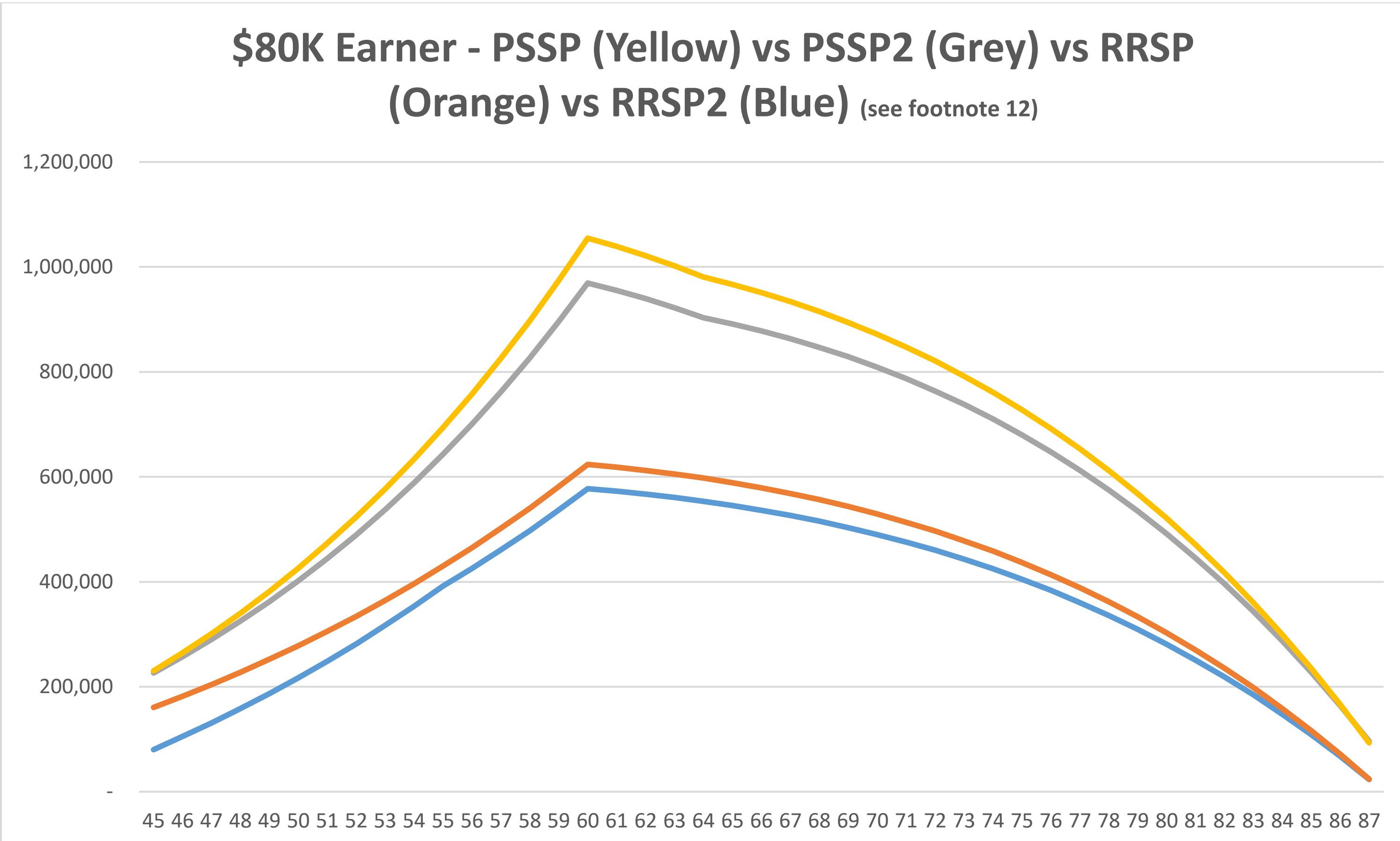
Members of DB plans are provided with the following advantages in relation to those that save for retirement through RRSPs:[9]

- Members only pay for a portion of the retirement benefit, with the remainder being funded by the employer.
- Members can purchase past service benefits.[10]
- The value of retirement benefits significantly exceeds what can be accumulated under an RRSP.
- Retirement benefits received before age 65 qualify for both pension splitting and the pension income tax credit.
- Investment shortfalls are effectively funded by the employer.
- Indexing of benefits may be available.[11]
- Benefits are payable for life, protecting against longevity risks.

Members of DB benefit plans are therefore able to accumulate substantially higher pension values than members of RRSPs or DC plans. This discrepancy can be even greater if the business owner does not maximize RRSP contributions in their early years due to additional costs associated with operating a business (legal, accounting, office, etc.) in relation to a salaried employee.

The graph on the following page demonstrates the significant discrepancy in accumulated values between a member of the federal government's pension plan with final average earnings of $80,000 and a business owner who receives the same amount of employment income over their working career and who contributes to an RRSP. As is demonstrated, the accumulated value of the federal employee's pension is almost double that of the business owner's RRSP throughout the applicable accumulation and retirement period.

[9] DC plans have some of the benefits of DB plans but are in other respects treated similarly to RRSPs.
[10] If a small business owner must forgo an RRSP contribution, that person can carry-forward the unused contribution amount but loses the benefit of the tax-deferred growth on the deferred contributions. Further, if the business owner receives dividends in lieu of salary, this contribution room is lost.
[11] This is true for the federal government pension plan.



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Based on the foregoing, we don't believe it would be fair and equitable to proceed with any changes to the rules governing the taxation of passive investments within private corporations without also reviewing and harmonizing the contribution limits and pension splitting rules applicable to RRSPs and registered pension plans.

c) Surplus Stripping Rules

Again, we are aware of the significant number of submissions that Finance has received relating to the proposals governing what is commonly referred to as "corporate surplus stripping". While acknowledging that the government has valid concerns relating to planning in this area, we are of the view that the draft changes to section 84.1 and the introduction of section 246.1 will result in many

[12] The yellow line (PSSP) represents the commuted value of the Public Service Superannuation Plan (PSSP) benefits plus permitted RRSP contributions; the grey line (PSSP2) represents the commuted value of pension benefits without additional RRSP contribution; the orange line (RRSP) represents RRSP contributions at a 4% rate of return; and the blue line (RSSP2) assumes a delay in making some RRSP contributions with a "catch" up of those contributions after 10 years. It is assumed the RRSPs are converted to a registered retirement income fund (RRIF) with the RRIF minimum amount being withdrawn each year.

unintended and punitive tax consequences. Our specific concerns and suggested recommendations to deal with these issues are discussed below.

Amendments to Section 84.1

We note the following concerns with section 84.1 with our recommended changes:

- The application date of July 18, 2017 means that "pipeline planning" for an estate that was in progress (but not completed) for a taxpayer who passed away before this date will no longer be permitted. In those situations where a capital loss cannot be realized in the estate and carried back to the terminal return of the deceased under subsection 164(6) of the Act, this will effectively result in double taxation. **We therefore recommend that a transitional rule be introduced that would continue access to pipeline planning where the taxpayer died before July 18, 2017.**
- Given the proposed limitations on pipeline planning, **we recommend that subsection 164(6) be amended to increase the time limit in which a graduated rate estate (GRE) can realize and carry-back capital losses to the deceased's terminal return (i.e., this does not have to be completed within the first taxation year of the GRE).**
- **We don't believe it is appropriate to apply proposed section 84.1 to non-arm's-length capital gains arising before July 18, 2017**. It will not be possible in many cases to trace transactions that could have taken place as far back as 1972, and this would create compliance issues for many taxpayers. As well, the CRA already has access to a number of anti-avoidance rules in the Act (including the general anti-avoidance rule (GAAR)) to challenge surplus stripping transactions that were commenced before that date.
- **We recommend that the government proceed to introduce a limited exception to section 84.1 (and related provisions) to permit genuine inter-generational transfers of shares in qualifying private corporations**. Please refer to our submission dated September 29, 2017 to the Minister of Finance for our recommendations on the design of such an exception.

New Section 246.1

We recommend that the government not proceed with section 246.1 without further review and consultation, for the following reasons:

- The application of this provision needs to be more clearly defined. As currently drafted it could apply to planning arrangements involving shareholders and private corporations which we believe should not be considered an avoidance transaction. **We recommend that section 246.1 not apply to a transaction or series of transactions "undertaken or arranged primarily for bona fide purposes other than the tax benefit" (similar to the GAAR in section 245 of the Act).**
- The consultation paper includes three new or revised provisions that can deem an amount to be a taxable dividend rather than another amount – subsection 120.4(4), section 84.1 and section 246.1. There are no ordering provisions in the legislation and this raises the concern that these provisions could be applied to the same transaction, event or series of transactions or events, in a way that may result in double taxation. This is of particular concern on the death of a shareholder and subsequent transfer of shares to the estate and/or estate beneficiaries. For

example, a deemed capital gain in respect of shares due to the death of the shareholder might be converted to a taxable dividend, and in turn if the shares are redeemed by the estate, there will be additional dividend taxation. **We believe this needs further consideration before proceeding with this legislation.**

- Again, the complexity of the various anti-avoidance provisions in the consultation paper and their interaction with other provisions in the Act raise the question of how small business owners are to determine the tax consequences of any transaction involving the extraction of capital from their corporation. This level of complexity creates a number of tax traps and significant compliance costs for small business owners that requires further analysis.
- Draft section 246.1 indicates that if *any* part of the tax is avoided because of the transaction, the full amount of the "portion of the amount received or receivable" will be treated as taxable dividend. Our interpretation is that the full amount received will be taxable as a dividend, even though the tax being avoided is less than the tax imposed on the deemed dividend. For example, if the portion of the amount received or receivable is $100,000, and the tax being avoided is $10,000, the full amount of the $100,000 will be included in the income of the recipient as a dividend (resulting in a tax liability of approximately $40,000). Assuming this is the case, this provision can create a significant tax penalty to the recipient.
- **The condition in draft subsection 246.1(2) that one of the purposes of the transaction is to effect "a significant reduction or disappearance of assets of a private corporation" requires further legislative clarification**, absent which there will be "significant" audit activity and tax litigation.
- The proposed application date of July 18, 2017 is problematic, as previously acceptable planning transactions which were undertaken but not completed before that date could be caught by this rule with punitive tax consequences. **We therefore recommend a transitional provision that would provide an exception where the series of transactions were substantially undertaken but not completed before July 18, 2017.**

Although the consultation paper and draft legislation contains no reference to corporate-owned life insurance, some professional advisors have indicated that section 246.1 could apply to eliminate the ability to pay out life insurance proceeds received by a corporation as a tax-free capital dividend. Consequently, some clients are being advised to defer the purchase of corporate-owned insurance until this issue is clarified. We don't believe this can be the intent of section 246.1, particularly when one considers that Finance just recently completed a comprehensive review of the life insurance taxation rules.[13]

We would therefore appreciate confirmation from Finance that section 246.1 is not intended to change the current tax treatment of corporate-owned life insurance, including the credit to the capital dividend account arising from the receipt of life insurance proceeds. This will remove the current uncertainty that exists and ensure that business owners will have confidence in the rules governing the tax treatment of corporate-owned life insurance. We would also be pleased to work with Finance officials to ensure the final version of section 246.1 accomplishes this goal.

[13] These rules took effect in 2017 and apply to both personal and corporate-owned life insurance policies.

iii. Summary

In this submission, we have outlined a number of concerns with the proposals set out in the consultation paper, and also provided our recommendations on how these proposals might be modified to both 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.

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,

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, Deputy Director of Policy, Prime Minister's Office