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September 15, 2017

Department of Finance Canada
14th Floor
90 Elgin Street
OTTAWA ON K1A 0G5

Via e-mail: fin.consultation.fin@canada.ca

Dear Sir or Madam:

Re: Tax Planning Using Private Corporations

We are writing in response to the Department of Finance release on July 18, 2017 of various documents for consultation on the proposals to changes in the taxation of private corporations. We are an independent firm of Chartered Professional Accountants located in Listowel, Ontario. Our clients primarily consist of small business corporations with a large proportion in the agricultural industry. Our review of these proposals has led to a conclusion that a significant amount of our clients will be affected by these proposed changes.

Our firm is concerned that there are several technical deficiencies in the draft legislation as proposed. Further it appears that there could be many unintended consequences of the legislation compared to what the Government's message has been and who it is intended to impact.

In completing this submission, we determined it would be useful to use examples (based on some common client situations) as to how these rules will impact taxpayers.

<u>Executive Summary</u>

The purpose of this submission is to outline selected concerns our firm has with regards to the proposals released by the Department of Finance on July 18, 2017. Our primary concerns are as follows:

1. The proposed measures will negatively impact most small business owners, not just the "top 1%" (concerns #1 through #10);
2. The proposed measures may penalize the "Middle Class" family much more than a "Wealthy" family (concern #1). In fact, the "Wealthy" family may have more to gain and nothing to lose;
3. The proposed measures do have retroactive implications (concerns #3 through #5, #8 through #10);
4. The proposed measures may result in double or triple taxation for taxpayers (concerns #8 through #10); Is double or triple taxation a "fair share of taxes"?; and
5. The proposed measures will increase the administrative and compliance burden on taxpayers (concerns #1, #2, #7 through #10).

In addition, as our firm services many agricultural clients, we have outlined specific concerns that appear to have a significant impact on the agricultural sector.

We have drafted this submission using practical examples and have outlined:

- Our understanding of the implications, whether they are intended or unintended;
- Our understanding and interpretation of technical concerns with the draft legislation and proposals; and
- Our suggestions for changes that may accomplish the same stated goals of the Department of Finance but in a more targeted way without the punitive consequences that we have identified in our concerns.

<u>Example – Grocery Store Owner</u>

Background

- Joe operates a grocery store business in a small town in Southwestern Ontario through a private corporation ("**FoodCo**"). Joe does not take any salary or wages from FoodCo.
- Joe's wife, Jane, works full time in the business doing various tasks including cashier, bookkeeping and janitorial work. Jane does not take any salary or wages from FoodCo.
- Joe and Jane have two children:
  - Jeff is 21 and is a university student studying to become a veterinarian.
  - John is 17 and is in his final year of high school. He is not sure what he would like to study after high school, but would like to take over the grocery business one day, if possible.
- Joe took over the business from his father, Jack, by way of an "estate freeze" 15 years ago whereby Jack holds fixed value Special shares of FoodCo.
- About 5 years ago, Joe and Jane again did an "estate freeze" to introduce a Family Trust as the sole common shareholder of FoodCo. On the freeze, Joe and Jane received fixed value Special shares of FoodCo.
- In the most recent fiscal year, FoodCo had an operating profit after corporate tax of $125,000 and paid a $90,000 dividend to the Family Trust which in turn allocated the dividend as follows:
  - Joe - $35,000
  - Jane - $35,000
  - Jeff - $20,000
- The next closest town center with a grocery store is located 25 km away. Local residents rely on the grocery store for convenience and because some cannot easily travel.
- The company employs 10 individuals not including Joe's family members.
- A summary of Joe's corporate structure is outlined in Appendix A.

<u>Income Sprinkling/Splitting Measures</u>

Canada's personal income tax system is based on fundamental principles which include:

- An individual's income tax liability is determined based on his or her income for a year, and generally without regard to the taxable income of family members or other related persons; and
- An individual's income tax rate increases as the amount of taxable income increases, known as a progressive personal income tax system.

Due to the above fundamental principles, a family unit can reduce its combined personal income tax by having income that would have been taxed as income of a higher-income individual, realized by family members who are subject to taxation at a lower tax rate or who may not be subject to tax at all. This concept of reducing a family's tax burden is commonly referred to as "income sprinkling" or "splitting".

To discourage families from undertaking transactions or creating structures that allow for income sprinkling or splitting, the Income Tax Act already includes certain measures including reasonability tests for wages, attribution rules, and the "Kiddie Tax", also known as the tax on split income ("TOSI") rules, which currently only apply to minors (i.e. individuals who have not attained the age of 17 before the beginning of the year).

These TOSI rules are proposed to be changed as follows:

- Extended to apply to other family members, including adult children, spouses and common-law partners;
- Expanding the types of income that are caught under the rules,
- Applying to "sprinkled income" amounts where the amounts are "unreasonable" under the circumstances; and
- Expanding the situations in which the TOSI rules apply.

The following analysis explains our concerns with the proposed measures in regards to income sprinkling:

Concern # 1 – "Reasonability"

Additional/Alternative Facts & Assumptions:

- A number of years ago, the bank provided a mortgage to FoodCo to purchase the building. The bank required a personal guarantee from Joe and Jane as a condition of providing the mortgage.
- Before working for FoodCo, Jane was a nurse and was making an annual salary of $80,000. To help the family business, she quit her job and focused her attention on growing the family business.
- During the summer months when Jeff is not in school, he helps the family business by doing various general labour tasks.
- Recently, FoodCo was audited by the Canada Revenue Agency ("CRA") and the assigned CRA auditor's opinion was that a reasonable return for Jane was $20,000 and $Nil for Jeff as he only worked during the summer months and thus was not actively engaged on a regular, continuous and substantial basis.

Implications

- The "unreasonable" portion of the dividends paid to Jane and Jeff of $15,000 and $20,000 respectively as determined under the proposed TOSI rules are now taxed at the top marginal tax rate of 45.3% in Ontario, which would be $15,855 in income tax. In comparison:
    - Before the proposed changes, Jane and Jeff would not have had any tax payable. A tax cost of $15,855 to the family.
    - If the $35,000 was otherwise allocated to Joe, he would have paid income tax of approximately $5,250 (based on an estimated marginal tax rate of 15%) on the additional $35,000 dividend.

Despite the family's assessment of what they thought was "reasonable", the family is subject to an additional tax cost (penalty) of $10,605 ($15,855 - $5,250) for making an "unreasonable" assessment. Does this example not show how a small business making under $150,000 is significantly penalized by these proposed changes?[1]

Technical Issues

- How does FoodCo determine what a "reasonable" return is to Jane and Jeff with any degree of certainty? How can FoodCo value a return to Jane for the personal guarantee and effort in growing the family business?
- What is meant by regular, continuous and substantial basis? Does Jeff's summer work term qualify as regular, continuous and substantial basis?
- Who is qualified to make a determination of what is a "reasonable" return to Jane and Jeff? Is Joe required to obtain expertise in valuations? Is Joe's accountant qualified to make a determination of what is a "reasonable" return?
- Is the "reasonable" test analyzed on an annual basis or a cumulative basis?
    - As an example, in most small business startup situations often the family does not pay themselves a "reasonable" return as the money is needed in the business. Once the business is able to pay income to the family, is there any recognition for prior years where the family members were paid less than a "reasonable" amount?
- Under the TOSI rules, why is the family significantly worse off than if the split income was allocated to Joe? In the example above, on just a $35,000 dividend misallocation, the tax cost to the family is an estimated $10,605 or 7% of their total family income before tax.
    - This type of penalty would have a substantial effect on this "middle class" family, compared to a more "wealthy" family that may be able to absorb the penalty.

[1] The Government has stated multiple times that these proposed changes will not affect a business earning under $150,000. FoodCo in our example only made profit $147,000 before corporate tax ($125,000 after corporate tax).

- o However, this type of penalty does not affect the wealthy assuming the controlling individual was in the top-marginal tax rate to begin as illustrated below:

	Joe	"Wealthy" High Rate Taxpayer
Taxable Income	$40,950[2]	$221,000
Potential Benefit of "Unreasonable" Allocation - $35,000	$5,250	$15,855
Potential Cost of "Unreasonable" Allocation - $35,000	$10,605	$NIL

From a mathematical perspective not only is the "Wealthy" family able to absorb a penalty but in fact, the "Wealthy" family would never be subject to a "penalty" for making an unreasonable allocation to begin with! Why would a "Wealthy" family not take the risk of making an unreasonable allocation (they have everything to gain and nothing to lose)! How does this improve tax fairness?

Suggested Changes

- Specific guidance should be provided on how to determine a "reasonable" return given the degree of involvement, risk and fair market value of investment of a family in operating a family business.
- Rather than having the split income taxed at the top marginal tax rate, the "attribution" rules currently in the Income Tax Act should be expanded to attribute the "split income" back to the taxpayer who is seen as earning the income/capital gain so it is taxed at the same marginal rate as that of the controlling individual (i.e. Joe in the above noted case).
- The Canada Revenue Agency should have the onus to prove that amounts are "unreasonable". This contrasts to the current rules where taxpayers are required to prove that payments are "reasonable".

Concern # 2 – What is Considered "Capital" in Applying the "Reasonability" Rules

Additional/Alternative Facts & Assumptions:

- A number of years ago, Jack (father) loaned FoodCo $100,000 when FoodCo added a bakery department. Assume that given the specific business risk an arm's length investor would have wanted a 10% interest rate.
- Jack's has other regular income of $25,000 (CPP, OAS, Other interest) – a marginal tax rate of 5% applies to additional dividend income that Jack receives.
- Rather than paying interest on the loan, FoodCo pays a dividend to Jack on the Special shares he owns.
- Jane also owns 100,000 Special shares of FoodCo with a fair market value of $100,000 and $1 of adjusted cost base, legal stated capital and paid-up capital (as shown in Appendix A).
    - o Her dividend allocation from the Family Trust was decreased by $10,000 from $35,000 to $25,000
    - o A $10,000 dividend is paid to Jane on her special shares (10% rate of return also assumed reasonable)
    - o In this taxation year, Jane did substantial volunteer work in the community and was not able to provide any labour to FoodCo
- Jane has no other income other than dividends received from FoodCo – a marginal tax rate of 0% applies to additional dividend income that Jane receives.

[2] $35,000 x 1.17 dividend gross up factor.

Implications/Technical Issues

- It is unclear/uncertain if Jack's loan of $100,000 constitutes contributed capital for purposes of evaluating a "reasonable" dividend return to Jack on his special shares. If it is not considered capital, then the TOSI rules apply as follows:

Taxes on $10,000 dividend (Non TOSI)	$500
Taxes on $10,000 dividend (TOSI)	$4,530
Additional Tax ("Penalty")	$4,030

- It is unclear if capital contributed refers to adjusted cost base, paid-up capital or fair market value when FoodCo pays a dividend to Jane on the 100,000 Special shares she owns.

	Income Not Subject to TOSI	**Taxes**
Reasonable Dividend Based on Fair Market Value	$10,000	$NIL
Reasonable Dividend Based on ACB/PUC/LSC	$0.10	$4,530

- For special shares as held by Jane, valuation is relatively more simple assuming there are no arguments against using a fixed-redemption value. For common shares where the value fluctuates, does a valuation need to be completed every time a dividend is declared?
  - What would be considered a "reasonable" valuation for this purpose? (i.e. prepared by client, prepared by sole-practitioner accountant, prepared by Chartered Business Valuator)
  - What is a "reasonable" rate of return?

Suggested Changes

- Guidance should be provided on what constitutes contributed capital, how contributed capital is determined and what is a "reasonable" rate of return on capital.

Concern # 3 – Impact of TOSI Rules on Current Structures

Additional/Alternative Facts & Assumptions:

- Assume that rather than the Trust owning shares, Joe owns 50 Class A common shares and Jane owns 50 Class B common shares (see Appendix B) The accountant set this structure up long ago as it was legally accepted, simple and common for family run businesses.
- Jane has never been involved with FoodCo. The earnings of FoodCo were never able to support the family and as such she was required to keep her job as a nurse to support the family financially and has never had time available to help run the family business.
- Jane's marginal tax rate on capital gains is 15%.
- FoodCo does not pay any dividends to Jane.
- Jane's 50 Class B common shares have a fair market value of $500,000 and adjusted cost base/legal stated capital and paid-up capital of $Nil.
- Jane's available lifetime capital gains exemption ("CGE") is $250,000. She used her CGE in the past when her family farm was sold.
- Jane qualifies for the special transitional rules and files an appropriate election in 2018 to "crystallize" her remaining $250,000 of CGE.

Implications

- Despite the fact that FoodCo does not pay any dividends to Jane (no income sprinkling), the TOSI rules will apply to the $250,000 accrued gain remaining on Jane's 50 Class B common shares that Jane couldn't elect on using the special transitional election as well as any future gain on these shares during which Jane owns the shares
    - In effect, this "locks in" the highest marginal tax rate to Jane for the future on accrued gains not eligible for the CGE. She never will be able to realize this capital gain and use her lower marginal tax rates.
        - Future capital gains on sales to arms-length parties (i.e. a partial sale to a key employee) will always be taxed at 26.75% compared to her anticipate marginal capital gains tax rate of 15%.
        - Future capital gains on sales to non-arm's length parties (i.e. a partial sale to a child) will always be taxed at 45.3% compared to her anticipated marginal capital gains tax rate of 15%.[3]
    - If the shares were not eligible for the CGE in 2018, the entire $500,000 of accrued gain would be subject to the TOSI rules. This would be retroactive as the TOSI rules are being applied to gains accrued before their introduction!

- Jane would like avoid the application of the TOSI rules by re-organizing the share structure of FoodCo.
    - On the existing $250,000 of accrued gain not able to be sheltered by CGE there does not appear to be any options to avoid the "locked in" TOSI penalty.
        - If Jane sells the shares to Joe for fair market value, there will be a $250,000 capital gain that will be recharacterized into a deemed dividend taxed at the highest marginal tax rate.
        - If Jane gifts the shares to Joe, do the attribution rules apply and the TOSI rules continue to apply to Jane?
        - If the shares are redeemed by FoodCo, there will be a $250,000 deemed dividend taxed under TOSI at the highest marginal tax rate.
        - If Jane transfers the shares to a new Holding Company owned only by her and has the FoodCo shares redeemed inter-corporately, do the TOSI rules always apply to any dividends/share redemptions from the new Holding Company (despite Jane perhaps starting a new active business in Holdco in the future)?
    - For future capital appreciation a "freeze" of Jane's existing shares may be able to be completed.
        - This reorganization would not otherwise be completed for any other reason other than the introduction of the TOSI rules adding unnecessary professional fee costs to the small business.
        - Will a sole practitioner/bookkeeper be able to identify and complete the required reorganization without engaging a potentially more expensive valuator, lawyer and tax specialist?

Technical Issues

- In their present form, the proposed changes may have a retroactive application to many common, basic share structures.
- Despite the possible application of the proposed special transitional rule, concerns remain about how to reorganize the existing share structures to avoid the TOSI rules.

[3] In light of proposed changes to Section 84.1, there is a significant potential for double taxation as illustrated further in this paper.

Suggested Changes

- To avoid uncertainty and retroactive application, transitional rules should provide for a fixed cutoff such as valuations of shares done on a specific date so that any past capital appreciation in private company shares that is not able to be sheltered with CGE will not be subject to the TOSI rules.
  - This could be implemented similar to the cutoff valuations completed effective December 31, 1971 (Valuation Day) as these proposals in our opinion represent a fundamental change to the taxation of capital gains regime.

Concern # 4 – Application of TOSI to Investment Holding Companies

Additional/Alternative Facts & Assumptions:

- Assume that when Jack's (father) interest in FoodCo was "frozen" that the new common growth shares (same class) were issued 50/50 to Joe and Jane and not to the family trust
- FoodCo has built up extra cash reserves not needed in the business at the current time.
- For creditor protection is it recommended that this excess cash be removed from FoodCo to a new Holding company ("Holdco").
- The accountant has completed a re-organization to move the excess cash to Holdco on a tax-deferred basis such that Joe and Jane are now 50/50 common (same class) growth shareholders in Holdco (See Appendix C).
- Jane is very interested in the investment markets and spends considerable time researching, reading, attending investment courses and determining how Holdco should invest its funds to maximize investment returns. She decides to invest the Holdco cash into investments generating interest income. The interest income gives rise to refundable corporate taxes.
- It is advised that a $10,000 taxable dividend be paid from Holdco to recover the refundable taxes paid.

Implications

- Due to the simple share structure, Joe and Jane each must legally receive the same amount of the dividend based on their shareholding percentages - $5,000 each. There is no option to "sprinkle" in any discretionary manner.
- Despite Jane spending significant time in determining how to invest Holdco's money, her labour contribution under the TOSI rules is deemed to have no value when determining what is a reasonable amount to pay her.
- From a capital perspective Joe and Jane are equal in that their common shares of Holdco have the same fair market value, and nominal legal stated capital, paid up capital and adjusted cost base.
- When determining what a "reasonable" amount of the Holdco dividend is for TOSI purposes, an analysis of Jane's contribution to FoodCo appears to be the determining factor.
- It is determined that only 50% of Jane's dividend is considered "reasonable" under the TOSI rules based on her past involvement with FoodCo as Joe is more active and involved in FoodCo than Jane. The capital contributions in FoodCo between Joe and Jane were equal.
  - Jane's tax on the Holdco dividend prior to July 18, 2017 proposals: $NIL
  - Jane's tax on the Holdco dividend after July 18, 2017 proposals: $1,133 ($5,000 x 45.3% x 50% non-reasonable portion)
- The 50% determination of TOSI appears to apply to all future Holdco dividends received by Jane given the analysis of how the funds now in Holdco were generated in the past in FoodCo, not the fair market value of Jane's shares (investment) in Holdco. There doesn't appear to be any way to change this TOSI determination no matter how involved Jane gets involved with FoodCo or Holdco in the future.

<u>Jane is locked into the highest rate of tax on a portion of the dividends received from the Holdco shares forever, even though she would usually otherwise be in the lowest marginal tax bracket. This does not appear to be able to be changed.</u>

Technical Issues

- The “locked in” TOSI allocation appears to be ***retroactive*** in nature based on historical involvement with FoodCo.
- How is an investment holding company shareholder actually able to go back and determine an appropriate TOSI allocation?

Suggested Changes

- To avoid uncertainty and retroactive application, transitional rules should provide for a fixed cutoff such as valuations of shares done on a specific date so that any past capital appreciation in private company shares that is not able to be sheltered with CGE will not be subject to the TOSI rules.
    - This could be implemented similar to the cutoff valuations completed effective December 31, 1971 (Valuation Day) as these proposals in our opinion represent a fundamental change to the taxation of capital gains regime.

Concern # 5 – Capital Gains Exemption While Shares held in Trust

Additional/Alternative Facts & Assumptions:

- Joe, Jane and John have not previously claimed any of their CGE.
- The value of the common shares held by the Trust in 2018 was $250,000 and the value of the special shares held by Jack in 2018 was $500,000. They make the relieving “transitional election” outlined in the July 18, 2017 proposals to crystallize these gains in 2018.
- After high school John obtained a college business diploma and after graduation came home to help Joe with the grocery business. With John’s new education and entrepreneurial drive he makes significant changes to the grocery business increasing the value of the business very rapidly.
- It is now 2024 and the FoodCo shares have been valued at $2,500,000. As part of Amazon.com’s on-going strategy of moving into the grocery business, it has made an offer to buy 100% of the shares from Jack and the Family Trust and the family accepted the deal to sell the shares.
- The Family Trust trustees decide that John was a major reason why the value of the business increased so much so quickly before the sale. As such they allocate the $2,250,000 capital gain from the Family Trust as follows:
    - Joe - $707,500
    - Jane - $707,500
    - John - $835,000

Implications

- Pre-July 18, 2017 Proposals - Tax implications on sale of Trust shares

Proceeds from Sale	$2,500,000
Adjusted Cost Base of Shares	250,000
Capital Gain	2,250,000
Joe CGE	(707,500)
Jane CGE	(707,500)
John CGE	(835,000)
Remaining Capital Gain Subject to Tax	0
Tax @ 26.75% (Ontario 2017 Rate)	**0**
After Tax Cash to Family	**$2,500,000**
Effective Tax Rate on Sale	**0%**

- After July 18, 2017 Proposals - Tax implications on sale of Trust shares[4]
    - For capital gains accrued while the shares were owned by a Trust the CGE is no longer available.

Proceeds from Sale	$2,500,000
Adjusted Cost Base of Shares	250,000
Capital Gain	2,250,000
Joe CGE	Denied
Jane CGE	Denied
John CGE	Denied
Remaining Capital Gain Subject to Tax	2,250,000
Tax @ 26.75% (Ontario 2017 Rate)	**$601,875**
After Tax Cash to Family	**$1,898,125**
Effective Tax Rate on Sale	**24%**

- **As a result of the July 18, 2017 proposals the family pays $601,875 more income tax then they would have under the old tax rules.**

Technical Issues

- There are many non-tax reasons for holding shares in a Trust including probate tax planning, creditor protection, privacy, family law, asset maintenance, etc.
- There are many non-abusive tax reasons for holding shares in a trust including:
    - Allowing a deferral of tax on accrued gains on shares transferred to the next generation when it is uncertain what family members will ultimately become involved in the company as direct shareholders using the Subsection 107(2) "rollout"
    - Purification of excess assets from an operating company to a holding company in a tax-efficient, professional fee efficient manner.
- The proposed rules will make small business owners have to choose between having access to the CGE or using the Subsection 107(2) rollout
    - This may cause business owners to give certain family members direct shareholdings when it does not make sense from a business succession perspective
    - Why should a taxpayer have to choose between the non-tax benefits of having a trust and the loss of using their CGE?
- If a beneficiary of a trust is active in the growth of a company and its annual earnings, why is it offensive from a policy perspective to allocate them a gain that they have "earned" and allow them to use their CGE?

Suggested Changes

- The TOSI rules already seem to deny use of a CGE unless it is reasonable in the circumstances. The denial of the CGE on trust property seems redundant and not necessary. The restriction on using the CGE for property held in trust in the new proposals should be removed.
- Otherwise, an exception could be provided to allow an active beneficiary to claim their CGE on a gain allocated to them from a Trust to the extent the TOSI rules do not apply.

[4] Assuming the TOSI rules do not apply and that the gain allocations would otherwise be considered "reasonable"

Concern # 6 – Special Election

As a “relieving measure” to mitigate some of the negative impacts of the July 18, 2017 proposals, a taxpayer may be able to elect to realize accrued capital gains (a “deemed” capital gain) if certain conditions/criteria are met.

Issues/Uncertainties

- As the deemed capital gain is likely considered “phantom income”, is the special election of any benefit to Trusts with trust deeds that do not expressly contemplate the allocation and payment of “phantom income” to beneficiaries? There may not be enough time for taxpayers to reorganize their structures to potentially make use of the special election in these situations.
- Generally in order to allocate a capital gain to a beneficiary of a trust the amount must be paid or legally payable. Why is the Government forcing taxpayers to make a decision now on allocation of value? As an example, issuing a promissory note to an 19 year old that can legally enforce a payment? Can a Trust do the special election without issuing a promissory note with consent of the adult beneficiary?
- With the requirement to value the shares of the private corporation, what are considered reasonable efforts for valuation for purposes of the special election? (is a Chartered Business Valuator required to be involved?)

Suggested Changes

- As taxpayers are being forced to crystallize capital gains in 2018 by filing the special election, the resulting income should be exempted from Alternative Minimum Tax and income tested benefits.
    - Forcing a taxpayer to pay the Alternative Minimum Tax may lead to cash flow issues given no sale will actually occur.
    - “Middle class” families may face financial hardship with a loss of child benefits and seniors may face a clawback of their Old Age Security payments.
        - While we have agricultural specific comments below we foresee this having a substantial impact on farm families
- Subsection 69(11) should not apply to taxpayers and their family members who make an election
    - The application of Subsection 69(11) would have a substantial impact specifically on farm families and would cause a retroactive impact if properties were transferred in the few years leading up to the July 18, 2017 announced proposals.
- The special election should be open to minors as they currently could utilize their CGE on arm’s length sales in 2017.
- Due to the short notice, the period to make the election should be 2019, not 2018

Concern # 7 – Practical TOSI Considerations

Implications

- The proposals would impose a significant administrative and compliance burden on taxpayers. As examples:
    - Taxpayers may have to re-evaluate existing structures;
    - Taxpayers may have to engage experienced tax professionals to ensure there are no unintended consequences from any reorganization;
    - Taxpayers will have to document and retain documents to support involvement of family members in the business potentially forever;
    - Taxpayers will have to be aware of the different tests for family members age 18 to 24, and for those 25 and older.
- The complexity of the proposals as well as the added risks in preparing tax returns may result in sole practitioners that are not tax experts no longer being able or willing to provide tax services to the public or alternatively sole practitioners who do not understand the proposed tax rules may prepare incorrect tax returns or provide incorrect advice to clients.

- In addition to taxpayers and accounting professionals, given the degree of complexity of the proposals, it is difficult to believe that CRA auditors would also be able to understand and apply the proposed rules on a fair and unbiased basis.
- Who is responsible for making an incorrect TOSI analysis?
    - The company who pays the dividend and prepares the T5 slip?
    - The tax preparer who prepares the tax return? (may not be the same as the corporate accountant)
    - The client?
- How does a tax preparer know that the income allocated is subject to TOSI if they are not the corporate accountant, or T5 preparer?
    - Will the TOSI be required to be indicated on T5 slips?

The proposals would impose uncertainty and subjectivity to the compliance process. The CRA will undoubtedly reassess taxpayers on the basis that TOSI applies.

Converting Income Into Capital Gains Measures

Through certain reorganizations, taxpayers who held shares of private corporations were able to convert what otherwise would have been a taxable dividend (with a top marginal tax rate of 45.3% in Ontario for non-eligible dividends) to a capital gain (with a top marginal tax rate of 26.75% in Ontario), a rate differential of up to 18.55%. We believe the Department of Finance was aware of this planning and wanted for it to stop.

As a result, Section 84.1 is proposed to be amended and new Section 246.1 is introduced. However, in our opinion these new provisions go far beyond the targeted abuse.

The following analysis explains our concerns with the proposed measures in regards to converting income into capital gains.

Concern # 8 – Post Mortem Issues

Additional/Alternative Facts & Assumptions:

- Jack died on February 2, 2015

Implications

- On Jack's 2015 date of death personal tax return he reported a deemed disposition of his 500,000 FoodCo shares and a resulting capital gain of $500,000. His Estate paid $125,000 of capital gains tax on the $500,000 capital gain.
- Joe inherited the 500,000 shares from Jack's estate. When Joe redeems the 500,000 shares of FoodCo in the future, he will pay up to another $226,500 of income tax on the deemed dividend. This results in double taxation.
- This results in $351,500 of income taxes paid on $500,000 of value, or a rate of 70.3%.
- Joe had planned to use the "pipeline" strategy to avoid double tax in the future. There was no time limit or deadline for completing the "pipeline" strategy. However, as a result of the income tax changes released July 18, 2017 there is now no way to implement the "pipeline" strategy to avoid the double tax.

Technical Issues

- The proposed change to Subparagraph 84.1(2)(a.1)(ii) is punitive as it results in double taxation that cannot be avoided. The original intent of Section 84.1 was to ensure that "surplus stripping" was only allowed where taxes have been paid – not to apply double taxation.
- The proposed change to Subparagraph 84.1(2)(a.1)(ii) is retroactive as it impacts taxpayers regarding transactions that occurred before July 18, 2017. There is no recognition given for taxes paid by related parties in the past.

- The proposed change to Subparagraph 84.1(2)(a.1)(ii) requires a complete knowledge of the entire history of the shareholdings of the company. These details are often not available to the current accountant.

Suggested Changes

- The proposed change to Subparagraph 84.1(2)(a.1)(ii) should *at a minimum* be revised such that it only applies to non-arm's length dispositions that occurred after July 18, 2017.
- The proposed change to Subparagraph 84.1(2)(a.1)(ii) could be revised such that it does not apply to dispositions that occurred upon a death prior July 18, 2017.
- Subsection 164(6) could be expanded to allow for a longer period to carryback losses from an Estate to a date of death terminal tax return. Since only "Graduated Rate Estates" can make an election under Subsection 164(6) the permitted period should be at a minimum the length that the "Graduated Rate Estate" is in existence.
    - As there was no previous time limit applicable to the "pipeline strategy" perhaps the permitted time period to make a Subsection 164(6) election should be unlimited.
- The capital gains inclusion rate could be increased from 50% to 75% on non-arm's length inter-vivos dispositions of private corporation shares increasing the effective capital gains tax rate closer to the dividend tax rates.
- A special additional tax or credit system could be enacted to bring the capital gains rate up to a dividend rate when selling shares with "hard" adjusted cost base to a company that a taxpayer does not deal at arm's length with.

Concern # 9 – Succession Planning

Additional/Alternative Facts & Assumptions:

- Assume that when Jack's interest in FoodCo was "frozen" that the new common growth shares were issued 100% to Joe and that a subsequent freeze in favour of the family trust never occurred (See Appendix D).
- After high school John obtained a college business diploma and after graduation came home to help Joe with the grocery business.
- It is now 2024 and the FoodCo shares have been valued at $2,500,000. As part of Amazon.com's ("USA CO") on-going strategy of moving into the grocery business, it has made an offer to buy 100% of the shares from Joe and Jack.

Example Part 1 – Cash Sale

- John would really like to take over the family business, but due to circumstances in Jack and Joe's lives they would like cash, similar to the USA CO offer.
- Despite the indication in the July 18, 2017 Department of Finance proposals to look at allowing the CGE to be used in a family succession, it was determined that there was no feasible way to allow this due to potential for abuse.
- John, Joe and Jack go to their accountant for a meeting to determine the tax implications of sale to either John or to USA CO.

Example Part 2 – Sale to John for Promissory Note

- Due to differing circumstances in Jack and Joe's lives they have decided they do not need to be paid by John for their shares of FoodCo. They are also against selling to anyone but family.
- Joe is not interested in completing an estate freeze due to potential uncertainty with certain post-mortem tax issues that he has heard about. Jack would like to sell his shares to John to make his Estate administration potentially less complex.
- John also is not married so it is recommended for Family Law protection for John, that Jack and Joe should simply sell their shares of FoodCo to John for promissory notes, forgiven upon their deaths.

Implications

Part 1 – Cash Sale

- Sale to USA CO:

Proceeds from Sale	$2,500,000
Adjusted Cost Base of Shares (Joe & Jack)	NIL
Capital Gain	2,500,000
Jack CGE[5]	(500,000)
Joe CGE (Using 2017 Amount – ignoring indexing)	(835,714)
Remaining Capital Gain Subject to Tax	1,164,286
Tax @ 26.75% (Ontario 2017 Rate)	**311,447**
After Tax Cash to Joe and Jack	**$2,188,553**
Effective Tax Rate on Sale	**12.5%**

- Sale to John with <u>no</u> advanced tax planning (double taxation):

Proceeds from Sale	$2,500,000
Adjusted Cost Base of Shares (Joe & Jack)	NIL
Capital Gain[6]	2,500,000
Jack CGE	(500,000)
Joe CGE	(835,714)
Capital Gain Subject to Tax	1,164,286
Tax @ 26.75% (Ontario 2017 Rate)	**311,447**
Future dividends to John from FoodCo to pay Jack and Joe	2,500,000
Tax @ 45.3% (Ontario 2017 Rate)	**1,132,500**
Total Taxes Paid by Family	**$1,443,947**
Effective Tax Rate on Sale	**57.8%**

- Sale to John with advanced tax planning to avoid double taxation:

Proceeds from Sale	$2,500,000
Dividend to Joe and Jack	2,500,000
Tax @ 45.3% (Ontario 2017 Rate)	**$1,132,500**
After Tax Cash to Joe and Jack	**$1,367,500**
Effective Tax Rate on Sale	**45.3%**

<u>As Joe and Jack end up with $821,053 more after tax cash on the sale to USA CO they sell the grocery business to USA CO. Does the Government want to encourage selling businesses to non-family members?</u>

[5] This assumes that the TOSI rules do not apply to Jack's capital gain on the basis that "capital" is determined based on the fair market value of his shares when the 2017 tax proposals were completed. If the TOSI rules apply then taxes would increase under both the sale to USA CO and to John

[6] This assumes that the TOSI rules do not apply to recharacterize Jack's capital gain taxed at 26.75% into a dividend taxed at 45.3%.

Part 2 – Sale for Promissory Note

- The taxes payable are the same as outlined above as a sale to John with no advanced tax planning (double taxation):

Proceeds from Sale	$2,500,000
Adjusted Cost Base of Shares (Joe & Jack)	NIL
Capital Gain[7]	2,500,000
Jack CGE	(500,000)
Joe CGE	(835,714)
Capital Gain Subject to Tax	1,164,286
Tax @ 26.75% (Ontario 2017 Rate)	**311,447**
Dividend to John of FoodCo cash to pay Jack and Joe	2,500,000
Tax @ 45.3% (Ontario 2017 Rate)	**1,132,500**
Total Taxes Paid by Family	**$1,443,947**

- However, under this option, as FoodCo is a Qualified Small Business Corporation, a special tax reserve can be taken such that Jack and Joe can realize their capital gains into taxable income equally over a 10 year period. This is attractive for Jack so he does not have a clawback of his Old Age Security benefits or have to pay the Alternative Minimum Tax. This is attractive for Joe so he does not have to pay the Alternative Minimum Tax. It may also allow them to reduce the marginal tax rate applicable to the gain to lower than 26.75% by realizing the gain in their next 10 years of tax returns.

In order to realize special benefits[8] to allow for succession planning currently in the Income Tax Act, the family must accept double taxation as a certainty.

Technical Issues

- It is more tax efficient under the tax system for a private company small business owner to sell to a foreign or public company than it is to sell to a family member. While the tax proposals do not change this fact[9], unless specific advanced tax planning is done, the proposals greatly increase the risk of double taxation.
  - Not all small business owners have access to qualified tax professionals to guide them through this new complexity. Sole practitioner accountants will likely not be able/willing to advise on these transactions given the high risk of double taxation.
  - Additional professional fees will be required to be paid by small business owners.
- Under no circumstance can Jack or Joe realize the tax benefits associated with using their CGE.
- Due to the changes made to Section 84.1 a sale of shares from Jack and Joe to John would result in double taxation, first to Jack and Joe on the capital gain on the sale of shares not sheltered by CGE, then again when John withdraws cash dividends from FoodCo to pay Jack and Joe (or repay a personal bank loan).
- If FoodCo arranges for a bank loan of $2,500,000 to facilitate the succession and redeems the shares held by Jack and Joe, the interest on the bank loan may not be fully tax-deductible.
- It appears that the best option would be for Jack and Joe to sell their shares to a Holding Company setup by John and rely on Section 84.1(an anti-avoidance provision) to deem them to receive a dividend such that the interest on the bank loan is deductible.
- Even if the principal of the Promissory Note is never paid, even on a simplistic sale of shares between family members it appears that a corporation will be required to always make the purchase to avoid double taxation. This increases complexity and transaction costs to small business owners.

[7] This assumes that the TOSI rules do not apply to recharacterize Jack's capital gain taxed at 26.75% into a dividend taxed at 45.3%.
[8] Various benefits include the deferral of income tax by using the CGE on family share transfers and benefits associated with using a 10 year reserve including reduced OAS clawback, Alternative Minimum Taxes, and other income tested benefits and credits.
[9] Assuming the TOSI rules do not apply to re-characterize capital gains into dividends

- Certain provisions to encourage family business succession like the 10 year reserve in Subsection 40(1.1) of the Income Tax Act appear to be rendered much less beneficial or even useless as to take advantage of them, a family must subject itself to double taxation.
    - If a corporation is used as the purchaser of shares for succession purposes, the 10 year reserve is also not available as it is only applicable to sales to a "child".

Suggested Changes

- The capital gains inclusion rate could be increased from 50% to 75% on non-arm's length inter-vivos dispositions of private corporation shares and Section 84.1 could be left unchanged. While this does not affect the difference between the taxes paid on a sale between a foreign or public company and family, it would decrease the risk of double taxation.
- A special additional tax or credit system could be enacted to bring the capital gains rate up to a dividend rate when selling shares with "hard" adjusted cost base to a company that a taxpayer does not deal at arm's length with. This also does not affect the difference between the taxes paid on a sale between a foreign or public company and family, however, it would decrease the risk of double taxation.

Concern # 10 – Ordinary Commercial Activities

Additional/Alternative Facts & Assumptions:

- FoodCo owns an adjacent vacant lot to the grocery store building. The lot has been kept for future expansion purposes.
- A developer has approached Joe and is interested in purchasing the lot.
- Joe asks his accountant what the income tax implications of selling the lot would be. His accountant states that there will be a capital gain on the sale and that half of the capital gain can be taken out of FoodCo as a capital dividend.
- Before talking to the accountant Joe liked the developer's offer, however now that the accountant has told him of the capital dividend Joe is even more in favour of it as it could allow him to take funds out of FoodCo in a tax-efficient manner to someday help Jeff purchase his first home.

Implications

- If one of the purposes of the sale of the lot to the developer is to avoid income tax, which having access to the capital dividend would, then the taxes on the sale of the lot will significantly increase from a tax rate of up to 26.7% to approximately 50.5%.

Technical Issues

- Proposed Section 246.1 is drafted so broadly that it could apply to almost any ordinary capital commercial transaction as capital gains always result in a tax-preferential position.
- Proposed Section 246.1 does not provide for any time limits either before or after a transaction takes place. This provides a retroactive result contrary to statements made that the proposals are meant to be prospective only in application.
- Proposed Section 246.1 uses subjective language like a "significant reduction or disappearance of assets of a private corporation"
    - What is meant by "significant"?
        - Is a "disappearance" of assets determined on a "gross" or "net" basis? (i.e. sell a $500,000 property to a company and take out $500,000 in cash)
- Proposed Section 246.1 refers to "one of the purposes". Would this not apply in every instance a capital dividend is paid?

Suggested Changes

- Proposed Section 246.1 appears to have been drafted to formally include in the Income Tax Act a general scheme against "surplus stripping". The CRA has argued this many times in the courts but has been unsuccessful.
- If there is now a desire by Government to codify this concept in the Income Tax Act then the provision should specifically target artificial "Surplus Stripping" transactions, not impose measures that raise a risk of double taxation.
- Proposed section 246.1 should be revised to consider the following:
    - An exclusion for arm's length sales;
    - An exclusion for tax-paid adjusted cost base of capital property of the taxpayer; and
    - Only apply to dispositions after July 18, 2017.
- An alternative solution would be to increase the inclusion rate on capital gains on private company shares to 75% from the current 50% rate. This would take away the "spread" between dividend and capital gains rate in a targeted way to minimize surplus stripping transactions.
    - This would not impact the general population who hold many different types of capital properties (i.e. public company shares, real estate, etc.) and would continue to benefit from favourable treatment of capital gains.
    - An incentive is still available to private corporations to sell shares as they can use their CGE.
    - The 75% inclusion rate could also apply to deemed gains triggered under Subsection 55(2) to restore its anti-avoidance goals.

Holding Passive Investments Inside a Private Corporation

Canadian Controlled Private Corporations ("CCPC") pay an initial low rate of tax on their "active business income". In Ontario the current rate is 15%. When the after-tax profits of a CCPC are paid out as dividends to the shareholders, the shareholders pay another level of tax on the dividend such that the total taxes paid by the CCPC and the shareholder equal the tax an unincorporated business owner would pay on the same amount of business income. This principle, known as "integration", is the basic foundation for the Canadian income tax system and has been so since 1972. The Government targets integration to work mathematically by looking at the taxes paid by a theoretical taxpayer earning income in the highest tax bracket. The principle is illustrated by continuing Joe and FoodCo's example as follows:

Additional/Alternative Facts & Assumptions:

- Assume Joe's grocery business has a fantastic year due to changes in the local grocery market. FoodCo has taxable income of $320,000.
- Joe has heard a lot in the media about the "top 1%" earning income in the highest tax bracket benefiting from incorporation. Joe wants to know how his CCPC benefits him on the income he earned above $220,000, the highest tax bracket in Ontario, compared to if he was not incorporated.

Implications:

	Joe - FoodCo CCPC	Joe – Not-Incorporated	Differences
Taxable Income above $220,000	$100,000	$100,000	$Nil
Initial Tax	$15,000	$53,500	$38,500
Funds to Re-Invest	**$85,000**	**$46,500**	**$38,500**
Future Taxes	$38,505	$Nil	$38,505
Final Total Tax	$53,505	$53,500	$5
FINAL AFTER TAX CASH	**$46,495**	**$46,500**	**$5**

Joe realizes that his incorporated status gives him $38,500 initially more to invest than what he would have had if he was not incorporated. Joe's accountant explains that the initial lower rate of tax in the CCPC is meant to provide a deferral of income tax to provide more funds to the CCPC to grow its business.

FoodCo has repaid all of its debts and Joe does not currently have any expansion plans for the business. His staff levels are appropriate and his equipment is all modern. Joe hasn't started saving for retirement as all of his investments to date have been into FoodCo's business. Joe also doesn't have much RRSP room as he has only paid himself dividends[10], he does not pay himself wages or a salary.

Joe decides to invest the extra $38,500 into GIC's. While he hopes it will be the start of his retirement savings, he also knows that while business is going well now, he may need that $38,500 in the future if the market deteriorates, if he decides to expand his business, or when he needs to replace/fix his equipment.

The year after, Joe meets with his accountant. FoodCo earned $1,000 of interest income on the GIC investment. Joe is shocked when his accountant tells him he has to pay $500 of tax on the $1,000 of interest income – a rate of 50%!

Joe's accountant explains that while the tax system provides preferential tax treatment of "active business income" (the grocery business profits), there is no tax benefit of earning passive investment income in a corporation. However, Joe's accountant shows him the following example to show him that he also is no worse off earning the interest income in FoodCo compared to personally, as the "integration" principle in the tax system also works for passive investment income[11]:

	Joe - FoodCo CCPC	Joe – Not-Incorporated	Differences
Interest Income	$1,000	$1,000	$Nil
Initial Tax	$500	$535	$35
Funds to Re-Invest	**$500**	**$465**	**$35**[12]
Corporate tax refund on dividend payment	$(310)	N/A	N/A
Personal tax on dividend	$367	N/A	N/A
Final Total Tax	$557	$535	$22
FINAL AFTER TAX CASH	**$443**	**$465**	**$22**[13]

Joe asks his accountant, why is the Government concerned?

Joe's accountant explains that FoodCo has a greater amount of starting capital (the $38,500 deferral advantage) that an employee does not have.[14] Joe's accountant explains that therefore a CCPC could therefore be seen as a "super-RRSP" with no contribution limits, and with more investment flexibility. Over time this deferral advantage could lead to the incorporated business owner having more after tax savings than an employee.

[10] Dividends do not create RRSP contribution room.
[11] Assuming Joe again was a theoretical taxpayer in the highest tax bracket.
[12] 3.5% deferral difference generally not considered offensive by tax practitioners or the government historically. This difference changes nominally year over year depending on tax rate changes. The government is not targeting this difference.
[13] Currently there is actually a 2% permanent tax cost of earning investment income in a corporation compared to earning investment income personally!
[14] An unincorporated business owner could gain this advantage by incorporating their business therefore an incorporated business owner does not have any advantage over a non-incorporated business owner as there are generally no restrictions on incorporating a business. Therefore, the comparison must be to non-business owners, employees.

Technical Issues

- The 1972 Method was repealed in 1973 due to its complexity. If it did not work then, why would it suddenly work now?
- The "deferred taxation" Method now outlined seems more complex than the 1972 Method. If the 1972 Method is too complex to work, how can it be thought that a more complex method would work?
- There is no restriction on Canadian corporations that are non-CCPC's to reinvest their earnings into only business assets. In fact, these proposals would give non-CCPC Canadian corporations continuing advantage as they would be able to obtain a tax-deferral on passive investment income (non-CCPC Canadian corporations pay a rate of 26.5% on all income, active and passive)
- In order to properly comply with the deferred taxation method, small business owners would have to pay excess professional fees to expensive tax specialists as it is unlikely a sole practitioner accountant or the client themselves would be able to comply with these rules on their own.

Suggested Changes

- Passive investment income is already taxed at the highest rate in CCPC's and there is no deferral advantage to earning investment income in a corporation. The current system works!
- The proposals should not be pursued and should be abandoned.

Farm Specific Issues with Proposed Changes

Approximately 50% of our client base consists of primary agricultural producers (cash crop, dairy, poultry, eggs, turkey, swine, beef, etc.) While some of the following issues could apply to non-farming businesses we have identified the following issues that we believe may have a more significant impact on farmers than other industries:

TOSI Impact on Inter-Generational Farm Rollovers

The "inter-generational" farm rollover rules in Sections 70 and 73 allow for the transfer of farming assets (land, buildings, equipment, shares of "Family Farm Corporations", interests in "Family Farm Partnerships") to children on a tax-deferred basis if certain conditions are met. There is no changes being proposed to these rules.

However, we question whether these rules will continue to be effective and provide the same benefit to farmers in the future after the introduction of the proposed TOSI rules.

Example Facts & Assumptions:

- Tom is a widowed farmer who was the 100% shareholder of FarmCo.
- FarmCo's assets consist of farm land, barns, equipment and livestock.
- Tom's son, Bob, grew up on the farm, helping out his dad throughout his life, and is now ready to take over the farm.
- Bob has a sister, Jenny, who lives in the city, but hasn't helped on the farm since she was a young child.
- On January 1, 2017 Tom transferred (gifted) 100% of his common growth shares of FarmCo to Bob valued at $1,000,000 pursuant to the inter-generational farm rollover rules at the share's tax cost (adjusted cost base) of $NIL such that no capital gain arises.
- When Bob turned 18, the value of the common shares of FarmCo was $100,000.
- On January 1, 2017 Tom transferred (gifted) 100% of his fixed value special shares of FarmCo valued at $250,000 to Jenny pursuant to the inter-generational farm rollover rules at the share's tax cost (adjusted cost base) of $NIL such that no capital gain arises. Jenny will be a silent investor and while the value of the shares she is receiving have less value then the common shares, she considers this to be a fair inheritance given her past involvement in the farm compared to Bob. (*Fair, but not Equal*)
- After the transfer, Tom retires to a nursing home and no longer provides any labour to the farm operation.
- See Appendix E for the structure.

Example Part 1 – Annual Earnings:

- In FarmCo's 2018 fiscal year, FarmCo has an after corporate tax profit of $75,000.
- As a silent investor Jenny has always received a $5,000 dividend annually (2% rate of return)
- Bob meets with his accountant to determine his year end compensation. During that meeting the accountant and Bob do an analysis of what Bob's labour contribution would be worth had he hired outside help to do the work rather than himself. They decide $40,000 would be a reasonable amount.
- Despite determining that Bob's labour contributions were worth $40,000, Bob mentions he would like to draw the full remaining $70,000 in profit from FarmCo as he has some personal items he would like to purchase.
- As such, FarmCo declares a $70,000 dividend to Bob and a $5,000 dividend to Jenny.

Example Part 2 – Capital Gains:

- It is now 2025. While land values have significantly increased since Bob inherited his shares, due to market conditions Bob can no longer make a reasonable income from the farm and would like to sell the shares of FarmCo to a neighbour so he can invest in other ventures. His shares are now worth $2,000,000.
- The sale also requires Jenny to sell her shares to the neighbour farmer.
- Due to the additional tax and uncertainty in the TOSI rules regarding income, Bob decided after the first year to just pay himself a reasonable wage out of FarmCo annually.

Implications:

Part 1:

- As Jenny did not make any labour or capital contributions to FarmCo and has received a $5,000 dividend that is considered "unreasonable", the dividend that she did not "earn" would be subject to the TOSI rules and the highest marginal tax rate of 45.3% despite the fact that Jenny usually pays a 20% marginal tax rate on the $5,000 dividend she receives annually from FarmCo.
- As Bob did not make any capital contributions to FarmCo and has taken a dividend in excess of the value of his labour contributed, the excess $30,000 that he did not "earn" would be subject to the TOSI rules. Therefore, the income taxes payable on the $70,000 dividend would be approximately $13,590. (0% income tax on first $40,000 of dividends due to marginal rates and personal credits, and 45.3% on $30,000 portion of dividend subject to TOSI rules)
- Before the TOSI rules Bob would have paid approximately $6,500 of income taxes on the $70,000 dividend.
- **The TOSI rules create $7,090 of additional income tax to Bob.**

Part 2:

- Bob has been compensated annually for his labour contributions with his wage. He never made any capital contributions, but because his income is in the top tax bracket due to the sale he is not subject to the TOSI rules. Therefore he is able to use his CGE on the share sale to shelter a portion of the capital gain and pays tax on the remaining gain at capital gains tax rates.
- Jenny never contributed any labour since she acquired the shares and never made any capital contributions. Therefore, the TOSI rules apply and Jenny cannot use any of her CGE on the share sale.
    - Tax to Jenny before July 18, 2017 proposals = $NIL
    - Tax to Jenny after July 18, 2017 proposals = $66,875

Technical Issues:

- How will the Department of Finance interpret "capital" under the TOSI rules when shares have been gifted/transferred for a nominal amount specifically where other rules in the Income Tax Act such as the inter-generational farm rollover rules encourage this planning? Will they look to fair market value, legal stated capital, paid-up capital, or adjusted cost base in determining the capital amount?
- Jenny has been happy to be involved in the farm with Bob as a silent investor and has accepted a 2% rate of return on her $250,000 investment (lower than what she could have earned in alternative investments with the same risk profile) as it allowed Bob the chance to continue the family farm business.
    - If Jenny called for a redemption of her shares causing FarmCo to obtain financing from the bank (assuming the bank would even give financing and likely at a higher interest rate and require principal repayment requirements) it could cause significant cash flow issues to FarmCo.
        - It is common for farm family members to hold investments in a farm operation until the farm assets are actually sold out of the family.
    - However, with the TOSI rules, an incentive is given to Jenny to move her investment into other investments as her after-tax rate of return would be much greater (i.e. higher returns ***and*** lower tax!)
    - What if the Canada Revenue Agency thinks that a 2% rate of return is too low? Will they deem a higher reasonable rate of return to Jenny so that they can collect more tax at the highest marginal tax rate under the TOSI rules?
- Bob is the sole legal owner of the common shares. A rate of return has been paid to Jenny on her share capital. Therefore, it would seem that all remaining profits are Bob's. There is no income sprinkling or splitting being done.
    - Is it fair to subject any unreasonable portion of dividends or capital gains on the shares to the highest possible rate of tax?
- The inter-generational farm rules provided for a deferral of tax. However, upon a future sale, if the shares are subject to the TOSI on a non-arm's length sale (i.e. a sale of shares from Jenny to Bob), the capital gain is re-characterized from a capital gain to a dividend at a higher tax rate. Therefore, the deferral benefit of the inter-generational farm rollover rules may be diminished or eliminated if it is not greater than the additional permanent tax cost on dividends compared to capital gains.
    - How can a farmer make an educated succession decision on using the deferral rules when they do not know if it may cost the family more permanent tax in the future?

Past Farm Gains Accrued while Under Age 18

Example Part 3:

- Assume the same background facts as the above with Tom, Bob and Jenny.
- Assume Bob and Jenny have both worked on the farm full time since they received the shares and that the Department of Finance has clarified that the "capital" test under the TOSI reasonability rules is met by looking at the *fair market value* of the shares when they were transferred to Bob and Jenny from Tom.
- Assume the fair market value of Jenny's shares of FarmCo was $250,000 when she turned 18.
- Bob and Jenny sell their shares to their neighbour.

Implications:

- The $100,000 capital gain accrued before Bob turned 18 is not eligible for the CGE. Bob realizes a total capital gain of $2,000,000. Is he able to apply his $1,000,000 CGE to the $1,900,000 portion of the capital gain accrued since he turned 18, or is a pro-rata calculation required? (i.e. $100,000/$2,000,000 x $1,000,000 CGE). Is the CGE applied on a first in, first out method?
- The $250,000 capital gain accrued before Jenny turned 18 is not eligible for the CGE.
    - Tax to Jenny before July 18, 2017 proposals = $NIL
    - Tax to Jenny after July 18, 2017 proposals = $67,000

Technical Issues:

- Bob and Jenny were not able to make the relieving "transitional election" in 2018 to utilize their CGE on the gains accrued in the shares before they were 18 due to Subsection 69(11) of the Income Tax Act as the shares were transferred to them on January 1, 2017 and 3 years had not passed.
- Significant complexity and cost is added due to the fact that a retrospective valuation of FarmCo at the time Bob and Jenny turned 18 is now required.
- Is the $100,000 of capital gain accrued before Bob turned 18 ignored as we assume his $1,000,000 of CGE can be applied to the $1,900,000 gain accrued after Bob turned 18 or is a pro-rata calculation required?
    - If a pro-rata calculation is required then the tax rules have a retroactive effect as a decision could have been made on January 1, 2017 before the July 18, 2017 announcement of the rules to utilize a portion of Tom's CGE on the share transfer which would decrease the amount of capital gains tax now faced by Bob due to the pro-rata calculation.
- The July 18, 2017 rules apply retroactively to apply tax on Jenny's capital gain which could have otherwise been sheltered with Tom's CGE when the decision to transfer the shares on January 1, 2017 was made.

Impact on Unincorporated Farm Partnerships

Many farm clients operate as unincorporated farm partnerships, usually between a husband and wife. Generally these partnerships do not have a formal partnership agreement in place and a simple income allocation of 50/50 is made at the end of each taxation year without a formal analysis completed.

The documents released on July 18, 2017 and comments by Government officials have not emphasized that the proposed changes to the tax rules also affect unincorporated partnerships.

Individual partnerships are generally used when legal protection is not important (common for farm operations) and incorporation is cost prohibitive as there are generally higher annual professional compliance costs for corporations compared to partnerships.

However, increased risk and compliance costs will now be forced onto unincorporated partnerships annually in navigating the TOSI rules applicable to income and capital gains.

Transfers of Farm Property to Corporations

It is quite common for sole proprietor farmers or farm partnerships to partially incorporate themselves or transfer assets on a continuing basis over time to their existing corporations for a variety of reasons. One of the reasons is always tax related. It would appear that due to the broad drafting of proposed Section 246.1, that potentially every transfer of farm property to a corporation would be at risk to having this provision apply.

The adjusted cost base of these farm assets is tax-paid. The consideration given by the corporation for the tax paid portion of the asset is usually a tax-paid promissory note (shareholder loan). It appears that these rules could apply double taxation to almost any transfer of property no matter how benign the transfer or transaction may seem. Further, if the TOSI rules apply, in addition to double taxation at capital gains rates, even higher rates of taxation could occur due to recharacterizing capital gains as high rate dividends.

This adds significant risk, complexity and cost to farmers in managing their affairs.

Conclusion

Over the past few years our clients, our firm and tax practitioners have faced a massive increase in tax compliance, uncertainty and risk given the substantial tax changes already introduced before July 18, 2017 including:

- Changes to the taxation of eligible capital property (specifically this has had a substantial impact on our farmer clients with quota)
- Changes with regards to utilizing the small business deduction (specified corporate income), and
- Changes to Subsection 55(2).

Given the significant changes and uncertainty surrounding the changes already made, adding the July 18, 2017 proposals seems to make not only tax planning, but general tax compliance itself, almost impossible to comply with in a reasonable, accurate manner.

We believe that there are simpler alternative solutions that may accomplish the same stated goals of the Department of Finance, but in a more targeted way without the punitive consequences that we have identified in our concerns.

We would welcome the opportunity to discuss the proposals, our concerns, and our suggestions with any officials from the Department of Finance. If you have any questions on this submission, please do not hesitate to contact us.

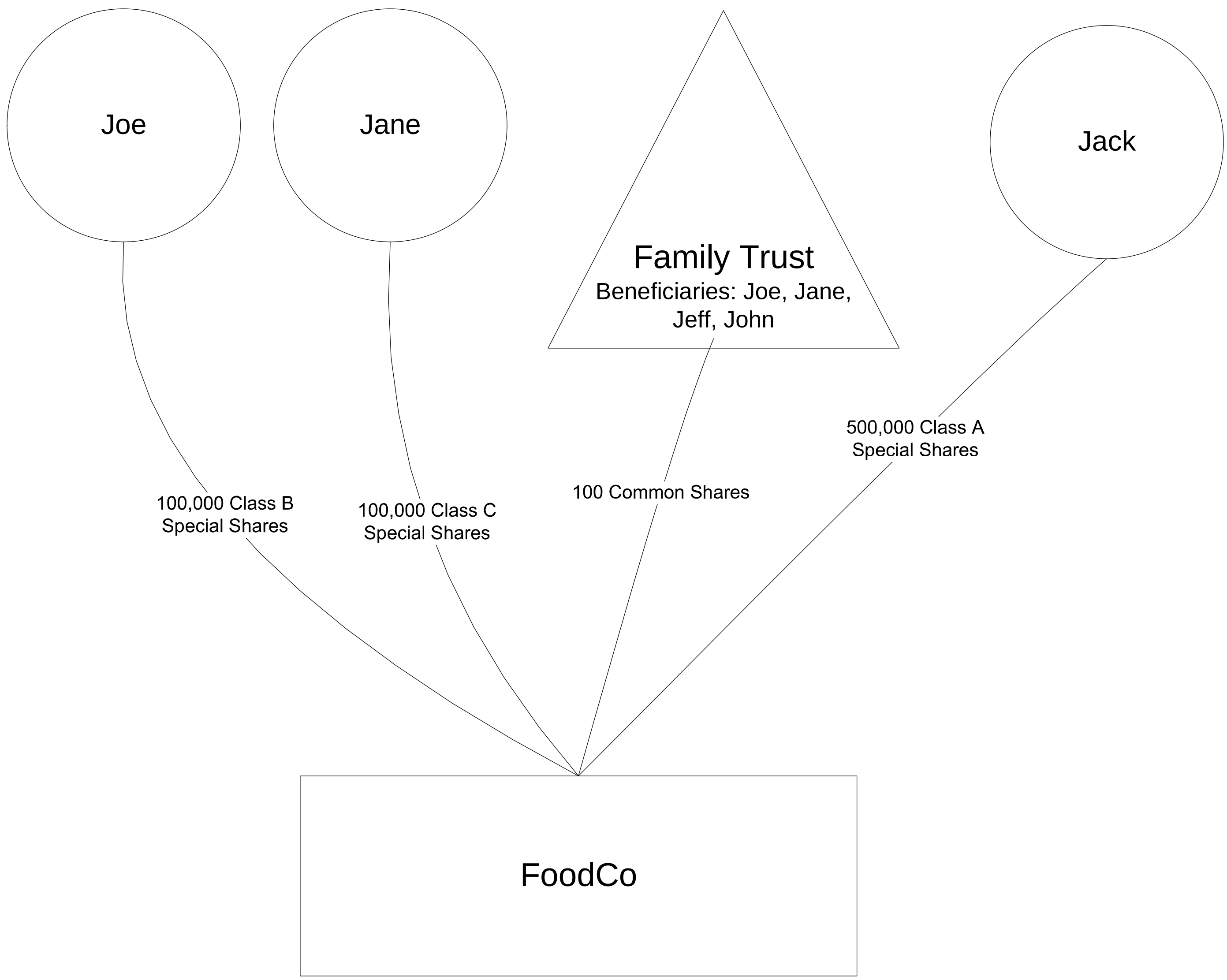
Sincerely,

Ward & Uptigrove

WARD & UPTIGROVE CHARTERED PROFESSIONAL ACCOUNTANTS

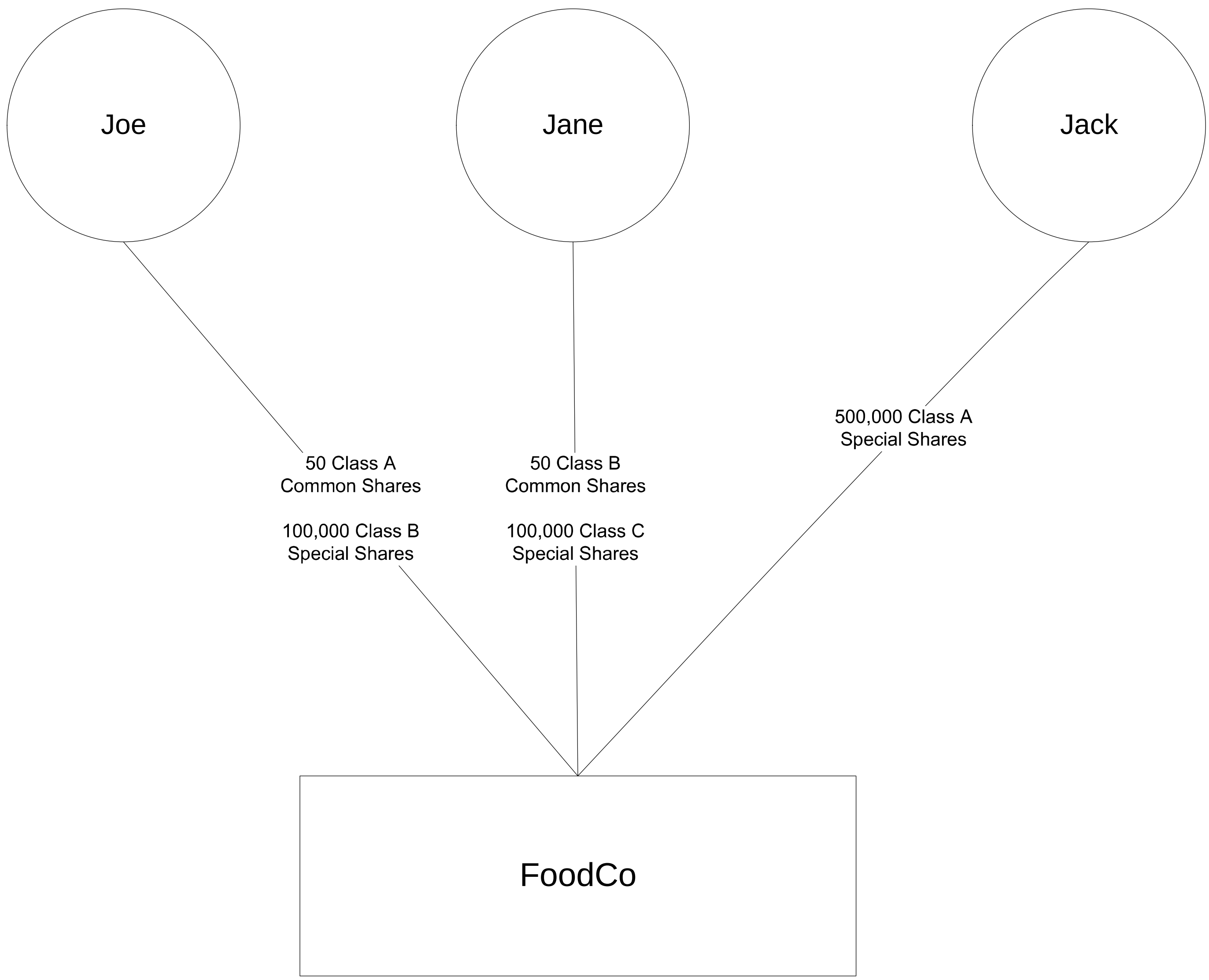
cc. Rt. Honourable William Morneau
Honourable Andrew Scheer
John Nater, M.P. Perth-Wellington County

Appendix A

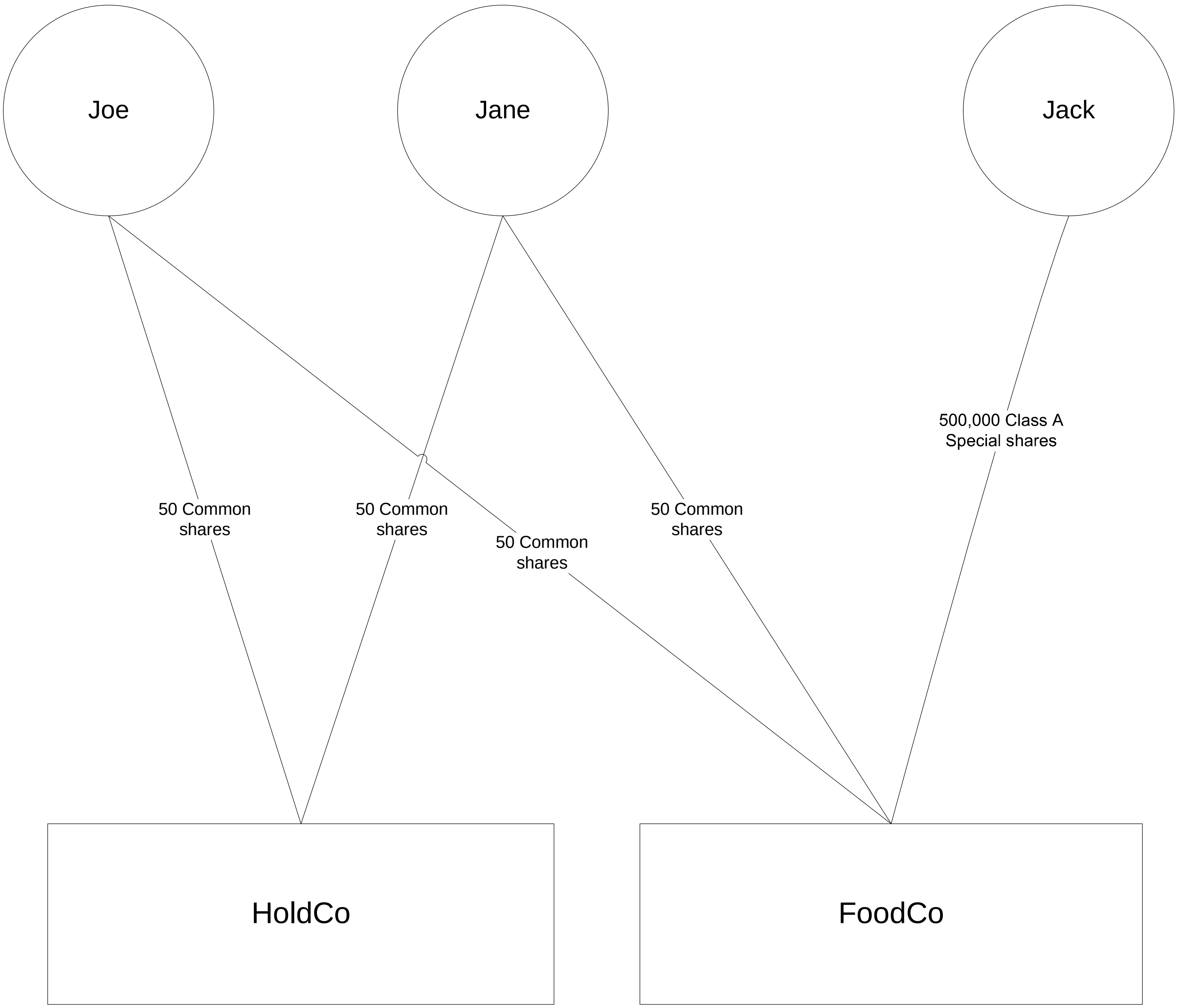


Joe
Jane
Family Trust
Beneficiaries: Joe, Jane, Jeff, John
Jack
100,000 Class B Special Shares
100,000 Class C Special Shares
100 Common Shares
500,000 Class A Special Shares
FoodCo

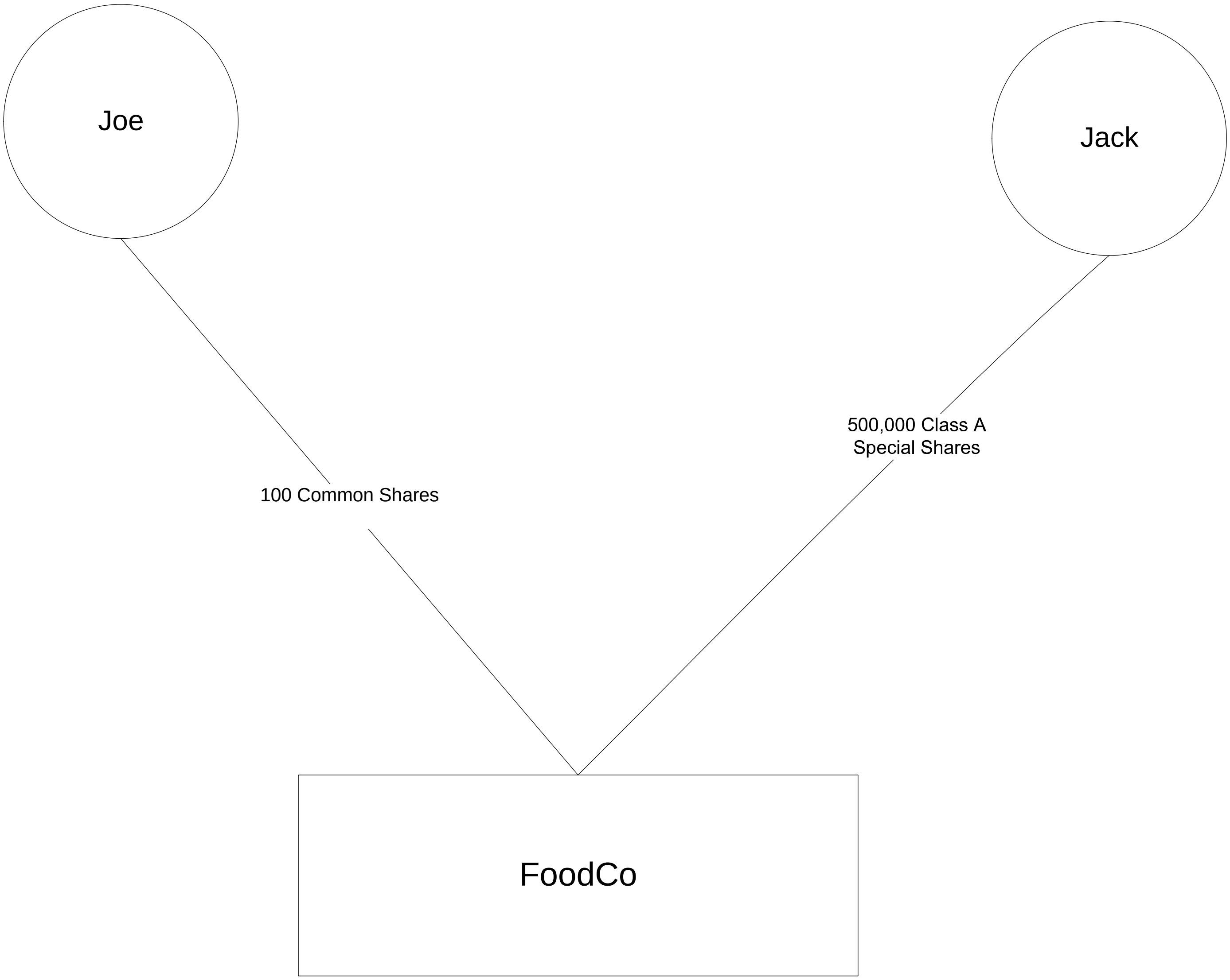
Appendix B


Joe
Jane
Jack
50 Class A
Common Shares
100,000 Class B
Special Shares
50 Class B
Common Shares
100,000 Class C
Special Shares
500,000 Class A
Special Shares
FoodCo

Appendix C


Joe
Jane
Jack
500,000 Class A
Special shares
50 Common
shares
50 Common
shares
50 Common
shares
50 Common
shares
HoldCo
FoodCo

Appendix D


Joe
Jack
100 Common Shares
500,000 Class A Special Shares
FoodCo

Appendix E