Dear Honourable Minister of Finance, William Morneau

Mr. Brian Ernewein, Department of Finance

Mr. Justin To, Department of Finance

Honourable Minister of Small Business and Tourism, Bardish Chagger

Kingston and The Islands Member of Parliament, Mark Gerretsen

Purpose: Kingston Advocacy for Small Business ("KASB") Response to July 18th, 2017 Proposed Tax Reforms – Open Submission

Introduction

This is KASB's response to the July 18th, 2017 proposed tax reforms. We have included **'*Critical Points*'** throughout our submission that we wish to highlight to the reader. While KASB advocates for small businesses, we also have included points of concern to other stakeholders, including farmers. Note that our response presumes readers have some basic understanding of the existing laws in the *Income Tax Act* ("the Act"). This is a significant assumption that we believe had to be made given both the time constraints and lack of resources. Our group would welcome any additional dialogue with the Department of Finance or other government officials about our response.

Who is KASB?

It is important that you understand the composition of our group so you have context for our views. Please note:

- KASB is not a political group
- KASB has 59 members. We are a group of local accountants, lawyers and interested others (See the complete member list in Exhibit 1)
- Our group formed in response to the July 18th, 2017 proposed tax reforms. This group has never existed previously in any form

Our members specialize in advising or educating in respect of business matters and small businesses in our local community

KASB's purpose is to educate and inform our community and small business owners about the possible impact of the proposed tax reforms. The following summarizes our common view:

"We think the government should slow down this process and we encourage a comprehensive review of our tax system. We think some of the policy objectives have merit but that the proposed tax reforms will have many unintended consequences that will negatively impact small businesses and therefore, our communities. This does not mean we are saying there will be harm in all situations, but in enough situations, such that the proposed tax reforms should not be passed until there is significant consultation with Canadians."

We note that any comprehensive review needs people who represent the interests of all Canadians and not just the Department of Finance, tax policy makers and tax professionals.

KASB held an information session with Kingston and area residents on September 19th, 2017. It was clear that the vast majority of attendees are concerned but unaware of the consequences of the proposed tax reforms. In fact, the question: "are you aware of the consequences?" was specifically posed to the attendees at the beginning of the information session. Their responses can be viewed in the copy of the information session that forms part of this submission (See Exhibit 2).

We believe the government intends to address the increased concentration of wealth in Canada with these tax changes. However, in our view, the proposed changes will harm the creation of wealth by middle class small business owners in a way that is not consistent with the government's stated policy objectives. It is important to note that 'wealth' and 'income' are not the same. We believe the policy objectives will not be met given the proposed tax reforms are an 'income tool'; therefore, they do not address the wealth issues that we understand are the real issues that the government wishes to address

For example, assume a small business owner borrows $300,000 from a bank to start a business. Assume all amounts are spent on advertising and brand awareness. Assume no profit or loss is earned in years 1 or 2. In year 3, the business earns $200,000. The government's statements would seem to indicate that this business and its owner are "rich Canadians" on an *income* basis. However, they are clearly not *wealthy* given the negative $100,000 of net value.

Critical Point ***If the intended policy objectives are to target the "richest Canadians" only, we propose the government consider changes that target 'wealth' rather than the proposed reforms that target 'income'.***

Submission Format

There are four themes present throughout this submission. We believe the proposed tax reforms will:

- Result in increased complexity
- Result in increased uncertainty
- Be retroactive 'in impact'
- Result in increased compliance fees and tax

Our submission is based on these themes; which are outlined in more detail in Exhibit 2.

Bearing these themes in mind, we have organized our submission as follows:

1. Response to proposed law in respect of converting capital gains into dividends and new subsection 84.1(2)(a.1) including:

    i. Negative impact of proposed laws on estates that own private companies, and

    ii. Negative impact of proposed laws on business succession plans and transfers of family businesses

2. Response to proposed law in respect of tax on split income ("TOSI")

3. Inter-relation of new TOSI rules and impact on intergeneration family business transfers

4. Response to new section 246.1 including the negative impact on the Capital Dividend Account

5. Response to discussion paper regarding the taxation of passive investments inside as private company

6. Response to proposed law in respect of lifetime capital gains exemption in respect of ownership by family trusts

Recognizing the proposed legislation's scope, complexity and potential harm to small businesses, a responsible review of the Proposals demands more time for consideration and consultation. We submit that <u>none of the Proposals should become effective until at least January 1, 2019</u>, and that appropriate transitional provisions be included in the ITA to mitigate the harm to small businesses in the transition from the current, long-standing provisions to the new provisions.

1. <u>Response to Proposed Law in respect of Converting Capital Gains into Dividends and new subsection 84.1(2)(a.1)</u>

The policy objective here is that the Department of Finance wishes to ensure that any value extracted from a company are taxed at the personal dividend tax rates of 40-45% (eligible and non-eligible dividends at the top combined federal and Ontario tax rate) and not the capital gains rates of 27% (the top personal tax rate for federal and Ontario tax). There is a clear tax advantage if a capital gains rate can be achieved.

Negative Impact of Proposed Laws on Estates that own Private Companies

We will illustrate one example of the impact that the proposed modification to section 84.1 will have on some estates and their beneficiaries (See Exhibit 3 for calculation details).

<u>Assumed Facts</u>

- The parent owns 100% of the common shares of a private company

- The parent will be the 'second to die' and there will be a deemed disposition of the shares at fair market value at death

- Assume a top marginal tax rates for dividends of 45.3% and capital gains of 26.76% (which is common in situations such as this)

- The fair market value of the shares at death is $600,000

- The cost base and paid-up capital of the shares is nominal ($1 for illustration purposes) on the basis that the parent started the company

Double & Triple Tax Risk

Even under the prior to July 18th, 2017 rules, there is a risk that the value of a private company that passes to an estate could be subject to double or triple tax. Here is how:

First Tax – Tax on Death on the Deemed Disposition of Private Company Shares

Fair Market Value of the Shares	$ 600,000	
Cost base of the shares	$ 1	
Capital Gain on Death of Parent	$ 599,999	
Tax on death of at 26.76%	$ 160,600	**First Taxation of $600,000 value**

Second Tax – Tax on Funds Taken From Private Company as a Dividend

The share attributes of the common shares that the estate holds in the private company are as follows:

Fair Market Value	$ 600,000
Cost Base of the Shares	$ 600,000
Paid-up Capital of the Shares	$ 1

When the $600,000 of value is taken from the private company, the following tax arises:

Assets Extracted from Company	$600,000	
Paid-up Capital	$ 1	
Dividend Income to Shareholder	$599,999	
Tax on the dividend at 45.3%	$271,800	**Second Taxation of $600,000 value**

Thus far, the total tax paid on the $600,000 of corporate value is $432,400 or 72%.

Planning Prior to July 18th, 2017

The income tax system allowed for two main planning tools to avoid the double taxation example above. The first is termed a '164(6) Loss Carryback' (termed for the section of the Act that provides the mechanism). The second tool is termed a 'pipeline' and relies on the mechanics of section 84.1. In the context of a deceased person, the tool is termed a 'post-mortem' pipeline.

Therefore, if a small business owner hired a tax advisor after someone died, the advisor had these two tools available. It is critical to note that the section 164(6) tool is only available within one year of death[1]. The pipeline tool also has well-established restrictions and the CRA would reassess a taxable dividend under section 84(2) if you run afoul of the planning parameters. Therefore, advisors had to be careful in what situations they used this tool[2].

<u>The 164(6) Tool</u>

The main advantage of using the 164(6)-loss carryback tool is that there is a high degree of certainty that the desired tax result will be achieved. Generally, the estate must wind-up the private company within one year of death. This may not be possible in many situations for a variety of reasons. If one did use this plan, then on the redemption of the private company shares, a capital loss would be created that could be carried back against the terminal tax return such that the capital gain in the terminal tax return would be nil, and; therefore, the 26.76% capital gains tax would be eliminated. This would eliminate the double tax scenario as only the tax on the share redemption would be left. This share redemption is illustrated as follows:

<u>First Calculation – Dividend Disposition</u>

Estate redeems common shares	$ 600,000
Paid-up Capital of the Shares	$ 1
Deemed Dividend	$ 599,999
Tax at 45.3%	$ 271,800

<u>Second Calculation – Disposition of the Share on Redemption</u>

Proceeds on Disposition	$ 600,000
Less deemed dividend (Proceeds taxed above)	$ 599,999
Adjusted Proceeds of Disposition on the Shares	$ 1
Adjusted Cost Base	$ 600,000 – *stepped up on the death of Parent*
Capital Gain (Loss)	$(599,999)

As long as the estate redeems the common shares within one year of the parent's death, this capital loss is carried back to the terminal return of the parent, such that the $160,600 of tax ("First Taxation") is eliminated. Therefore, the estate is only left with the "Second Taxation" or $271,800 of tax to pay.

<u>The Pipeline Tool</u>

There are various reasons that an estate cannot wind up a private Company within one year of death including liability reasons, beneficiary disputes, nature of the assets, grief, health related

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[1] This redemption can only be performed by a 'Graduated Rate Estate' for the loss carryback mechanism to work. See section 164(6) for details.

[2] There are many articles written on the parameters when a pipeline could be used. The 2013, Federal Court of Appeal Case in MacDonald denied the pipeline attempt. There are many CRA rulings that provide that a pipeline was acceptable planning to avoid double tax in the post-mortem context including the CRA view 2013-0503611R3.

matters, locating wills, contacting beneficiaries who could be spread around the world, and many other reasons.

If the company cannot be wound up within one year, then the estate will be subject to the double tax (72%) scenario but for the pipeline solution. Essentially, prior to July 18th, 2017, section 84.1 allows for the 'hard' (or 'tax paid') cost base of a share to be converted into paid-up capital or a note payable (either which could be extracted tax-free from the company). We will spare the reader the mechanics of section 84.1, but what would happen is that the $600,000 of 'hard' cost base after conversion to paid-up capital or a note payable is complete, the section allows $600,000 to be taken out of the company on a tax-free basis. The function of this is that double tax is avoided and only the "First Taxation", or $160,600 of tax, is owing on death.

Proposed amendment to subsection 84.1 (2)(a) Takes Away the Pipeline Tool

The proposed tax reforms to section 84.1 means that in the above example, the paid-up capital or note could not be extracted tax free from the company. The result in the estate context is that the only way to avoid double tax is to perform a 164(6) loss carryback.

Critical Point ***If you cannot wind up a private company within one year from the date of death, a taxpayer is forced into double tax; a tax rate of up to 72%! The types of companies whom are most likely to be harmed by the imposed one year time limit will be businesses that have illiquid business assets (e.g. manufacturing plants, specialized equipment, inventories, etc.), not companies that hold passive investments. KASB is concerned that this level of tax could be crippling for a family business.***

Critical Point: ***KASB notes that some estates are, at a minimum, trapped into double tax scenarios (see Third Tax example below). Taxing the same corporate value more than once seems unfair particularly when the estate may have been planning to use a pipeline plan prior to the proposed tax reforms. We do not believe the elimination of the pipeline could have been anticipated. If these reforms are passed, many estates will be financially devastated by the impact of huge tax liabilities. Active companies could potentially need to terminate employees and liquidate their assets if a suitable third party purchaser cannot be found.***

Third Tax – Accrued Value Inside the Company

It is possible for the corporate value to be subject to a third level of tax. Assume the asset owned inside the company is an asset with an accrued gain. Assume the cost base to the company of the asset is $300,000[3] and the fair market value (FMV) is $600,000. When the private company liquidates the asset, it will pay tax of:

Proceeds on disposition (FMV)	$ 600,000
Adjusted Cost Base	$ 300,000
Capital Gain	$ 300,000
Tax at 25%[4]	$ 75,000

[3] For simplicity, we assume that the UCC is also $300,000 such that no recapture income would arise.

[4] The capital gains tax rate inside a private company is at 50.13%, and the capital gains rate is 50% of this amount.

Cash flow Issues and Comparing the Result to a Sale to a Third Party

Even prior to the proposed tax reforms introduced on July 18th, 2017, how an estate was going to fund for the taxes due on the death of the key operator of a family business could take years of planning. It is critical for small businesses to plan for this scenario as often liquid assets are not available to pay for the tax liabilities noted above. Planning for 27% or 45% tax rates is hard enough. The proposed tax reforms introduce a 72% possibility and, in some cases, higher, that would make the tax burden on death unbearable and cause certain business failures.

Put another way, this proposed reform encourages estates that are trapped in this situation to seek out third party purchasers so that tax at 27% will be paid, rather than expose the estate to the risk of double tax of up to 72%.

Even if double tax can be avoided by using the 164(6) Tool, the family business will be subject to a 45% tax rate compared to a 27% tax rate on a sale to a third party.

Negative Impact of Proposed Laws on Succession Plans and Family Transfer of Businesses.

KASB builds on the above points to demonstrate our concerns in the context of the sale of a family business to a child. The conclusions are similar to those noted above. Please see Exhibit 4 for the detailed calculations. Assume the same facts used in the estate scenario, except the transfer of the shares of the private company are completed when the parent is alive. Due to the proposed modifications to section 84.1, in the best-case scenario, a transfer of a business to a child will result in a dividend taxed at a rate of 45%.

Compare this to a sale to a third party where a tax rate of 27% will arise. In addition, please note the point below, where the result is even more biased if we factor in the capital gains exemption[5].

- The parent could sell the shares to a third party and pay tax of $160,600
- If a sale to a third party is not possible, the parent's most tax efficient option under the proposed reforms is to freeze the shares of the business and pay tax on a dividend in the amount of $271,800. This is accomplished when the parent exchanges their common shares in the company for fixed value preferred shares. The child could then subscribe for new common shares for a nominal amount.[6]

Prior to July 18th, 2017 a parent could sell the shares to a child and owe tax on the capital gain in the amount of $160,600 (the same tax owed if sold to a third party). The child could then form a holding company and transfer the operating company shares to the holding company and extract tax-free funds (either by a note or paid-up capital) and then repay the parent. Again, this mechanism levels the playing field between selling a business to a family member or to a third party. This will no longer be possible if the proposed tax reforms are voted into law as drafted, because of new subsection 84.1(2)(a).

It is important to highlight that tax was not avoided in the above scenario. The parent would pay tax of $160,600 at the time of the transfer. Further, the capital gains exemption could NOT be

[5] Capital gains exemption refers to the lifetime exemption that each person has with respect to certain capital gains. This exemption is $835,716 in 2017 for qualifying shares and $1,000,000 for qualifying farming or fishing property.

[6] This exchange could be affected via Section 86, 85 or 51.

used by the parent because this would create 'soft' cost base in the shares purchased by the child and would mean the child would receive a deemed dividend of $600,000 (45% tax rate) on transferring the shares to a holding company and taking back a note or high paid-up capital shares. Put another way, in this situation, the tax system prior to July 18th, 2017 already disadvantaged families in that they could sell their shares to a third party and avoid paying any tax; however, the same result was not possible within the family.

Critical Point: ***The proposed tax reforms make it more disadvantageous to sell your company to your family and encourage a sale to a third party. KASB believes policies that bias against family businesses in favour of third parties will be harmful to Kingston and other Canadian communities.***

Retroactive 'In-Impact' of Modifications to subsection 84.1

Critical Point: ***Proposed subsection 84.1(2)(a) applies in a way that unwinds years of retirement planning and is 'retrospective' in impact. It will have the effect of increasing the tax on some family succession plans in ways that families will not have planned. KASB believes it is unfair to change laws in a manner that unwinds years of tax planning and to do so, in the family business context, will cause irreparable harm to business successions.***

2. Response to Proposed Law in Respect of Tax on Split Income ("TOSI")

The proposed tax reforms expand section 120.4 of the 'kiddie-tax' provision (as it is known), to restrict dividends on payments to children aged 18-24 and to spouses and other family members. Prior to the July 18th, 2017 proposals, no dividend could be paid to a child who is a minor (under the age of 18). If such a dividend was paid, it was taxed at the top marginal tax rate.

Under the proposed tax reforms, a dividend paid to a family member that is not "reasonable" would be taxed at the highest marginal rate. What is "reasonable" is based on subjective and complex tests. Note the proposed legislation is far reaching as it also catches other forms of payments (e.g., capital gains and interest) as being subject to the punitive provisions. It also catches distributions from partnerships or trusts.

KASB believes the proposed reforms will increase complexity, uncertainty and compliance costs when determining contributions of a spouse in a business. The proposed reforms require the assessment of vague reasonableness tests. The proposed reforms generally require the business owner to quantify in dollars each family member's:

- Equity value of risks assumed
- Equity value of assets contributed
- Value of labour contributed

in comparison to ALL prior amounts paid to the person.

The following summarizes our main concerns on this matter.

Risks Assumed

In the context of 'risks assumed' we ask: how is this determined? How do you factor in changing risks during the maturation process of a business? For example, if one spouse started a business before becoming a common-law spouse or getting married and the risks of the business were higher at start-up as compared at the time of becoming common-law or married, how do you quantify this value? How does one factor in the risks assumed in a business in the context of marital law? Presumably guarantees and co-signing loans would be factored in, but how do you quantify this value? What if the business is subject to a technological change (or tax law change)? How does one quantify this impact on each family member?

There are a multitude of other risks we have not mentioned. Complexity arises from the fact that risks are different for each small business. Further, it appears a business owner will need to go back in time and analyze these risks from the date of the inception of the company. This could be decades for some businesses. Presumably, the CRA will need to evaluate these risks. How? Consider the investment in resources for both the CRA and business owners in trying to enforce and comply with these rules.

Assets Contributed

It appears from our review of the proposed reforms that dividends, which reflect a reasonable return on the assets contributed to the business would not be caught by the TOSI rules. We recognize that public company valuations are difficult, but at least public companies operate in an observable market. There is no such market in private companies to help determine what a private company rate of return would be 'reasonable' based on the nature of the company and its risks. Again, we ask: do we need to consider each family member's contributions over time and what the rate of return expected would be over time? Further, the 'risks assumed' would interrelate to the return expected on capital contributed. Does each one need to be evaluated independently? What is a reasonable rate of return? We submit that, based on various factors, this expected rate of return would vary over time.

Consider, how do you value a 'great idea' or luck in a business? For many small businesses, strategy discussions happen informally around the kitchen table at dinner time or during other family activities. How do you place a value on this idea or intellectual property? What if a good business result (e.g., change in sales channel) was due to good fortune? How do you value this? As was the case with 'risks assumed', evaluating this in the private company context would seem contentious, expensive, uncertain and complex.

Labour Contributed

The evaluation of labour contributed is likely the simplest of the three measures to understand. We have case law interpretation of what is a reasonable salary so presumably, these factors can be used to help value this component of the TOSI equation.

Factor in 'ALL' Prior Amounts Paid

It is KASB's understanding that this provision requires the small business to subtract from the value determined from the above factors (i.e., risks assumed, assets contributed, labour contributed) the amount paid to the family member previously. This suggests you must go back to the date of the formation of the private company to complete this analysis. Is this accurate?

Critical Point: ***KASB believes we should have simpler laws for small businesses that make it clear that they are in compliance. It will be impossible for some small businesses to evaluate the factors above as they date back to the formation of the private company. Further, in some cases, it will be impossible for the CRA to determine what is "reasonable" in this context. At a minimum, it will be costly and time consuming. We ask: what can be expected beginning January 1st, 2018 when a company wishes to make a dividend payment? How could a small business owner possibly understand if there is an issue or not? There is no prescribed guidance provided here, and, if history repeats, it will take years before we have any meaningful common law interpretation. Taxpayers will not know if they have complied with the law or not.***

Retroactive 'In Impact' on Retirement Planning

Numerous family companies will have years of retirement planning unwound immediately if the proposed TOSI reforms is voted into law. For example, assume a married small business owner recently retired and his and his spouse's plan is to live from the funds saved through their private company. Even if the two spouses had significantly unequal contributions of labour, risks assumed, and assets contributed, the existing tax laws allow them to split corporate income through dividends.

This no longer appears possible under the proposed tax reforms. A non-active spouse who had previously received dividends would not be able to receive any future dividends if the value of all prior amounts received exceeds the value of the three variables (i.e., labour contributed, risk assumed and assets contributed). Regardless of the Department of Finance stating that these proposed reforms only apply prospectively, the impact of this law means that corporate income would no longer be able to be split in some retirement scenarios.

An Example – From a True Story:

- The non-active spouse in the business has received $400,000 of dividends since the inception of the company
- The active spouse in the business retired on August 15th, 2017
- If the value of the non-active spouse's attributes (the three tests of labour contributed, risks assumed and assets contributed) is only $300,000, then the non-active spouse would never be able to receive a dividend from the company

Consider another real-life example: A company sold its business assets two years aog to an unrelated purchaser and the purchaser continued to carry on the business. The company that sold its assets now holds investments. The retirement plan for the two spouses who own the shares in the company is to pay out dividends equally during their retirement years. One spouse was clearly more active than the other while they operated the business. Had the spouses known, when the assets were sold, that a good portion of the dividends in their retirement (i.e.; their retirement income) would be taxed at the highest tax rate, they would have negotiated a share sale. Each spouse would be investing their portion of the sale price personally and each legitimately reporting half of the investment income going forward.

One may say that it is a 'fair' tax result that income cannot be split at retirement with a non-active spouse. However, consider that those with public pensions or RRSP savings can split pension income with their spouse in retirement. How is it fair that such others can split pension income and the business owner who retired on August 15th, 2017 or two years ago cannot?

Further, if the business owner knew the tax laws were changing, they could have paid themselves a salary to create RRSP room and then make RRSP contributions to their spouse's RRSP. The spouses would then be able to split their retirement income similar to employees. However, understandably, they made decisions based on the existing tax laws at the time of sale. This couple will now be required to pay more tax on their retirement income as a result of a significant and unexpected change in tax laws.

Critical Point: ***The impact of the proposed TOSI rules in some situations will unwind years or decades of retirement planning. KASB does not believe this is fair? Further, if the government believes splitting income is unfair, how does it support the splitting of qualifying pension income? Finally, at a minimum, any proposed reform should be drafted without a 'retroactive impact'.***

It is important to note that there is a similar retroactive impact on anyone who has saved for their children's education through their private company, rather than through a RESP. KASB recommends that any final TOSI legislation provide for transition rules to allow parents who have saved for their children's education where their children are now just about to begin their post-secondary education. Failing to take this into account will either increase the tax burden on families and their business or it could mean that some children will not be able to attend post-secondary education as planned for. This would unwind several years of educational planning.

Critical Point: ***Transitional rules should be provided for where funds are withdrawn from a private company for the purpose of paying for expenses relating to a child's post-secondary education***

Impact of TOSI Laws on Middle Class Small Business – The $73,000 Example

KASB believes those affected by the proposed tax reforms have the right to be informed. The Honourable Finance Minister, Mr. Morneau has said repeatedly the proposed reforms will have no impact on middle-class small businesses, including a small business that earns $73,000 a year. KASB disagrees with this.

Critical Point: ***KASB has demonstrated in Exhibit 5 that the proposed tax reforms do impact some small businesses that earn $73,000 annually. It is important for the Department of Finance to communicate this to small businesses so that they are aware. Further, consideration should be given to allowing the existing tax regime for paying dividends to non-active spouses who are shareholders in a private company to continue to exist.***

The Proposed Tax Reforms Penalize Lower Income Earners – Not High-Income Earners

Who is penalized the most if the CRA decides that an "unreasonable" dividend is paid? Is it high income or lower income Canadians? It is the lower income Canadian who is penalized because the high income earner is already taxed at the top marginal tax rate. We submit that some very high income earners will not even care to work through the complex evaluation of variables as this does not impact them personally. Middle-income small business owners have no such luxury.

For example:

BUSINESS INCOME	$40,000	$90,000	$150,000	$500,000
Corporate Tax @ 15%	$6,000	$13,500	$22,500	$75,000
Personal Tax				
No Income Splitting	$-	$5,500	$22,500	$155,000
Unreasonable Dividend	$7,500	$18,000	$34,000	$155,000
"Penalty"	$7,500	$12,500	$11,500	**$0**

Impact on the Canada Child Benefit ("CCB")

The Canada Child Benefit is an income tested benefit. To the extent that personal income increases, the CCB is reduced. In our $73,000 example, if the two spouses had a child, we calculate the CCB will be reduced by $367. To 'fill this void' in the personal finances, the family will have to remove about $500 from the company. This calculation is circular given the $500 that is removed further reduces the CCB benefit.

3. <u>Inter-Relation of New TOSI Rules and Impact on Intergeneration Family Business Transfers</u>

The proposed TOSI rules require a review of the contributions of family members to the business of the private company (see TOSI rules in Section 2 for details). A common mechanism to transfer a business to a child is through a freeze of corporate value where the parent exchanges their common shares for fixed value preferred shares. The child could then subscribe for new common shares.

For example, assume

- The child has begun working in the business prior to sale date
- The parent reduced their workload to allow the child to gain experience
- Of the $600,000 value of the company, $400,000 is derived from the contributions of the parent and $200,000 is derived by the new ideas, processes and work performed of the child

While the parent owns $600,000 of fixed value preferred shares, the parent's entitlement to the $600,000 value based on KASB's understanding of the proposed TOSI rules would appear to be in excess of what the parent is entitled to receive, the $400,000. This would mean that each dividend paid by the company to the parent could be subject to tax at the top rate of 45%, rather than the parent's marginal tax rate which could conceivably be less than 45%tgiven their reduced workload and hence, personal income. KASB does not see any relief for a small business owner in this situation under the proposed TOSI rules.

Consider another real life example: the parents froze their investment in their company 30 years ago by exchanging common shares for preferred shares. Their adult children acquired the new common shares for a nominal amount. Over time some of the business assets have been sold and the parents' preferred shares have been redeemed. The parents paid tax over time as their shares were redeemed. The parents have retained voting control. The parents now have shares that have no rights to dividends and no value. The children own all the value and all rights to dividends. Consider further, one child has been involved in some of the operations during the life of this company; the other has not. Based on KASB's understanding of the proposed reforms, it appears the TOSI rules would apply here and possibly tax all dividends in the inactive child's hand at the top tax rate of 45% and possibly some or all the dividends paid to the partially active child. This is notwithstanding that the two children have owned the shares for 30 years and the freeze was not done for income splitting purposes; it was done for estate planning and family business succession purposes and no one other than the two children can legally receive dividends from the company.

<u>Critical Point:</u> ***Therefore, the proposed TOSI rules in conjunction with the proposed section 84.1 rules greatly disadvantage a family succession. In many situations families will be forced into TOSI-created, high tax rate penalty situations with no possible relief. These are only two examples of many situations where families are trapped by the TOSI rules and their complexity. A transfer to a third party purchaser is easier and less expensive. Once again, the proposed reforms bias against a family transfer of a business.***

There are other situations where the proposed TOSI rules create unexpected negative results for families including, but not limited to:

- Two university students (not related) start up a business and each child's parent contributes the capital
- Sale by a parent to a child and they want to use the 10 year capital gains reserve
- A 19 year old child works part-time on a farm due to seasonality.
- Parents, who start a business, gradually reduce their work time. Children take over the business and perform all the labour

4. Response to New section 246.1 including the Negative Impact on the Capital Dividend Account ("CDA")

The proposed tax reforms to section 246.1 appear to be aimed at certain tax plans that result in certain CDA amounts paid out to shareholders tax free. CDA is the 50% tax-free portion of capital gains that is recognized at the corporate level. Prior to these proposed reforms, the law allowed for CDA to be paid out tax-free. The purpose of section 246.1 is to allow for the integration of personal and corporate tax. Based upon KASB's review of the proposed reforms, the broad wording in proposed section 246.1 could be interpreted that no CDA dividend can ever be paid again. The wording of section 246.1 is such that it applies to CDA created prior to July 18th, 2017. We further worry that the broad wording could capture CDA created from life insurance policies that have been set up in prior years as part of a family business succession plan.

Again, this type of language makes the proposed reforms retroactive 'in impact'. KASB believes proposing reforms that are retroactive in impact causes significant tax uncertainty. It is important to clarify the proposed tax reforms, and if they do have a retroactive impact, adjust them eliminate this impact.

KASB is unsure of Department of Finance's intended impact of section 246.1. Therefore, KASB has prepared a questionnaire in Exhibit 6 and provided six (6) situations. We are asking the Department to Finance to clarify its position as soon as possible. We need to know if CDA created before and after the July 18th, 2017 release date can be paid out tax free. Further, we are unsure if proposed new section 246.1 is intended to change the tax result for life insurance policy payouts and restrict CDA dividends from being paid. Please see Exhibit 6 for our questionnaire. We would greatly appreciate a response at your earliest convenience given we are currently unable to help businesses move forward with CDA elections.

Critical Point: ***The proposed reforms have resulted in a state of uncertainty for some business owners with respect to CDA. KASB strongly recommends that life insurance policies not be impacted by these proposed reforms given for some businesses the planning has been in place for decades (e.g., to use CDA to help in buy-sell arrangements). KASB also strongly recommends that these proposals first, be limited to transactions occurring after July 18, 2017 and, second, that it be made clear that the CDA will remain for gains created by arm's length sales.***

5. Response to Discussion Paper Regarding the Taxation of Passive Investments inside a Private Company

In addition to the draft legislation released on July 18th, 2017, the Department of Finance (DOF) released a consultation paper that proposes changes to the way passive income is taxed inside a Canadian-controlled private corporation ("CCPC"). The DOF is requesting feedback on this consultation paper.

The DOF policy objective appears to be to prevent high wealth individuals from continuing to accumulate wealth in a faster manner than would be available to other individuals. The DOF notes, "Since this sort of arrangement is not available to someone who collects a paycheque every two weeks, it can mean gaining an unfair tax advantage over them".

The policy, at its essence, is trying to achieve the goal that those who have a CCPC do not accumulate returns from investments in a tax preferential manner compared to an individual investing personally. It is possible that someone can accumulate funds more quickly in a CCPC as the first $500,000 of active business income is taxed at a 15% tax rate (using Ontario tax rates). The DOF illustrates that the system they propose for discussion would make the after personal tax funds equal, whether those funds are from the profits of a business and are invested by the CCPC or by an individual personally (See Table 7 from the July 18th, 2017 Finance paper)[7].

KASB agrees the math presented by the DOF is consistent with the policy objective when the taxpayer is at the top tax bracket. However, the system does not work well for lower income individuals. Further, the system could have unintended negative consequences on small businesses in Canada and disproportionately harm middle and lower income taxpayers. In addition, new legislation could achieve its policy objective but it could also increase the risk capital leaves Canada. Therefore, tax revenues could decrease (e.g.; collecting a higher tax on fewer dollars vs collecting a lower tax on more dollars). Finally, consider the potential lower economic activity if capital leaves Canada.

Public Company Taxation of Investment Income

One reason that private company small business owners may feel unfairly targeted is they see the proposed July 18th, 2017 reforms only impact private companies. Small business owners are left wondering why the proposed changes are not targeting public companies as well. This confusion is multiplied when we examine the differences in how public and private companies are taxed on regular investment income. A CCPC is already subject to a high tax rate of 50% under current laws. Once the CCPC pays a dividend, approximately 30% of this tax is refunded to the company (termed Refundable Dividend Tax On Hand or "RDTOH") such that the net tax ultimately payable is 20%. Comparatively a public company (in Ontario) pays a flat 26.5% tax rate with no dividend refund mechanism.

One of the conceptual methods proposed by the DOF would eliminate the 30% refundable tax that Canadian private companies receive. Thus, the 50% tax rate would be a final corporate tax.

KASB believes it could be perceived the DOF is favouring large public companies that only pay tax of 26.5% on the same investment income. KASB prepared calculations in Exhibit 7 to illustrate this.

[7] See Page 44 of July 18th, 2017 Document "Tax Planning Using Private Corporations"

KASB considered $100,000 of active earnings that are taxed at the corporate level by CCPCs and public companies in our scenario. The after tax profits are then reinvested at 5% for one year. After one year, the total funds are paid as dividend to an individual. To illustrate personal tax bracket differences, KASB compared a dividend paid to a top tax bracket individual versus one who is in the $74,000 to $84,000 tax bracket (referred to as the "middle bracket").

The findings show the proposed reforms result in more tax for middle class taxpayers than for the top rate taxpayers. Presently a shareholder of a CCPC would end up paying about 36% combined personal and corporate tax on investment income in the middle bracket. The proposals would increase that tax to 60%; this is an increase in tax of 167%. At the top personal tax bracket, currently a shareholder of a CCPC would pay combined personal and corporate tax of 56%. The proposals increase this to 73%; an increase of 130%. Investment income earned through a public company paid out to its shareholder in the quoted middle bracket is subject to combined corporate and personal tax of 33% under both current law and this proposal and 56% if in the top personal tax bracket, both currently and under the proposal.

<u>Critical Point:</u> ***Why would our tax system tax CCPCs and ultimately their shareholders at a higher tax rate than public companies and their shareholders?***

If the corporate tax rate is increased as outlined in the DOF discussion paper, the shareholder will have less funds than they would otherwise have for themselves and their families.

<u>Special Election?</u>[8]

The white paper released by DOF contemplates a 'special election' whereby some private companies could elect to be taxed under the existing tax regime for passive income. Few details were provided in this respect and KASB's request of DOF is that this special election not advantage wealthy Canadians.

<u>Complexity</u>

Complexity is a theme that KASB has raised many times since the July 18th, 2017 proposed tax changes. We recognize that we are in a longer consultation period for changes to how passive income is taxed inside a CCPC, for which we are grateful. We hope that if any changes are proposed by DOF in this respect, that it do so in a straight forward way that does not increase the cost to both small business owners (through additional compliance) and to the CRA (for administration).

The DOF discussion paper discussed "fund" or "surplus pools" that could be tracked in the passive income context. We are pleased that the DOF recognizes the complexity of such tax tracking systems. KASB does not think these systems should be pursued.

<u>Reduction of the Small Business Deduction</u>

Finance states that the inequity that we are discussing results from the low 15% corporate tax rate. We wonder if a solution is address the source of the problem; which, we see as the small business deduction (SBD). SBD provides for the 15% tax rate on the first $500,000 of active business income for qualifying CCCPs. We understand that some tax systems just have a single corporate tax rate, like in the UK. Moving to a single corporate tax rate would simplify the tax

[8] See page 50 of July 18th, 2017 document "Tax Planning Using Private Corporations"

system, although our general corporate tax rate (federal and Ontario) of 26.5% tax rate would need to be considered in this context as the UK single corporate tax rate which is at a lower 19% rate. This solution could significantly increase tax certainty and decrease complexity. To be clear, KASB does not think the SBD should be eliminated without first fully reviewing the consequences to all stakeholders.

An alternative might be to retain the SBD but lower the business limit from $500,000 per annum thus preserving the lower tax rates for the "middle class". Perhaps a practical solution would be to allow for the SBD to be claimed on active business income of up to a threshold, such as $200,000, rather than $500,000. This could assist start-up companies and new entrepreneurs. If these funds are then withdrawn from the company for personal living expenses, the dividend would continue to be taxed at the non-eligible rate so that they are treated equally to a salaried person.

For any wealthy individuals, any passive income benefit would likely be nil or immaterial to their situation. Further, the SBD is already reduced when taxable capital begins to exceed $10,000,000. This threshold could also be reviewed if it is considered too high.

<u>Why Would a Small Business Prefer to Save Through a Private Company than a RRSP?</u>

Both Registered Retirement Savings Plans ("RRSP's") and CCPC savings are tax-preferred savings methods over non-registered personal savings. However, understanding how a small business owner uses cash flow in their business and saves for retirement is critical to understanding how these rules could inadvertently harm a small business owner if not implemented properly.

A private company with retained earnings in the form of cash has funds that it can use for a variety of purposes. These include reinvesting in the business, hiring additional staff, purchasing capital assets, or simply saving additional funds for a possible economic downturn. Having excess funds in a private company provides stability both to the small business and to our economy as a whole.

The DOF discussion paper states that a small business owner can save for retirement through a RRSP. However, for a business owner it is not that simple. When a business owner has retained earnings from a positive income year, it would not be an easy decision to remove excess funds from the CCPC and place these inside a RRSP. Once the funds leave the company they are not easily accessible if the business experiences financial difficulty or requires the funds for any other reason (i.e., business expansion). KASB knows business owners who have had to cash RRSPs to keep their businesses afloat. They do not have the ability to recontribute to their RRSPs at a later date. Therefore, being able to save in a private company for a business owner may be a reasonable and wise alternative to RRSP savings. KASB also knows business owners who would have had to close their business if they were to move funds from their business into their RRSP. For example, one business we are aware of had excess funds of about $800,000 prior to the 2007-08 financial crises. They are in a highly cyclical industry and require significant cash funds for bonding. If those funds had been removed from the company, this business would have had to close its doors as a result of that financial crisis in 2008.

It is also important to consider that many middle class business owners do not have any excess funds for retirement until they sell their business. The nature of their income may not allow for the maximum RRSP contribution limit to accrue (recall that you need 'earned income' or salary to create RRSP room). Maximizing RRSP contributions would require that a business owner remove funds from the CCPC and incur personal tax, simply to obtain RRSP contribution room. The incidence of personal tax would mean that there is less cash to assist the business in an economic downturn or to fund expansion.

Should There Be a Cap on Private Company Savings for Retirement?

The policy objective as stated by DOF is essentially to prevent the 'wealthy' from having an unfair advantage over others by allowing them to multiply their wealth through the use of a CCPC. The proposed idea in the discussion paper would seem to achieve this goal on this portion of the population. However, if it applies equally to small business owners (i.e., the non one-percenters) there can be significant negative consequences to their businesses. These consequences are possibly so severe that some people may decide that it is not worth it to continue to operate a business, or that it is not worth it to leave a job to start up a new business. KASB knows many business owners who have made incredible technological advances that benefit the broader community and created excellent jobs that help our economy. See Exhibit 8 for an email from one small business owner who would not have started their software company in this tax environment in Kingston, Ontario because it would not have been worth the risk. 25 people now work as part of this successful Canadian company that is now situated in Whitby, Ontario

So how do we design a system that does not stamp out entrepreneurship and allows the policy objective to be achieved? KASB hesitates to provide solutions without proper consultation and studies.

Perhaps a cap on the amount of private company savings that is subject to the current investment income tax regime would be appropriate. Any cap would be imperfect, but at least it would eliminate the impact on many small businesses. Maybe the figure is $2 million, $5 million or $10 million of corporate savings.

It is very difficult to differentiate a cap based on the nature of business without creating a very complex law. One business may have a very low capital requirement, but another very high. This capital requirement is based on many factors including the riskiness and cyclical nature of the business, costs of machinery and other capital assets, investment required for research and development, timing of business cash flows and other factors.

We must be careful in implementing any policy. Simply having it apply in the same manner to every business owner would surely have negative consequences on some small businesses while benefitting others. On the flip side, a policy to address each business owner would be extremely complex to implement. Significant study should be undertaken before such a policy is implemented to avoid unintended consequences.

Capital Dividend Account in Relation to Passive Income

It was discussed in the DOF discussion paper that the CDA might be eliminated as part of proposed tax changes relating to passive income. KASB believes that the CDA is critical to preserving the integration of capital gains earned personally and those earned by a CCPC. Our position is that the CDA should be preserved. In Exhibit 9, we have shown an integration calculation between an individual and a CCPC as it exists today. We note that there is a fundamental assumption that the funds used to generate the corporate level capital gain result from funds paid into the CCPC as compared to retained earnings that were reinvested. Exhibit 9 also illustrates in an example that there is actually a tax cost where corporate funds invested are invested from personal capital and are withdrawn in the year of the gain being realized. If the CDA were eliminated there would be a significant disadvantage to earning capital gains through a CCPC compared to earning them personally. This would represent a fundamental breakdown to the "integration" concept.

Transitional Rules for Any Proposed Changes

KASB believes to be fair and to minimize any unintended consequences, including 'retroactive in-impact' consequences, transitional rules need to be provided to prevent the unwinding of years of tax planning or rules that would harm business operations. A reasonable solution might be to allow the movement of excess funds from an existing CCPC into a separate holding company (i.e., another CCPC). Perhaps such a holding company could be allowed to operate using the existing tax system. Again, any proposed changes need to be discussed with businesses, their advisors, policy advisors, the CRA and any other key stakeholders to make sure the desired objectives are achieved.

Movement of Capital Outside of Canada

KASB is concerned that increasing the tax rate on private capital domestically may result in funds being moved outside of Canada. Capital may be able to move to other tax countries via lower withholding tax rates for dividends based on tax treaties. KASB worries that Canada may not actually capture the appropriate amount of tax that should be paid once the funds leave Canada. This is a complex consideration and beyond the scope of this submission, but we do understand that off-shore non-compliance is significant. KASB does recommend the DOF consider pursuing passive income abuses outside of Canada, than within.

Conclusion

This is a complex issue and it is not as simple as saying that any CCPC owner has an unfair advantage over those who do not. With all the complexity that has been proposed in the draft legislation for the proposed income splitting rules and new section 84.1 (converting dividends to capital gains), maybe we could say that the existing passive income rules works reasonably well for CCPCs. Perhaps the issue is only for large companies. Perhaps a *de minimus* threshold could be used to make it so that only companies with greater resources would have to navigate these new rules.

It is worth pausing at this point and asking ourselves a simple question; why would we make the laws more difficult on CCPCs than public companies? If we are going to increase the tax rate on passive income for CCPCs, then surely we should do so for public companies as well.

6. Response to Proposed Law in Respect of Lifetime Capital Gains Exemption in Respect of Ownership by Trusts

Proposed section 110.6(12) would restrict the lifetime capital gains exemption in a number of situations, including gains accrued while shares are held in a family trust for a beneficiary. We understand the concerns brought forth by Finance with regard to allowing beneficiaries access to their capital gains deduction when they have not personally contributed to the value of the underlying business. KASB generally does not have an issue with tightening up these rules where this exemption has been multiplied through family members who have had little or no involvement in the business or farming activity. However, we do have concerns that these new rules would apply equally to a beneficiary of a trust who does make a significant contribution to that business

There may be several non-tax related reasons that shares are held in trust as opposed to directly by that beneficiary. For example, a parent who is retired but has a significant financial interest in a company (e.g., as a preferred shareholder) may wish to keep all voting control during his or her lifetime as a trustee, despite the fact that their child is now running the business. In fact, if it is the child who is now operating the business, under the new TOSI rules, it may be necessary that it be the child with the only participating rights in the company. However, if that child is a vulnerable person, such as a person with financial difficulties or personal issues, a trust may be a far better ownership structure than outright share ownership which could potentially expose the entire family to great economic loss. Rather than disqualify all indirect shareholders through beneficial interest in a trust, the rules could be more targeted at the indirect shareholders who do not contribute value to a business. Once again, if the child were an arm's length person instead, he or she may not be precluded as the proposed rules would still allow for an employee share ownership trust to hold shares without reducing the capital gains deduction that could be claimed by the employee. Therefore, a family member taking over a family business will be subject to higher taxes than an arm's length employee.

Critical Point: ***Trusts are an important tool which help with intergenerational succession planning and matters which are not tax-related. Denying access to the LCGE for trust beneficiaries who are active in and make significant contributions to the family business does not seem fair when compared with arm's-length employees in a similar position or adult children who have the opportunity to own their shares outright.***